

Central bank rate cuts: How fast and how far?

Central banks are at a crossroads. Inflation is down and the growth outlook is increasingly uncertain. Can policymakers deliver a soft landing? And how far are rate cuts likely to go? Here's our latest thinking



Central banks are at a critical juncture, much like drivers navigating the confusing road networks in Brussels

Central banks at a crossroads

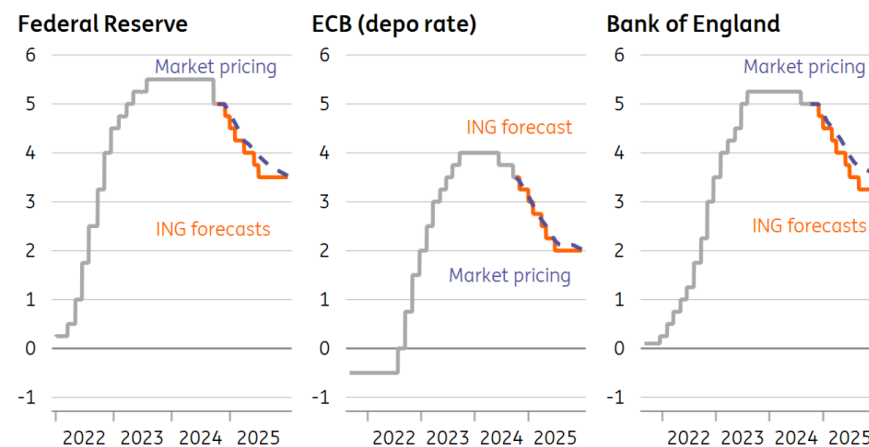
Do you remember 2022? This was the year central banks in developed markets finally abandoned their 'inflation is transitory' narrative and started the fight to restore their reputation. They did this not only by gradually leaving behind ultra-loose monetary policy but by going all-in on rate hikes. For followers of eurozone monetary policy, [a speech by](#) European Central Bank Executive Board member Isabel Schnabel in Jackson Hole in the summer of 2022 was a pivotal moment: the optimal policy to counter inflation, she said, was a 'forceful response'.

More than two years later, major central banks appear to be at another critical juncture. It's not exactly a crossroads, but more like one of those confusing traffic situations in Belgium where you have only two choices: keep driving straight ahead or make a sudden U-turn. The question is, will central banks continue to squeeze out the last remnants of inflation, or will they abruptly abandon

concerns about a second inflation wave and start supporting the cooling economy?

For the second time in little more than two years, central banks are at a turning point. The key issue now is whether this turning point will be abrupt or gradual. Financial markets have already found their answer to the question. They think that major central banks will cut rates aggressively over the coming months. Are they right? To get to the core of the matter, here are a few topics we need to discuss first...

How ING central bank forecasts compare to market pricing



Source: Macrobond, ING calculations

How have central banks' reaction functions changed? Are central banks really focusing more on (the lack of) growth than on inflation?

For the Federal Reserve to cut interest rates by 50bp after the economy grew 3% in the second quarter, inflation is still above target, unemployment stands at just 4.2% with jobs still being added, and equity markets are at all-time highs, suggests that the Fed is behaving differently this cycle and is more forward-looking. The bank does not want to cause a recession if it can avoid doing so, and with inflation tracking towards target, policymakers appear to be of the view that they can move policy towards neutral quickly. It is possible that there is concern about data quality, particularly in light of the provisional benchmark revisions lower on jobs numbers. Given this situation, they are likely putting increasing focus on their own data gathering. The Federal Reserve's Beige Book – and anecdotal survey of trusted contacts – suggests that 75% of the regional Fed Banks are seeing flat or negative growth right now. This is more aligned with the weakness seen in business surveys, such as those published by the ISM and the NFIB, than official data.

The Fed differs from other central banks in that it formally has a growth target proxy in the form of “maximising employment”. Remember, too, that Joe Biden added a third target of making the maximum number of people feel the benefits of growth. The central bank had signalled in late 2023 a growing confidence that inflation was on the path to 2% with the December forecast including three 25bp rate cuts, only for the inflation data to come in hot in the first few months of 2024, which forced the Fed to backtrack. This time around there is more conviction that inflation is on the glide path to 2% and with the jobs outlook looking weaker, the bank has pivoted to put

more emphasis on this aspect of its mandate – hence Jerome Powell’s comments that “we don’t seek or welcome further cooling in labor market conditions” and that “The time has come for policy to adjust. The direction of travel is clear“.

