Who will be next in the race to hike rates?

Our answers to this month's big questions

Economic and Financial Analysis

25 July 2017

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The rate race is hotting up and here are the contenders....

Global Economics and Strategy Team

July 2017

The interest rate race
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Who's next in line to tighten monetary policy?

ING policy rate forecasts

Rate hike QE/balance sheet change

	2017	2018	2019
ECB	Oct/Dec 17 Tapering announced (Q)	Jan 18 Tapering begins (Q); Q4 First depo rate hike (Rate hike)	
Fed	Sept 17 Balance sheet unwind starts (Q); Dec 17 (Rate hike)	June 18 (Rate hike); Dec 18 (Rate hike)	
BoE			May 2019 (Rate hike)
BoJ	Potential changes to QE communications? (Q)		
BoC	Oct 17 (Rate hike)	April 18 (Rate hike); Oct 18 (Rate hike)	
RBA		Feb 18 (Rate hike); Aug 18 (Rate hike)	
RBNZ		Feb 18 (Rate hike); May 18 (Rate hike); Aug 18 (Rate hike)	
Riksbank		April 18 (Rate hike); Oct 18 (Rate hike)	
Norgesbank		Dec 18 (Rate hike)	

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Bank of Canada has fired the starting gun, but what's next?

Bank of Canada (BoC) takes a look forward

The BoC has hiked rates for the first time in seven years, despite all measures of inflation undershooting the target.

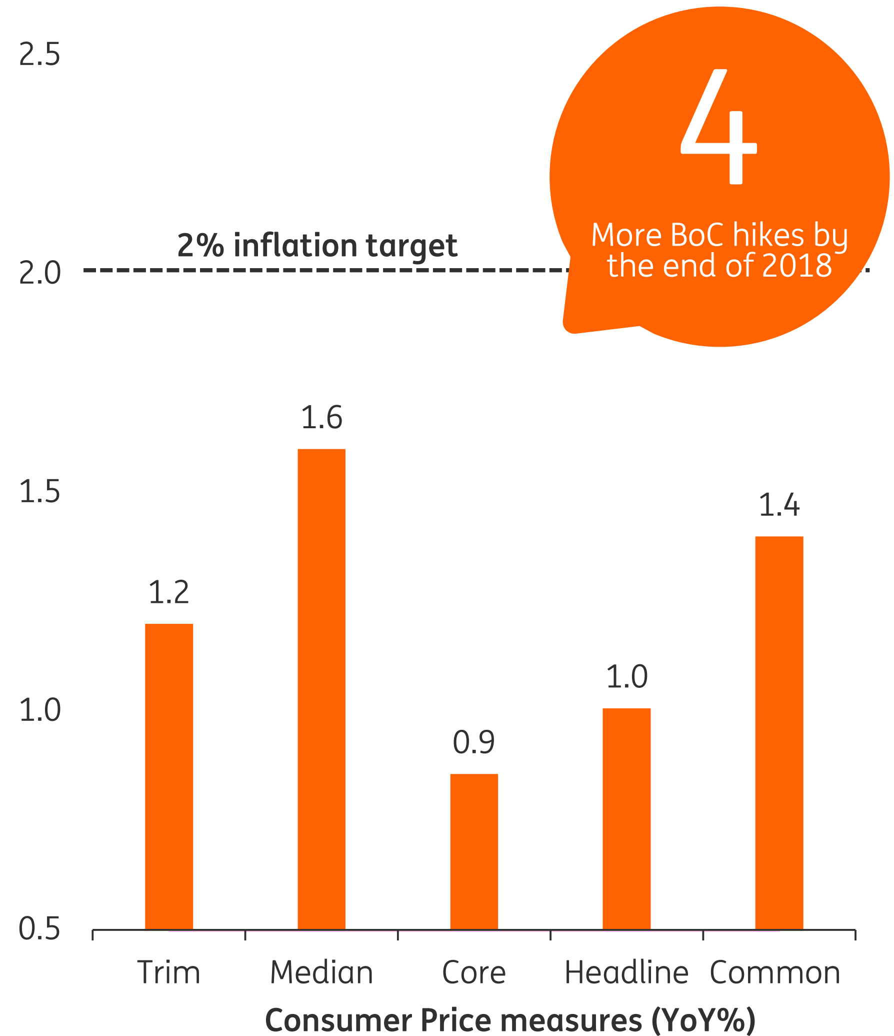
The Bank is taking a forward-looking approach to interest rates, anticipating a pick-up in inflation from the buoyant economy and labour market.

