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What to watch: The Fed's lessons from the past, central banks on hold next week and Switzerland opens up

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Executive Summary

This week, we look at three important issues:

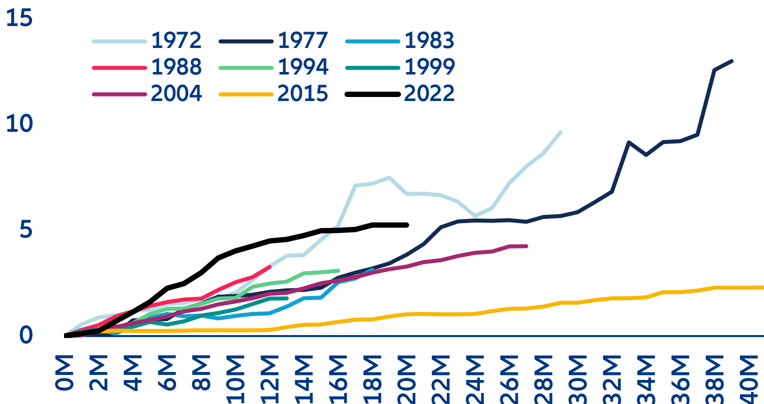
- First, **the Fed is learning from past tightening cycles.** Here are the four key takeaways of the nine Fed tightening episodes since 1972: i) the full impact of monetary tightening will continue to weaken GDP growth for another 12 months; ii) the rapid disinflation this time around is atypical and definitely supports the soft-landing narrative; iii) main transmission channels (housing and corporate lending)are working according to textbooks, no more, no less; iv) profligate fiscal policy is clearly distorting monetary tightening this time around.
- Second, **major central banks to remain on hold until summer 2024.** Next week is central banks week. We expect the Fed, the ECB and the BoE to maintain interest rates at current levels. As disinflation continues and evidence of an economic slowdown is building up, we expect central banks to pause for a good six months before the Fed (in June 2024), the ECB (in July), and the BoE (in September) start cutting interest rates. By December 2025, key rates should be at: 3.75% for the Fed, 2.75% for the ECB and 4% for the BoE, which is fighting stickier inflation and wage growth.
- Third, by reducing its industrial import tariffs unilaterally to zero, **Switzerland becomes one of the most open economies in the world.** Starting from 1 January 2024, Switzerland will unilaterally abolish import duties on nearly all industrial goods, which could lead to import gains of about 12.3% or USD38.2bn annually. This should ultimately boost the competitive advantage of Swiss companies in manufacturing and assembling on the global stage.

The Fed is learning from past tightening cycles

The full impact of monetary tightening will continue to weaken GDP growth for another 12 months. Looking at all the past Fed hiking cycles since 1972 (nine episodes, Figure 1), we find that GDP growth reacted very differently to monetary tightening (Figure 2). In many instances (1972, 1977, 1983), GDP growth actually picked up before dipping only after more than two years after the first FFR hike (in 1977 and 1983). This highlights how long and variable the transmission of monetary policy to the real economy can take. In the current cycle, GDP growth weakened quicker than in all other episodes, but this reflects payback from the strong pandemic recovery. GDP growth is currently picking back up (Q3 2023 GDP grew at +5.2%), but history suggests that it could well weaken again in the next quarters (which we also expect).

H**owever, the rapid disinflation this time around is atypical and definitely supports the soft-landing narrative**. This time inflation has been different, picking up much more rapidly prior to the beginning of this tightening cycle than in other cycles (Figure 3). Equally remarkable, it dipped as quickly following the first Fed hike in March 2022. Surprisingly, inflation in past episodes was quite steady and, as a matter of fact, it even picked up pace later in the cycle (1972, 1977, 2015) or barely moved at all (1983, 1988 etc). In this context, the rapid disinflation seen today supports the soft-landing narrative.

