Kudos to central banks

By Jesper Rangvid

Inflation has come down and there is no recession on the horizon. This is about as close to a soft landing as it gets, and central banks deserve credit for it. But is it too soon to celebrate? What potential risks still loom?

It has been a while since you have heard from Rangvid's Blog. Over the past few months, I've been deeply immersed in the final, intense phase of an exciting journey: I've completed a new book! It explores interest rates and their impact. The manuscript has been submitted and is now in the publishing pipeline. I am thrilled about it, but as you know, the publishing process takes time. I expect it to be released by Spring 2025. I will keep you posted, so stay tuned.

Back to blogging

After the hiatus since early summer, it is time to get back to blogging. Since my last post, we have seen the first rate cuts from both the Fed and the ECB. The Fed made a significant 50-basis-point cut, while the ECB reduced rates by 50 basis points in two steps, in July and September.

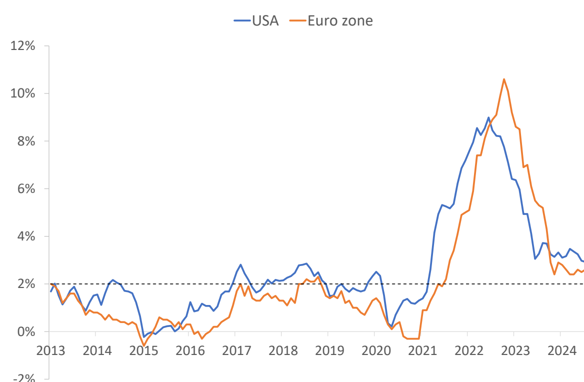
These rate cuts signal that central banks are confident inflation is under control. At the same time, the economy has managed to avoid a recession, and no immediate downturn seems likely.

If central banks succeed in bringing inflation back to target while avoiding a recession—despite the sharp interest rate hikes we have seen—it would be a major accomplishment. While I was highly critical when inflation first surged, because of central banks' delayed policy response, credit is due if they end up having navigated this inflation battle without causing significant damage. We are close to this situation, but last risks remain. Before discussing these risks, it is helpful to recall what we have experienced and achieved.

Inflation under control

Figure 1 highlights the dramatic rise and subsequent decline in inflation across the euro area and in the U.S.

***Figure 1**. Inflation (annual percentage changes in consumer price indices) in the euro area and the U.S., January 2013 – August 2024.*
Source: Datastream via Refinitiv and J. Rangvid.

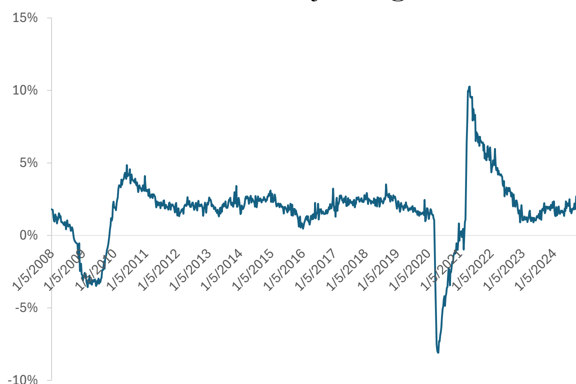


Pre-pandemic inflation was subdued, frequently falling short of central banks' 2% inflation target. However, starting in 2021, inflation surged unexpectedly, reaching nearly 10% in the U.S. and exceeding 10% in Europe. Just as quickly as it spiked, inflation has now declined, coming close to target levels. In fact, the flash estimate for expected inflation in the euro area for September 2024 is 1.8%—below the target.