There's more to come…

We expect the BoC to continue the cycle with another rate hike this year. But the Bank will maintain some caution along the way:

High household debt - $1.67 per $1 of disposable income – and booming house prices present a fine balancing act.

There's also still plenty of uncertainty surrounding Trump's plans on NAFTA & trade.



Source: Macrobond

More voters need to be convinced about a UK rate hike

These are the movers and shakers at the Bank of England

The **"maybe later this year"** camp

Mark Carney
Governor

Sir Jon Cunliffe
Deputy Governor

Andy Haldane
Chief Economist

Silvana Tenreyro
External member NEW

Ian McCafferty
External member

Michael Saunders
External member

The **"immediate hike"** camp

Ben Broadbent
Deputy Governor

Gertjan Vlieghe
External member

The **"now is not the time"** camp

There's been a real hawkish shift at the Bank of England, but so far, only two (current) members have voted for a hike.

Andy Haldane seems to be coming around to the idea too although, like Carney, his decision to hike rates hinges on a pick-up in investment and wage growth.

We think that's unlikely at this stage - a view shared by Broadbent and Vlieghe.

Cunliffe tends to vote with the Governor, and Tenreyro is unlikely to rock the boat at her first few meetings.

So, whilst we may see 3 votes for a rate hike in August, the MPC as a whole still needs some convincing and we think they are unlikely to move this year.

Another poor 2Q GDP reading should also reduce the case for tighter interest rates

All images sourced from the Bank of England

The key to unlocking a UK rate hike is investment…

…and the signs aren't looking good at this stage

82%

of CFOs believe external financial and economic uncertainty facing their business is **above normal or high**

Source: Deloitte CFO survey

71%

of CEOs ranked uncertainty over UK's role in Europe as their top business concern

Source: CBI London Business Survey

64%

of businesses have **less, or the same** business confidence in as the last 12 months

Source: BCM

46%

of CEOs are concerned about the future of the Eurozone

Source: PWC 20th CEO survey

54%

of CEOs plans to maintain their current investment plans

Source: CBI Business Survey

US political headwinds mean a December Fed hike most likely

Balance sheet reduction could commence in September

President Trump has pinned his hopes of strong growth on meaningful tax cuts, but his defeat on healthcare & opposition against unfunded tax cuts from fiscal hawks suggest he may need to water these down. This would mean growth forecasts could be lowered.

There has been creeping doubt over recent months about their likely timing and scale, including within the Federal Reserve.

As such, it is unlikely to alter significantly the market's rates outlook, given it was already extremely doubtful of the Fed's own prediction of four 25bp rate hikes by the end of 2018.

We are still forecasting three 25bp rate rises, but softer data and subdued inflation makes it more likely the next Fed rate hike will be in December rather than September.

Federal Reserve policy rate expectations (%)

Source: Federal Reserve, Bloomberg, ING

A rules-based Fed?