Figure 1: Cumulative change in the Fed Funds rate (pp)



Sources: Refinitiv, Allianz Research

Figure 2: Change in y/y GDP growth (pp)

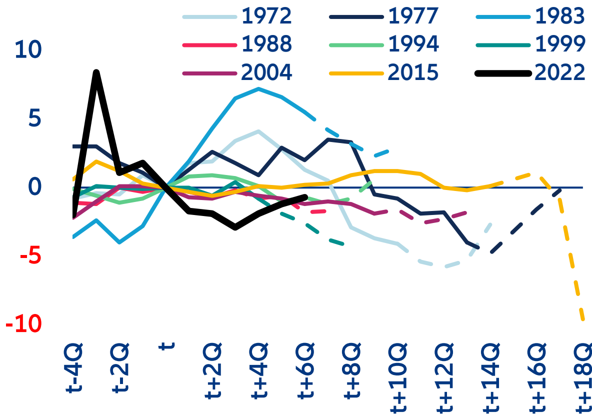
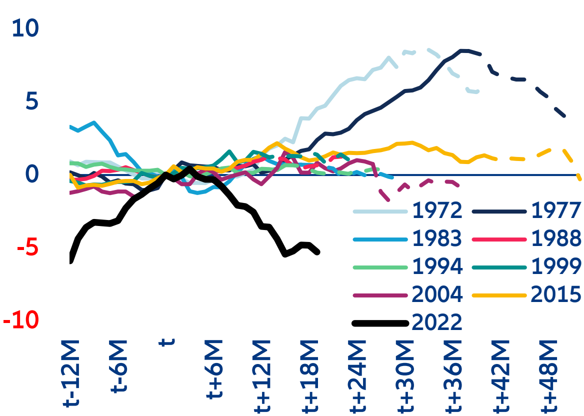


Figure 3: Change in y/y inflation (pp)



Sources: Refinitiv, Allianz Research. Note: We label the start of the hiking cycle as "0", with t-1, t-2 etc. the months or quarters prior the first Federal Funds Rate hike, and t+1, t+2 etc. the months of the quarters following the first rate hike. Dashed lines depict the prolonged time series after the final Fed hike.

The housing market channel is working well. The housing market is one of the most interest-rate sensitive sectors of the economy. However, in most past episodes, real house prices continued to increase while the Fed was increasing rates (Figure 4). Of course, this reflects the fact that the Fed was responding to excessive house-price growth (such as in 2004). Nevertheless, even at the end of many of the hiking cycles, house-price growth continued unabated (1977, 1999 etc.). In terms of existing home sales (Figure 5), the picture is quite similar, with a relatively low response to higher rates. In contrast, the current cycle stands out as having impacted the housing market quite significantly, notably home sales.

Figure 4: Real home prices level, index

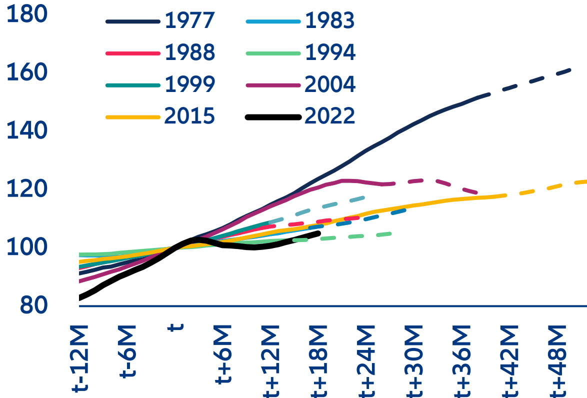
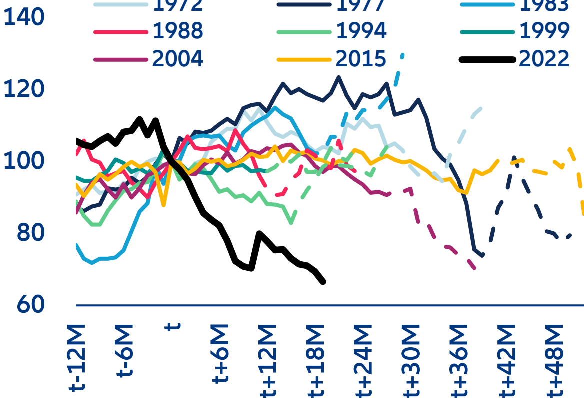


Figure 5: Existing home sales, index



Sources: Refinitiv, Allianz Research. Note: We label the start of the hiking cycle as "0", with t-1, t-2 etc. the months or quarters prior the first Federal Funds Rate hike, and t+1, t+2 etc. the months of the quarters following the first rate hike. Dashed lines depict the prolonged time series after the final Fed hike.

