Economic Research Unit

Economics Weekly

Bank of Ireland

Central Banks set to cut rates through 2025

This week we published our latest Bank of Ireland, Global Markets Watch. A key theme is that confidence has grown amongst financial market participants in recent months that CPI inflation rates are durably returning to central banks' 2% targets. In part, this reflects tentative signs that the US economy is slowing, accompanied by the temporary correction in US equity markets. Moreover, Fed Chair Jerome Powell said in his August 23rd Jackson Hole speech that 'the time has come to adjust policy'. The latest PMI surveys also suggest that after decent GDP growth of 0.3% and 0.2% in Q1 and Q2 2024 respectively, the pace of expansion may have slowed in the euro area. Hence, both the ECB and Federal Reserve are expected to cut interest rates at their September 12th and 18th policy meetings. Overnight index swap (OIS) curves now imply the ECB deposit rate and Fed Funds rate will fall to 2% and 3% respectively by end-2025.

Signs European and US growth softening: Investor confidence in the US economic outlook was hurt in August by the temporary correction in equity markets, but also that the unemployment rate rose to 4.3% in July, accompanied by a soft 114,000 rise in non-farm payrolls. All eyes will now turn to today's US non-farm payrolls data for August. Nonetheless, the data have already been sufficiently weak for the Federal Reserve to decide to give explicit guidance rates will soon be cut. In his August 23rd Jackson Hole speech Fed Chair Jerome Powell said '*downside risks to employment have increased (and) the time has come to adjust policy*'. Turning to the euro area, GDP expanded by a solid 0.3% and 0.2% in Q1 and Q2 2024 respectively, but the euro area composite PMI was 51.0 in August, only slightly above the 50 no-change level. The PMI signaled a contraction in manufacturing had offset the more robust services sector. In this context, the ECB's forecast that euro area GDP growth will accelerate towards 1.5% in 2025 now looks increasingly optimistic.

Inflation concerns moving into rear-view mirror: Headline inflation in the US has now fallen to 2.5% and to 2.2% in both the euro area and UK. Here, the contributions from energy and food prices have dissipated broadly as expected through the first half of 2024. Moreover, the risk of persistent, second round effects, from past double-digit inflation onto wage growth has dissipated. Falling vacancy rates have shown that labour market conditions are gradually loosening. The ECB has now published for the first time it's '*wage-tracker*' for 2025. This suggests wage growth will decelerate rapidly towards 2.5-3% next year, based on information on pay settlements. The situation is more complex in the UK where regular pay growth (ex-bonuses) is still elevated at 5.4% in June, and where Brexit may have contributed to a tighter labour market.

Rate cuts expected through 2025: Both the ECB and Federal Reserve are now both expected to cut rates at their September 12th and 18th policy meetings respectively. Given the 5-4 split vote, only just in favour of rate cut at the MPC's August 1st meeting, and cautious comments on the pace of easing from Governor Andrew Bailey, the Bank of England is expected to wait until November before cutting rates again. However, overnight index swap (OIS) curves point to central banks normalising rates rapidly next year, falling to 2% in the euro area, 3.6% in the UK and 3% in the US by end-2025 (see chart below). The ECB has published research suggesting the 'neutral rate' (that neither stimulates nor cools the euro area economy) is circa 2%. So market expectations imply the ECB's deposit rate will be back to this neutral level by the end of 2025.

Dollar under pressure: In foreign exchange markets the dollar was under pressure through August as Fed rate cut expectations firmed and US yields fell on a relative basis. The dollar-euro exchange rate peaked at $1.12 in August, well up from $1.07 in June. Although the exchange rate has fallen back to $1.11, it remains close to a one-year high. Looking forward, we expect both the euro and sterling to gain some ground against the dollar, trading in ranges of $1.11-1.17, and $1.31-$1.36 respectively in the first half of 2025. Sterling is currently trading at 84p against the euro, a relatively strong level, and at the bottom of our expected trading range of 83-87p over the next twelve months.

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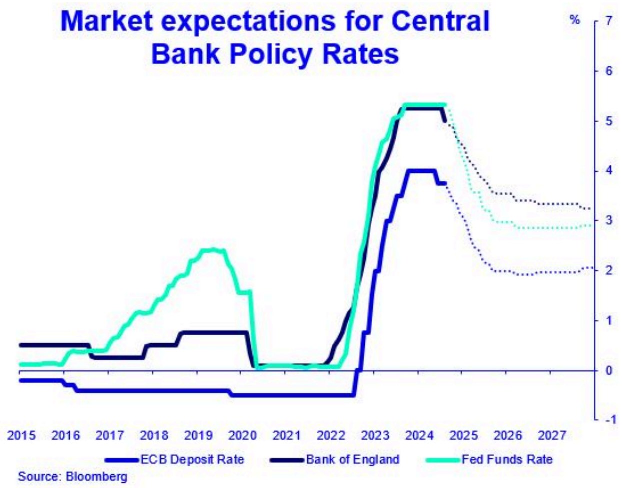

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