Taylor rules could create more problems than they solve

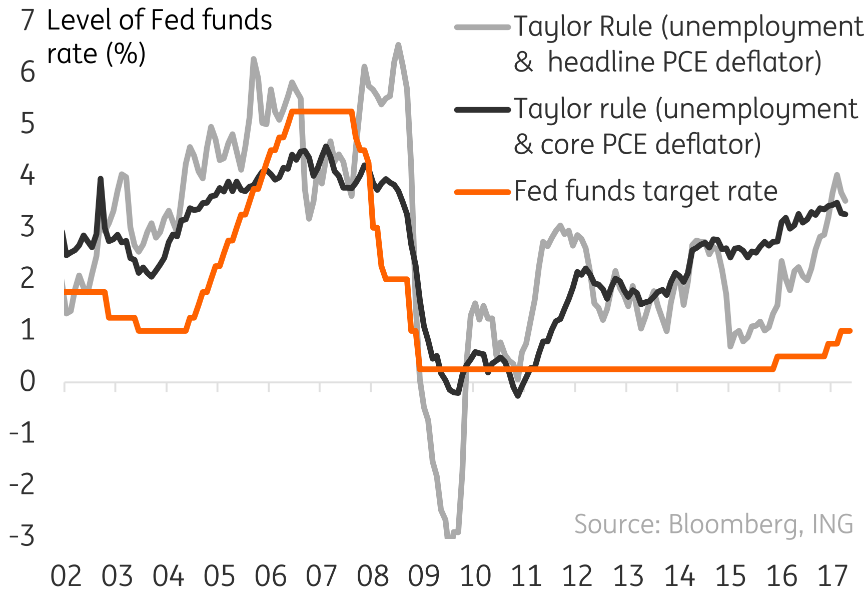
Fed Chair, Janet Yellen's term ends in February and many Republicans want "regime change"

They are keen for the Fed to formally adopt a "rules based" system to set monetary policy.

The Taylor rule:

$$i = r^* + pi + 0.5\,(pi - pi^*) + 0.5\,(y - y^*)$$

i = nominal fed funds rate
r* = real federal funds rate (usually assumed to be 2%)
pi = rate of inflation
pi* = target inflation rate
y = logarithm of real output (or growth rate)
y* = logarithm of potential output (or potential growth)



Taylor rule suggests rates should be 3%+

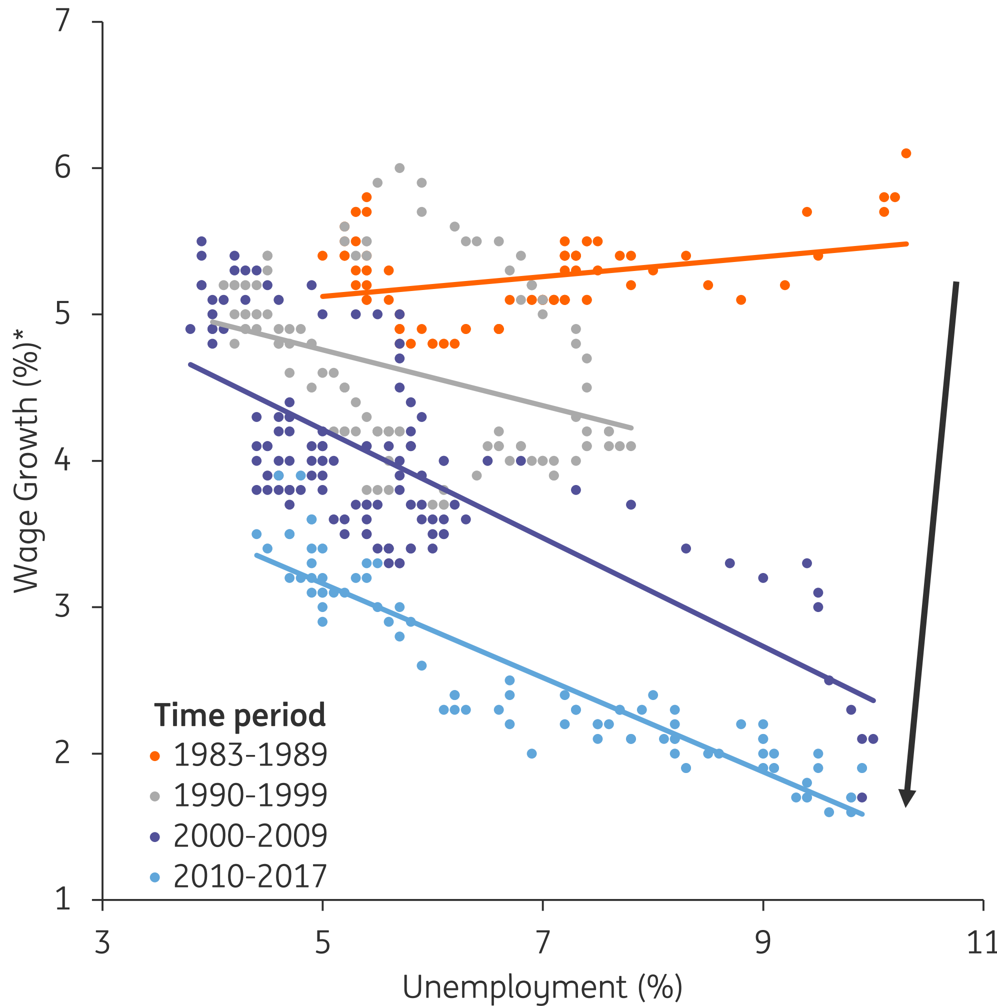
But there's problems with the inputs – which ones do you use, and if you don't trust them, why would you set policy by them?