For the corporate sector, it's a tale of two stories: the lending channel is working well, but the interest payments one is not. Higher interest rates are supposed to deter new lending (corporates cut back their borrowing as it becomes costlier, while banks become more risk averse to lend to them) and to increase debt repayments as loans and bonds are rolled over with a higher interest rate, eventually weighing on corporate investment spending. We notice that (real) borrowing undertaken by the non-financial sector has been falling in the current cycle (Figure 6), in line with what we would expect. However, in previous episodes, borrowing continued to increase, even at the end of the hiking cycle. In many episodes of monetary tightening – including the current one – net interest payments as a share of profits (Figure 7) actually fell[1], pushing back against the Fed's actions. Only in the 1988 and 1999 hiking episodes did they increase – effectively responding well to the Fed's actions. Non-financial corporate investment (not shown here) has also increased relatively mildly in the current episode, while in most other cycles it increased more rapidly.

[1] There can be two (non-mutually exclusive) reasons for this: i) corporates have a large quantity of assets that yield them high interest income and/or ii) the maturity profile of corporate debt is very long and set with fixed interest rates rather than variable interest rates.

Figure 6: New (real) borrowing
financial corporate sector, index

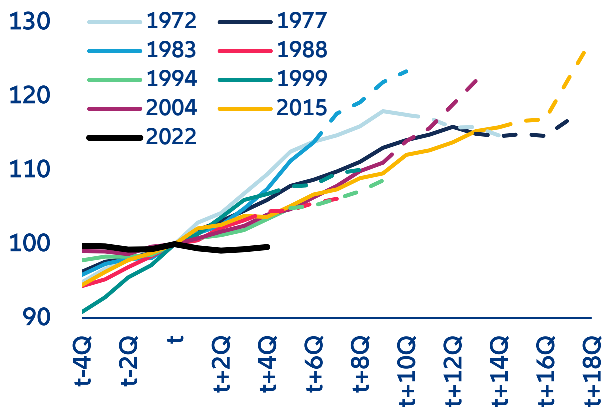
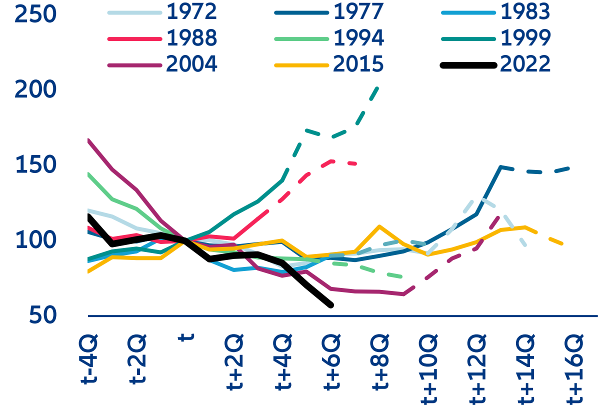


Figure 7: Net interest payments over profits for the non-
by the non-financial corporate sector, index



Sources: Refinitiv, Allianz Research. Note: We label the start of the hiking cycle as "0", with t-1, t-2 etc. the months or quarters prior the first Federal Funds Rate hike, and t+1, t+2 etc. the months of the quarters following the first rate hike. Dashed lines depict the prolonged time series after the final Fed hike.

