Thinking through central banks' next moves

__Neil Shearing__ is the Group Chief Economist at Capital Economics. He has overall responsibility for managing our global team of 70+ economists and leading our research, as well as developing the firm's products and its relationship with clients. Neil is a leading voice within the investment community and his views are regularly sought by global media outlets, including the Financial Times, the Wall Street Journal and Bloomberg. He is also an associate fellow at Chatham House.

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Meetings of the world's major central banks over the past two weeks have produced a range of responses to the inflation shock brought on by the conflict in the Middle East. The European Central Bank and the Bank of Japan raised interest rates, while the Bank of England and the Fed opted to leave policy unchanged – albeit packaged in a hawkish message to markets in the Fed's case. This divergence in rate moves reflects differences in economic fundamentals, the severity of the inflation shock, policy starting points and central banks' attitudes towards inflation.

The key question now is how monetary policy will evolve from here. Much will, of course, hinge on whether the talks between the US and Iran that are now underway succeed in ending the conflict and reopening the Strait of Hormuz. We suggested last week that the truce would be a delicate one, and so it has proved. Nonetheless, our baseline assumption that both sides will come to some agreement that includes reopening the strait remains a reasonable one. On this basis, while there are lots of different stories playing out at a country level, it is useful to divide central banks into four groups.

Defensive hikes no longer needed

The first group comprises emerging market central banks that might otherwise have raised interest rates to defend their currencies or to prevent inflation expectations from becoming unanchored, but where any further tightening is now likely to be postponed. These are economies whose external positions are vulnerable, or at least somewhat fragile, and where policymakers remain sensitive to exchange-rate pressures. This category includes economies such as Indonesia, Pakistan and Turkey.

Cuts incoming

The second group contains countries where interest rates are likely to come down (and may even have come down even without the US-Iran agreement). This group consists of countries that have either i) seen a sharp appreciation of their currency against a backdrop of weak underlying price pressures (Hungary, Israel) or ii) have a very tight monetary policy stance in which real interest rates are well above their neutral level (Brazil, Russia and Colombia).

More work to do

The third group consists of central banks where interest rates are likely to rise regardless of developments in the Middle East. These are economies where spare capacity is limited, labour markets are tight and policy settings remain insufficiently restrictive. The most important example is the Bank of Japan, where we continue to expect rates to rise to around 2% by the end of next year. The Reserve Bank of Australia may also have more work to do. This is not because monetary policy in Australia is exceptionally loose, but because labour market conditions are tight, wage growth is running faster than policymakers would like and core inflation pressures are building. This group of central banks also includes those of Korea, Czechia and Chile.

Hiking then cutting

The final group includes central banks that might have contemplated additional tightening if the energy shock had persisted or intensified, but which could now choose to remain on hold. The Bank of England falls into this category. Its communications last week suggested that policymakers are comfortable looking through the recent rise in energy prices for the time being.

The ECB may also belong in this group despite its decision to raise rates at its latest meeting. The ECB's response has been shaped by the experience of the 2022 energy shock and a view within the institution that it was too slow to respond to the resulting surge in inflation. As a result, policymakers have been reluctant to risk a repeat.

Nonetheless, the case for a significant and sustained tightening of monetary policy is weaker than it was then. The energy shock is smaller, labour markets are not as tight and policy is starting from a much less accommodative position. Moreover, inflation expectations remain relatively well anchored and there is so far little evidence of so-called "second-round effects" on core inflation.

That said, as we argued last week, inflation is still likely to rise a little more in advanced economies, particularly in Europe, even if the agreement to reopen the Strait of Hormuz holds. Against that backdrop, another modest increase in ECB rates over the next few months would not be a major surprise. However, there would be little reason to maintain a tighter stance once inflation begins to fall back, meaning any insurance hikes this year are likely to be unwound in 2027. One common thread that links economies in this fourth group is that market pricing for interest rates in 2027 looks too high (our forecasts for major DM and EM central banks can be found on our Central Bank Hub).

Table 1: Central Bank Groupings

Central Banks that no longer need to defensive rate hikes	Central banks that will now start – or continue – easing cycles	Central Banks that will tighten further	Central Banks that will look through inflation shock and/or unwind previous tightening
Indonesia	Brazil	Australia	Euro-zone
Pakistan	China	Canada	Poland
Turkey	Colombia	India	Sweden
	Hungary	Japan	Switzerland
	Israel	Korea	UK
	Russia	Mexico	
		New Zealand	
		Norway	
		US	

Sources: CE

How does the Fed fit in?

All of this leaves the world's most important central bank: the Fed. It sits somewhere between the third and fourth groups, though is arguably closer to the third. Labour market conditions in the US are tightening and economic growth has held up well, with our GDP Nowcast pointing to growth of around 3% q/q annualised in Q2. Core PCE inflation is now running at 3.3% y/y and is likely to edge somewhat higher in the coming months. The adoption of AI does not yet appear to be generating a meaningful disinflationary impulse and may, at the margin, actually be *contributing* to inflation pressures. Meanwhile, fiscal policy remains highly expansionary.

Taken together, these conditions make the US economy look more like those in the third group than the fourth. At his first meeting as Fed Chair, Kevin Warsh followed through on his pledge to scale back forward guidance, making the near-term policy outlook harder to assess. While the latest Summary of Economic Projections (the 'dot plot') of FOMC members showed nine of the 18 participants submitting projections of where they expect rates to go now expecting them to rise this year, that probably reflects the relatively hawkish views of regional Fed presidents, several of whom are non-voters. More tellingly, while Warsh abstained from participating, he said in his press conference that "we've got some work to do on the price stability point".

That leaves him in an awkward position. Having been appointed with a mandate to lower interest rates, he now faces an economy that on balance requires tighter rather than looser policy. Accordingly, if interest rates change over the next six months, the direction is more likely to be up than down. Accordingly, we now expect two rate hikes this year, to take the fed funds target range to 4.00-4.25%. This is a forecast that reinforces our long-held view that markets remain too dovish on the Fed.

Neil Shearing, Group Chief Economist

In case you missed it

Vicky Redwood explained why we are still broadly optimistic about the economic impact of AI.

David Oxley outlined the challenges to building new pipeline infrastructure to bypass the Strait of Hormuz.

Jason Tuvey set out the long-term consequences of the war for economies in the Gulf.

Contact

Email sales@capitaleconomics.com
Visit www.capitaleconomics.com