The Fed do already use rules, but "use judgement and historical precedence to decide if that guidance makes sense". Rules are sometimes too simplistic

Mid-term elections are just 16 months away. Does Trump want to see sharply higher interest rates given tepid growth and his already low personal popularity ratings?

Why US wage growth has left the Fed & markets puzzled

The Phillips Curve has shifted inwards in the US



* Atlanta Fed measure on nominal median wage growth

Source: Macrobond, ING

One of the biggest conundrums for the Federal Reserve is why haven't wages responded to the sharp drop in unemployment?

Admittedly there has been a major shift in the Phillips curve which may reflect the diminishing significance of manufacturing jobs.

More people work in the less secure service sector where job changes are more frequent.

Low productivity growth may be constraining pay awards, while technological advances could also be a factor.

Higher wage growth is critical for stronger economic activity and for the Fed to reach its inflation target.

Fed officials believe it is "only a matter of time".

We're looking for another Fed hike in December…

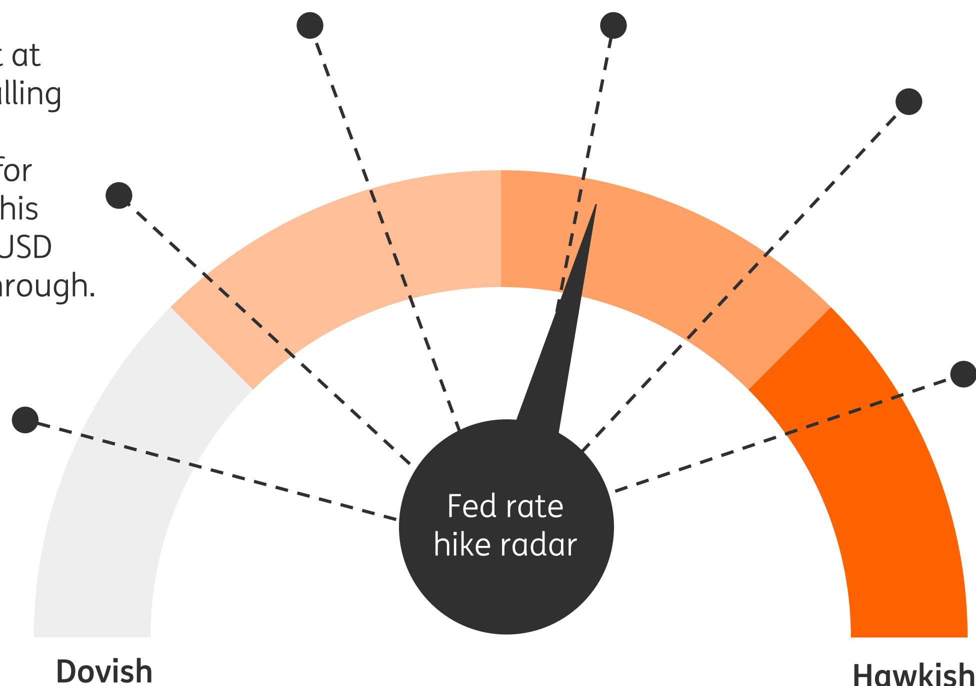
Wages
The tight labour market and increasing job-to-job flows should continue to push up wage growth, but this will take time. Avg. hourly earnings is unlikely to push above 3% this year.