Profligate fiscal policy is clearly distorting monetary tightening this time around. The effect of monetary policy on the economy can be impaired or alleviated if the other arm of macro policy – i.e. fiscal policy – is pushing back in the other direction. To assess the fiscal stance, we look at the effective personal income tax rate (Figure 8) and the effective transfer rate (Figure 9)[2]. The evolution of personal taxes truly stands out in this cycle, showing a large easing of fiscal policy[3] that helped support household disposable income and, ultimately, consumption spending. The transfer rate moved broadly within the historical median, but it followed very high levels during the pandemic, which has also supported household income through the present day. The 2022-23 fiscal easing is thus by far the largest during any of the Fed's tightening episodes since 1972, followed by 1983 when President Regan cut taxes and 1972 when transfers started to shoot up about two years into the Fed tightening cycle.

Figure 8: Cumulative change in Effective personal income tax rate (pp)

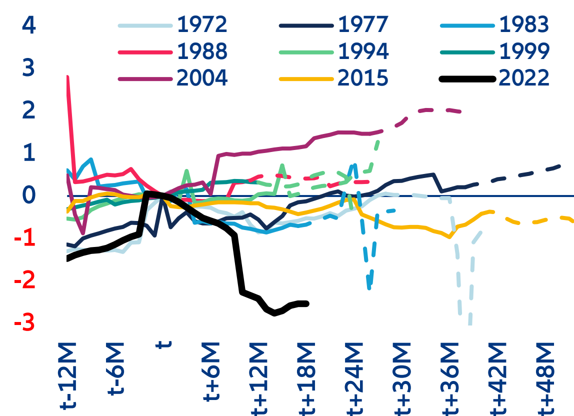
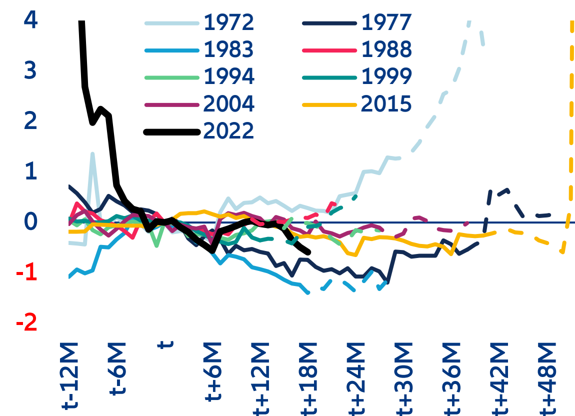


Figure 9: Cumulative change in Effective transfer rate (pp)



Sources: Refinitiv, Allianz Research. Note: We label the start of the hiking cycle as "0", with t-1, t-2 etc. the months or quarters prior the first Federal Funds Rate hike, and t+1, t+2 etc. the months of the quarters following the first rate hike. Dashed lines depict the prolonged time series after the final Fed hike.

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[2] Tax payments and income transfers are both expressed in terms of household primary gross disposable income.
[3] The fact that the economy is currently running above potential indicates that lower personal income tax rates do not reflect the working of automatic stabilizers in the face of a weak economy.

Major central banks to remain on hold until summer 2024

US interest rates have peaked. The FOMC is widely expected to keep interest rates on hold (within the range 5.25-5.50%) at its upcoming meeting on 12-13 December. FOMC members have gradually softened their very hawkish tone in recent weeks, noting progress on the inflation front. Core goods inflation has now completely normalized to the pre-pandemic norm, upstream production prices in the food industry continue to ease and core services prices excluding shelter are slowing, with the three-month annualized PCE rate slowing to 2.7% in October. The FOMC is increasingly confident that rates have reached their peak and the next move will be a cut.

We expect the first Fed rate cut in June 2024, later than market expectations as risks to inflation outlook remain. We have pulled forward our expectation for the first Fed rate cut slightly, from July to June. Admittedly, progress has been on the inflation front while the labor market is continuing to cool. However, it does not mean that inflationary pressures are vanishing altogether. Notably, one year ahead households' inflation expectations have picked up for two consecutive months in October and November according to the University of Michigan survey. Five-year ahead inflation expectations have also increased in November. Meanwhile, the NFIB small business survey points to still elevated plans to raise compensation and to raise selling prices. Against a backdrop of loosening financial conditions and large fiscal deficits supporting economic activity, we think the Fed will be wary of cutting interest rates too soon even if current inflation continues to normalize.

