



## KBC Flash

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### ECB to downplay decline in headline inflation

- ECB to leave rates unchanged for the second month in a row
- Threat of second round effects to prevent an early easing in ECB policy rates
- Potential changes of the rules reigning the collateral used in liquidity require attention

At the **September ECB policy meeting**, the ECB is widely expected to leave rates unchanged at 4.25%. As usual, markets will look out for the ECB press conference for some hints whether recent changes in the growth and inflation outlook have altered ECB thinking on how interest rate policy might evolve in the future.

**Over the summer, the euro zone economic outlook has deteriorated sharply** and during last month's press conference, ECB's Trichet admitted that the ECB was partly surprised by the speed of deterioration, as he said that 'recent data suggested a materialisation of downside growth risks'. In recent months, financial markets have increasingly focused on weaker activity and begin to anticipate an eventual turn in ECB policy. However, **Mr Trichet and a host of other ECB officials speaking in the past month have continued to stress upside inflation risks** and added they had no bias on the future outlook for interest rates.

This month's introductory statement will include **new ECB staff growth and inflation projections for this and next year**. Based on recent data, a significant downward revision of the growth projections can be expected from the previous forecasts of 1.8% this year and 1.5% next year. A key question is whether the ECB feels slower growth will alter inflation prospects. In June, the mid-point of the inflation forecasts stood at 3.4% this year and 2.4% next year. Based on the latest Survey of Professional Forecasters, an upward revision of the inflation projections cannot be excluded to around respectively 3.6% and 2.6%. The new ECB staff projections should however be treated carefully, as they will be based upon information available up to the end of August and won't take into account the latest 10% decline in the oil price.

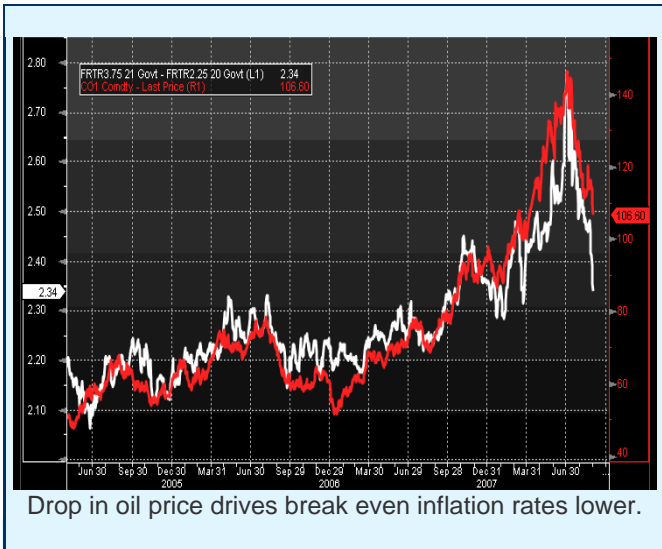
Since the peak at around 150 USD/barrel, oil prices have dropped to around 105 USD/barrel currently. This will have a huge impact on the headline inflation rate, which has already declined in August from 4.0% Y/Y to 3.8% Y/Y. But **despite the expected decline in the headline inflation rate, the ECB is likely to remain concerned about the potential second round effects** from past increases in

commodity prices mainly via higher wages. The pick-up in the hourly wage growth in Italy in August to the highest level since 1997 for example indicates that some second round effects are occurring.

	ECB June staff projections	Survey of Professional Forecasters
Inflation '08	3.4%	3.6%
Inflation '09	2.4%	2.6%
GDP growth '08	1.8%	1.6%
GDP growth '09	1.5%	1.3%

**ECB inflation worries are unlikely to diminish in the short term**, as the headline inflation rate is expected to remain above the 2% level at least until the middle of next year. Last week, ECB's Weber highlighted the ECB concerns, as he questioned whether the average inflation rate will fall below the 2% level in 2010 and added that the ECB may have to raise rates again once the growth outlook improves.