Growth
Confidence remains buoyant, despite fiscal policy disappointments. 2Q Growth should come close to 3% in data due out on Friday – led by a rebound in consumption after a slow start to the year.

Inflation
The Fed continues to point at "transitory" factors (e.g. falling prices of mobile phone contracts) as justification for recent sluggish inflation. This should improve as recent USD weakness starts to filter through.

Financial conditions
A range of key metrics – volatility (VIX), credit spreads, stock prices and bond yields to name a few – all point to financial conditions at multi-year lows. Fed voter Dudley has recently used this as an argument for hiking faster.

Market expectations
Markets are still unconvinced about another hike this year. This scepticism could persist if inflation/wage growth takes time to recover.

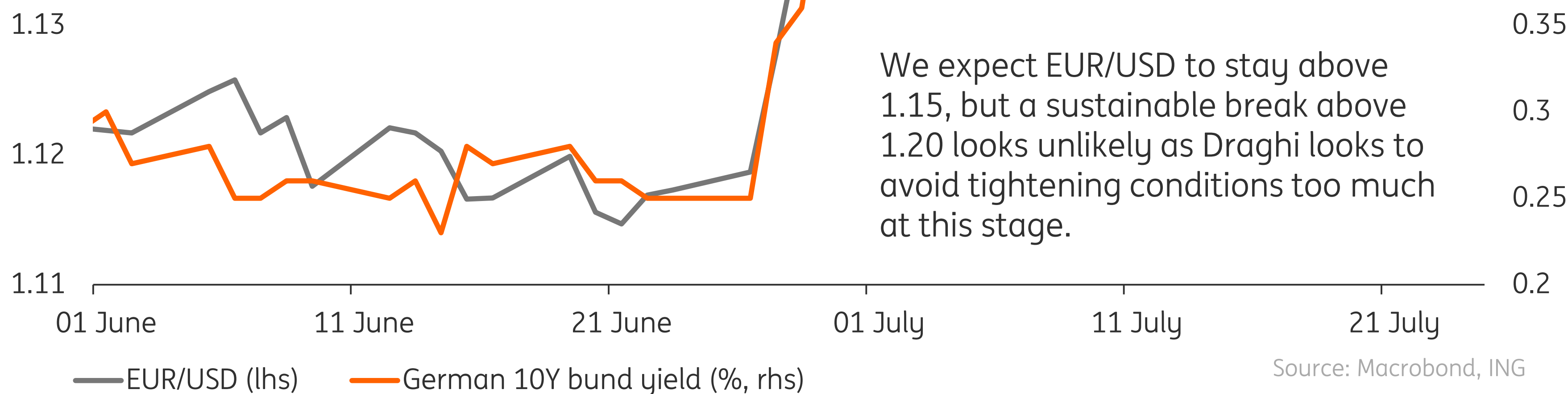


Asset prices
Several Fed voters have recently pointed to stretched asset valuations, as a way of broadening out reasons for hiking rates. Yellen recently described assets as "somewhat rich".

Sintra shocker: Is the QE genie out of the bottle for markets?

After a strong market response to Draghi's recent speech in Sintra, the ECB stayed cautious at the July meeting. Even so, Draghi was not dovish enough to weigh on the Euro, although the bar was high.

We think a tapering announcement is most likely to come in October or December following some further cautious communication in the months ahead.