The ECB should stay on hold again as monetary policy bites. In the upcoming Governing Council meeting on 14 December, expectations are set for the ECB to maintain the status quo, holding the deposit rate at a historically high 4.0% (MLF: 4.75%, MRO: 4.5%). This decision comes in light of the apparent progress in the disinflation process and underwhelming economic activity, where risks are increasingly skewed to the downside. Notably, November saw a decline in the inflation rate to 2.4% y/y (core 3.6%), falling short of expectations from both market participants and the ECB. Remarkably, the monthly change in core inflation decreased by -0.2% m/m, a record low outside of the pandemic year 2020 (Figure 10-11).

All eyes will be on the new staff projections. Given weaker inflation prints and lower oil prices, the ECB staff will likely revise their 2024 headline inflation forecast down from 3.2% to 2.9%, while maintaining 2025 at 2.1% and introducing 2026 at 2.0%. Albeit lower, these projections are still higher than market expectations (Bloomberg survey 2.7% in 2024). Staff projections will therefore serve not only as predictions but also as a communication tool to push back against aggressive market expectations, which anticipate roughly five rate cuts in 2024, totaling 125bps, with the first cut already priced for March.

Our expectations are comparatively more hawkish as we do not expect a severe recession in the Eurozone. We anticipate the ECB's first rate cut in July 2024, following the Federal Reserve's expected cut in June. This timing is based on the assumption that after a brief inflation spike in Q1 2024 due to unfavorable base effects, both headline and core inflation rates will near the ECB's target by then. The ECB is cautious about premature rate cuts, considering factors such as high nominal wage growth, the potential for a depreciating euro leading to imported inflation and lessons learned from previous delays in addressing inflation. Therefore, we foresee only two consecutive cuts totaling 50bps in July and September, followed by a pause thereafter as economic activity rebounds in the second half of 2024.

The ECB is unlikely to announce an expedited exit from PEPP (Pandemic Emergency Purchase Program) reinvestments, but will rather defer this discussion to Q1 2023. However, as rate cuts approach, the ECB faces a narrowing window in order not to mix hawkish and dovish policy at the same time. ECB president Lagarde said last week that PEPP reinvestments might be up for discussion in the "not-too-distant future". Currently the ECB has stopped reinvesting proceeds from its APP program (EUR3trn remaining, average run-off 30b per month) but previously indicated it would keep reinvesting the proceeds of its PEPP program until the end of 2024 (EUR1.7trn remaining).

Figure 10: Inflation and components (y/y)

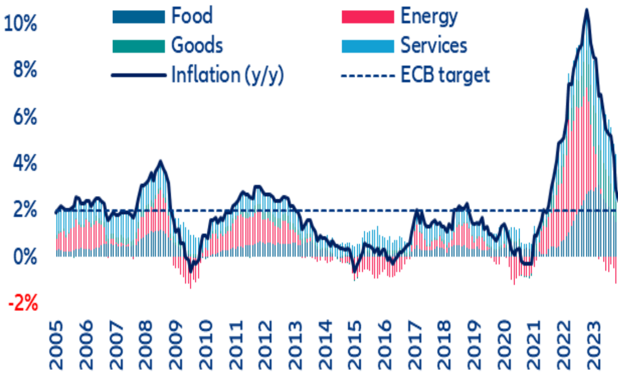
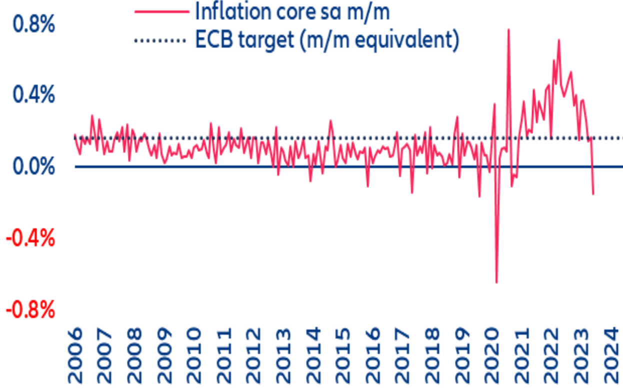


