

G4 central banks

ECB is first G4 central bank to hike interest rates

- **ECB hikes rates while policy is left unchanged at Fed and Bank of England.**
- **Oil prices, Japanese disaster, austerity and mixed economic data in Q1 make timing of next moves uncertain.**

ECB takes bold move

The European Central Bank has become the first of the G4 central banks to start normalising policy since rates were cut to record lows during the financial crisis, hiking its main policy rate by 25 basis points to 1.25%.

The move was expected, and priced into the financial markets, having been flagged up in advance by policymakers over the past month. We had indicated [back in January](#)¹ that the ECB was set to hike rates before the Bank of England, which is seen as the next to tighten policy, citing how the ECB has been bold in the past in adhering to its mandate of ensuring price stability for the region.

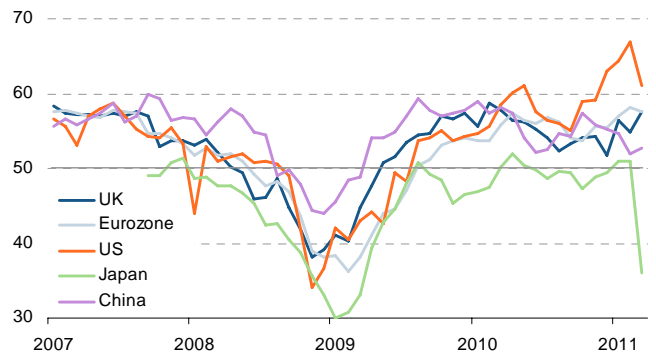
The Bank of England decided to hold rates at 0.5% at its April meeting, while US and Japanese policy rates were left unchanged at 0.25% and zero respectively. The US Fed and Bank of England also made no change to quantitative easing, although talk has recently turned towards the timing of loose policy withdrawal in both cases. The Bank of Japan is thus the only G4 central bank to come under pressure to *boost* stimulus and help lift the economy out of the crisis resulting from the earthquake of 11 March. A loan facility to help businesses struggling after the disaster has already been set up.

PMI survey data have provided a good guide to G4 policy rate changes in the past and, with the exception of Japan, have all moved into rate hike territory ([see charts](#)), highlighting the emphasis in much central bank rhetoric towards tighter monetary policy in recent weeks.

¹ http://www.markit.com/assets/en/docs/commentary/markit-economics/2011/jan/European_rates_11_01_14.pdf

Manufacturing and Services PMIs

PMI Output Index (manufacturing & services)

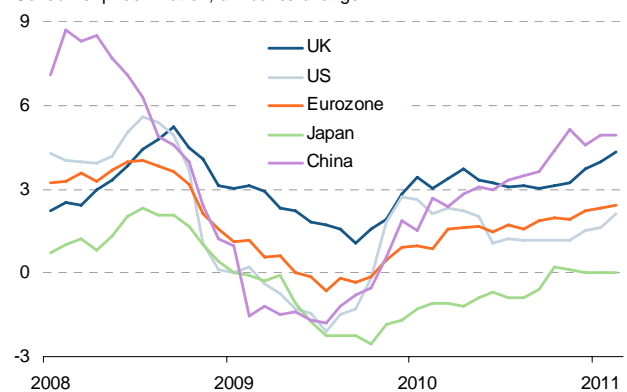


Sources: Markit; ISM.

Strong economic growth, as signalled by the PMIs for the US, Eurozone and the UK (the surveys are consistent with GDP growth of 1.2% for the US and 0.8% for the UK and Eurozone) add to the risk that current high consumer price inflation could rise further if 'second round' price pressures develop, whereby employees negotiate higher pay rates and firms pass rising costs on to customers.