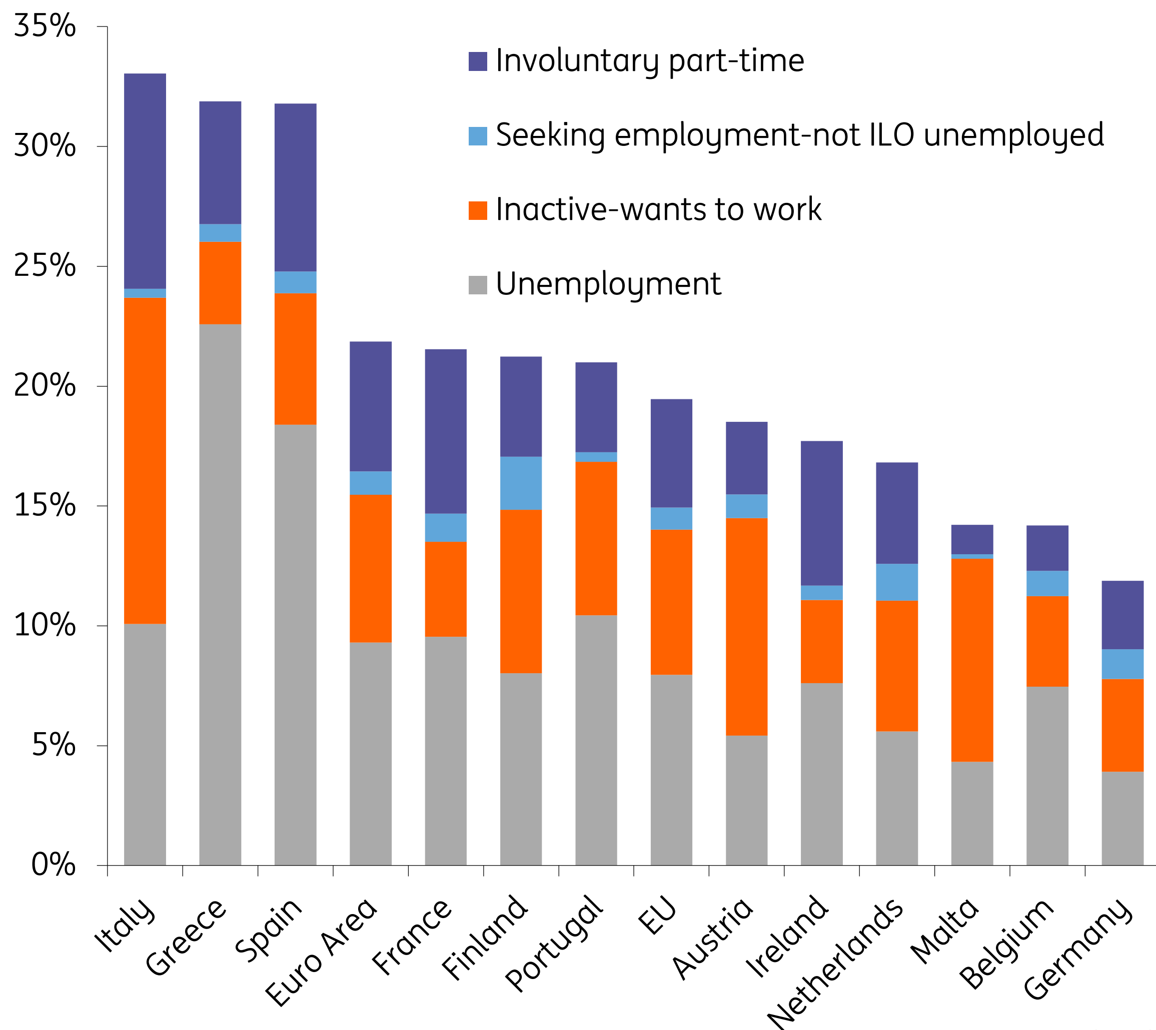


We expect EUR/USD to stay above 1.15, but a sustainable break above 1.20 looks unlikely as Draghi looks to avoid tightening conditions too much at this stage.

Source: Macrobond, ING

Draghi's lacklustre 'lynchpin'

Wage growth is showing no signs of life – and might not for some time



Source: Macrobond

At 1.4%, wage growth is not where Draghi wants it.