Figure 11: Sequential core inflation (m/m)



Sources: Refinitiv, Allianz Research

The Bank of England is likely to be the last major central bank to start cutting interest rates as inflation in the UK is stickier than elsewhere. Inflation moderated more than expected in October – to 4.6% from 6.7% in September – but 70% of this is due to energy and food. Core inflation fell by -0.3pp to 5.7% against 4% in the US (Figure 12). Household inflation expectations in the next 12 months stand above 4%. Wage growth, which still runs above 8%, in services and manufacturing, will remain high, given that job vacancies remain 30% above trend and that the number of people available for work but not looking for jobs remains at a high 7mn. We also expect the minimum wage to be raised further in 2024 by close to +10%, which will continue to keep services inflation high. Overall, we expect wage growth at +8.3% in 2023, followed by +5.4% and +3.3% in 2024 and 2025. Total real wage growth turned positive since June, and even since last April in the services sector. While the BoE did not increase interest rates to 6% as suggested by the level of inflation, it will probably keep them at 5.25% until September 2024 and cut them to 4% by end-2025.

The transmission of monetary policy will continue until mid-2024 but a recession will be avoided. The bulk of outstanding mortgages are fixed for either two or five years and businesses are generally hedged across a similar period. This has slowed the rise in effective average interest rates charged on the outstanding stock of debt. As these fixed rates come to an end, consumers and businesses will find spending budgets coming under pressure, mainly starting in 2025. Some of the pressures will be absorbed by still resilient corporate earnings and by cash holdings, which stand at 20% above pre-pandemic for households and more than 30% for corporates. Hence, we believe the UK will avoid a recession but growth will remain weak at +0.6% in 2024 and +1.5% in 2025.