No recession

Meanwhile, we have avoided a recession. In fact, the economy remains surprisingly strong. Economists at the New York Fed have developed a measure of weekly economic activity in the U.S., a composite of ten key weekly indicators. It is shown in Figure 2. With this indicator, we get a relatively high-frequent indicator of the stance of the US economy. The interpretation of the indicator is: "*if the WEI reads -2 percent and the current level of the WEI persists for an entire quarter, one would expect, on average, GDP that quarter to be 2 percent lower than a year previously.*"

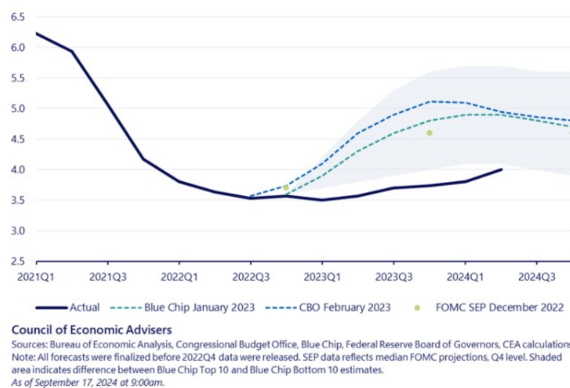
Figure 2*. Weekly Economic Index, January 2008 – October 2024.*
Source: St. Louis Fed and J. Rangvid.



The index reliably tracks recessions and expansions, showing sharp declines during the 2008 financial crisis and an even steeper drop during the COVID-19 recession in 2020, followed by a strong rebound as the economy recovered. Currently, the index indicates real GDP growth at 2.7%, reflecting solid and robust economic expansion. Similarly, the Atlanta Fed's GDPNow model estimates US Q3 2024 GDP growth at 2.5%, reinforcing the picture of strong economic performance.

This is remarkable. Many, including myself, who closely follow the economy expected the aggressive interest rate hikes by central banks to have far more severe consequences. I came across an illustration—reproduced in Figure 3—depicting consensus expectations for unemployment compared to how it actually unfolded (link). The figure highlights that most experts anticipated significantly higher unemployment by now. In reality, unemployment is lower than even the most optimistic projections.

Figure 3*. Expected and actual unemployment in the US: Source: link.*

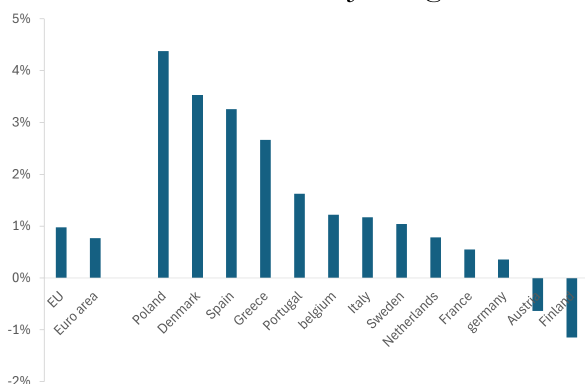


We can debate whether this unexpectedly strong economic performance—and lower-than-expected unemployment—stems from overly expansionary fiscal policies. I believe that is a valid argument. Nonetheless, the fact remains that the economy has performed surprisingly well.

In Europe, the situation is similar, with no signs of recession, although growth is slower than in the U.S. Figure 4 highlights the most recent European growth figures.

Figure 4*. Percentage growth in the EU, the euro area, and selected European economies, Q2 2023 – Q2 2024.*

Source: EU Commission and J. Rangvid.

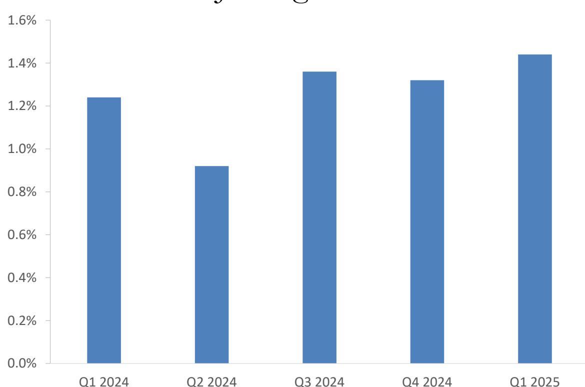


The EU economy grew by 1% from Q2 2023 to Q2 2024—a modest but positive increase. There are large dispersions across countries, though. The Polish economy grew by more than 4%, and the Danish close to 3.5%, but the large (in Europe) French and German economies grew by less than 1%, dragging down overall European growth. But, again, growth was positive.

Looking ahead, professional forecasters expect growth in Europe to improve slightly, with no recession in sight, as shown in Figure 5.

Figure 5*. Expected GDP growth in the euro area from the ECB's Survey of Professional Forecasters, quarterly growth rates adjusted to annual figures.*

Source: ECB and J. Rangvid.



