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EcoFlash

The Fed is heading for an extended pause, unlike the Bank of Japan

The FOMC decided to keep interest rates steady at 3.5% – 3.75% at its 27–28 January meeting, following three consecutive rate cuts at the end of 2025. Solid economic growth and easing concerns about employment prompted this decision, and we now expect the Fed Funds target range to remain stable throughout 2026, with no interference from the question of Chair Jerome Powell's replacement. As such, the Fed would join the ECB in maintaining the status quo. The Bank of Japan and the Bank of England would continue to be exceptions: the former by raising rates and the latter by continuing its gradual easing.

A widely expected rate decision

The outcome of the FOMC's first meeting of 2026 was no surprise, with a 98% market probability that the target range would remain at 3.5% – 3.75%. Two governors, Christopher Waller and Stephan Miran, dissented and voted in favour of a 25bp cut. In December, Fed Chair Jerome Powell had mentioned that monetary policy was 'well positioned', and the GDP, employment and inflation data released since then did not suggest that further action would be needed.

BNP Paribas scenario: rebalancing completed

The cycle of rate cuts restarted in September 2025 (-75bps in total) intended to bring monetary policy closer to neutrality in the face of increasing risks surrounding the "maximum employment" component of the Fed's dual mandate. However, **US growth remains dynamic, as it is expected to reach +2.9% in 2026** (after +2.3% in 2025) thanks to resilient domestic demand (consumption and non-residential investment), **which would mark the fourth consecutive year of above-potential growth**. While the issue of "K-shaped growth" or "jobless growth" will likely remain a major theme in the US economy in 2026–2027, this is outside the Fed's scope of competence in the absence of a move away from full employment.

For this reason, the decline in private payroll growth in 2025 (+61k monthly average, vs. to +130k in 2024) must be viewed within the context of the slowdown in supply and the relative stability of layoffs (1.7 million per month in 2025[1] as in 2024) and in the unemployment rate, which is mitigating concerns. **The FOMC statement removed the reference to a recent rise in 'downside risks to employment'**, while the rate cuts at the end of 2025 have not yet taken effect. Furthermore, while **Jerome Powell does not expect second-round effects from tariffs on price levels**, the actual and expected persistence of inflation above target (we anticipate an average CPI of +2.7% in 2026, stable compared to 2025) is reducing the likelihood of rate cuts. **These developments, combined with Powell's optimism about future progress on both components of the dual mandate, point to stability in the Fed Funds target throughout 2026, at 3.5% – 3.75%.**

Heads down in the data

After breaking his silence on the criminal investigation conducted by the Department of Justice against him, Jerome Powell resumed his usual stance. He declined to comment further on the grand jury subpoenas, did not indicate whether he would remain on the Board of Governors beyond May 2026[2] and did not answer on Trump v. Cook. The data led the Fed to pause, an approach expected to last beyond Powell's term as chair. However, Powell **defended the Fed's independence**, saying that his colleagues, who will remain beyond May, are clearly committed to it.

Central banks: the Japanese exception

The Fed and the ECB are expected to keep their rates unchanged in 2026. The improvement in the Eurozone's growth outlook points to a stable deposit rate in 2026. The **Bank of England** (BoE), meanwhile, **has not concluded its easing cycle** and is expected to cut its key rate by 25bp (to 3.5%) in H1 2026 due to lower inflationary pressure and weak growth momentum. By contrast, the **Bank of Japan (BoJ) is moving towards accelerating the '*adjustment of the degree of accommodation*' of its monetary policy**. The prospects of a more expansionary fiscal policy following the February snap general election, the resulting amplification of the bond sell-off, and movements around the USD/JPY are among the risks, for inflation in particular. Under these conditions, the BoJ would move faster (one rate cut per quarter in Q2 and Q3) and further (moving towards a key rate of 2% at the end of 2027), according to our scenario.

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[1] Monthly average between January and November

[2] Jerome Powell's mandate as Chair of the Fed ends in May 2026, but his mandate as a member of the Board of Governors runs until January. Under unwritten tradition, chairs leave all of their positions within the central bank when finishing up as chair, but there is no certainty over what Jerome Powell will do.