



## KBC Flash

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### ECB downplays chance of early rate cuts

- ECB suggests it is not planning to change policy anytime soon
- Worries about inflation and easing of growth fears mean Trichet sounds less dovish than a month ago
- We still expect rates to fall by 75 basis points by end year
- Soaring Euro, impact of weak US economy and strains in Spain and Italy will force the ECB's hand
- We now expect first rate cut in June but wouldn't rule out earlier move if financial conditions deteriorate or activity data disappoint

The European Central Bank kept its key policy rate unchanged at 4.00% for the ninth successive month. Mr. Trichet, the ECB President, used his regular monthly press conference to suggest that the ECB does not intend to alter policy anytime in the near future. In this regard, his main purpose was to deflate market hopes for any near term cut in interest rates.

Mr. Trichet emphasised that the ECB's focus remains firmly on retaining price stability. Eurozone inflation remained at the record level of 3.2% for a second month in February, some considerable distance above the ECB's target. So, it will take compelling evidence of a sharp deterioration in Eurozone economic conditions (that would bear down on inflation) before the ECB feels sufficiently comfortable to contemplate reducing rates.

In the wake of Mr. Trichet's comments today, financial markets take the view that circumstances should change sufficiently to allow the ECB cut rates once in the Summer and probably two more times before end year. We believe that clearer evidence of a sharp weakening of activity and an associated improvement in the inflation outlook should materialise in the next couple of months. As a result, we think the ECB might be forced to cut rates somewhat earlier than the market now envisages. **Our expectation that notably poorer economic conditions will develop in the next few months also implies the ECB may have to cut rates as many as three times by the end of the year.**

#### What Trichet said

Probably the key change in the tone of today's press conference from a month ago was that **Mr. Trichet made a determined effort to downplay concerns that the Euro area economy is set to experience a marked deterioration of the sort now being suffered by its US counter-**

**part.** In this regard, the first paragraph of today's press statement no longer includes any reference to 'downside risks' to economic activity. Instead it simply reiterates that *'the fundamentals of the Euro area are sound'* – presumably in an attempt to emphasize the contrast with problems in the housing market and balance of payments of the US. It goes on to say that *'incoming macroeconomic data point to moderating but ongoing real GDP growth'*. Again, the tone of this sentence is markedly different, and intentionally so, to yesterday's Federal Reserve Beige Book which indicated that (US) *'... economic growth has slowed since the beginning of the year. Two thirds of the Districts cited softening or weakening in the pace of business activity, while the others referred to subdued, slow or modest growth.'* Mr. Trichet spoke of *'different Central Banks in different universes'*. **Clearly, the ECB and Fed are oceans apart in their assessment of current conditions in their respective economies.** To an extent this reflects a significant difference in the scale of downturn in economic conditions between the two zones. However, it also underscores a difference in policy signals. The Fed is emphasising the process of reducing US official rates will continue at its March 18th policy meeting (with a further substantial cut, probably of 50 basis points). The ECB sought to emphasise today that it is not ready to contemplate beginning the process of reducing interest rates in the Euro area.

**The subtle but very important shift in the tone of today's press conference likely reflects the influence of two factors.** First of all, **Eurozone inflation has remained stubbornly high** of late and the combination of record commodity prices and a worrying German wage round have increased the likelihood that inflation will remain higher for longer than expected. Second, the ECB were probably heartened by **signs of resilience in a range of Euro area indicators in the past month.** At the margin, the risk of a possibly severe slowdown that was suggested by Euro area



purchasing managers data for January and the information coming from the US in early February may have caused some at the ECB to fear an imminent and pronounced deterioration in economic conditions a month ago. However, in the interim, a significant rebound in February PMI services data set alongside resilient readings from the IFO and a number of other surveys probably materially lessened such fears. Although the ECB still acknowledges that risks to activity lie to the downside, this threat appears far less immediate than a month ago.

### What do new ECB projections tell us?

**The ECB has reduced its forecasts for economic growth and raised its forecasts for inflation both for 2008 and 2009.** Inflation is now seen sharply higher at 2.9% in 2008 (previously 2.5%) and somewhat higher in 2009 at 2.1% rather than 1.8%. While the upward revision to the 2009 projection is slightly larger, the rise in the 2009 estimate is more significant. First of all, it implies the ECB sees no significant unwinding of inflation next year even as a result of favourable base effects. Second, the fact that the 2009 outturn remains above the ECB's definition of price stability to the end of the (published) policy horizon emphasises that in the ECB's judgement inflation risks remain to the upside. Of course, it should be emphasised that today's projections effectively assume that the ECB cuts its policy interest rate to 3.25%. **So, the ECB's projection that inflation would remain above target in such circumstances is consistent with the ECB's view that cutting interest rates sharply in coming months would not be appropriate.** In this sense, the projection is a technical representation of Mr. Trichet's comments today that *'we do not underwrite future market interest rates.'* That said, he stopped some distance short of rubbishing market expectations entirely by adding that the ECB never precommits. It should also be noted that if lower interest rates mean inflation might be higher than the ECB would want, a failure to cut rates also means economic growth would be lower than today's ECB projections envisage.

**Although today's projections underscore the ECB's reluctance to countenance early rate cuts, the reality is that circumstances are changing rapidly** and in a manner that makes projections outdated very quickly. In this regard, the ECB projections assume the Euro will average \$1.47 in 2008 and \$1.46 in 2009. They also assume oil prices will average \$90.6 and \$89.1 in these two years given how dated these now appear. So, it would be very surprising if the assumptions underlying today's projections remain valid for any length of time.

### We continue to expect lower interest rates

**In summary, today's ECB press conference should be seen as a determined effort to prevent excessive hopes for an early cut in interest rates.** We reckon stubbornly high inflation and less activity troubling data in the past month have made the ECB more resistant to any notion of an early easing in policy. However, the reality is that Central Banks rarely if ever prepare a 'glide path' when the interest rate cycle is about to turn downwards. The statement the US Federal Reserve released after its August 7th meeting last year warned that the Fed's *'predominant policy concern remains the risk that inflation will fail to moderate as expected'*. Within a very short time its words and actions emphasised a very different agenda. We don't think the ECB wants to cut rates now and we don't think it envisages cutting anytime soon but our long-term characterisation has always been of *'a bumpy path to lower rates'* in the Euro area.

**In spite of the apparent resilience in some recent indicators, we think a trend towards markedly weaker economic growth in the Euro area is now becoming established.** A recent worsening in financial market conditions will add to these pressures. We also note the particular strength of the Euro on FX markets and the rather lame reliance by Mr. Trichet on empty utterances from US policymakers that they favour a 'strong' Dollar. In reality, the authorities in Washington are glad of the support a declining currency gives to American exports. So, provided there is no adverse feedback from a weaker currency to the price of US assets, a policy of 'polite' neglect towards the Dollar will persist. However, the impact of the Euro regularly breaching record highs against the Dollar and Sterling should quickly become painful for Eurozone companies that export or compete with imports. Finally, we think signs of particular strains in the economies of Spain and Italy that together account for around 30% of the Eurozone economy will lead to a clear weakening in Euro area activity in coming months.

**Because we also see Eurozone inflation easing clearly from March, we expect the ECB will cut rates by June.** However, it is not too difficult to envisage circumstances in which the ECB could be forced to cut somewhat sooner if financial market conditions continue to deteriorate and/or economic indicators confirm a notably poorer trend than the ECB now anticipates. **Reflecting our more pessimistic view on the outlook for activity, we also feel the ECB may be compelled to cut rates by as much as 75 basis points by end year.**

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