MIMS – Research Area

Macro Research Team

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Monetary Policy in 2024 - Current Scenarios and Future Outlook

Central banks have been forced to go into uncharted waters as responding first to the pandemic and then to rising inflation and geopolitical frictions. The existence of lags for monetary policy effectiveness has shaped the way in which its standard transmission channels have worked in the past three years, leaving us with the question of which will be the direction of future policies. In our May report we turn to the cases of US, EU, China and Japan, and we aim at understanding the rationale behind the current monetary policy stances and their associated future outlooks.

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The United States

In the post Covid-19 period, the US economy continued its path of recovery from the adversities brought by the pandemic. Amid a surge in inflation, the Fed initiated a succession of 11 interest rate hikes, increasing the level of interest rates by roughly 5 percentage points from March 2022 to January 2024 (from approximately 0.25% to 5.25%). The level of interest rates then stabilized around 5.3% as the economy progressed into the first quarter of 2024. Nevertheless, despite relentless monetary policy tightening focused on taming inflation, the economy remained robust throughout the period, recording a 2.5% growth rate for the entirety of 2023, above the 1.9% expansion witnessed in 2022. The labor market also exhibited outstanding resilience throughout the year, impacting heavily monetary policy decisions, given the dual mandate of the Fed. Indeed, following the pandemic-induced downturn in 2020, job opportunities escalated significantly, peaking at 12.0 million in March 2022. Unemployment also recovered to its initial pre-crisis levels by the spring of 2022. The labor market remained tight throughout 2023 as the demand for labor continued to exceed supply.

Macroeconomic context in the Q1 of 2024

The macroeconomic landscape of the United States in the first quarter of 2024 reveals a nuanced picture, marked by a deceleration in GDP growth and a notable uptick in inflationary pressures.

Preliminary data indicates that gross domestic product (GDP) expanded at a subdued annualized pace of 1.6%, falling short of the earlier projected estimate of 2.4%. This growth rate represents a notable slowdown from the previous quarter, reflecting a palpable easing in various sectors including consumer spending, exports, and state and local government expenditures. Meanwhile, inflationary pressures are escalating, as evidenced by the first-quarter core inflation measure surging to a 3.7% rate, driven by a 5.1% jump in service-sector inflation that excludes housing and energy. Consumer prices are rising by a stronger-than-expected 3.5% in March, marking the third above-expectation reading for US consumer price index inflation.

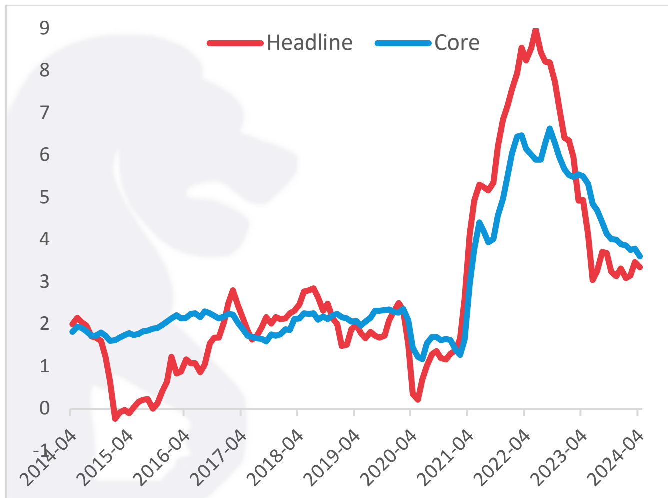
Inflation's recent uptick, particularly in the service sector excluding housing and energy, has shown significant growth, with a notable 5.1% increase compared to the previous quarter. This surge is largely attributed to surging insurance costs, a point emphasized by Jerome Powell. The automotive industry is the main driver of this increase in prices, as it is experiencing a notable surge in insurance rates, with auto insurance costs skyrocketing by 22.2% over the past year, marking the most substantial increase since the 1970s (More in Appendix (1.1.))