Figure 12: CPI dashboard, %

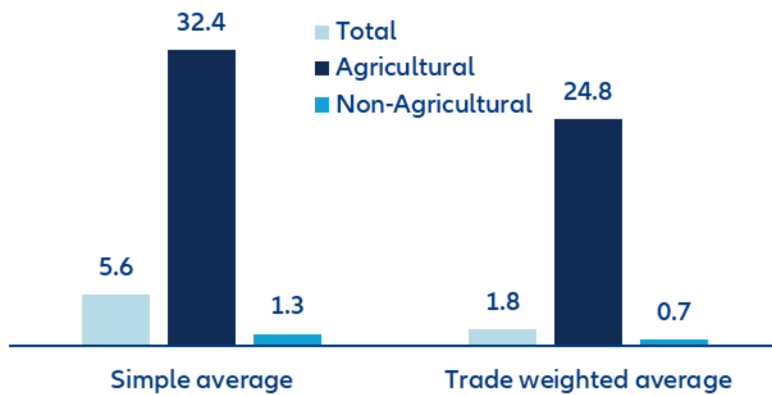
	Jan-21	Feb-21	Oct-22	Nov-22	Dec-22	Jan-23	Feb-23	Mar-23	Apr-23	May-23	Jun-23	Jul-23	Aug-23	Sep-23	Oct-23
Total CPI	0.7	0.4	11.1	10.7	10.5	10.1	10.4	10.1	8.7	8.7	7.9	6.8	6.7	6.7	4.6
Food, alcoholic beverages & tobacco	0.4	0.3	13.1	12.7	12.8	13.7	14.8	15.5	16.4	15.9	15.2	13.4	12.8	11.9	10.3
1 - Food and non-alcoholic beverages	-0.7	-0.6	16.2	16.4	16.8	16.7	18.0	19.1	19.0	18.3	17.3	14.8	13.6	12.1	10.1
2.1 - Alcoholic beverages	0.3	-0.2	4.0	4.1	3.5	5.8	5.7	5.9	7.0	6.9	6.7	6.9	9.2	10.5	10.0
2.2 - Tobacco	5.9	5.7	8.3	4.0	3.9	4.5	5.7	4.7	11.0	11.5	11.6	11.8	11.8	11.9	12.1
Energy	-8.3	-5.9	59.0	55.6	52.8	51.2	49.0	40.5	10.8	8.4	3.2	-7.8	-3.2	-0.2	-15.7
7.2.2 - Fuels and lubricants	-8.2	-3.5	22.2	17.2	11.5	7.7	4.6	-5.9	-8.9	-13.1	-22.7	-24.9	-16.4	-9.7	-7.6
4.5.1 - Electricity	-3.1	-3.1	65.7	65.4	65.4	66.7	66.7	66.7	17.3	17.3	17.3	6.7	6.7	6.7	-15.6
4.5.2 - Gas	-15.4	-15.4	128.9	128.9	128.9	129.4	129.4	129.4	36.2	36.2	36.2	1.7	1.7	1.7	-31.0
Core CPI	1.4	0.9	6.5	6.3	6.3	5.8	6.2	6.2	6.8	7.1	6.9	6.9	6.2	6.1	5.7
Goods	-0.2	-0.5	14.8	14.0	13.4	13.3	13.4	12.8	10.0	9.7	8.5	6.1	6.3	6.2	2.9
Non energy industrial goods	1.2	0.2	6.7	6.3	5.8	5.6	5.7	5.7	6.6	6.8	6.4	5.9	5.2	4.7	4.3
Cars (new)	5.7	4.1	1.8	0.5	0.3	-0.7	0.1	0.6	3.4	4.2	4.3	3.0	1.5	0.9	-0.5
Clothing and footwear	-3.4	-5.7	8.5	7.5	6.5	6.2	8.1	7.2	6.8	7.1	7.2	6.6	7.0	6.9	6.2
Games, toys and hobbies	8.4	7.4	1.5	-0.5	-4.8	2.8	0.3	1.2	2.0	4.6	5.1	2.6	3.4	5.2	4.8
Services	1.7	1.5	6.3	6.3	6.8	6.0	6.6	6.6	6.9	7.4	7.2	7.4	6.8	6.9	6.6
Non-core services	3.2	2.8	6.6	6.1	7.8	6.7	7.1	7.7	7.1	8.6	8.2	8.8	7.0	7.2	7.2
Transport services	6.7	5.5	10.0	8.1	14.2	5.5	5.9	7.6	4.6	9.3	8.7	10.8	7.2	6.5	5.4
Education	2.1	2.1	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	3.2	4.1	4.5
Package holidays	0.7	0.4	10.2	10.4	10.5	10.8	11.6	11.9	12.7	13.1	12.5	12.4	10.5	10.7	11.2
Core goods	0.5	0.1	2.9	2.7	2.4	2.1	2.1	2.1	2.6	2.6	2.5	2.4	2.0	1.9	1.6
Core services	1.2	1.0	5.3	5.4	5.6	4.8	5.3	5.2	5.6	5.9	5.7	5.8	5.5	5.6	5.3

Sources: ONS, Allianz Research

Switzerland becomes one of the most open economies in the world

By reducing industrial import tariffs unilaterally to zero, the Swiss economy will join the club of economies with the lowest tariffs worldwide, alongside Hong Kong, Kiribati, Macao and Singapore. Switzerland is widely recognized for its high average cost of goods and services compared to neighboring countries, partly the result of both tariff and non-tariff trade barriers that effectively isolate the Swiss market, allowing companies to charge higher prices. But from 01 January 2024, as part of a series of import-facilitation measures, Switzerland will unilaterally abolish import duties on nearly all industrial goods (excluding a few specific agricultural products, such as albumin, dextrin and acid oils). As a result, the compliance and import procedures for these products will become less complex and time-consuming, reducing costs for businesses and consumers. Special procedures such as temporary importation or inward-processing relief may no longer be necessary, and the number of Swiss tariff lines will be reduced. It is worth noting that tariff rates vary significantly across different product categories. Agricultural goods tend to have higher tariffs on average, while non-agricultural products already have relatively low tariffs on average (Figure 13). However, this measure will still have a significant impact on Swiss imports since agriculture goods only account for 4.7% (USD15.1bn) of total imports, while non-agricultural products make up 95.3% (USD309.3bn) of Swiss imports.

