



## KBC Flash

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### ECB to hold rates steady for some time

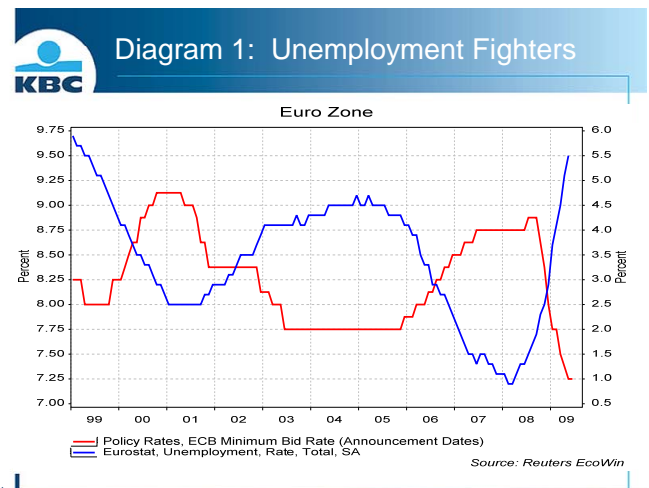
- ECB leaves rates unchanged but acknowledges weak economic prospects
- Statements hit at concerns about worsening jobs outlook
- Dramatic change needed to force ECB's hand anytime soon
- Possibility of more non-standard support in Autumn
- Rates unlikely to rise before second half of 2010

**Today's decision by the European Central Bank to leave its key policy interest rates unchanged was universally expected. That is not to say that the policy outlook is completely clear cut.** Today's surprise rate cut by the Swedish Riksbank and growing expectations that the Bank of England may step up the scale of its quantitative easing highlight a widely held view that further policy action maybe needed to put economies and financial systems on a healthier path. Clearly, the ECB is mindful of this possibility.

The notable feature of the ECB's monthly press statement today was the extent to which **it remains cautious about the outlook for activity in spite of a continuing improvement in survey-based indicators of late.** Mr Trichet was careful to signal that the ECB is likely to remain on hold for some significant time and also said that upside and downside risks both to activity and inflation remain balanced. However, he added once again that the ECB has not entirely ruled out the possibility of further rate cuts. More significantly, the press statement contained some subtle changes from last month that hint at continuing concerns about the Eurozone economy. First of all, the ECB reiterated that the second half of 2009 should see some improvement but today's indication that activity *'should decline less strongly'* seems a less confident assertion than June's observation that activity would decline at *'much less negative rates'*. The ECB also added *'further increases in oil and other commodity prices'* as a downside risk and highlighted the risk of *'a stronger or more protracted negative feedback loop between the real economy and the turmoil in financial markets'*. This threat may be linked to particular fears about the jobs market. Certainly today's acknowledgement of the risk posed by

*'increasingly unfavourable labour markets'* strikes a more worried tone than last month's reference to *'more unfavourable developments in labour markets'*.

It may be that this tweaking owes something to today's news that unemployment rates in the Eurozone and in the US both jumped to 9.5%. The European figure is the highest since the Spring of 1999 whereas the US number is the worst since 1983. Several recent comments by ECB officials suggest worries that a degree of labour 'hoarding' (via short-time working schemes) may be happening in several European countries. **In the event of a weaker end to 2009, a further marked rise in unemployment could follow in 2010, with adverse consequences for spending in the economy and the health of the financial system.**



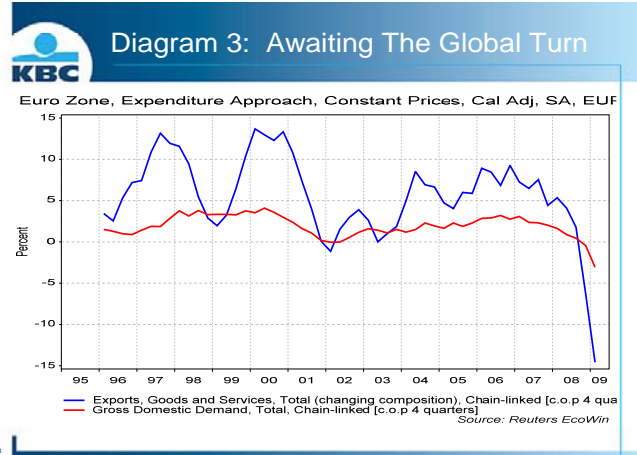
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While the ECB continues to pursue its primary policy mandate of price stability, the evidence from diagram 1 (overleaf) which compares ECB interest rates with the unemployment rate underlines the importance of the economic cycle to ECB policy. Typically, ECB interest rates rise as the unemployment rate falls and pressure on resources builds. ECB policy also responds to increased slack in the economy by cutting rates. **As long as upside risks to unemployment remain substantial, the case for a very accommodative policy stance on the part of the ECB will persist.**

