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A giant leap for the ECB, a small step towards lower interest rates

- ECB calls off threat 'to act pre-emptively' against higher inflation
- Mr. Trichet acknowledges increased threat of weaker growth
- Comments provide ECB with leeway for early rate cut if needed
- March reduction can't entirely be ruled out but April/May reduction now looking more likely
- ECB may cut interest rates 3 times in 2008

While the European Central Bank kept its key rates unchanged today, comments made by its president, Jean Claude Trichet, will serve to increase expectations that the ECB could cut rates in the not too distant future. As a first step, Mr. Trichet stood down the threat of further rate increases which the ECB had signalled every month since it last raised rates in June 2007. In addition, the tone of Mr. Trichet's remarks, which emphasised concerns about weak growth and repeatedly alluded to a determination not to pre-commit on policy, will sustain the possibility that rates could be reduced within a matter of months if poorer economic conditions were to warrant such action.

It would take a dramatic further deterioration in economic conditions to prompt the ECB to cut rates as early as next month, but such a possibility can't entirely be ruled out. It now seems more likely that **accumulating evidence of weaker growth, a marginal improvement in inflation and a non-threatening wage round will likely prompt an initial rate cut in April or May.** Because the global outlook has weakened materially, rates may fall further than we previously envisaged. **It now looks more likely that Euro area rates will fall by 75 basis points in 2008 and, in the event of a further step-down in global growth, rates could fall a full percentage point to 3 per cent.**

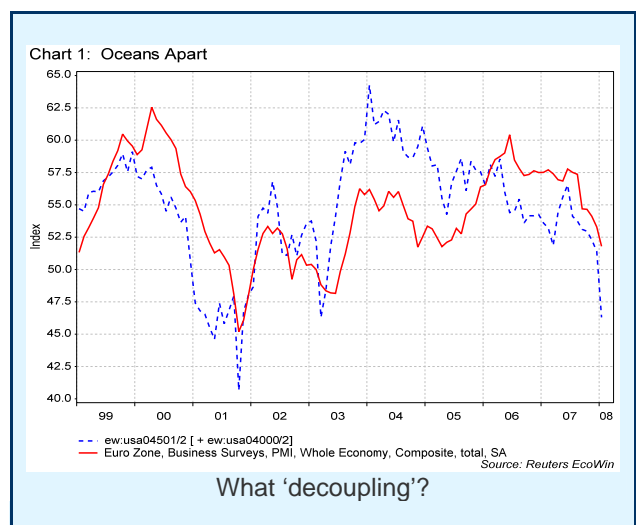
A month is a long time in economics

In stark contrast to last month's ECB press statement which emphasized a readiness 'to act pre-emptively' against inflation, this month's phrasing that the ECB 'remains committed to preventing the materialisation of upside risks' is altogether less threatening. Mr. Trichet also said the decision was unanimous and that the option of raising rates had not been considered. This represents a significant, if overdue, re-assessment of emerging economic realities.

Today's press conference suggests that ECB thinking on the outlook for economic activity has undergone quite a dramatic change in the past month. Mr. Trichet

pointedly refused to repeat last month's assertion that the ECB sees growth in 2008 being 'broadly in line with potential'. Instead, in response to repeated questions on this point, he said that last month's statement had acknowledged risks were to the downside. **The ECB is admitting those downside risks have begun to materialise.**

If the extent of today's changes in ECB thinking comes as something of a surprise, the grounds for a substantial re-assessment are fairly clear-cut. Without doubt, the most notable development of late has been a sharp weakening in the US economy and associated dramatic cuts in US interest rates in the past month. The strength of the relationship between business conditions in the US (dotted line) and those in the Eurozone (solid line) is clearly seen in Graph 1.



The evidence in recent days from composite purchasing managers surveys taken on either side of the Atlantic suggests that any 'decoupling' between the two economic zones tends to be limited and temporary in nature. Mr. Trichet acknowledged today that the Eurozone

economy can't expect to emerge unscathed from the current US downswing. In the past month Mr. Bernanke and his colleagues of the Fed are likely to have made Mr. Trichet fully aware of their concerns about a notably weaker outlook for the US.