There is an evident job growth accompanied by real wage increases, indicative of an incredibly resilient labor demand. Notably, first-quarter job expansion in 2024 surpassed pre-pandemic averages, met by a

corresponding uptick in labor supply, mitigating the risk of market overheating.

Figure 1

US Consumer Price Index inflation

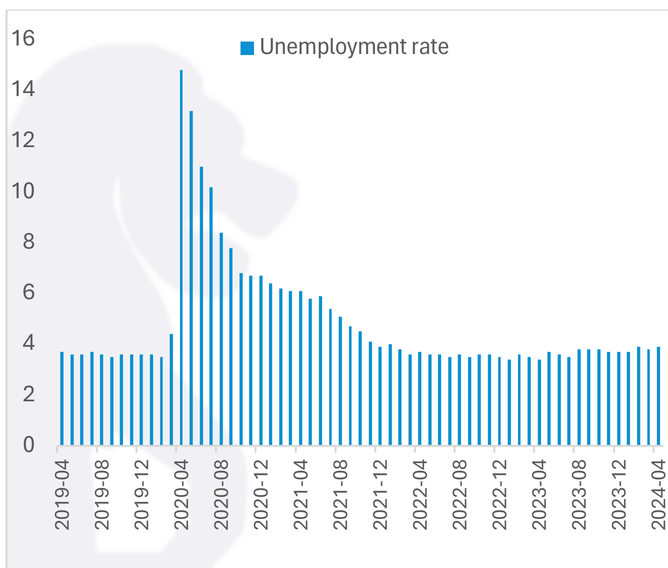


Source: Federal Reserve Bank of St. Louis

In this shifting landscape, immigration emerges as a pivotal force in shaping the trajectory of the labor market as relaxed immigration policies alleviate labor shortages and aid in curbing wage-driven inflationary pressures, in order to crucially achieve a "soft landing"" (More in Appendix (1.2)).

Figure 2

US Unemployment rate



Source: Federal Reserve Bank of St. Louis

Monetary Policy Outlook

The stark shift in rate expectations has dampened prospects for imminent rate cuts, with analysts suggesting that rates may need to stay higher to tame inflation.

The CME FedWatch tool noted a sharp decline in market expectations for a June rate cut following the release of the report, with the probability dropping to 21% from 53% the day prior and 73% the previous month.

In the ever-shifting landscape of global finance, uncertainty casts shadows over the path to stability. Persistent inflation and the specter of prolonged higher interest rates emerge as prominent concerns, threatening to unsettle the delicate balance of financial markets. Moreover, geopolitical tensions and the looming specter of the 2024 U.S. presidential election add further layers of unpredictability

In a context of financial uncertainty, however, a semblance of stability emerges—a testament to the resilience of the financial system in the face of adversity. The Federal Reserve's reassurance of a sound and resilient banking system, bolstered by risk-based capital ratios that exceed regulatory requirements, offers a glimmer of hope amidst the storm. Moreover, indicators such as a modest household debt-to-income ratio and robust business investment, albeit with some signs of slowdown, paint a picture of relative stability. Consumer spending remains buoyant, and federal spending continues to grow, providing crucial support to the economy in these challenging times. While uncertainties persist, for now, the financial landscape appears steady.

The Euro Area

Monetary Policy Overview

In accordance with the single mandate of price stability of the ECB, we focus on the interesting monetary policy stances of the ECB in the years 2021-2023, which can be summarised with the December 2021 statement: Optionality, Gradualism and Flexibility.

The ECB began signaling a more hawkish approach with clear communication (forward guidance) in the past two years, providing an anchor for inflation expectations.

As a by-definition unexpected shock, the pandemic started the inflationary path for the EU area. Still, it did not trigger ECB to resort to policy rate cuts to stimulate the economy, since the main policy rate (the deposit facility rate) already stood at -0.5% since September 2019.

