



## KBC Flash

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### The Bank of England cuts rates, but the ECB signals no early easing

- Bank of England rate cut today underlines emerging financial and economic difficulties
- ECB hold rates unchanged and talks tough on inflation
- Mr. Trichet says question of raising rates was discussed but option of cutting wasn't
- We think a range of factors prompted Mr. Trichet to sound hawkish today but note softer growth forecasts and lower inflation in 2009
- We remain of the view that ECB policy rates will fall to 3.5% by next Summer, but continue to expect a bumpy road to easier policy in the Eurozone

Today was quite a busy one for interest rate markets. The Bank of England signalled a major turnaround in policy by cutting rates today by 25 basis points to 5.5%. In the past couple of weeks a range of members of the Bank's rate setting committee argued that inflation risks remained and the UK economy needed to experience some slowdown in growth. Certainly, in recent years the UK has grown more quickly than expected. However, two of the key factors supporting growth, a buoyant property market and exceptional strength in the financial services sector face the threat of a reversal in the year ahead. As a result, it is expected that UK economic growth will ease from a rate close to 3% in 2007 to around 2 per cent in 2008.

Indeed, there are some suggestions that growth next year could be appreciably lower if the housing market and/or the city suffer a marked deterioration. It is a certainly the case that rising house prices have supported wealth-related increases in consumer spending. A weakening housing market and debt worries could hit confidence and reduce housing related borrowing. In addition, the financial services sector has both supported the housing market and made an outsized contribution to economic growth. The current financial market turmoil is likely to result in markedly lower bonuses and job losses in financial services in the UK in 2008, an outturn that will mark a dramatic change from the experience of buoyant gains in recent years.

Reflecting such risks, the Bank of England announced a rate cut today and indicated that weaker household and business surveys coupled with a deterioration in credit markets threatened the outlook for activity and could drive inflation

below the Bank's 2% target. Although the Bank said it would continue to monitor upside risks to inflation, today's UK cut signals an appreciation that the major risk at present is that activity will weaken more than envisaged rather than that inflation will take hold.

The likelihood is that this was a very close decision on the part of the Bank's rate setting committee and it would be no surprise if it's hapless Governor, Mervyn King, voted against today's rate cut (as he did in August 2005). The statement that accompanied the rate cut hints at divisions within the Bank by offering only a limited explanation for today's move. The key driver of lower rates appears to be concerns about the credit market. Certainly the fiasco over the UK authorities handling of Northern Rock's problems means the Bank of England is very sensitive to risks of this sort even if its public utterances have repeatedly warned of the risks of creating 'moral hazard' by aggressively supporting markets. Even allowing for this extremely uncomfortable dilemma, history suggests the Bank of England could move UK rates forcefully lower in coming months.

The Bank of England's action today has some implications for the European Central Bank. However, it should be acknowledged that housing market and financial sector developments don't pose the same risk to Eurozone economic activity at present as they do to the UK. More generally, however, the Bank of England's assessment of downside risks in the current environment further weakens an oft repeated ECB view that Europe could remain largely insulated from a US centred economic and financial downturn. In addition, the prospective weakening of the UK economy, which is the most important



trading partner of the Eurozone, is of no small importance to the outlook for Euro area exports. Finally, the recent softening in Sterling (which is only marginally less important than the Dollar in the Euro's Trade Weighted Index at 20.8% against 23.7%) will aggravate upward pressure on the Euro on currency markets.

### Fog in the Channel – Europe Cut Off

If a changing economic outlook forced the Bank of England into a slightly uncomfortable if entirely appropriate cut in UK interest rates, **the ECB appears some considerable distance from contemplating easier policy.** Indeed, the message financial markets took from Mr. Trichet at today's monthly press conference is that there is a greater risk of a further rise in interest rates than had been anticipated.

**We continue to believe weaker global activity will translate into a further easing in Euro area growth through 2008. We think that this will necessitate lower Euro area interest rates in the first half of next year.** However, as the title of our assessment of the November ECB meeting 'A Bumpy Road to Lower Rates' indicated, we think the path to an ECB rate cut could contain several twists and turns. Today's developments underscore such risks.

