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ECB signals interest rates won't change anytime soon

- Trichet's comments broadly similar to those of early March
- ECB says inflation still 'temporary high'...
- ... and 'economic fundamentals solid'
- So, ECB sees no need to follow rate cuts of other Central Banks
- Trichet does acknowledge greater threat from financial market turbulence
- So, policy on hold for next few months, but ...
- We think ECB will be forced into a summer cut and expect interest rates will be 75 basis points lower by year end

Today's decision by the European Central Bank to leave its key interest rates unchanged was almost universally expected. However, there was some uncertainty as to precisely what message would emerge from ECB President Jean Claude Trichet's monthly press conference. In February Mr. Trichet appeared to strike a dovish tone which fuelled expectations of lower ECB rates by mid-year. In early March, however, Mr. Trichet adopted a notably tougher tone which has caused markets to virtually abandon hopes for a significant easing any time in 2008. Indeed, as we describe in the final section of this note, Mr. Trichet's March press conference contributed to a substantial rise in market interest rates and in the exchange rate of the Euro, implying a marked tightening in financial conditions facing Euro area businesses in the past month. Continuing strains in credit markets and the Euro hitting new lifetime highs against both the Dollar and Sterling in the past twenty-four hours made for a difficult backdrop to today's press conference. So, the key question was whether Mr. Trichet would continue to talk tough or whether he would attempt a more nuanced approach. **In the event Mr. Trichet said little dramatically new. So, markets still see little prospect of a rate cut anytime soon. We think events could force the ECB's hand.**

Mr. Trichet's comments today were very similar to those of a month ago. So, it might seem that the ECB's assessment of prospects both for inflation and activity have changed little in the past month. In reality, a largely unchanged commentary likely reflects the broadly offsetting influence of some significant developments in the shape of poorer inflation data on one side and increased credit market concerns on the other. Judged from this perspective, the limited changes in the press statement hint at an attempt to balance concerns

about the further increase in Eurozone inflation in March against the risk that **market turbulence 'could last longer than initially expected'** and increase the threat to the real economy.

If ECB policy is on hold it is not an entirely comfortable position for the ECB. The first paragraph of today's statement contains a new and interesting, if slightly awkward, sentence; *'in fact, we are experiencing a rather protracted period of temporarily high annual rates of inflation resulting mainly from increases in energy and food prices.'* This acknowledges the recent deterioration but attempts to downplay its importance for policy purposes both by suggesting it to be 'temporary' and by emphasising the role played by food and energy prices, elements that aren't readily available to ECB policy. On the other hand, the ECB is also continuing to downplay the risks to Eurozone economic activity from slower global growth and strained financial markets. In this context, Euro area growth is expected to be *'moderate but ongoing'*. **By repeating the phrase 'we believe that the current monetary stance will contribute to achieving our objective' the ECB is continuing to emphasize its intention to keep policy unchanged for the foreseeable future.** It is also trying to signal that it is in a very different situation to the US Federal Reserve or the Bank of England, both of whom are in rate cutting mode.

There is little doubt that there is unanimous agreement within the ECB Governing Council that policy should not change anytime soon. Equally we think there is also considerable divergence as to what is likely to happen beyond the timeframe of the next two or three months. Clearly, inflation remains uncomfortably high and expectations of an early improvement have faded as commodity prices show

no clear signs of weakening. With the headline pay increases in recent German wage deals also troublesome even if the underlying deals are less threatening, there appears little scope for the ECB to signal an 'all clear' on inflation that might resurrect market hopes for lower rates in the near term. **While Euro area headline inflation is awful at present, we are encouraged by the lack of any marked second round effects on 'core' inflation from outsized increases in energy and food costs.** In part, this reflects the restraining influence of weaker economic conditions and a rising exchange rate which impose a greater need for competitive pricing. While continuing upward pressure on commodity prices creates a degree of uncertainty, we would be hopeful that headline inflation will ease slightly in April. Although we are unlikely to see dramatic easing unless commodity prices tumble, **there should be a gradual decline in headline inflation to around 2.3% by end year. At that point, the likelihood of subdued activity levels, (providing that there are no further increases in commodity prices), should imply that inflation will be in line with the ECB's price stability goal in 2009 and 2010.**