The pandemic impacted the financial health of most sectors. Temporary supply-demand mismatches followed as sectors re-opened and re-closed in response to the various waves. However, the ECB assessed these forces to be short-lived in nature, as well as the climbing oil prices.

There were no sudden changes of the monetary policy stance and by July 2021, there were still no concerns for the medium-term inflation outlook. Thus, the implemented forward guidance was supplemented by commitments to continue net asset purchasing under APP (Asset Purchase Program) and PEPP (Pandemic Emergency Purchase Program) until the pandemic crisis would come to an end.

When the first world banks adjusted their monetary policy in 2021, wage growth and long-term inflation expectations were not impacted as in other countries, until the December commitment of stopping the purchases under the PEPP by the end of Q1 2022 was made clear. This was clearly supported when the Ukrainian conflict broke out, with the promise that the general policy of Quantitative Easing would end in the third quarter. It was clear that while (pent-up) demand was resurging , the main issue was the supply side, also given another China's shutdown.

With the June 2022 Eurosystem staff projections anticipating inflation averaging 6.8% in 2022, 3.5% in 2023, and 2.1% in 2024, the ECB decided the first 50 basis point hike in July, announcing the introduction of Transmission Protection Instrument (TPI) as anti-fragmentation instrument.

From July 2022, ten consecutive rate hikes followed and APP investments were suspended in 2023. In a simple macroeconomic scenario, the persistence of hike decisions is related to the variable of uncertainty about the strength of the dynamic inflation propagations.

Macroeconomic context

Throughout 2023, the EU economy struggled with stagnation, barely avoiding a technical recession by year-end. Real GDP remained flat, with consumption and investment failing to meet expectations. External demand contributed positively, driven by a decrease in imports exceeding that of exports. This economic weakness persisted into 2024, with indicators suggesting no immediate rebound. Inflation, while high, declined notably from its peak in late 2022, primarily due to falling energy prices and tightening monetary policy. Despite this, inflation still outpaced nominal wage growth, impacting purchasing power and consumption. Tight credit conditions further hindered investment growth, particularly in construction. However, the labor market remained resilient, dispelling concerns of employment losses.

Commodity markets have shown limited reaction to regional tensions, with crude oil prices declining and expected to continue falling due to weak demand and ample supply. European gas and electricity prices have fallen significantly, with expectations of stability at current levels. Food and metal prices have also decreased, driven by weak economic activity and supply recoveries.

Table 1

EU Key Current Indicators and Figures

Real GDP growth (Q4 2023)	**0.1%**
Euro area Inflation (March 2024)	**2.4%**
Euro area Core Inflation (March 2024)	**2.9%**
EU Unemployment rate (February 2024)	**6.0%**
Imports of goods and services growth (Q4 2023)	**-2.5%**
Exports of goods and services growth (Q4 2023)	**-2.8%**
EURUSD (18/4/2024)	**1.07**
EURGBP (18/4/2024)	**0.86**
Oil Brent	**87**
Interest rate on main refinancing operations (September 2023)	**4.50%**

Source: "Macroeconomic projections", March 2024, ECB

Monetary Policy Outlook

Despite a slower-than-expected recovery in the short term in the European Union, growth is anticipated to gradually improve throughout 2024. This recovery is attributed to rising real disposable income, declining inflation, robust wage growth, and improved terms of trade. According to the ECB macroeconomic projections (March 2024), over the medium term, the recovery is expected to be supported by the diminishing effects of the ECB's monetary policy tightening.

Inflation is expected to further moderate due to easing pipeline pressures and monetary policy tightening, albeit at a slower pace than in 2023. The fading of pipeline price pressures, coupled with declining energy prices, is anticipated to be offset by strong labour cost developments. Nominal wage growth is expected to remain elevated due to tight labour market conditions, gradually easing over the projection horizon as inflationary impacts diminish.