Broader unemployment measures indicate the slack in the market is still very significant in the Eurozone, and that's keeping a lid on pay rises.

There's also structural factors, like weak productivity growth, globalisation and digitalization; they're adding downward pressure too.

This means the ECB is still some way off tightening policy, beyond the tapering of quantitative easing.

Read more about the ECB's wage growth battle here

Why are Chinese interest rates inching up?

Clue: It's all about deleveraging!

Reform and related policies are the main determinants of interest rates in China

The authorities in China have been utilising two main policy pillars to support supply-side reform.

Open market operations help prevent easy money from going into 'zombie' companies, and **macro prudential measures** limit on and off-balance sheet growth for banks.

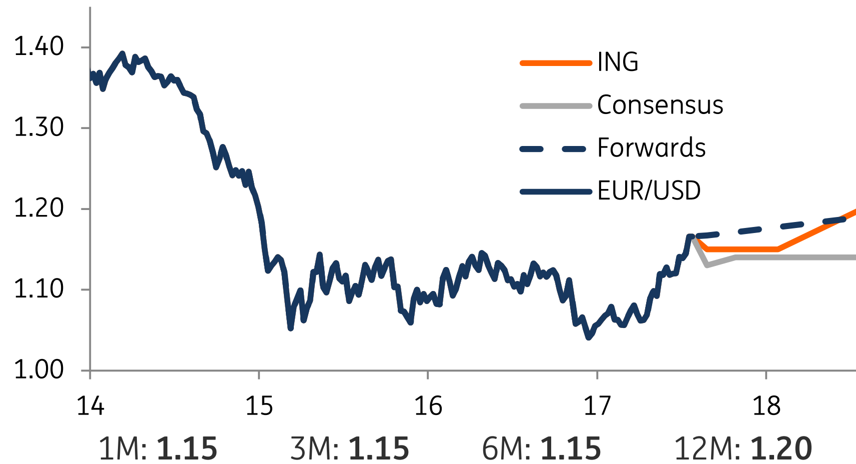
We expect these macro-prudential measures to be tightened and broadened out to cover a wider range of activities in the second half of the year. The PBoC could also tighten conditions in the interbank market further. After all, it won't want to send the wrong message to the market that it is ready to ease liquidity.

We therefore believe interest rates in China will rise from their current level.