The regular monthly ECB press conference for December was uneven and at times appeared uncomfortable for Mr. Trichet. **We think there are several reasons why the ECB might choose to emphasise that an ECB rate cut remains some considerable distance away and might also want to continue to threaten the possibility of higher rates.**

**First of all we think the ECB wanted to indicate that today's Bank of England rate cut had no immediate implications for ECB policy.** In this regard we note that the tone of the formal press statement was notably less hawkish than the subsequent remarks made by Mr. Trichet. This might suggest that on assessing the significance of the UK rate cut, the ECB wanted markets to appreciate that there is no prospect of a co-ordinated easing in policy at present. Mr. Trichet's indication that today's ECB council meeting had considered the option of raising rates but not the option of cutting rates, coupled with his admission that some council members favoured raising rates makes it abundantly clear that policymakers at the ECB and the Bank of England are weighing up different concerns. **It might also be noted that calls in recent days by Italian and French politicians for an ECB rate cut would also have added to ECB determination not to be influenced by 'outsiders'.**

### High Inflation is Troubling the ECB

**On a more fundamental note, the high rate of inflation in the Eurozone at present is a major concern for the ECB.** In this regard, the contrast between Euro area inflation at 3.0% and UK inflation at 2.1% (together with still notably higher UK policy rates, now at 5.5% against 4% ECB rates) hints at significant differences in the room for manoeuvre of policymakers in the two economic zones. As we noted in previous commentaries, current circumstances are probably exposing significant divisions within the ECB Governing Council. It is probably the case that a small number of ECB

council members would favour an early interest rate increase. Comments by Mr. Liebscher and Mr. Garganas in recent weeks hint at their feelings in this regard. And although Mr. Weber may have been a little more measured of late, he too would probably favour emphasising a very real threat of higher policy rates.

**The need for the ECB to emphasise its inflation fighting credentials is also required by the release today of its staff projections which show inflation in 2008 at 2.5%,** a notably higher forecast than had been expected. If this were to materialise next year, it would be the poorest inflation performance since the ECB came into being in 1999. Of course, it should be emphasised that the ECB see next year's deterioration entirely in terms of the impact of higher oil and food prices and they also note that in 2009, which is the timeframe relevant for interest rate policy to have an impact, inflation should tumble to 1.8 per cent which is at or even marginally below levels consistent with the ECB's target of price stability. So, as Mr. Trichet repeatedly indicated today, ECB interest rates are appropriate and there will be no need for tighter policy providing 'second-round' price pressures do not develop.

**Yet another reason why the ECB might be reluctant to have markets dismiss at least the possibility of higher interest rates is continuing uncertainty about the impact of financial market uncertainty on economic activity in the Euro area.** Recent business survey readings were somewhat stronger than expected and somewhat dated activity indicators confirm the 3rd quarter was solid. In these circumstances, particularly given the troubling level of inflation at present, **the ECB will want compelling evidence of a marked slowdown in activity before it is willing to contemplate lower interest rates.** In this regard it should be remembered that many of Bank of England officials also downplayed the prospect of late until signs of weakness in recent data and increased nervousness in money markets prompted action. A final consideration for the ECB at present may be a strong desire not to be 'boxed in' to rate cuts in the manner that the US market appears to have done to the Federal Reserve. The ECB does not want financial markets to set its agenda.

### Is The ECB More Concerned Than It Admits?

**For these reasons we think it is understandable why Mr. Trichet struck what markets viewed as a slightly threatening tone in today's press conference.** That said, we reckon that in private the ECB is less confident that the Euro area economy will withstand the current financial market turmoil and a notably slower US economy. The text of today's press statement contained a number of pointers towards developing concerns in this respect. First of all, while the December press statement repeated the view that *'the economic fundamentals of the Euro area remain sound'*, it pointedly omitted last month's continuation *'...and support a favourable medium term outlook for activity'*. Similarly, November's reference to *'continued strong external demand should provide ongoing support to Euro area exports'* has been replaced by the markedly less upbeat *'external demand should provide ongoing support to European exports'*.

Ultimately, the key question in terms of the outlook for Euro area rates depends on the extent to which global economic activity slows and the degree to which the Euro zone economy can withstand this downswing. Our assessment of today's developments is that the Bank of England's decision to cut rates testifies to growing concerns regarding the financial and economic outlook that will filter through to weaker activity (and reduce price pressures) in the Eurozone.

We think a combination of factors explain why Mr. Trichet might have chosen to emphasize that the ECB's focus on uncomfortably high inflation at present means risks centre on higher rather than policy rates. However, Mr. Trichet also indicated in response to a question about connections

between economies that 'we are all interdependent and mutually influence each other'. This suggests that in time, debate regarding ECB policy will turn to the question of lower policy rates. We still reckon this shift is likely to occur reasonably early in 2008. As a result, we remain of the view that ECB policy rates will fall to 3.5% by next Summer. Currently, markets only discount a remote chance on an interest rate cut. Therefore, we are still looking to go long at the short end of the curve, but currently prefer a buy bonds on dips approach, as the current downward correction may last somewhat longer.

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