Table 2

Inflation rates in Euro Area

2023	**5.4%**
2024 (e)	**2.3%**
2025 (e)	**2.0%**
2026 (e)	**1.9%**

Source: "Macroeconomic projections", March 2024, ECB

The ECB Survey of Professional Forecasters for the second quarter of 2024 expects the interest rate on the ECB's main refinancing operations (MROs) to fall to 4.25% in the second quarter of 2024, reaching 3.5% by the fourth quarter of the year and declining further to 3% in 2025 and 2.5% in 2026. However, ECB President Lagarde emphasized the need for more evidence before making decisions, highlighting May as pivotal due to wage settlements. Market expectations for rate cuts in June align with policymakers' outlook, with a possibility of multiple cuts totalling over 150 basis points.

Also, productivity growth (supply-side) recovery should alleviate labour cost pressures, while weakening profit growth may buffer labour pass-through. Annual average headline HICP inflation (Harmonised Index of Consumer Prices inflation) is forecasted to decrease from 5.4% in 2023 to 2.3% in 2024, 2.0% in 2025, and 1.9% in 2026. Revisions to HICP inflation for 2024 and 2025 reflect lower energy commodity price assumptions and reduced labour cost pressures, while projections for 2026 remain unchanged.

All the discussed factors are crucial in assessing the outlook of EU monetary policy and state that currently there is no directional bias for future interest rate decisions, with the ECB monetary policy stance remaining data-dependent, and second-round adjustment mechanisms remaining crucial for the potential rate cuts coming up this year.

China

Monetary Policy Overview

The People's Bank of China (PBC), established in 1948, gained significant monetary authority with China's economic opening in 1984. The PBC is state-controlled and this fact justifies the higher attention placed on the country's general economic outlook rather than monetary policy per se.

The primary (and formal) mission of PBC is to ensure currency stability, supporting price stability and favorable exchange rates to foster economic growth. Traditionally, the Chinese central bank relied on quantity-based instruments. However, in recent years, it has shifted towards price-based instruments, such as interest rates, aligning with global practices and enhancing flexibility to address mounting financial risks.

The year of 2023 marked the reopening and recovery efforts of China's economy following the Covid-19 pandemics. While the IMF-reported growth of 5.2% surpassed the official target of 5%, many of the issues that have plagued post-Covid China were further exacerbated. Despite two cuts in the loan prime rate (LPR), from 3.65% to 3.55% and to 3.45%, and expansionary fiscal policy in the latter half of the year, policymakers were unable to reinspire growth momentum.

Macroeconomic context

Structural deficiencies, including supply chain relocation, industry decline, aging demographics (Japanification), and deflationary threats, now challenge China's once-explosive economic reform narrative. Real-time changes in growth sources are evident; for instance, net FDI saw an 80% decline from 2022 to $33 billion in 2023, the lowest level in 30 years. Analysts increasingly question the validity of China's economic data, potentially casting a harsher outlook on its economic health.

Deflationary concerns have persisted into 2024, with year-on-year CPI change remaining below 2% since January 2023, occasionally dipping into negative territory, reaching as low as -0.8% in January 2024. This poses a significant challenge, especially considering the high levels of debt in the economy, where inflation could help alleviate some of the burden. In March 2024, the Consumer Price Index (CPI) increased by only 0.1%, falling short of the market's forecasted 0.4%. The deflationary pressure in China stems from factors such as the real estate market crash, overcapacity in traditional industries, and excess supply, which collectively dampen aggregate demand. The decline in household wealth due to the real estate crisis, coupled with economic uncertainties, has weakened consumer confidence, leading to higher savings rates rather than spending. Additionally, China's relatively weaker employment situation has prevented wage-driven inflation, a phenomenon observed in other developed economies.

