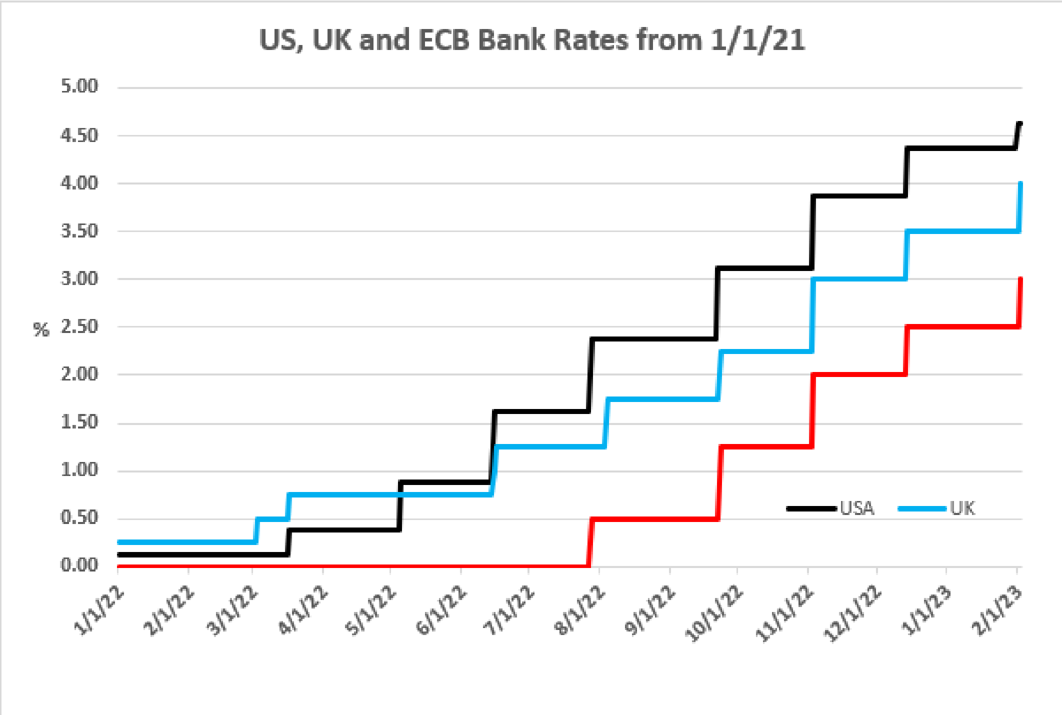
February begins with bank rate rises

Synopsis: The Federal Reserve, Bank of England and European Central Bank have all increased interest rates, to nobody's surprise.

Date published: 02.02.2023



On Wednesday, the US Federal Reserve increased its Fed fund rates by 0.25% to 4.50%-4.75%, its eighth consecutive rise, albeit much smaller than the 0.75% hikes seen in the middle of last year. The following day saw the Bank of England adding 0.5% to its bank (base) rate, taking it up to 4.0% and the European Central Bank making the same increase to its main refinancing rate, taking that up to 3.00% (and its deposit rate by the same 0.5%, to 2.50%).

All the moves had been widely anticipated, which meant the main attention was not the numbers but the accompanying statements and press conferences. What the markets are trying to discern is when each central bank's pivot will occur, i.e. the point at which rates stop rising and start to head downwards.

The Fed's formal statement played a straight bat, repeating its line from the two previous statements...

'The Committee anticipates that ongoing increases in the target range will be appropriate in order to attain a stance of monetary policy that is sufficiently restrictive to return inflation to 2 percent over time. In determining the extent of future increases in the target range, the Committee will take into account the cumulative tightening of monetary policy, the lags with which monetary policy affects economic activity and inflation, and economic and financial developments'.

At the post-announcement press conference, Jerome Powell, the Fed Chair, was pressured on how much further rates might rise and whether the recent buoyancy in the US markets was working against the Fed's tightening objectives. Powell said enough to encourage the markets in its belief that rates may top out around 5% and then start to drop later in 2023.

However, Powell does not agree, saying *"...given our outlook, I just I don't see us cutting rates this year."* The market's judgement of that opinion can be seen in Wednesday's 0.1% fall in the yield on the two-year Treasury bond, which is particularly sensitive to short-term rates.

The Bank of England's statement was also perceived as a sign that rates might be peaking. In December, the Bank said...

'The majority of the Committee judges that, should the economy evolve broadly in line with the November Monetary Policy Report projections, further increases in Bank Rate may be required for a sustainable return of inflation to target.'

In February, the tone had changed...

'The MPC will continue to monitor closely indications of persistent inflationary pressures, including the tightness of labour market conditions and the behaviour of wage growth and services inflation. If there were to be evidence of more persistent pressures, then further tightening in monetary policy would be required.'

The Bank revised its forecasts from the gloomy vision in the November Monetary Policy Report. It now sees inflation at around 4% by the year end, 1% lower than its November projection and easily satisfying the Prime Minister's and Chancellor's pledges of halved inflation. By Q2 2024 the Bank says inflation will be below 2%, although it notes there are risks from the labour market, keeping up domestic inflation.

In terms of growth, the Bank now expects the UK economy to contract by 0.5% in 2023, an improvement from November's 1.5% shrinkage and in line with the recent -0.6% figure from the IMF.

While the ECB matched the Bank of England's 0.5% rate rise, it was more aggressive on future rate increases...

'The Governing Council will stay the course in raising interest rates significantly at a steady pace and in keeping them at levels that are sufficiently restrictive to ensure a timely return of inflation to its 2% medium-term target. Accordingly, the Governing Council today decided to raise the three key ECB interest rates by 50 basis points and it expects to raise them further. In view of the underlying inflation pressures, the Governing Council intends to raise interest rates by another 50 basis points at its next monetary policy meeting in March and it will then evaluate the subsequent path of its monetary policy.'

That is about as clear as short term forward guidance can be. To add to the monetary squeeze, the ECB also set out its plans to start quantitative tightening from next month, initially shrinking its QE-acquired bond portfolio of about €5tn by €15bn a month.

Comment

After this trio of central bank meetings, the ECB has come out as the most hawkish and arguably the Bank of England has assumed the most dovish title, with the Fed somewhere nearer the Bank than the ECB. The next meeting of the Fed, on 21-22 March, will attract even more attention than usual. It will be the first of 2023 to include the infamous dot plot. Last December's showed the Fed's consensus was for interest rates to be at around 5.25% by the end of 2023. How far will that have moved when spring arrives?