



KBC Flash

From KBC Market Research Desk - More research on www.kbc.be/dealingroom

ECB threatens July rate rise

- Trichet suggests rate rise likely next month
- ECB to act as inflation likely to start higher for longer
- Threat of further increases likely to hang over interest rate markets
- ECB adopting a very high risk strategy
- Higher interest rates unlikely to alter food or fuel costs...but could damage a clearly weakening Euro Area Economy

Today's European Central Bank decision to leave its key policy rate unchanged at 4.00 for a twelfth consecutive month did not come as a surprise to financial markets. However, Mr. Trichet's warning that rates could rise as soon as next month certainly did.

The indication that interest rates could rise as early as next month is probably the biggest shock the ECB has delivered to financial markets in its 9 ½ year history. Traders had looked to the ECB's monthly press conference for some guidance on the outlook for Euro area interest rates. In the past month or so, hopes for lower rates had all but vanished. Instead, the markets had begun to price in the prospect of an increase in official rates in the Autumn. In these circumstances, investors looked forward to Mr. Trichet's pronouncement today but there was little expectation of the fireworks he delivered.

The monthly press statement was more hawkish than expected. However, Mr. Trichet went a great deal further in responding to questions than the tone of the opening press statement had suggested. **In today's Q & A session, he said that a number of the ECB council wanted to raise rates today and suggested that the ECB "could move a small amount in July".** While he said it was not certain that rates will rise next month, he made it more than clear that 'it's possible to move in July'.

Mr. Trichet went so far today in preparing the market for a rate rise in July that it is difficult to see what would make the ECB decide against hiking rates next month. A failure to raise rates would leave markets completely lost as to what determines ECB policy and communications. Furthermore, the ECB's much wanted medium term focus means that the vagaries of monthly data between now and the next policy meeting on the 3rd of next month should not

dramatically alter ECB thinking. Hence, in sharp contrast to our earlier expectations, it now looks very likely that interest rates are set to rise next month.

Why are rates moving higher?

The rationale for today's shock announcement appears to be the expectation that inflation pressures will remain stronger for longer. Today's ECB projection envisages inflation averaging 3.4% in 2008 and 2.4% in 2009. This implies that inflation will remain well above the ECB's target for the foreseeable future. **The main reason for runaway inflation in the Eurozone and elsewhere is the trajectory of fuel and food prices even though there has been some easing of late.** However, Mr. Trichet also suggested that the ECB is concerned about the risk that a lack of competition in the services sector could also drive inflation higher. **Mr. Trichet was quite evasive on the precise cause for the marked change in ECB thinking in the past month. It appears that the ECB feels its credibility could be jeopardised if it isn't seen to respond to inflation staying so far above its target for such a long time.** So, we see today's words and next month's likely action as intended to convey the ECB's determination to deliver price stability – regardless of the cost.

What could prevent a rate increase?

Mr. Trichet's comments today suggested there were clear divisions within the ECB's governing council on whether rates should be raised. We think a rate increase is almost inevitable next month, even if it is still not completely certain. We think it would take an unexpectedly dramatic deterioration in the Euro area Economy to convince the ECB to back down. In the past few days we have seen considerable weakness in Eurozone retail sales and unexpectedly weak German manufacturing orders. **How-**

ever, today's comments make it quite clear that from the ECB's perspective, growth concerns fall a very poor second to worries about persistently high inflation. They also imply the ECB doesn't see activity weakening to the extent needed to make a decisive difference to the inflation outlook. Concerns about the impact of the credit crunch have also disappeared in regard to their monetary policy implications.

What happens next?

We think Economic growth in the Euro area will slow sharply in coming months. We don't share the ECB's expectation that it will rebound markedly in 2009. As a result we still think that eventually the ECB will be forced to change tack. That would imply an eventual easing in interest rates. However, that is now a very distant and seemingly remote prospect. **If we are right in thinking that a rise in interest rates is intended to underscore the ECB's credibility, then as Mr. Trichet said today 'a small increase' might suffice. However as inflation could push higher through the summer months, concerns about a further increase in the Autumn may well persist.** Certainly the ECB's current inflation forecast for 2009 holds out some possibility of a further tightening of policy. Although we think this is unlikely, it will remain the focus of financial markets and underpin upward pressure on Eurozone interest rates in the next few months.

Is the ECB Brave or Foolish?

There is no question that the ECB, like Central Banks right around the world, has found itself in a very difficult position. That said, it's solution to raise interest rates to underscore its commitment to price stability is a very risky strategy. The mainstay of the current inflationary impulse in the Eurozone is the surge in commodity costs. This will not be reversed by a small rate rise or possibly even by large measures. If food and fuel prices continue to rise, consistency could put pressure on the ECB to raise rates further in the Autumn.

The ECB's credibility across Europe could also be jeopardised if tighter policy is regarded as contributing significantly to a sharp slowdown. For some, the ECB could be a very easy target for economic strains both within and across countries within the Eurozone. In this regard, the timing of today's announcement will do little to garner support for the Lisbon treaty in next week's Irish referendum. Indeed, today's surprise from the ECB could reverberate around Europe for some time to come.

Austin Hughes, IIB Bank, Dublin
Bob Maes, KBC Bank, Brussels

Brussels Research (KBC)		Global Sales Force	
Piet Lammens	+32 2 417 59 41	Brussels	
Peter Wuyts	+32 2 417 32 35	Corporate Desk	+32 2 417 45 82
Didier Hanesse	+32 2 417 59 43	Commercial Desk	+32 2 417 53 23
Bob Maes	+32 2 417 51 94	Institutional Desk	+32 2 417 46 25
Dublin Research (IIB)			
Austin Hughes	+353 1 6646889	London	+44 207 256 4848
Prague Research (CSOB)		Frankfurt	+49 69 756 19372
Jan Cermak	+420 2 6135 3578	Paris	+33 153 89 83 15
Zdenek Safka	+420 2 6135 3570	New York	+1 212 541 06 97
Jan Bures	+420 2 6135 3574	Singapore	+65 533 34 10
Bratislava Research (CSOB)			
Marek Gabris	+421 2 5966 8400	Prague	+420 2 6135 3535
Silvia Cechovicova	+421 2 5966 8405	Bratislava	+421 2 5966 8436
Warsaw Research (Kredybank)		Budapest	+36 1 328 99 63
Piotr Radzewicz	+48 22 6345 946	Warsaw	+48 22 634 5210
Budapest Research (K&H)			
Gyorgy Barcza	+36 1 328 99 89		

Our reports are also available on: www.kbc.be/dealingroom
This non-exhaustive information is based on short-term forecasts for expected developments on the financial markets. KBC Bank cannot guarantee that these forecasts will materialize and cannot be held liable in any way for direct or consequential loss arising from any use of this document or its content. The document is not intended as personalized investment advice and does not constitute a recommendation to buy, sell or hold investments described herein. Although information has been obtained from and is based upon sources KBC believes to be reliable, KBC does not guarantee the accuracy of this information, which may be incomplete or condensed. All opinions and estimates constitute a KBC judgment as of the date of the report and are subject to change without notice.