Research Institute - Insight

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#Europe / #Insight / #Monetary policy

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BoE wants to pause; ECB isn't done yet

Both the European Central Bank and Bank of England hiked by 50bps today. But they gave different steers about the direction of policy from here.

Key takeaways

- The European Central Bank (ECB) and the Bank of England (BoE) both raised interest rates by 50 basis points today, to 2.5% and 4% respectively. This was in line with market pricing.
- Both central banks expect headline inflation in their jurisdictions to come down sharply this year. But they remain concerned about persistent core price pressures above the inflation target.
- Nevertheless, there was a notable difference in communication about the outlook for monetary policy from here.
- The ECB all but pre-committed itself to another 50 basis point (bps) hike at its March meeting, although declined to give much guidance beyond that point. Language about "staying the course" suggests the ECB remains in regaining-inflation-credibility mode. We are expecting further rate hikes in March and May, but then rate cuts by year-end.
- By contrast, changes to the BoE's language suggest it thinks policy rates may now have peaked. We suspect the BoE may be underestimating near-term core inflation pressures from the labour market, so still expect some further hiking. But we then think a cutting cycle will begin in late-2023.

ECB "staying the course", hiking 50bps and intending to do more

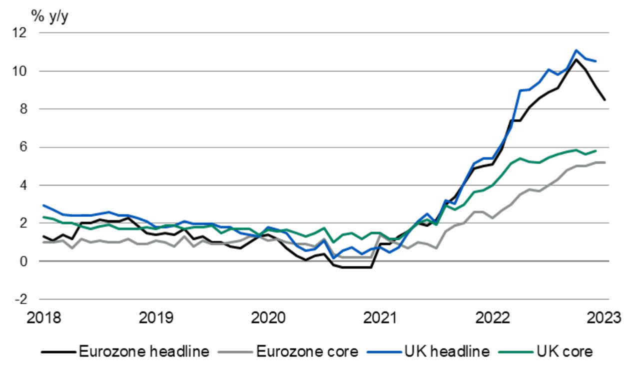
The 50 (bps) rate hike was in line with market pricing. More interesting was the explicit forward guidance on the future path of policy.

In particular, the monetary policy decision states that "the Governing Council intends to raise interest rates by another 50 basis points at its next monetary policy meeting in March".

Lagarde muddied the strength of that pre-commitment a little at the press conference, and it's also notable that there is no guidance for meetings further out. The initial reaction in financial markets latched onto those aspects of the announcements. But we thinkthe ECB is still very much in regaining-inflation-targeting-credibility mode.

That's especially important in the Eurozone given that core price pressures remain elevated (see Figure 1). Moreover, with economic activity holding up better over the winter, more of the work of bringing down underlying inflation has to be done by the central bank.

Figure 1: Inflation is well above target in both the Eurozone and the UK



Source: Haver, abrdn, February 2023

Quantitative tightening details reveal how the ECB balance sheet will incorporate climate considerations

We also got some more details on how quantitative tightening (QT) will operate. The ECB will reduce its balance sheet by €15bn per month from March until June, and then decide on the pace of further run-off thereafter.

This is about half the pace at which the portfolio is maturing naturally. This means partial reinvestments will continue, broadly in line with the current arrangements.

However, importantly, reinvestments of maturing corporate bonds will now be tilted “towards issuers with a better climate performance”. This small detail could end up being the most consequential part of the decision today, because it’s the first concrete step in using the ECB balance sheet to further climate objectives – something we have spoken about in the past.

BoE hikes 50bps. But new forecasts suggest “inflation has turned the corner”

In the UK, the 50bps increase, taking Bank Rate to 4.0%, was also in line with market pricing.

The Bank’s growth forecasts were revised up and its inflation forecasts revised down.

The forecasts still incorporate a recession this year, but the peak-to-trough decline is now 1% rather than the early 3%. This reflects a smaller real income drag from lower energy prices, looser financial conditions, and the ongoing strength of the labour market. The Bank also now thinks that more of the rebalancing of the labour market can occur through lower hours worked and a fall in job openings, rather than via rising unemployment.

Headline inflation is expected to drop sharply, falling below 2% by spring 2024. This is in large part driven by lower energy inflation. Core inflation is also expected to decline amid easing global supply chains pushing down on global goods price inflation, and the opening up of an output gap during the UK recession.

That said, the Bank was clear that the risks around its inflation forecasts were strongly skewed to the upside. In particular, the poor supply side performance of the UK economy is a big concern which could make core inflation generated by the labour market sticky.

Language changes suggest BoE thinks rate hikes might be finished

There were two important changes to the BoE’s rhetoric, which point in a dovish direction.

First, the forward guidance on interest rates now reads “if there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required”. This is much more conditional than the previous “should the economy evolve broadly in line with the November Monetary Policy Report projections, further increases in Bank Rate may be required”.

Put another way, the BoE’s default expectation has moved from doing more hikes, to keeping interest rates at this level.

And second, the monetary policy summary dropped the phrase “further forceful monetary policy response”. At the press conference, Governor Bailey did little to dispel the impression that the BoE thought it was done with rate hikes in its central case – although was very clear about the risk scenario of persistent core inflation necessitating further hikes.

Our ECB and BoE forecasts see further hikes followed by rate cuts

Our near-term forecasts are that the ECB will hike by 50bps in March and then by 25bps in May amid still high core inflation. We will think carefully about our call that the BoE will still be hiking in March and May as well, but for now stick with it. However, we expect both central banks to be in easing mode by the end of 2023 amid much lower inflation and recession, with rate cuts above and beyond those priced into markets.

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