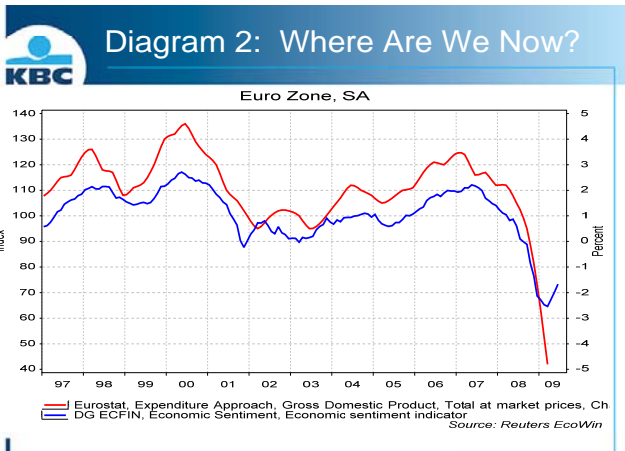
**We do not see any significant prospect of a near term ECB policy move.** In addition, we think that if policy shifts in the next six months, it will most likely take the form of a step-up in unconventional methods rather than a further cut in policy rates. Markets may continue to debate the possibility of further ECB action through the summer. However, for the reasons set out below we think it will take a dramatic change in economic conditions to force the ECB's hand, particularly as there appear to be very substantial differences in thinking within the ECB's governing council.

**Traditionally, the ECB has been cautious in its policy making.** By its standards, the dramatic action taken since last October represents a radical experiment. It is understandable that the ECB should now want to take some 'time out' to assess the impact of its aggressive easing process for several reasons. **First of all, the current health of the Eurozone economy remains extremely uncertain.** In spite of the deterioration in unemployment, this week's European Commission economic sentiment data (diagram 2) confirm the message coming from a range of survey based indicators (that provided speedy warnings of last Autumn's collapse) that there has been some improvement in conditions of late. Activity still appears to be weakening, albeit at a much more modest rate than seen earlier in the year.

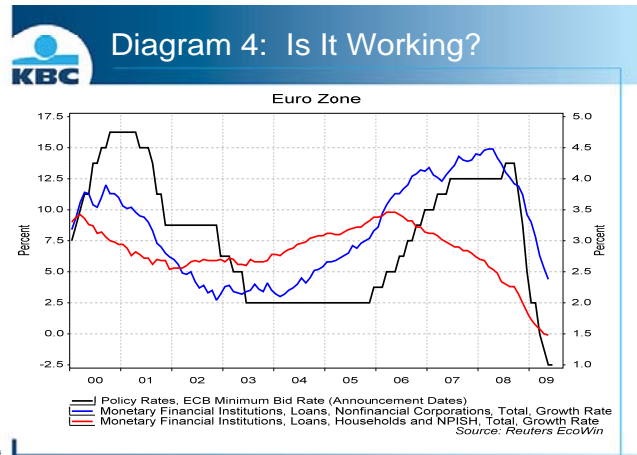
spending in the Eurozone, while significant, has been dwarfed by the collapse in Eurozone exports. So, policy decisions taken in Washington or Beijing may be at least as critical to the outlook for Eurozone activity as decisions taken in Frankfurt (or Luxembourg where today's ECB meeting was held). This external dimension would also tend to support the argument for a period of inactivity on the part of the ECB.



There were several questions at today's press conference on the feedthrough of lower ECB rates to cheaper credit for households and businesses. Unfortunately, even in the absence of credit constraints this is not a speedy process. It will take time for recent ECB rate cuts to flow through to the 'real' economy. As diagram 4 shows, lending to households and businesses has fallen very sharply of late but as Mr. Trichet noted today, this reflects weaker demand as well as constraints on supply. It took quite a while for lending to grow in response to the ECB rate cutting cycle that began in May 2001 – a time when credit constraints weren't a significant issue. **So, the impact of lower policy rates will take some significant time to flow through to lending activity even if financial conditions improve rapidly.** As the ECB is not really in a strong position to speed up this process, it may feel the need to bypass the banking sector and provide direct credit to the economy. This may be increasingly the case if banks continue to deposit their excess liquidity at the ECB's deposit facility.



**The task for the ECB is hugely complicated by the extent to which the prospects for many Eurozone companies are shaped by developments elsewhere.** As diagram 3 illustrates, the drop in domestic



### Summary

A year ago, the ECB raised interest rates in an action that even at the time seemed hopelessly out of touch with emerging realities. **Since October it has reacted very aggressively by its standards to support the Eurozone economy and its financial system. It seems reasonable that the ECB should now choose to remain 'on the sidelines' for some significant time.**

Given the exceptional nature of current circumstances and the usual time lag with which monetary policy operates, it will be some time before we can say with any confidence whether the ECB's policy response has been inadequate or excessive.

Today's comments by Mr. Trichet suggest that uncertainty about the outlook for the Eurozone economy remain significant and the outlook for unemployment

may be a particular concern. For this reason, markets may continue to speculate about the prospects for further ECB easing in the Autumn. We would not entirely rule out some step-up in unconventional methods and perhaps a further tranche of 12 month refinancing at the main ECB rate in September. (So far the ECB hasn't indicated whether it will provide these funds at a premium to the refinancing rate) **That said, divergent views on the ECB council and the tortuous process it has taken to roll out the covered bond purchase programme – now stretching over three or four months, argue that we should not expect anything too dramatic from the ECB for some time.** On the other hand, this would also suggest the threat of higher policy rates looks at least a year or more away.

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