Central banks will not make the same mistake twice!

2024 is just around the corner and the financial markets have already positioned themselves for a pivot in monetary policy.

OECD has in their latest Economic Outlook warned of easing monetary policy too soon given the economic and structural challenges that the Eurozone and the US are facing. The lack of demand after the Financial Crises have been replaced by a lack of supply.

So, will the central banks make the same mistake and lower interest rates to zero as many in the financial market is hoping for? We look closer at the current situation in the last Newsletter of 2023.

OECD Outlook

As 2023 draws to a close, we have looked into OECD's Crystal ball and their latest Economic Outlook for 2024 and 2025; an outlook that is raising a number of significant concerns regarding the economic development.

Overall OECD expects slightly lower US and Euro growth of 1.5% and 0.9% respectively in 2024 with inflation in easing to 2.9% in the US and 2.8% in the Euro area. A forecast that is pretty much middle of the road.

What is more interest from a long-term investors point of view is the list of key policy priorities which should *"ensure that inflation is durably reduced, address mounting fiscal pressures, and improve the prospects for sustainable and inclusive growth in the medium term."*

OECD lists the following issues:

- *"Monetary policy needs to remain restrictive until there are clear signs that underlying inflationary pressures are durably lowered, with inflation* *expectations moderating further and a rebalancing of supply and demand in labour and product markets."*

- *Governments face rising fiscal pressures from high debt burdens and additional spending on ageing populations, the climate transition and defence. Debt-service costs are also increasing as low-yielding debt matures and is replaced by new issuance. Without action, future debt burdens are likely to rise significantly.*
- *Given the long-term decline in economic growth and the pressing challenges from ageing populations, the climate transition and digitalisation, ambitious structural reforms are needed to reinvigorate growth and improve its quality.*
- *Enhanced multilateral co-operation is required to revive global trade.*

On the four issues the outlook is ranging from not very encouraging to nothing will happen neither short term or medium term.

A central problem for almost all G20 economies is the policy mix between fiscal and monetary policy is wrong.

Governments are more interested in spending money and lowering taxes than implementing the structural reforms which are required. As a result the public sectors are running huge deficits and in order to control inflation central banks have to tighten monetary policy.

As OECD rightly points out in their forecast, there needs to be a rebalancing of supply and demand in the labour and product markets. In other words, the lack of demand in the economy after the Financial Crises in 2008 has been replaced with a lack of supply.

But where are the central banks on monetary policy? Can we expect that the central banks make the same mistake twice and lower interest rates to zero again to fulfil market expectations?

Federal Reserve

The biggest surprise during the closing meeting of the central banks meetings for 2023 came from the Federal Reserve.

From the FOMC meeting in September to the meeting mid-December the policy statement completely changed.

In September the "dot-plot" signalled approximately one lowering of interest rates in the 2024. Now the "dot-plot" indicates a 3 lowering's of interest rates over the next 12 months and the financial markets are expecting at least 6. So what has changed.

Looking at the economic figures – not a lot.

Yes, head inflation has fallen quite a bit but “median” inflation and the underlying price pressure are still high as GDP growth continues be robust and unemployment rate remains very low.

It is important to remember that Federal Reserve rarely lowers interest rates when unemployment rate is under 5%, so why did the FOMC change policy stance to quickly? Several factors could play into their thinking and communication.

Especially two sectors in the US have had problems with the fast increase in the interest rates:

- The building/construction sector where activity has almost collapsed and many property investments are going into foreclosure or sold at huge discounts.
- The financial sector, where especially the banks sitting on the large unrealised losses on their government bond portfolio

Since the beginning of November the US government bond market lowered 10 and 30 years bonds yield with more than 1%-point in anticipation that Federal Reserve will lower interest rate as inflation has fallen.

This clearly helps the construction and property sector which is in serious problems right now to sell or obtain refinancing for their projects.

