

Flash Comment

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Allan von Mehren, +45 4512 8055, alvo@danskebank.dk

Søren Dijohn, +45 4512 8516, srdi@danskebank.dk

Euroland: ECB in a state of heightened alertness

Overview: ECB kept rates unchanged but the statement was very hawkish compared to the previous statement. This is the closest they can come to saying vigilant (and hence preparing for a hike) they can.

Trichet mentioned several times that the ECB was “in a state of heightened alertness”, and mentioned that although the decision to leave rates unchanged in the end was unanimous member of the board did have different views.

Details:

Without actually being so, the statement was as close to an announcement of a rate hike as it can be.

ECB is “in a state of heightened alertness” as risks to price stability over the medium term have increased further. This is reflected in the ECB staff projections for inflation which have been raised markedly for both 2008 and 2009. In 2009 inflation is projected to be in an interval of 1.8-3% thus likely to stay above 2% through out 2009. Trichet stressed that the ECB would prevent second-round effects and ensure that risks to price stability over the medium term do not materialise by acting in a firm and timely manner.

Concerning economic growth Trichet did mention that the new staff projection for 2008 (1.5-2.1%) were in the upper end of the interval in the March projection and that 2009 forecast were lowered (to 1-2%). Growth is projected to weaken in 2008 before accelerating gradually in the course of 2009.

Whether the ECB chooses to hike in the coming months is a close call. It was a unanimous decision to leave rates unchanged for the moment. However, in the question secession Trichet spoke very frankly about the exchange of opinions leading up to the decision to keep rates unchanged for now. He mentioned that a number of governing board members were in favour of a hike now, a number were in favour of a hike but not now and some were not in favour of a hike.

Assessment and outlook:

Possibility of a hike has increased significantly, It's a possibility but not certain. Markets are expecting a hike in July/August. By making such a strong statement and the following market reaction one can argue that not much is gained by the ECB if they do not raise rates. However even if the ECB hike rates we do not think the ECB will raise rates by 75 bp as markets currently are pricing.

In light of the strong statement we are considering changing our outlook for rates. We are in uncharted territory. The Board members very different view on the necessary rate policy mirrors among other things this.

What does it take for the ECB not to hike rates? In our view it takes either a significant decline in oil prices or very clear cut signals of a strong deterioration of the growth outlook (relative to the staff projections) e.g. a very markedly drop in the ifo. Until now the ifo has not declined as sharply as many other indicators on the economic situation so we may have something in store.

Projections for Euroland economy

	Euroland forecast			
	Danske Bank	ECB	OECD	
GDP %	2008	1.4	1.8	1.7
	2009	1.5	1.5	1.4
Inflation	2008	2.8	3.4	3.4
	2009	1.9	2.4	2.4

Sources: ECB Jun08, OECD Economic Outlook June 2008

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