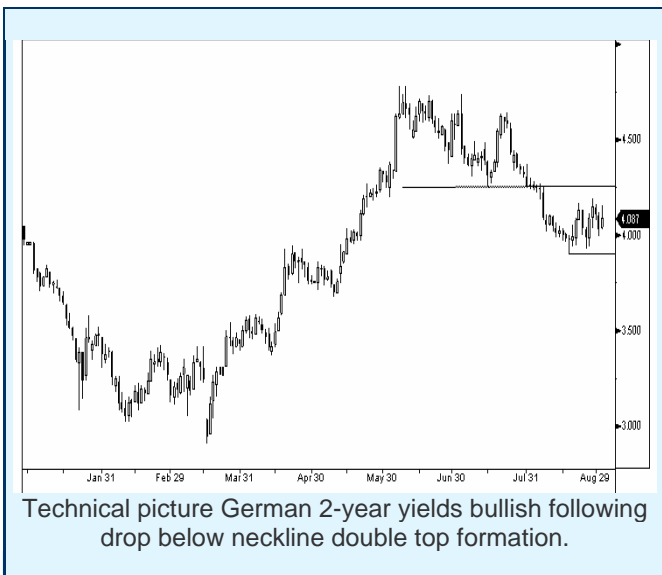
**Yesterday's market's reaction to the drop in the oil price illustrates that the outlook for interest rates isn't clear cut**. At first, the bond market considered it more from the angle of higher potential growth in the future than as lower inflation. As a result, bonds sold off and equities surged. However, the mood changed and markets started to see the sharp drop in oil prices as evidence of the sharp growth slowdown and bonds rebounded. It should however be emphasised that in both cases financial market inflation expectations extended their recent decline. Since the peak in July at 2.80%, 10-year French break even inflation rates have fallen back to around 2.35% currently.



As regards tomorrow's press conference, we expect Trichet to downplay the recent decline in headline inflation given the threat of second round effects. The positive impact of the oil price on the growth outlook may even buy the ECB some time to await further developments. At the same time, the decline in the euro also calls for some cautiousness, as it is not only a positive for the growth outlook, but also a negative for the inflation outlook. As such, we expect the ECB to be quite comfortable with the current market expectations for no change until the middle of next year when a first rate cut is expected. **Recent hawkish comments of the ECB have however indicated that the ECB wants to prevent any speculation on an early rate cut, which makes that the risk is for a slightly more hawkish than expected press conference.**

ECB interest rates derived from one month Eonia futures						
Sep	Oct	Nov	Dec	Jan	Feb	Mar
4.30%	4.30%	4.30%	4.30%	4.24%	4.23%	4.19%

As such, we continue to prefer a buy-on-dips approach towards the necklines of the double bottom formation in bond prices. In 2-year yields, this level stands at 4.25%.



Besides the monetary policy decision, the **ECB might announce some measures regarding the collateral banks use in liquidity-providing operations of the ECB.** The ECB was highly successful in keeping the financial system liquid at the height of the credit crisis during last summer, due to the rules governing its liquidity operations. These are very easy both regarding the large numbers of market participants allowed to participate, as to the length of the duration of its operations, the wide variety of assets (and its rating) accepted, the collateral and the applied pricing of the collateral. However, as time went by, the ECB got more and more frustrated as financial institutions relied increasingly on the ECB for liquidity, using lower quality collateral (mortgage-backed assets), that were often created exclusively to get access to ECB liquidity. This not only hinders the mortgage-backed security markets from reviving, but it might also imply an implicit subsidy for the financial institutions that use it. Not surprisingly, Spanish and Irish banks are cited as being very active in extracting more liquidity from the ECB, creating once more a distortion in an EMU that has no central fiscal authority (that might take up the cost of potential credit losses or implicit subsidies).

The financial markets remain fragile and it could certainly not be the objective of the ECB to inject extra uncertainties into the market. **So, the ECB will have to act cautiously when changing the rules and therefore it might be more a fine-tuning than an overhaul of the system.** However, one should carefully look to the decisions the ECB will take, as it might have implications for markets.

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