In the financial sector, a number of regional banks with huge exposures towards building/construction sector could be in serious problem and without a “un-freezing” of the building/construction sector be forced to take losses on their property loan portfolio. Such an event that could trigger a requirement to unwind their government bond portfolio leading to further losses leading to a run on these regional banks.

This would be concern for Federal Reserve.

Presidential election

It rarely – if ever - happens that a politician will cut spending or increase taxes in an election year. Therefore, most likely scenario is, that the Democrats and the Republicans will continue with a very expansive fiscal policy. GDP growth will most likely continue to be positive fuelled by public spending in 2024. Referring back to the OECD outlook, US will run a public deficit of around 7% of GDP in 2024 so it is very unlikely that the demand side will let up in 2024.

Monetary policy

With such expansive fiscal policy, a tight labour market it seems unneeded to loosen monetary policy as such a pace as the financial markets are predicting.

By their “talk” and lowering of the “dot-plot” forecast Federal Reserve have let the market ease the monetary policy without doing anything. Since Chair Powells press conference after the FOMC meeting, members of the committee have all signalled the market has overreacted and to many lowering interest rates is currently priced in.

Referring to the list in OECD latest outlook mentioned above, it is possible to check off the entire list for the US. Therefore, it is highly unlikely that Federal Reserve would lower interest rates at the pace predicted by the market.

For the US our base scenario for 2024 would be a one reduction before the summer period and another lowering of interest rates after the Presidential election in November.

ECB.

Inflation in the Eurozone has been a lot more rigid than the ECB might have hoped for.

ECB and OECD are quite aligned in their forecast of inflation in 2024 with forecasts of 2.7% and 2.9%. Growth in the Euro-zone is forecasted around 1% for 2024.

In their policy statement after their December meeting ECB noted that there is an underlying price pressure from growing unit labour market cost as our previous Newsletter pointed out.

Since our previous Newsletter the figures for Q3 2023 for unit labour cost and productivity have been released and it is not encouraging reading for ECB.

Figure 1 EU - Unit labour cost per hour worked year-on-year growth *source Eurostat*

Unit labour cost for worked hour continue to increase and there are not any signs that employees have difficulties in obtaining increase in salaries.

The other peaks in the unit labour in 2009 and 2020 unemployment where respectively above 10% and 7.5% in the Euro-zone. The latest unemployment rate for October 2023 is 6.0% in the Eurozone, so it is difficult to see lowering of unit labour cost until unemployment rate has increased significantly.

Likewise, productivity continued to drop in Q3 2023 as seen from Figure 2.

Figure 2 EU - Real labour productivity per hours worked year-on-year growth *source Eurostat*

Underlying inflation pressure in the Eurozone remains strong and while the headline inflation is also falling the Eurozone, the case for fast lowering of interest rates by ECB remains weak.

ECB can also check all the points on OECD list and they might be even more challenging in the Eurozone than in the US. The need for structural reforms in the Eurozone has long been argued by ECB, however, with little to no effect on Eurozone politicians.

Monetary policy in the Eurozone

In our opinion is ECB highly aware of structural problems in the Eurozone and the problematic fiscal and monetary policy mix which we currently have in EU.

ECB also indicated the last meeting of 2023 that reinvestment of principals in their different programs will be reduced in 2024 and fully stopped in 2025, which equal further implied tightening of the monetary policy.

If the modest growth in the Eurozone continues strongly supported by an expansive fiscal policy and the unemployment rate do not increase significantly, it is difficult to identify a reason for ECB to lower the interest rate.

Or in other words, if heading inflation falls towards 2% then 4% in official rates must be around the appropriate level. ECB is fully aware, that the Eurozone do not any longer face a demand problem but rather a lack of supply primarily in the labour market.

Zero or negative interest did not solve the demand problem and only created asset inflation in the Eurozone. Given the significant structural problems in EU, it seems very unlikely that we ECB will revisit the zero interest rate regime again.

We wish everyone a wonderful Christmas and a prosperous 2024.