In the aftermath of Covid-19 and amid sluggish growth in other developed markets, coupled with the gradual relocation of the value chain away from China, export prices have also declined. However, some positive signs

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come at sight, with export prices expected to stabilize and manufacturing showing signs of recovery, reflected in PMI values above 50 in March and April. Additionally, the trade surplus grew significantly in early 2024, from $75.3 to $125.16 billion, surpassing end-of-year estimates by $20 billion.

Table 3

China Current Macroeconomic Indicators

Real GDP growth (Q1 2024)	**5.3%**
Inflation month on month (March 2024)	**0.1%**
Core inflation month on month (March 2024)	**0.6%**
Unemployment rate (March 2024)	**5.2%**
Manufacturing PMI (April 2024)	**50.4**
Export volume (March 2024)	**$279.68 B**
Import volume (March 2024)	**$221.15 B**
USD-CNY (4/5/24)	**7.24 ¥**
Loan prime rate (benchmark for bank lending) (May 2024)	**3.45%**

Source: Trading Economics

Monetary Policy Outlook

The underlying structural challenges facing China's economy are expected to persist or even worsen in the near future.

Despite government efforts to address the real estate crisis (real estate investment as a percentage of GDP fell 4.3% from its peak in just three years), concerns linger that the market won't stabilize soon, potentially impeding economic growth. Investors anticipate the end of deflation, with inflation forecasted to remain low-positive throughout the year. Policymakers are expected to focus on supply-side spending, particularly in green technologies and manufacturing, to meet the State Council's 2024 growth target of 5%. However, prioritizing demand-side policies would better address deflationary risks. This anticipated response aligns with China's historical trend of prioritizing meeting macroeconomic targets over addressing systemic economic deficiencies.

The outlook for China's economy remains largely unchanged, with policymakers facing the challenge of addressing structural issues. Unlike in 2023, where growth benefited from base effects, 2024 is expected to offer a more realistic view of performance. Economic growth is forecasted at just 4.6% for the year, despite expansionary efforts such as the 1 trillion-yuan infrastructure investment plan (~1% of GDP). Nomura suggests that the government is unlikely to artificially inflate numbers later in the year. Increased coordination between fiscal and monetary policy is anticipated, with the Politburo signaling a “proactive” fiscal policy complemented by a “prudent”, flexible monetary policy to stimulate demand and aid local governments affected by the real estate bubble. Additionally, President Xi Jinping has hinted at expansionary open market operations to inject liquidity into the economy, aligning with China's managed exchange rate regime aimed at supporting exports.

Overall, monetary policy in China is expected to play a supportive and reactive role as the country seeks to regain its pre-pandemic economic momentum. The significant structural challenges facing China's economy necessitate a reevaluation of fiscal and monetary policies (and their interplay). There's a possibility that Chinese monetary policy may gain greater independence from the influence of the State Council, as it grapples with the need to balance domestic price stability and currency stability to avoid potential debt crises.

Japan

Monetary Policy Overview

Over the past three decades, Japanese monetary policy has been characterized by the mission to spur aggregate demand in a stagnating economy. With the policy rate fixed at, near, or sub-zero levels for nearly 25 years, Japan has had to develop various unconventional tools to combat a culmination of different structural components slowing the Japanese economy down. The BOJ has notably initiated innovative tools such as QE, Negative Interest Rates, ETF Purchases, and, more recently, the Yield Curve Control to provide liquidity to markets and fix actors' expectations in the economy. The YCC has been a particularly useful option in the BOJ’s toolkit, as it helps anchor interest rate expectations for longer time horizons by explicitly controlling the entire yield curve. The BOJ used the YCC to constrain risk-free rates on all horizons in order to lower borrowing costs and spur investment. Japanese Monetary Policy has proved unique over the decades marking its battle against its stagnating economy wherein many innovative measures have been taken.

