ECB and Bank of England Monetary policy decisions: possible reasons for the diverging stances on interest rates

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A disclaimer at the outset – I am not an economist (I don't count 'A' level Business and Economics as a sufficient academic base to claim otherwise). But as a more experienced political scientist practitioner, I find it fascinating that the monetary authorities in the UK and EU took starkly different decisions on interest rates last week within the space of a few hours. Here's a quick recap of the decisions and a few thoughts as to possibly why the position diverge.

On 3 February the Bank of England (BoE) published its February Monetary Policy Summary with the headline decision to increase the Bank Rate by 0.25 percentage points, to 0.5%. The Monetary Policy Committee (MPC) voted 5-4 for this increase. Interestingly, the minutes explain that the 4 opponents (Jonathan Haskel, Catherine L Mann, Dave Ramsden and Michael Saunders) voted thus as they preferred a more hawkish stance, supporting a 0.5 percentage point increase to 0.75%.

Now contrast the BoE position with the decision by the European Central Bank (ECB) that very same afternoon. In its combined monetary policy decisions and statement the ECB's Governing Council 'confirmed the decisions taken at its monetary policy meeting last December', essentially leaving interest rates on hold: 'interest rate on the main refinancing operations and the interest rates on the marginal lending facility and the deposit facility will remain unchanged at 0.00%, 0.25% and -0.50% respectively'.

So why the diverging stances on interest rates? Surely both the UK and EU are being impacted economically in similar ways the by the same global phenomenon: COVID, inflation, supply chain bottlenecks, geopolitical tension in Ukraine etc?

Despite the similarities regarding current inflation (5.4% in UK vs. 5.1% in EU) the answer to the divergence apparently lies elsewhere. Quizzed on this at the ECB press conference, President Christine Lagarde inferred the BoE decision was down to higher historical inflation in the UK and a tight job market, in part due to Brexit, leading to wage inflation.

But to my mind, the major difference regarding current and future interest rates relates to diverging future projections on inflation. And to political considerations.

In its February Monetary Policy Report, the BoE predicts a 1.5% interest rate by mid-2023, with inflation peaking at around 7.25% in April 2022 (2% higher than the projected in its November 2021 Monetary Policy Report).

For its part the ECB's forward guidance remains the playbook on interest rates, with its sequencing ensuring no rises until net asset purchases are completed (probably until the end of 2022). Despite having 'surprised to the upside in January' and remaining the likelihood of being 'elevated for longer than previously expected' the ECB still believes inflation will 'decline in the course of this year'. Taken together, the ECB views on interest rates and inflation seem more dovish than the BoE's. Or put another way, the BoE appears more willing to normalise monetary policy more quickly.

Markets interpreted the ECB decision as more hawkish than previously and are now pricing in one or even two ECB interest rate rises in 2022, pointing to Lagarde's comments that meetings in March and June will be 'critically important to determine whether the three criteria of our forward guidance are fully satisfied'.

European interest rates will undoubtedly rise. But markets would be wise to recall the political implications of such rises on the EU governments and citizens. A rate rise will not do much to alleviate the painful impact of soaring energy and food costs which are impacting vulnerable citizens hardest (a point alluded to by Lagarde in her statement and exchange with MEPs earlier this week). The same is true for the UK of course.

So perhaps we should look elsewhere for the ECB's seeming reticence to increase interest rates. Rises in Europe would increase debt servicing costs for Member States, the majority of whom are heavily indebted, as well as increasing mortgage repayment costs for many households. Such squeezes are unlikely to be welcome by EU governments or citizens, both of whom will be loath to see their purchasing power cut further. This would have a negative spillover on economic growth, putting pressure on public spending and tax receipts at a time of high alert for governments regarding social unrest.

Of course, monetary authorities are fiercely independent, with a mandate focused on price stability. But keeping interest rates artificially low at a time of rampant inflation and expansive covid-induced fiscal policy would clearly put the ECB on a different path to its UK (and US) peers. If the ECB were to follow its peers, that would make life difficult for EU leaders in capitals. Assuming, therefore, the ECB's assumption of inflation easing off this year holds, it might in the end be the politics rather than the economics which drives monetary policy decisions more in Frankfurt than in London or Washington.