

# Central banks

## ECB flags-up rate hike in July while US and UK rates remain on hold

- **ECB flags-up July rate hike to 1.5%.**
- **Fed shows little interest in QE3, holds rates at 0.25%.**
- **Bank of England holds rates at 0.5%.**

The US Federal Reserve, the Bank of England and the European Central Bank all left policy unchanged at their May meetings, as anticipated by most analysts. However, the ECB looks set to hike rates again in July, and many in the financial markets were disappointed by US Federal Reserve Chairman Bernanke showing no support for further quantitative easing.

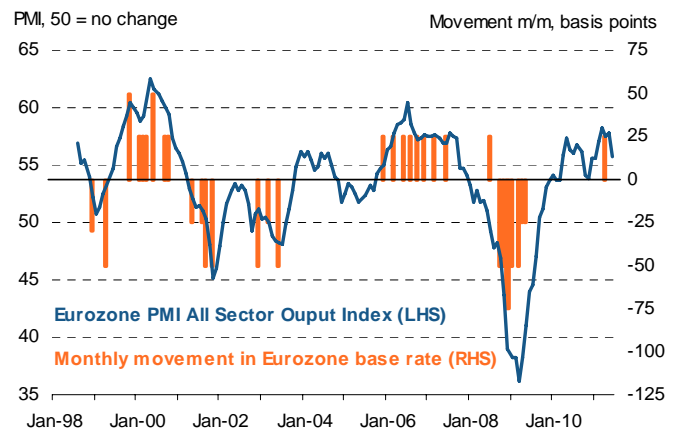
The future direction of rates in all three cases depends on whether the current soft patch in economic growth proves transitory or not.

### Eurozone rates set to rise again in July

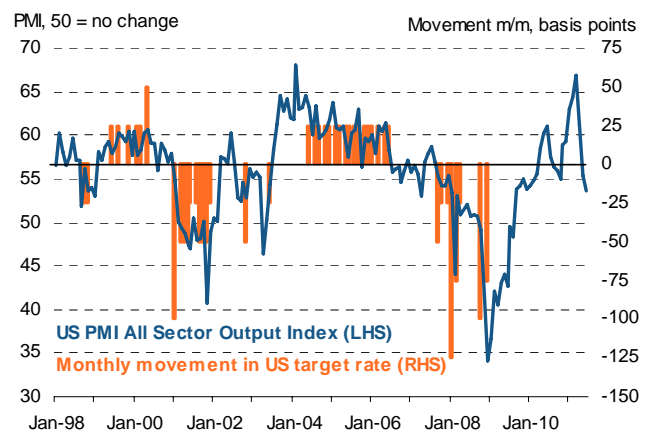
The **European Central Bank** held rates steady at 1.25%, choosing again not to follow up on April's 25bp (basis point) hike. However, President Trichet noted that 'strong vigilance is warranted' in relation to the build up of inflationary pressures. While the ECB does not pre-commit to rate changes, the choice of words is a recognised signal for rates to hike at the July meeting.

Higher interest rates in the Eurozone look justified. First, headline inflation in the single currency area was running at 2.7% in May, above the ECB's target of just under 2.0%. The ECB staff projection for inflation this year was also raised to 2.6%. Second, economic growth remains relatively strong – the mid point of the staff projection is for 1.9% growth this year - and has shown resilience in the second quarter so far. The Markit Eurozone PMI™ moved down to a five-month low in May but remains at a level that has historically been consistent with policy tightening. Importantly, growth in core countries such as France and Germany is running above trend. This is especially the case in the latter, where GDP rose at a quarterly rate of 1.5% in the first quarter and unemployment has reached a post-unification low. Such growth raises the risk that