In the eurozone, the European Central Bank appeared to be ahead of the Federal Reserve when it began cutting interest rates in June. However, the rate cuts in June and September were more about fine-tuning the level of monetary policy restrictiveness rather than addressing heightened growth concerns. This stance seems to have shifted now. With speculation about an October rate cut, the ECB is aligning with the Fed’s increased focus on the lack of growth.

So far, the Bank of England’s reaction function has less obviously changed. The hawks still talk about potential permanent shifts in price and wage-setting behaviour that make rate cuts look premature. And the notion of “inflation persistence” is still the key buzzword for the committee as a whole. The ongoing focus on inflation over growth stems from service-sector price pressure that remains more troublesome than elsewhere, an economy that has outperformed over recent months, and a jobs market that is cooling but seemingly not falling apart.

Could rate cuts go faster than we thought?

The Fed also started the 2007 rate-cutting cycle with a 50bp cut, but outside of times of critical stress, this is unusual. Typically, the Fed favours 25bp increments and Jerome Powell stated on 30 September that “This is not a committee that feels like it’s in a hurry to cut rates quickly”, suggesting 25bp moves are the most likely course of action in November and December.

There is less empirical evidence for rate-cutting cycles in the eurozone. The few short episodes that we have seen, however, show that the ECB has actually more often cut rates by 50bp than people think, particularly in times of financial or economic stress and when interest rates were at relatively higher levels. At the current juncture, the ECB looks set to follow a very gradual rate-cutting path. Inflation looks sticky and the economy is resilient. If inflation turns out to be less sticky and the economy’s resilience fades, rate cuts at a faster pace or with larger steps seem likely.

The Bank of England is in a similar situation, though markets are pricing some divergence between US and UK rate cuts. That’s entirely consistent with history, where the BoE’s reputation as a ‘Fed satellite’ is a bit of a myth. In this case, though, we think the BoE will end up accelerating rate cuts through the winter when services inflation looks more palatable and thus the UK won’t look like an outlier.

In the end, all central banks currently emphasise their data dependence and do not want to send any signals of precommitment. However, the shift towards greater focus on growth over inflation, means that if activity and jobs data deteriorate more quickly and inflation remains benign or even falls back, larger rate cuts will be almost unavoidable.

Can central banks orchestrate a soft landing and what does history tell us?

Recent analytical work by the ECB shows that inflation driven by supply shocks is the largest challenge for central banks and the biggest risk for a hard landing. As the ECB’s paper states: “Central banks have typically hiked aggressively in response to supply shocks. Rates were also cut earlier in the inflationary phases, and more quickly, possibly in response to a weakening growth

outlook and declining inflation expectations. These past responses did not lead to soft landings in the past.”

For the US, former Fed vice-chairman Alan Blinder analysed soft and hard landings [in the Journal of Economic Perspectives](#) and concluded that eight of the eleven monetary policy tightening periods since 1965 were followed by recessions. Admittedly, the last two after 2006 and 2019 were triggered by external events and not by monetary policy tightening. However, when looking closer at the episodes that Blinder identified as being followed by hard landings, it becomes clear that in some cases creating a recession was actually part of the plan.

At the current juncture, US data still points to a soft landing as activity data remains robust and employment levels are high. Business surveys and consumer confidence have softened, suggesting downside risks to future growth, but if monetary policy is loosened and a smooth US election allows political uncertainty to dissipate, this could be enough to generate a rebound in sentiment. Early action from the Federal Reserve under Alan Greenspan in the mid-1990s achieved such a feat, followed up with additional rate cuts in the late 1990s in response to the Russia crisis/LTCM failure, sandwiching a 25bp rate hike in 1997.

The major caveat with any historical comparisons is that fixed-rate borrowing has become much more prevalent over the past decade. Households and businesses took advantage of low rates to fix their costs for longer periods. That may partly explain why the US and eurozone economies haven't been seriously upended by aggressive rate hikes. But it also potentially means the Fed and ECB shouldn't expect to cut rates now and expect results as quickly as they might have done in decades gone by.

What do we think about terminal rates?

Markets have started to price in terminal rates for both the Fed and the ECB that are clearly below assumed neutral levels. We are a bit more cautious. Even if central banks in the shorter term are shifting their preferences and reaction functions, it is still hard to see inflation nicely settling down on target. The world has simply changed. Persistent supply-side constraints could easily bring back inflation as soon as demand in the economy picks up again; and the structural factors of 3D inflation – demographics, deglobalisation, and decarbonisation – continue to suggest a trend of higher inflation.

Recent experience has shown how those trends also mean that external shocks – be it from oil or natural gas prices – can more easily translate into persistent periods of inflation than in the post-financial crisis decade. Also, given that fiscal policy, (not only in the US) is very likely to remain (or turn) loose again, there is a strong argument that monetary policy needs to be tighter.

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