Macroeconomic Context

With the onset of post-Covid global macro trends, Japan has been able to evade a multi-decade-long stagnant and frequently deflationary economic environment. As of March 2024, inflation sits at 2.7%, above the BOJ target of 2%, and the Policy Board of the BOJ has made pivotal decisions in its March 19 Monetary Policy Meeting. During the meeting, the board voted on terminating many of their unconventional tools, including their ETF Purchases, Negative Interest Rates as they increased rates to 0.1%, and Yield Curve Control programs. The Board underscores that their reasoning behind these decisions stems from the majority consensus that structural components seem to reflect a Japanese economy, while characterized by "extremely high uncertainties" around "economic activity and prices", set to converge to the BOJ's inflation target in fiscal year 2025.

The BOJ anticipates a baseline scenario on top of which they concede the existence of ample risk to economic activity and prices. In the baseline scenario of the outlook of economic activity, the Japanese economy is forecasted to grow above its potential growth rate "as a virtuous cycle from income to spending gradually intensifies." The household sector is expected to gradually ramp up demand alongside increasing employment and a tightening labor market. Though employment rates are expected to improve, this trend is due to decline as an increase in labor supply inevitably becomes more challenging to sustain due to demographical constraints. Consequently, the BOJ expects to see both a moderate expansion of employment and a tightening of labor market conditions due to supply constraints. In turn, this trend is expected to onset a stronger price-wage dynamic, with recent labor union negotiations already concluding in an average wage hike of 5.24%, marking a 33-year high.

Private consumption is further projected to be contingent on government initiatives, as positive measures have recently been administered in efforts to limit pressure caused by rising crude oil prices. Corporations are also expected to benefit from uptrends in production and export levels, due to an expected rise in IT- related and tourism export demand as well as internal demand. Moreover, corporations are expected to gear for increased R&D and business-fixed investment in anticipation of labor market shortages. Current predictions by the BOJ forecast a 1.3% Real GDP growth rate for the fiscal year of 2023, followed by real growth rates of 0.8% and 1.0% in subsequent years.

As for the prices outlook, the BOJ expects the upward pressure of the pass-through of increased import prices on inflation to wane as global inflation abates and commodity prices decline. However, CPI is expected to remain above target until fiscal year 2025 as recent rises in crude oil prices will extend the effects of imported inflation. Apart from this transitory factor, we expect the output gap and tightening labor market to lead the Japanese economy back to the 2% inflation target through fiscal year 2025 onwards.

Finally, we observe that medium-to-long term inflation expectations in Japan have risen moderately. "The March 2024 Tankan" (Short-Term Economic Survey of Enterprises in Japan) indicates that firms' inflationary outlooks have increased on aggregate which will influence prices and labor wages. Conclusively, it is possible to observe a baseline scenario in which inflationary pressures can be expected to stabilize around the inflation target starting in 2025 and economic activity to be marked by moderate growth. The base scenario outlines a quasi-optimistic outlook that sees the Japanese economy entering a relatively healthy form after decades of turbulence. Unfortunately, the BOJ emphasizes high uncertainty clouding this baseline scenario. As a result, while the BOJ assumes an observant role, it remains committed to intervening whenever lingering risks compromise the possible fruition of this scenario.

The BOJ cites the most likely deviations from the baseline scenarios to be caused by high crude oil prices and a weakening yen, weakening the expectation that cost-push inflationary factors are expected to wane. This outcome would lead to upward pressure on prices and may lead the BOJ to increase the pace of monetary normalization. Other factors such as active fiscal policy and capacity shortages due to labor supply constraints could further support in a reversal of the decelerating inflationary pressures in Japan.

Monetary Policy Outlook

In the outcome that the baseline scenario materializes, monetary policy is expected to remain unchanged as the Japanese economy enters a positive output gap, experiences positive inflation and a healthy wage-price dynamic continues to strengthen. However, in the possible deviation from the baseline scenario where upward pressures on price persist, it is rather expected that monetary policy is more restrictive "than the path that is currently factored in by the market" (BOJ, March 2024). Many market expectations seem to converge around the baseline scenario depicted by the Bank of Japan with S&P Global forecasting a rise of "about 0.1 of a percentage point this year and about another 0.25 of a percentage point in 2025 from -0.1% now" (March 2024). However, almost all expectations concede the

existence of ample uncertainty and warn of the importance of nimble monetary policy, also given the structural factors of the Japanese economy.

