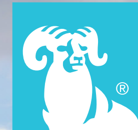
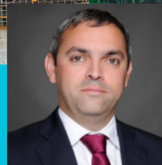


Central Banks Step Into Potential Policy Error Territory

Hawkish stances risk overtightening and causing recession.

July 2023



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Could we be entering the zone of a global monetary policy mistake? Recent hawkish stances taken by some major developed market central banks make this a valid question. There is now a meaningful risk that these central banks could overtighten in their quest to quell inflation and help push the global economy into recession as well as induce a financial market recession. China's central bank, on the other hand, may be making a different type of policy error by not easing policy enough to support the country's economy.

European Central Bank (ECB)

The ECB provided what is probably the most obvious recent example of an extremely hawkish position from a major central bank. At its June meeting, the ECB raised rates by 25 basis points (bp) and President Christine Lagarde said to expect another hike in July. Most significantly, it surprised the markets by raising its 2025 inflation forecast—consensus expectations had been for a decrease in the inflation outlook, so the increase sent a strong hawkish signal.

As a result of this revised forecast for higher inflation, we think the ECB could even hike again at its next meeting in September. However, like most central banks, the ECB does not have a strong track record for accurately predicting inflation, so there's a distinct possibility that inflation will be lower than forecast—resulting in overtightening of monetary policy.

Federal Reserve Bank (Fed)

Although the Fed kept rates steady at its June policy meeting following 10 consecutive increases totaling 500 bp, the Summary of Economic Projections (SEP) showed that policymakers expect to raise rates twice more in 2023. Fed Chair Jerome Powell underscored the Fed's seemingly muscular approach to taming inflation by declaring that rate cuts are unlikely for a couple of years. This may have been part of an effort to convince markets not to price in cuts this year, and it worked—futures contracts post-Fed meeting showed rate decreases starting in early 2024. However, Powell's comment about not expecting cuts until 2025 was at odds with the SEP's projections, which showed 100 bp of easing in 2024.

The Fed indicated that it will take into account the cumulative effects of policy tightening when determining how much more to raise rates, signaling that it is likely to take more time between hikes. But will that prove adequate to forestall a recession? The stickiness of core U.S. inflation and the Fed's focus on returning inflation to its 2% target could easily lead the Fed to move rates too high and be slow to cut when the economy enters recession.

Bank of England (BoE)

The BoE seemed to be on the right side of change when it became one of the first major developed market central banks to raise rates following the 2020 economic bounce back from the pandemic-induced recession. However, it then adopted

a "don't worry, inflation will come down" stance through much of 2022. As a result, it fell behind the curve in inflation fighting, and headline UK consumer price inflation spiked to well over 10%.

Now public sector workers in the UK are demanding massive pay increases, raising fears that a wage-price spiral may be setting in. In response, the BoE surprised markets with a larger-than-expected 50 bp hike to 5% at its June meeting, leading to expectations that its terminal rate for this cycle will be 6%. Mortgage rates could reach 8%, which would crush consumer spending in a country where fixed rate mortgages are rare. Pressured by this environment of still-hot inflation, the BoE could easily raise rates to a level that would push the economy into recession.

People's Bank of China (PBOC)

Of course, central bank policy errors can take different forms. Instead of raising rates too far, China may not be cutting them aggressively enough to sustain its economic growth.

The PBOC lowered its policy rate on one-year medium-term lending facility loans by a paltry 10 bp earlier in June, its first cut since August 2022. While it followed with minor cuts on the one- and five-year loan prime rates, China's economy is plainly faltering after a post-zero-COVID-policy bump, and it could have difficulty achieving even the relatively modest 5% annual growth target that the government set for 2023.

But China is an anomaly in a world of many developed-market central banks striving to contain inflation. By extending their hiking cycles amid sticky inflation, these central banks could be creating more economic pain down the line. In contrast, some emerging market central banks are successfully bringing inflation down after moving more quickly and meaningfully to raise rates. The central banks of countries such as Brazil are now considering rate cuts, leading us to question whether the local currency bonds of these nations are priced with an excessive risk premium—and whether developed market sovereigns have enough risk premium.

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