Consumer price inflation

Consumer price inflation, annual % change



Lack of certainty regarding future hikes

While the combination of PMI and consumer price inflation data point to the need for policy tightening in the US and UK, the case is by no means clear-cut. Similarly, the ECB stressed that it had not decided whether the 25bp increase in rates during April was necessarily the first in a series of hikes, reflecting the

uncertain outlook for growth and inflation. Oil prices, the Japan earthquake and deficit-fighting austerity measures all pose risks to growth.

Oil

One of the key concerns affecting all countries is the rising price of oil, which hit a new post-recession high this week (and reached a record high in sterling terms), as unrest in the Middle East led to ongoing worries about supply.

High oil prices will of course drive inflation higher and increase the need to raise interest rates (and was the main reason why the ECB hiked rates in 2008). However, looking further ahead, high oil prices have a tendency to cause recessions (see chart), and also deter firms from taking on staff as they seek to boost labour productivity to offset. While unemployment rates are high, this further diminishes the scope for oil prices to feed through to second round inflation effects.

Japan

The earthquake in Japan on 11 March resulted in a huge hit to business activity. The impact is likely to be felt for some time to come, not just in Japan but in other countries as supply chains are disrupted. The uncertainty resulting from the earthquake was acknowledged by ECB President Trichet, who also referred to the sharp drop in the JPMorgan Global PMI, and it is therefore likely that the disaster will add to caution in terms of tightening policy.

Austerity and budget deficits

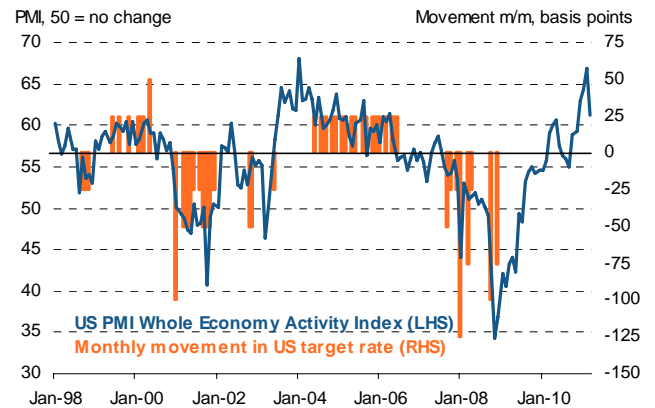
There is growing evidence to suggest that deficit-fighting public sector austerity measures are having a negative effect on domestic demand in the UK and the Eurozone periphery. The latter is also dogged by the ongoing financial crisis, with Portugal joining Ireland and Greece in requiring bail-out assistance to fund its deficit. Spain is the next worry and PMI data indicate that the country could be sliding back into recession, which will put further pressure on the deficit.

Similarly, the UK, having contracted in the final quarter of 2010, has seen a mixed bag of economic data so far. Official data have been providing worrying signs of high street distress and a stalling of the manufacturing sector.

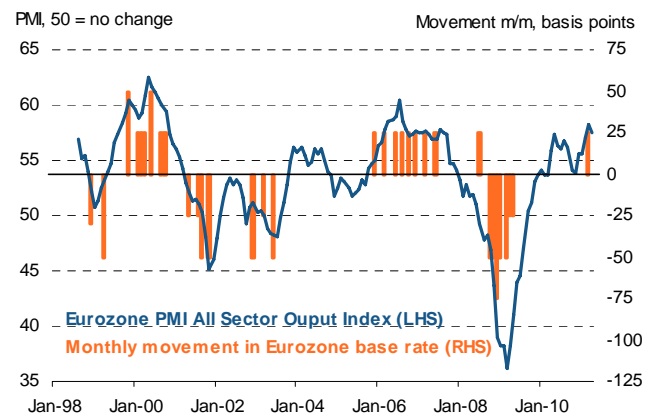
In the US, there is growing recognition of the need to eventually tackle the rising budget deficit, and fiscal

tightening will affect the timing of monetary policy normalisation.