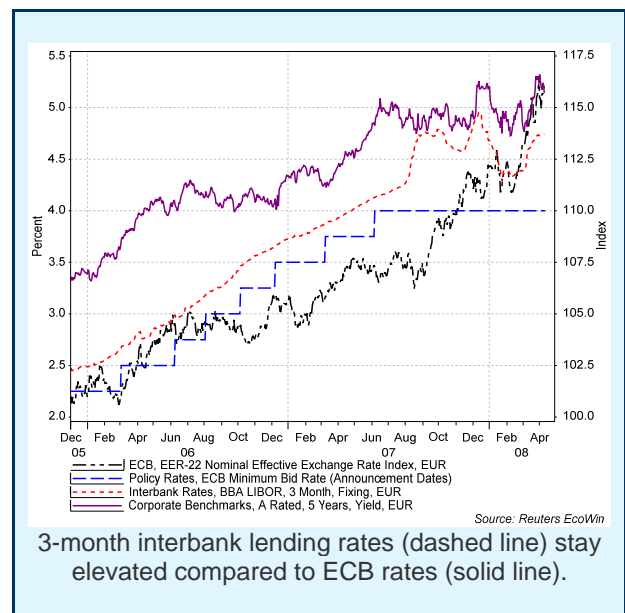
On this analysis, it would appear that we might not be too far from a turning point on inflation. However, it is easy to understand why the ECB has to consider a much nastier alternative, the possibility that higher commodity prices could spill over into poorer 'core' inflation. Such fears justify the hawkish rhetoric of ECB officials of late. However, if, as we suspect, 'second round' inflation threats do not materialise, the ECB could be in a position to contemplate rate cuts as early as its June policy meeting if broader evidence of a deterioration in economic activity suggests the need for such a course of action.

The case for early rate cuts has been undermined by signs of sustained strength in some Eurozone economic data of late. Both the ECB and financial markets are likely to have been surprised by the extent of resilience in activity indicators in recent months. To a significant degree, this reflects particular strength in German production and a weather related boost to Construction. However, as today's release of solid French output data for February shows, there is still no compelling evidence of a dramatic downturn. We reckon clearer evidence of a notably poorer trajectory for activity will materialise in the next couple of months. **For the ECB to ease two conditions must be in place (i) scope for a rate cut in the shape of a clear easing in inflation that is likely to be sustained and (ii) justification for a rate cut in the form of notably poorer activity data.**

While the experience of the past two months suggests financial markets were much too ambitious in anticipating speedy rate cuts, the risk now is that sentiment has moved too far in the opposite direction. **One reason why we are**

reluctant to abandon completely our call for a June ECB rate cut just yet is that there has been a particularly sharp increase in a range of negative forces acting on the Euro area economy of late. The step-down in the US and UK economies around the turn of the year is only now beginning to hit Euro area order books. In addition, the hawkish line taken by Mr. Trichet and other ECB officials during March contributed in no small way to a sharp tightening in Eurozone monetary conditions in the past month. Since the early March ECB press conference, the trade weighted value of the Euro has risen by near 2½%, equivalent to an ECB rate rise of around 30 basis points. In the same period, the cost of 3 month money has risen by roughly 35 basis points while 5 year corporate bond yields have risen by a broadly similar amount. So, the past month has seen an exceptionally sharp increase in the borrowing and currency costs facing Eurozone business. Indeed, as the graph below indicates, **the overall tightening in monetary conditions in the past month has been much more severe than in any month since the ECB began tightening at the end of 2005.**

With this additional restraint imposed on a weakening business climate, we think clearer evidence of a painful slow-down will emerge in coming months. **As a result, we think the ECB may still be forced to cut rates, perhaps as early as June. Even if the initial move is delayed a little longer, we still think the key ECB interest rate should fall by 75 basis points to 3.25% by end year.**



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