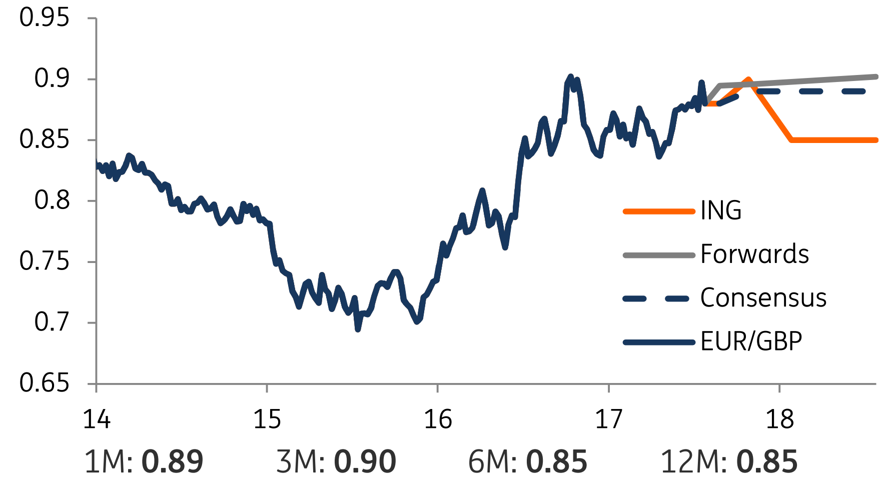
Our global forecasts

All data sourced from Bloomberg/ING forecasts

EUR/USD

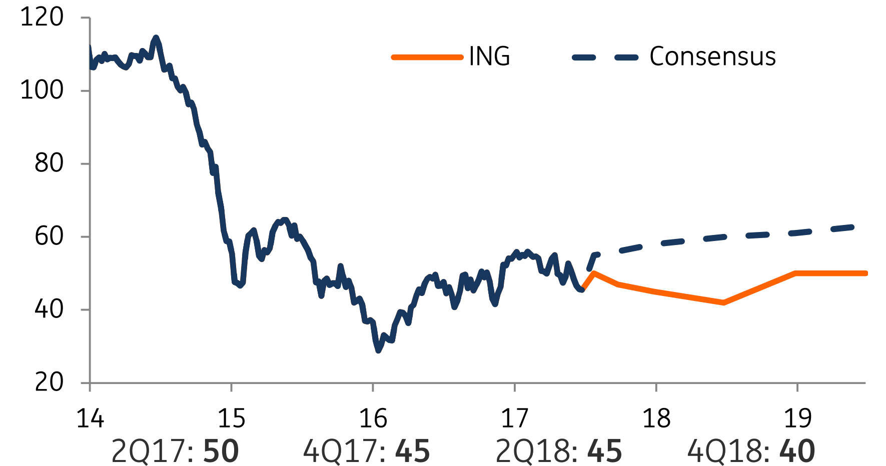


EUR/GBP



USD/JPY

Oil (Brent Crude)



Our global forecasts

	2017F					2018F				
	Q1	Q2	Q3	Q4	FY	Q1	Q2	Q3	Q4	FY
United States										
GDP (% QoQ, ann)	1.4	3.3	2.9	2.2	2.4	2.1	2.1	3.1	2.9	2.5
CPI headline (% YoY)	2.5	1.9	2.0	2.2	2.2	2.2	2.3	2.4	2.3	2.3
Federal funds (%, eop, lower bound)	0.75	1.00	1.00	1.25		1.25	1.50	1.50	1.75	
3-month interest rate (%, eop)	1.15	1.30	1.40	1.60		1.65	1.85	1.95	2.10	
Eurozone										
GDP (% QoQ, ann)	2.3	2.1	1.8	1.8	2.0	1.8	1.7	1.7	1.7	1.7
CPI headline (% YoY)	1.8	1.5	1.4	1.3	1.5	1.2	1.4	1.5	1.6	1.4
Refi minimum bid rate (%, eop)	0.00	0.00	0.00	0.00		0.00	0.00	0.00	0.00	
3-month interest rate (%, eop)	-0.33	-0.33	-0.33	-0.33		-0.33	-0.33	-0.25	-0.10	
Japan										
GDP (% QoQ, ann)	1.0	1.7	1.0	0.9	1.2	1.2	1.0	1.0	0.9	1.0
CPI headline (% YoY)	0.3	0.5	0.8	0.6	0.6	0.8	0.9	0.9	0.9	1.0
Excess reserve rate (%)	-0.1	-0.1	-0.1	-0.1		-0.1	-0.1	-0.1	-0.1	
3-month interest rate (%, eop)	0.05	0.05	0.05	0.05		0.05	0.05	0.05	0.05	
China										
GDP (% YoY)	6.9	6.7	6.5	6.5	6.7	6.4	6.4	6.5	6.6	6.5
CPI headline (% YoY)	1.4	1.5	1.6	1.8	1.6	2.2	2.1	1.9	1.8	2.0
PBOC 7-day reverse repo rate (% eop)	2.45	2.45	2.55	2.55		2.55	2.65	2.65	2.75	
UK										
GDP (% QoQ, ann)	0.7	1.5	1.0	0.7	1.5	1.1	1.4	1.8	1.6	1.2
CPI headline (% YoY)	2.1	2.8	2.9	3.0	2.7	2.9	2.7	2.7	2.7	2.7
BoE official bank rate (%, eop)	0.25	0.25	0.25	0.25		0.25	0.25	0.25	0.25	
BoE Quantitative Easing (£bn)	435	435	435	435		435	435	435	435	
3-month interest rate (%, eop)	0.35	0.35	0.35	0.40		0.40	0.40	0.40	0.40	

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