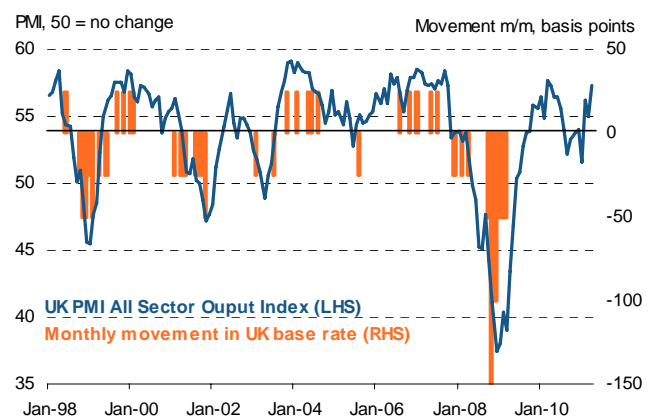
US all sector PMI and policy rate changes



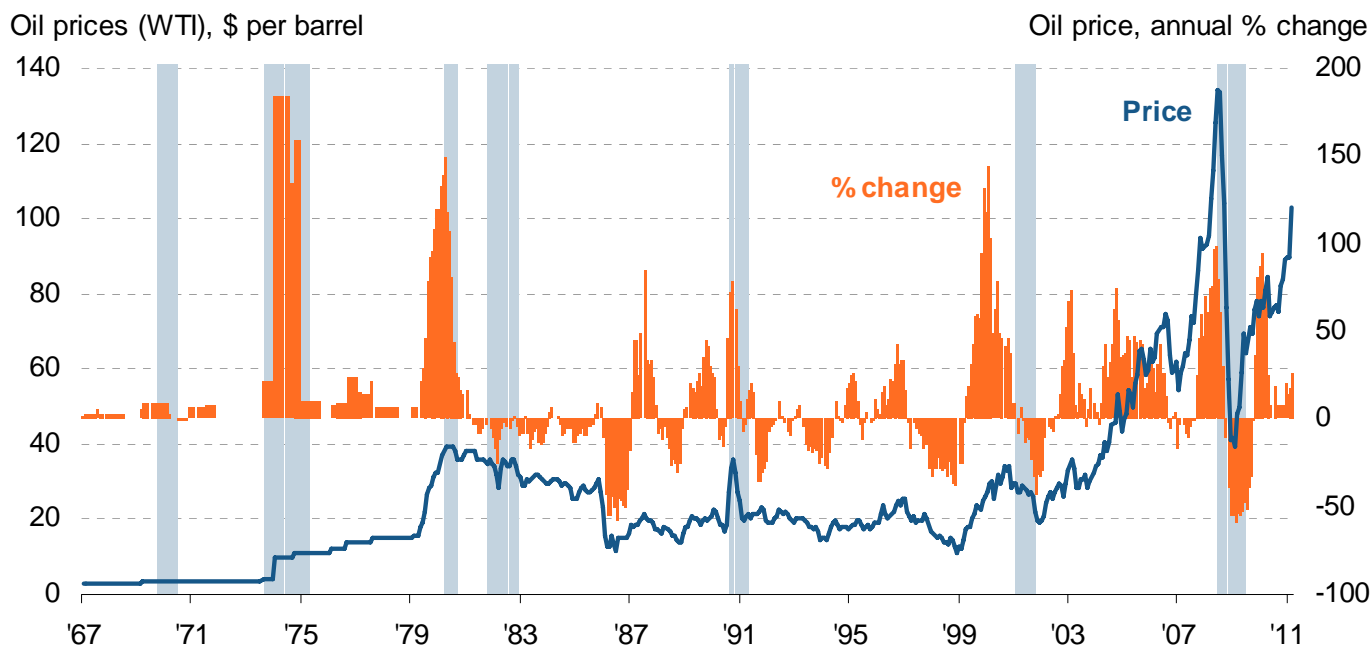
Eurozone all sector PMI and policy rate changes



UK all sector PMI and policy rate changes



Oil prices and US recessions (shaded areas depict recessions)



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