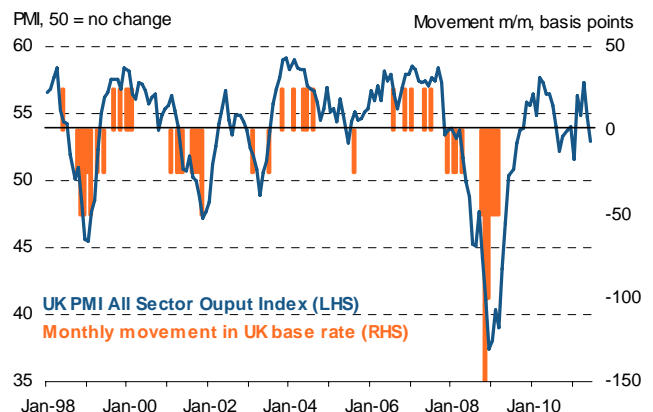
**Eurozone all sector PMI™ and policy rate changes**



**US all sector PMI™ and policy rate changes**



**UK all sector PMI™ and policy rate changes**



second-round inflationary effects may take hold, with wages being negotiated up in line with high inflation.

Although noting that the euro area economic recovery retains momentum, Trichet stresses that “uncertainty remains elevated” in relation to the economic outlook. Such uncertainty puts question marks over the possibility of further hikes beyond July and suggests that much depends on whether the current slowdown in growth is transitory or proves more entrenched.

### Fed shows little interest in QE3

The **US Federal Reserve** held its policy rate at 0.25%, as expected. However, in the US, the talk has moved away from the timing of the next hike in interest rates to the possibility of further stimulus being required. Economists were uncertain as to whether the Fed recognised any need for further quantitative easing (“QE3”), given the recent weakness of economic data and the ending of the Fed’s \$600bn bond purchasing programme (“QE2”) in June.

Although US inflation rose to 3.2% in May – its highest rate since October 2010 – recent economic data have disappointed and the risks of second-round inflation effects taking hold look far lower than in Germany, for example. US employment growth fell sharply in May, and PMI business surveys from the ISM have fallen out of rate-hike territory. The consumer sector seems especially subdued, with the downbeat mood reflecting the shaky housing market and persistent high unemployment. Domestic demand has acted as a key drag on growth as a result. The data suggest that there is little scope for economic growth to improve on the meagre 1.8% annualised rate seen in the first quarter.

Chairman Ben Bernanke sees the current weak growth as transitory, however, and expects inflation to ease and economic growth to accelerate in the second half of the year. This latter belief is largely based on growth being weaker than anticipated in recent months due to supply chains having been disrupted by the Japanese earthquake and tsunami. More economic data are needed before the Fed’s path becomes clearer.

### Bank of England holds rates at 0.5%

The **Bank of England's** Monetary Policy Committee, meanwhile, chose to sit on its hands again, leaving interest rates unchanged at 0.5% in June. The lack of action was widely expected, especially with arch-hawk Andrew Sentance having left the committee and the

economic data having disappointed in the past few weeks.

The UK situation is similar to that of the US in many respects. The recent weakness of economic indicators such as the Markit/CIPS PMIs suggests that the recovery remains fragile, having lost momentum in the spring. Global economic growth has also weakened, hinting that the UK recovery could lose further momentum as export growth deteriorates. The PMI™ has in fact already fallen out of rate hike territory and, if further declines are seen in coming months, we could soon see the data move into levels that would have triggered rate cuts in the past.

The concern is that inflation has risen to 4.5%, and the Bank expects it to rise further to 5% before falling back again. However, given the existing sluggishness of domestic demand, it is difficult to see how higher interest rates will help bring the rate of inflation down. Official data showed the UK consumer sector to have slipped back into recession in the first quarter, and household confidence remains at worryingly low levels in the second quarter, having been hit by widespread job insecurity, falling real incomes and public spending cuts. The risk is therefore that raising interest rates at the moment would not bring inflation down, because it continues to be generated largely through influences which are out of the Bank’s control, and may damage the economic recovery through the effects on the housing market and appreciation of sterling.

The signs are that the current high level of inflation will prove transitory. Employee pay growth remains very weak, at just over 2% and, despite its recent rise, oil has fallen nearly 7% from its peak earlier in the year in sterling-terms, alongside similar falls in the prices for other key commodities such as metals.

The financial markets are not pricing in a UK rate hike until May of next year which – given the recent flow of data – seems a reasonable estimate of when the economy may be able to withstand a tightening of policy.



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