When will central banks start “downsizing” rate hikes?

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Battling “supersized” inflation

Inflation was supersized by COVID, so monetary tightening had to be supersized as well.

Is it time to “downsize” rate hikes?

Today, some central banks are preparing to reduce the size of their rate hikes going forward.

A global view

Canada has led the way in downsizing rate hikes, the US may soon follow, but the picture is a bit less clear in Europe.

Thanks in large part to fast-food restaurants, many consumers grew up with the term “supersize” — associated with bigger portions and abundance. On the other hand, “downsize” is associated with loss — a decrease in portion size or even job loss. However, “downsize” has taken on a new, more positive meaning for me, as it relates to monetary policy. Some central banks that have been supersizing rate hikes are now preparing to reduce the size of their rate hikes going forward. It appears that we’re heading toward a downsizing of rate hikes, which in my view is more than welcome.

The Bank of Canada has already started downsizing rate hikes with a 50 basis point lift in late October following hikes of 100 and 75 basis points at its previous two meetings. And now the US Federal Reserve (Fed) appears poised to do the same.

What’s ahead for the Fed?

The minutes from the Federal Open Market Committee’s (FOMC) November meeting were released last week. We learned that a “substantial majority” of FOMC members believed that it would “likely soon be appropriate” to slow the pace of interest rate hikes. It appeared from the minutes that policymakers believe tightening thus far has had an impact on interest rate-sensitive sectors of the economy, but inflation was still too high. However, the calculus has changed. Now that rates have risen so far so fast, it seems an appropriate time to take a more thoughtful approach: “A slower pace ... would better allow the (FOMC) to assess progress toward its goals of maximum employment and price stability ...The uncertain lags and magnitudes associated with the effects of monetary policy actions on economic activity and inflation were among the reasons cited.”[1]

But how does that sync with some of the hawkish Fed rhetoric we’ve heard in the last few weeks? It seems simple to me: There’s one litmus test for downshifting rate hikes and another litmus test for ending rate hikes. And the bar is much higher for the latter than the former. Following are a few excerpts from recent Fedspeak:

- Minneapolis Fed President Neel Kashkari shared, “I need to be convinced that inflation has at least stopped climbing, that we’re not falling further behind the curve, before I would advocate stopping the progression of future rate hikes ... We’re not there yet.”[2]
- St Louis Fed President Jim Bullard suggested that the policy rate may have to rise to a level between 5% and 7% in order to quash inflation, though he added that this level could decline if inflation were to cool in the coming months.
- Kansas City Fed President Esther George said, “I’m looking at a labor market that is so tight, I don’t know how you continue to bring this level of inflation down without having some real slowing, and maybe we even have contraction in the economy to get there.”[2]

Inflation remains top of mind for Fed officials, as it should, and will largely dictate the terminal rate. If the Fed isn’t comfortable that inflation is in check, it's likely to continue hiking. And it's not just inflation readings. The Fed remains very sensitive to longer-term inflation expectations given its view that these expectations are "an important influence on inflation's behavior."[3] Last week's University of Michigan Survey of Consumers showed an uptick in longer-term inflation expectations. While still in a range that suggests longer-term inflation expectations are relatively well-anchored, it's not moving in the right direction. It will hopefully reverse soon as the Fed has pledged to not be "complacent" about assuming longer-term inflation expectations will remain well-anchored.

And so, while risk assets rallied after the release of the FOMC minutes, markets soon recognized that the minutes told us what we already knew. We know the Fed will be downsizing rate hikes at some point; we just don't know when it will hit the pause button. That will be gleaned from inflation data — and inflation expectations — which means these readings will likely have an outsized impact on markets in coming weeks and months.

The debate continues in Europe

The picture is less clear for the European Central Bank (ECB) and the Bank of England (BoE), given the more complicated situation there, with high inflation persisting as recessionary pressures increase. A few voices such as Isabel Schnabel of the ECB suggested it is premature for the ECB to downsize rate hikes, that more front-loading needs to be done. In addition, long-term UK inflation expectations remain much higher than other developed market economies, which could mean the BoE will feel the need to be more hawkish as it focuses on its credibility vis-a-vis inflation fighting.

