Major split opens between central banks

Nick Beams
15 December 2023

A significant division has opened up between the US Federal Reserve, on one side, and the European Central Bank (ECB) and the Bank of England (BoE), on the other, following their monetary policy meetings held this week—a division that could have implications for financial stability.

On Wednesday, the Fed indicated it was bowing to the demands of financial markets for interest rate cuts—possibly starting as early as March next year. Fed chair Jerome Powell abandoned the "hawkish" outlook he had maintained right up until the eve of the meeting.

The following day the ECB and the BoE adopted a different stance maintaining the position they had previously shared with the Fed that higher interest rates had to continue. In their monetary policy statements, both banks focused on the issue of wages as reasons for the need to maintain a restrictive interest rate regime to bring down inflation.

The BoE said monetary policy was "likely to need to be restrictive for an extended period of time" and "further tightening would be required if there were evidence of more persistent inflationary pressure."

The statement from its Monetary Policy Committee made clear the focus is directed to the labour market and wages.

It said that while annual private sector wage growth had declined to 7.3 percent in the three months to October "there remain upside risks to the outlook for wages growth." The Committee would closely monitor indications of persistent inflationary pressures, including the tightness of the labour market and wage growth.

In its report on the BoE decision, the *Financial Times* noted that "most evidence" suggested "the British labour market is still tighter than before the pandemic, boosting wage growth."

Later in the day, the ECB also indicated wages were central to its deliberations and decisions.

ECB president Christine Lagarde got to the core issue at the very beginning of her opening remarks to a press conference.

"Underlying inflation has eased further," she said. "But domestic price pressures remain elevated, primarily owing to strong growth in unit labour costs."

Lagarde returned to the question of wages during the question-and-answer session, saying a lot of data would be received in the first half of 2024, "particularly on the employment front." She noted that 50 percent of workers covered by the ECB in its wage tracker will have their terms of employment and possibly new wages set in new collective bargaining agreements coming up.

Setting out the line of the ECB, she said the central bank was "determined" to return inflation to the 2 percent target.

"Based on our current assessment, we consider that the ECB interest rates [which have gone from around zero to 4 percent in the present cycle] are at levels that, maintained for a sufficiently long duration, will make a substantial contribution to this goal. Our future decisions will ensure that our policy rates will be set at sufficiently restrictive levels for as long as necessary."

Naturally, virtually every question at the press conference was directed to the decision by the Fed the day before which all but declared that it was moving to cut rates.

Significantly, as the *Financial Times* (FT) reported, citing a person involved in the discussions, the "dovishness" of Powell's comments "caught many members of the ECB governing council off guard." According to the source "it was surprising for a lot of us" and "makes life more difficult."

In other words, the Fed did not even bother give the ECB, the second most important bank in the world, so much as a "heads up" that it was about to undertake a major reorientation.

If Lagarde had disagreements with the way the Fed had acted, she kept them to herself. She batted back questions on what had happened the day before while insisting the ECB was not going to follow suit.

In response to the first question, on the ECB's response to the possibility raised by the Fed that it would make as many as three cuts next year, Lagarde sharply reminded the questioner of "one thing." "We are data dependent. We are not time dependent. We are data dependent."

Then to emphasise the ECB stance, she later added: "Should we our lower guard? We asked ourselves that question. No, we should absolutely not lower our guard."

Perhaps she had in mind the phrase associated with former British Tory prime minister Margaret Thatcher "the lady's not for turning" as she again referenced wages.

There was one measure on which inflation that was not budging, domestic inflation. "And domestic inflation is largely generated by wages," she said.

Another journalist asked whether there was any discussion about rate cuts and how it might be done in light of the move by the Fed. Lagarde said the answer was "very easy."

"We did not discuss rate cuts at all. No discussion, no debate on this issue. And I think everybody in the room takes the view that between hike and cut, there's a whole plateau, a whole beach of hold."

Another questioner referred to Powell's remark that there was a risk of holding on to higher rates.

"Who wants to hold on for too long?" she replied. "But equally what we are saying today… is that we don't think it's time to lower our guard, and we believe there is work to the done and that we can very much take the form of holding."

That may prove to be easier said than done as a number of analysts have pointed out.

Nathan Sheets, a former US Treasury official, now at a major financial firm, told the FT: "Major central banks can deviate from the Fed in principle, but doing so in a significant way for an extended period historically has been difficult to do."

Frederick Ducrozet, head of macro-economic research at Pictet Wealth management, told the newspaper: "If the Fed does cut earlier and faster, it's going to be very difficult for the ECB to hold on to their position."

The Fed move not only blindsided the BoE and the ECB but also financial commentators in the US.

John Authers, a columnist at Bloomberg, a long-time observer of the US financial markets, said he had been convinced that Powell would have been uncomfortable with the recent easing in financial markets which made the Fed's task more difficult.

He had expected him to "speak aggressively to damp down any prospect of early rate cuts" with the only question being whether he could get the market to believe him. That prediction was based in large part on what Powell had said just two weeks before the Fed meeting, insisting that it was premature to speculate on when policy might ease.

Authers said the shift in three months, that is since the last projections, the so-called "dot plot" by Fed policy makers of where they thought interest rates would go, had been "startling."

"Three months ago, 10 members thought the Fed funds rate would be still above 5 percent by the end of next year. Now only three think that," he wrote.

He listed a number of significant shifts in Powell's remarks. Powell said policy was now "well into restrictive territory" not merely "restrictive" as he had said in November. He declared that the Fed would need to cut rates "way before" inflation reached the 2 percent target, and that the Fed was "very much focused" on the risk of keeping rates too high for too long.

The question which arises is what is to account for the sudden shift? The answers are to be found in the state of the US economy and financial system which have become ever more parasitically dependent on very low interest rates in a process going back decades.

The turn to higher rates has already had a major impact. Last March it resulted in three of the four largest bank failures in US history. The impact was only brought under control when financial authorities, including the Fed, gave an implicit guarantee to all wealthy uninsured depositors that the state would bail them out.

The $25 trillion US Treasury market, the basis of the global financial system, far from operating as a stable institution for the buying and selling of government debt, has become a snake pit of speculation which the Securities and Exchange Commission is desperately trying to bring under control.

Problems are emerging in the commercial property market because of the rise in interest rates. The money made available to tech firms when interest rates were low is drying up and corporations which took out loans at ultra-low rates face a major hit when they have to refinance at much higher rates.

These are just some of the issues which would have been under discussion behind closed doors at the Fed, in contrast to its public pronouncements that the financial system is "sound and resilient."

While Wall Street has rejoiced at the Fed's Christmas present to it, the divergence it has opened with other central banks has introduced another destabilising factor.

It should be recalled that one of the triggers for the October 1987 Wall Street crash—still the largest one-day fall of 22.3 percent—was the conflict between the Fed and the German Bundesbank which moved to raise its base rate.

History, of course, does not repeat itself.

However, it does contain lessons for the present. The divergence that has opened between the major central banks—by the fact that for all the talk of cooperation the Fed apparently did not even inform its counterparts in Europe of the shift—means that its actions this week could have far-reaching unintended consequences.