**A tale of three central banks…**

***Vicky Pryce***

We have had three interest rate decisions by three important central banks in mid-December – all with the same outcome: Rates were left unchanged by the Federal Reserve in the States, the European Central Bank (ECB) in the Eurozone, and by the Bank of England (BoE) in the UK. But the message and the signalling could not be more different between them, even though they each stressed that rates may have to rise if necessary to bring inflation back to target.

Let's start with the US. There was first of all acceptance by Jerome Powell that *"this inflation was not the classic demand-overload, pot-boiling-over scenario that we think about."* And he was concerned as he put it that there was a risk that high interest rates if kept at those levels for too long could endanger the economy. And as he signalled the possibility of three interest rate cuts to come in 2024, with more later, Powell also admitted that the Fed was *"aware of the risk that we would hang on too long"* before reducing borrowing rates, and that *"we know that's a risk, and we're very focused on not making that mistake."*[i]The markets rejoiced with the Dow Jones reaching a record high, even though for the moment the rate at stayed at its 22-high level at the 5.25-5.50 range for the third time running .

But we are at a turning point. And the US has pulled a remarkable feat. Despite a monetary squeeze accentuated by large Quantitative Tightening over the last year, growth of 2.5% is now expected for 2023 as a whole, boosted also by continued big fiscal giveaways in the shape of the Inflation Reduction Act and huge extra infrastructure spending either already happening or planned. Though now beginning to moderate, with 2024 likely to see growth of just 1.4% GDP, the US has seen inflation fall to just over 3%, not too far off the Fed's 2% target, with core inflation, excluding food and energy, around the same level.

In contrast, the Eurozone and the UK are in stagnation territory. At least the ECB was able to announce that the decision to keep rates on hold at 4-4.50% was unanimous though its language was as hawkish as always. How sustainable is that? Not clear given that GDP in the Eurozone contracted by 0.1% in Q3 and the German economy, accounting for some 25% of the bloc's GDP, remains in recession. What is more is that inflation at 2.4% is hardly different to target. GDP is estimated to have grown by just 0.6% this year and the rate of expansion is forecast to improve only marginally by 0.8% next. Lending conditions have tightened appreciably. But here too inflation has fallen dramatically to just 2.4%, again not too far off target. The markets are assuming that once the US moves, the ECB will have to follow. Christine Lagarde in the press conference that followed the rate decision did conceded that would look at data in the first quarter very carefully as they move forward. And sensibly the policy of reinvesting 100% of the pandemic emergency (PEPP)bonds coming into maturity will continue till June 2024 and then halve to 50% reinvestment before stopping completely by the end of the year. But some flexibility will remain.

What about the UK- still a laggard in terms of getting inflation under control and with wages, though moderating, still rising by just over 7% year on year. The economy saw no growth in Q3 and a fall in GDP in October by a larger than anticipated 0.3%[ii]. And though Christmas is approaching, little or no growth is likely in the quarter as a whole. More worrying is that the average independent forecast for next year is for growth of under 0.5%. In this context, it is particularly concerning that 3 out of the 9 rate setters still voted for an increase in rates rather than a pause- the same 6-3 split we saw last time round too.

But maybe all this is just theoretical as the markets seem to have decided to disbelieve all. In the States many more quarter point cuts in 2024 are being priced in. In the Eurozone the ECB's still relatively hawkish tone seems to be ignored[iii]. In the UK , where the British Chamber of Commerce is predicting a tough year ahead even on the assumption of a small interest rate cut at some point, there seems to be incredulity that this can be sustained.

So anything goes. And maybe in the end we will see a lot more coordination in interest rate movements than this week's pronouncement and tones at the various different press conferences that followed would suggest. And maybe we should take comfort from the fact that things are normalising elsewhere . On the same day that the BoE and the ECB rate setters were meeting , the Swiss central bank also left rates at 1.75%, unchanged since June[iv] . Inflation there is just at 1.4% and has stayed below 2% for the last six months!

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[i] https://apnews.com/article/federal-reserve-inflation-prices-interest-rates-cuts-d95b976ef2194cea8516f21c98f62ded

[ii]https://www.ons.gov.uk/economy/grossdomesticproductgdp/bulletins/gdpmonthlyestimateuk/october2023#:~:text=Monthly%20GDP%20is%20estimated%20to,of%200.2%25%20in%20September%202023.

[iii] https://www.fxstreet.com/news/european-central-bank-preview-ecb-expected-to-hold-interest-rates-again-202312140805

[iv] https://think.ing.com/snaps/the-swiss-national-bank-appears-slightly-more-dovish/#:~:text=As%20expected%2C%20the%20Swiss%20national,its%20level%20since%20June%202023.