ECB President Christine Lagarde has also emphasized how significant the inflation problem is: "Inflation in the euro area is far too high, having reached double digits in October for the first time since the start of the monetary union."[4] Lagarde admitted that the risk of recession has risen but, in contrast with last week's comments from Esther George at the Kansas City Fed, she acknowledged that a recession might not bring down inflation — in other words, stagflation is a possibility. But that makes sense and is why the situation in the eurozone is far more complicated, as key inflationary pressures cannot be controlled with monetary policy.

There is clearly a lot of pressure on the eurozone economy: November flash Purchasing Managers' Index (PMI) readings for the eurozone were released last week, showing contraction for five consecutive months (although there has been a moderation in the rate of decline). Both manufacturing and services are in contraction. Drilling down to the country level, Germany and France are both in contraction territory. The drop in business activity in November increases the odds of recession for the eurozone, although the good news is that some pricing pressures eased. The ECB's recently released Financial Stability Review underscored some of the growing risks to the eurozone economy. This includes the risks to euro area households, which are increasing as a result of rising energy prices and rising interest rates. UK PMI is also in contraction territory, although input costs and output charges have shown signs of easing. Looking ahead, I worry about a few risks: that energy pressures could worsen as the winter progresses, and that supply chain issues could re-emerge if COVID were to surge again.

At this juncture, the BoE and ECB both have to worry more about weakness in their respective economies than the Fed does. And so I still expect the ECB and BoE to start downsizing rate hikes soon. We have heard as much from Philip Lane, the chief economist for the ECB, who said that it will be harder to enact jumbo rate hikes going forward given that so much hiking has already been done. There is a greater question mark around when these central banks will hit the pause button. I would expect the ECB and BoE to be less hawkish than the Fed, although there is a school of thought emerging that suggests they could be more hawkish than the Fed. Suffice it to say these are challenging times.

Conclusion

The key takeaway is that inflation was supersized by COVID and countries' response to the pandemic. Hence, the monetary tightening had to be supersized as well. Now we've reached the point where monetary policy tightening can start to be downsized. I'll certainly welcome this as a positive development, even though it's largely been priced into markets. However, the focus will quickly turn to when central banks will hit the pause button. And that could be different depending upon the specific economy. There is just a lot less certainty around when the "pause" button gets pressed. And so I expect greater volatility as markets react to central bankers' words and the evolving data.

On the docket for this week will be the US jobs report, which will be important for what it tells us about wage growth, and therefore an important component of inflation. We will also get October unemployment and retail sales from Japan, as well as PMI data from China.

Notes

[1]Source: Federal Open Market Committee, November meeting minutes

[2]Source: Market Index, "Morning Wrap: S&P 500 falls on hawkish Fed comments, oil tumbles, ASX futures flat," Nov. 18, 2022

[3]Source: Federal Open Market Committee, November meeting minutes

[4]Source: Speech by Christine Lagarde, President of the ECB, at the European Banking Congress, Nov. 18, 2022

The Survey of Consumers is a monthly telephone survey conducted by the University of Michigan that provides indexes of consumer sentiment and inflation expectations.

Purchasing Managers' Indexes are based on monthly surveys of companies worldwide, and gauge business conditions within the manufacturing and services sectors.

The European Central Bank's Financial Stability Review is published twice a year and provides an overview of potential risks to financial stability in the euro area.

The Federal Open Market Committee (FOMC) is a 12-member committee of the Federal Reserve Board that meets regularly to set monetary policy, including the interest rates that are charged to banks.

The terminal rate is the anticipated level that the federal funds rate will reach before the Federal Reserve stops its tightening policy. The federal funds rate is the rate at which banks lend balances to each other overnight.

A policy rate is the interest rate at which a central bank will pay or charge commercial banks for their deposits or loans.

Stagflation is an economic condition marked by a combination of slow economic growth and rising prices.

A basis point is one hundredth of a percentage point.

Tightening is a monetary policy used by central banks to normalize balance sheets.