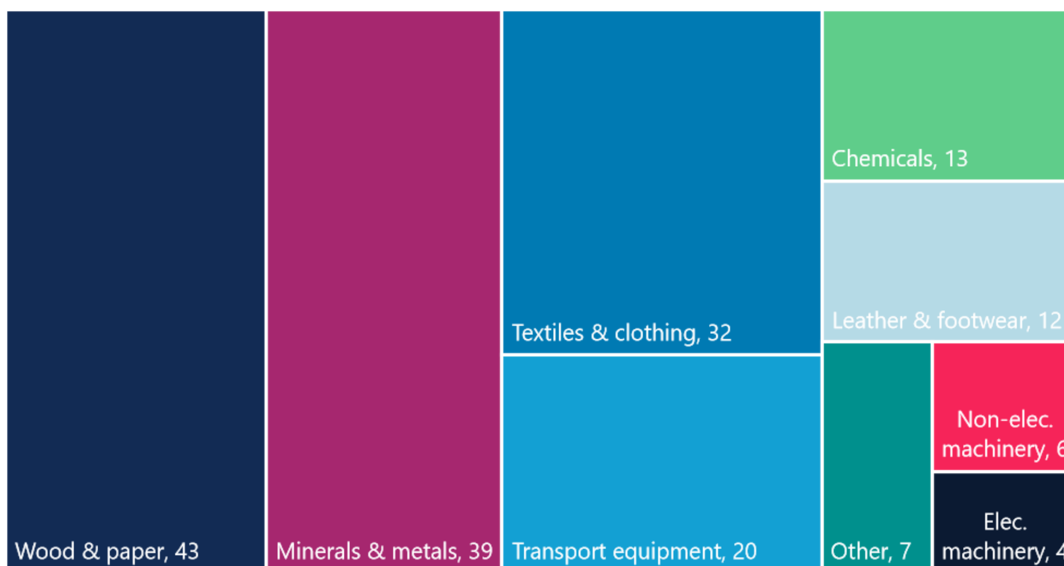
Figure 13: Tariff profile 2022, in %



Sources: WTO, Allianz Research

Overall import gains due to reduced tariffs amount to 12.3% or USD38.2bn per year. Besides reducing costs due to elimination of tariffs, companies are expected to also save costs through less burdensome import clearance. However, some red tape will remain for companies that operate within free-trade agreement (FTA) schemes. Going forward, proof of origin is not required for goods that remain or are consumed in Switzerland with a zero-tariff rate. But preferential proofs will still be needed for re-exported or unchanged goods to benefit from origin rules in other countries. As a result, firms will need to be aware of how and where their goods are used further in the supply chain. Eliminating the industrial tariffs could bring Switzerland import gains of approximately USD38.2bn or 12.3% per annum on average. Wood & paper, minerals & metals and transport equipment would benefit the most in percentage terms (Figure 14). This increases the competitive advantage of Swiss companies in manufacturing and assembling on the global stage. Further, the State Secretariat of Economic Affairs (SECO)[4] estimates welfare gains of approximately CHF860mn annually, CHF510mn of which are directly associated with the tariff elimination. Tariff reductions could bring an annual saving of around CHF350mn for Swiss consumers. Yet, the gains compare to a loss of -CHF555mn or -0.7% in federal revenue. With customs duties eliminated and the associated administrative procedures simplified, companies in Switzerland benefit from cheaper inputs and thereby also from lower production costs.

Figure 14: Import gains from tariff abolition, in % per annum



Sources: WTO IDB, CEPII, UNComtrade, Allianz Research; Note: The baseline is 2022.

[4] *The studies underlying this can be found here: Abolition of industrial tariffs (admin.ch).*

These assessments are, as always, subject to the disclaimer provided below.

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