Arguably of equal significance in today's change of heart by the ECB have been recent signs of faltering domestic demand in Europe. The expectation of softer Eurozone activity on foot of the emerging slowdown in the US has been central to our long held view that the ECB would be forced to cut interest rates in 2008. However, we were slightly surprised by recent data suggesting internal conditions in the Eurozone economy might be quite fragile. Signs of shrinking activity in the Services sectors of Germany, Italy and Spain in January point to some risk that weakening business sentiment and tighter lending conditions are already taking a significant toll on domestic activity. Overnight, the report that Cisco, the US technology firm, saw a particularly sharp slowdown in its European orders points in the same worrying direction. According to Cisco, its US orders eased to 12 per cent growth from 13 per cent in the previous quarter. However, it's European orders slowed far more dramatically from 20 per cent growth in the previous quarter to an 8 per cent pace in the November-January period. With Eurozone retail sales unexpectedly dropping for the third month in a row in December to record the largest annual drop in the ten year history of these data, **it seems that a range of recent indicators suggest the possibility that the European economy could be set for far weaker conditions than the ECB previously envisaged.**

Weaker growth is on the way. How will the ecb respond?

Reflecting these developments the IMF last week sharply revised down its Eurozone growth forecast for 2008 to 1.6% (from 2.1 per cent previously). With the IMF now expecting the Eurozone to grow a negligible 0.1% faster than the US this year, the pressure for the ECB to alter its thinking has become almost impossible to resist. Previously, the ECB had emphasised its focus was exclusively on inflation. However, **a substantially poorer outlook for growth should ultimately translate into the prospect of notably lower inflation.** The European Central Bank can do nothing to alter the current uncomfortably high inflation rate in the Euro area. While the tough talk of recent months was intended to prevent higher inflation becoming permanently embedded into the Euro area landscape, the reality is a much harsher economic climate is far more likely to achieve this result than ECB jawboning.

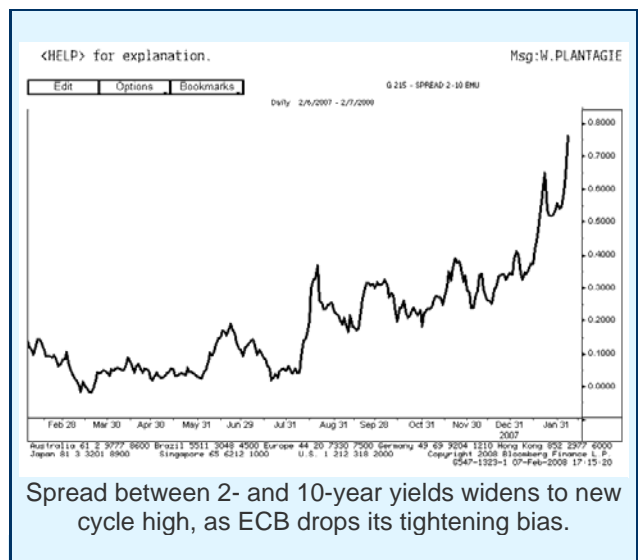
The ECB today sought to create room for manoeuvre on interest rates by acknowledging that headline inflation will remain uncomfortably high for some significant time. The awkwardness of the phrase used in today's statement that the ECB expects 'a protracted period of temporarily high rates of inflation' may owe something to the fact that the vast majority of the Governing Council do not speak English as their mother tongue. More fundamentally, it captures the dilemma facing the ECB. Inflation typically

reaches a peak after economic growth has begun to weaken. In 2001 the ECB faced a very similar problem and opted to cut rates in May of that year in spite of an inflation rate of 3.1%. Today's awkward language hints that the ECB could be trying to create leeway to cut in coming months even if inflation remains well above its target. **We think the inflation picture could improve more than the ECB now envisages.** In the past month oil prices have dropped by around \$7 per barrel. Together with favourable base effects, this should result in a significant improvement in Euro area inflation through the spring months. **Although inflation is likely to remain above 2 per cent for much of 2008, a clear downward trend should emerge.** In turn, this may mean the ECB could need to reduce its December projection that inflation would average 1.8% in 2009. Such a reduction would increase the scope for lower rates. **Indeed, on the traditional 'Taylor rule' approach, economic growth towards 1.5% and inflation around 1.7% next year would point towards three 25 basis point rate cuts by the ECB in 2008.**

Dramatic bull steepening European yield curve

Following the ECB press conference, short-term yields fell lower, as the ECB dropped its tightening bias. Curve-wise, there was an impressive steepening of the European yield curve. **The spread between 2- and 10-year yields widened to new cycle highs at around 75 bps.** Especially the latter does satisfy us, as we do advocate steepening trades already for a long time and **do think the steepening has a further way to go.**

Based on the Euribor strip curve, markets currently discount almost four ECB rate cuts of which two are priced in by the June meeting. This looks fair based on the current information. Therefore, we favour a buy on dips approach at the short end of the curve.



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