Weak signs

The only notable weak spots have been in the U.S. labour market. Unemployment has ticked up over the past year, and job creation has slowed. Wage growth has also cooled slightly but remains healthy at 4.6% (see the Atlanta Fed wage tracker: link). With inflation at 2.5%, this translates to a real wage growth of 2%—not exceptionally high, but certainly not low either. It is important to note that these softer labour market signals have not shown up in headline economic activity, which, as mentioned, remains robust.

In Europe, the labour market is still strong, with unemployment at record lows of 5.9% in the EU and 6.4% in the euro area. This does not look like a recession.

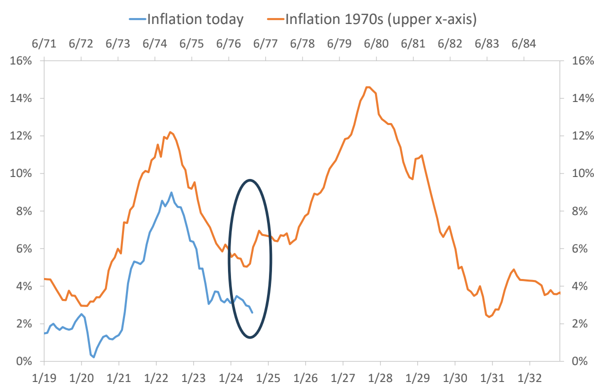
What could go wrong?

In my view, the biggest threat to the otherwise positive economic situation is a resurgence of inflation. As I often remind readers, in the 1970s, many believed inflation was under control, only for it to spike again. Figure 6 illustrates this by comparing U.S. inflation today with inflation in the 1970s. The pattern during 2021-2023 closely mirrors the first inflation peak of the 1970s. In the mid-to-late 1970s, a second inflation wave followed.

In a previous post (link), I argued that one reason inflation reappeared in the late 1970s was excessively loose monetary policy. Real interest rates were negative for much of the 1970s, despite relatively high inflation. This left the economy vulnerable to even modest shocks—such as the late 1970s oil price shock, which was arguably smaller than the one in the early 1970s—that reignited

inflation. Based on this historical lesson, I suggested that central banks today should keep interest rates elevated until inflation was fully subdued.

Figure 6. *US inflation (annual percentage change in CPI) from June 1971 to June 1984 (dates on upper x-axis) and from January 2019 to August 2024.*
Source: St. Louis FRED and J. Rangvid.



And they did just that. Inflation has fallen from around 10% in 2023 to near 2% today, as Figure 1 showed, yet central banks have maintained higher interest rates until inflation approached their target. This approach mirrors what I recommended: keeping rates high until inflation was firmly under control. Whether they followed my advice or not, their actions aligned with it, and I applaud their strategy.

Two risks

There are two potential risks on the horizon that could reignite inflation.

First, monetary policy could become overly loose. Markets anticipate a 50-basis-point cut this year and a further 100-125 basis points next year, and Fed governors expect about the same, as revealed by their "dot plots". This comes against the backdrop of a strong underlying economy, as noted earlier. In fact, the strength of the current US economy argues against further interest rate cuts, yet they are still likely to happen. There is a risk that future rate cuts could be too aggressive, potentially reigniting inflation. While this is not my base case—I still expect a soft landing—it is a risk we cannot ignore entirely.

The second risk is political: the upcoming U.S. election. Without delving too deeply into politics, it is fair to say that Trump's policies, if he wins, could be inflationary. A more politicized Fed (i.e., one that adopts an even more expansionary monetary policy), tariffs, quotas, import levies, and so forth, as well as highly expansionary fiscal policies, all point toward rising inflation. While this would not happen immediately, it is a risk we cannot fully dismiss.

Conclusion

The current economic situation looks promising. Central banks have tightened monetary policy significantly without causing any major disruptions. The economy remains strong, and inflation has returned to target levels. While there are some signs of weakness in the labour market, this is precisely the intended effect of monetary policy—to cool down the economy.

If central banks manage to avoid both an inflation surge and a recession, I will be ready to applaud them for a job well done. The chances of this happening are fairly high.