Uncertainty over where central banks' monetary policy is headed

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A fall in the headline rate of inflation in major economies and pressure from financial markets for interest rate cuts are creating the conditions for a conflict in the governing bodies of the major central banks over the direction of monetary policy.

Following a decline in the eurozone inflation rate to 2.4 percent in October, its lowest level since July 2021, pressure is building on the European Central Bank to start reducing its interest rates amid fears that unless this is done there could be significant economic and financial consequences.

The collapse of the Austrian real estate group Signa at the end of last month, which rose to stratospheric financial heights on the back of a near-zero interest rate regime, could well be a sign of what is to come if a tight monetary regime persists. There are also the ongoing concerns about the position of Italian banks and the financing of government debt.

As the *Financial Times* reported, the new governor of the Italian central bank, Fabio Panetta, hinted in a major address last week that rates might need to be cut soon.

He said that while the ECB tightening was necessary, present indications were that existing policy was bringing inflation down to the target range of 2 percent. "We need to avoid unnecessary damage to economic activity and risks to financial stability, which would ultimately jeopardise price stability," he added.

The chief global economist at Oxford Economics, Innes McFee, told the FT the major central banks were at risk of making a major policy mistake, particularly the ECB.

"They have every incentive to talk tough, but the action is going to have to change," he said.

Any move by the ECB to ease its monetary policy, however, is likely to meet opposition from within its governing body made up of representatives of the European banks.

The head of the German central bank, Joachim Nagel, said the fall in the eurozone inflation rate was "encouraging." He warned, however, that borrowing costs might need to go higher, adding that it was "far too early to even think about a possible reduction in key interest rates."

According to an FT report, OECD chief economist Clare Lombardelli said the ECB and the Bank of England would not be in a position to ease interest rates until at least 2025 given persistent underlying inflation resulting from wage pressures.

"Monetary policy is going to have to remain restrictive for a period of time—we are still worried about inflation persistence," she said. "You are going to need real rates to be high."

The issue of wages is front and centre in the determination of central bank monetary policy as was highlighted in an FT editorial this week. It said that while inflation was coming down fast, to "declare an end to the inflation battle—as some are doing—smacks of complacency."

It noted that while job markets had "cooled" they remained "tight" and while wage increases had fallen "they are still elevated."

"This is feeding into high services inflation—the largest component of the price indices. With productivity forecasts subdued, central bankers will want to see salary growth fall further to bring down core inflation, which is still higher than desirable."

The chief economist at the Bank of England, Huw Pill, has said that falling headline inflation could give a false impression that the inflation threat had passed. There was a challenge for policy makers to maintain their "persistence" in keeping monetary policy tight under conditions where there would be "lots of pressure in the face of weaker employment and activity growth and declining headline inflation, to declare victory and move on."

In other words, even in the face of higher unemployment, an economic slowdown and possibly even a recession, central banks must maintain their higher interest rate regime.

In the US, the central bank is under pressure from financial markets to declare that the rate tightening cycle is over, with traders making bets that the Federal Reserve will start cutting rates next year. Traders in financial markets now see a two thirds probability that the Fed will start cutting rates in March next year as compared to 20 percent little more than a week ago.

In a question-and-answer session following a speech last Friday, Fed chair Jerome Powell sought to push back against the market pressure, saying the Fed was "strongly committed" to bringing inflation down to 2 percent and keeping monetary policy restrictive until it was confident inflation was on a path to that objective.

"It would be premature to conclude with confidence that we have a sufficiently restrictive stance, or to speculate when policy might ease. We are prepared to tighten policy further if it becomes appropriate to do so."

Those comments eased the fall in market rates for a short period but then analysts seized on the conditionality of his remarks—"if it becomes appropriate"—and the downward movement resumed.

The continued uncertainty over the direction of monetary policy and the bets that the Fed will be forced to ease rates is reflected in the gold market. On Monday, as the value of the dollar continued to fall—it lost 3 percent in value against a basket of six currencies in November—the price of gold touched an all-time high of $2,135 per ounce, well above the previous record of $2,072 in August 2020 at the start of the pandemic.

Besides the immediate moves in currency and financial markets, there are other, longer-term factors in the upward movement in the gold price, including rising geo-political tensions and war.

At the start of the US-NATO war in Ukraine, the financial system was delivered a major shock when, as a result of US action, the dollar assets of the Russian central bank were frozen. This sent a warning to other countries that they could be subject to the same treatment should they cross the path of the US.

Central bank buying of gold reached a record high in 2022 and is on course for another record this year. According to the World Gold Council, central banks in emerging markets bought 573 metric tons of gold a year on average between 2010 and 2021. Last year they bought 1,100 metric tons and in the first three quarters of this year 800.

John Reade, a market strategist with the council, in comments to CNN, pointed to the rise in geopolitical tensions as a key factor.

In something of an understatement, he said: "The geopolitical risk environment appears to have changed, not just Russia invading Ukraine, not just the terrible things going on in Israel and Gaza, but the trade tensions between the US and China, concerns about what will happen in the South China Sea, concerns about what China will do in Taiwan."

The financial effects of these tensions are being exacerbated by conditions in the US, including the question of how long its massive deficits can continue to be financed, dependent on foreign purchases of government debt, and the political turmoil which is certain to intensify in the presidential election year of 2024.