The danger of complacency

Amidst the waves of overall optimism surrounding the financial outlook, the International Monetary Fund (IMF) issues a clarion call for vigilance. While acknowledging the potential for a soft landing for the global economy, the IMF warns against the dangers of complacency. Beneath the veneer of economic strength lie lurking risks—stretched asset valuations, geopolitical tensions, and the looming specter of rising debt levels—all of which demand careful navigation. The IMF's admonition to push back against overly optimistic expectations regarding the pace of disinflation and monetary policy easing serves as a sobering reminder of the risks that lie ahead.

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Appendix

APPENDIX 1

1.1 Insurance costs driving inflation

Inflation's recent uptick, particularly in the service sector excluding housing and energy, has shown significant growth, with a notable 5.1% increase compared to the previous quarter. This surge is largely attributed to surging insurance costs, a point emphasized by Jerome Powell. Across various sectors such as automobile, medical, and property protection, insurance expenses are on the rise, significantly impacting official inflation calculations. While grappling with this trend presents challenges for economic policymakers, its influence on overall price levels is unmistakable.

The automotive industry is the main driver of this increase in prices, as it is experiencing a notable surge in insurance rates, with auto insurance costs skyrocketing by 22.2% over the past year, marking the most substantial increase since the 1970s. Various factors, including increased car write-offs, quality concerns stemming from pandemic-induced production disruptions, and a shortage of skilled mechanics leading to prolonged repair times, have fueled this surge. Furthermore, the integration of advanced electronics in vehicles has driven up repair and maintenance costs, consequently impacting insurance premiums. As both car values and repair expenses continue to climb, insurers are compelled to adjust premiums accordingly, further exacerbating inflationary pressures.

Likewise, the domain of medical care insurance is witnessing an upward trend, albeit measured through a more nuanced lens within inflation metrics. This surge is anticipated to persist, at least until April, driven by factors such as insurers' post-benefit payout earnings. Moreover, the rapid increase in tenant and household insurance premiums can be attributed, in part, to climate-related challenges like wildfires and rising sea levels, rendering certain regions more costly to insure. These escalating premiums reflect the broader trend of insurance-induced inflation and underscore the enduring impact of climate change on economic stability, as insurers adjust premiums in response to the increasing frequency and severity of weather-related events

1.2 Post-COVID Labor Market: Pivotal in Safeguarding the US Economy

In the ongoing narrative of post-COVID economic recovery, the labor market emerges as a pivotal force safeguarding the US economy from recessionary pitfalls while grappling with sticky inflation and sluggish growth. Amidst the backdrop of the "Great Resignation" fervor of 2022, the labor landscape of 2024 finds itself transitioning towards a more balanced equilibrium.

There is an evident job growth accompanied by real wage increases, indicative of an incredibly resilient labor demand. Notably, first-quarter job expansion in 2024 surpassed pre-pandemic averages, met by a corresponding uptick in labor supply, mitigating the risk of market overheating. March saw a decline in the unemployment rate to 3.8%, a testament to the sustained vitality of the labor market.

The evolving dynamics of labor have profound implications for inflation. Transitioning from a tight labor market, where wage surges outpaced price hikes, to a more moderate environment, has subdued inflationary pressures. While wage growth has tempered, so too has inflation, resulting in augmented household purchasing power.

In this shifting landscape, immigration emerges as a pivotal force in shaping the trajectory of the labor market as relaxed immigration policies alleviates labor shortages and aids in curbing wage-driven inflationary pressures, in order to crucially achieve a "soft landing,".