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ECB Confirms Interest Rates to Rise in March

- Trichet warns of need for 'strong vigilance', thereby signaling a rate hike next month
- Tough talk from ECB continues to threaten a further increase...

As expected the European Central Bank left its key policy rates unchanged today. ECB President Jean Claude Trichet signalled that rates are set to rise again in March and the tone of his press statement suggests the ECB is anxious to ensure markets remain prepared for the possibility of a further hike later this year.

'Strong vigilance' is back

By repeatedly referring to the need for 'strong vigilance', the phrase consistently used in the past to signal an imminent rate increase, Mr. Trichet made it clear that the ECB intends to raise its key policy rate at its next scheduled policy meeting on March 8th.

There were two other notable aspects to the ECB press statement, which should be interpreted as offering a justification both for next months rate increase and the continuing threat of further interest rate increases later in the year.

The ECB is working hard to convince markets of the need for higher interest rates. We have repeatedly suggested that the Euro area inflation outlook had improved materially of late and this makes it increasingly awkward for the ECB to justify further rate hikes. Today's press statement mentions the need to look beyond favourable near term inflation prospects and notes the need to take 'a medium term perspective'. Conveniently, the statement makes no reference to the fact that the ECB's December projections suggested inflation would come in line with its price stability goal in 2008.

In recent months the ECB had suggested that inflation is expected 'to hover around 2% over this year and next'. In today's statement the ECB belatedly recognized the likelihood of notably lower inflation in the months ahead. However, it sought to downplay the significance of this development, arguing that it was likely to be a temporary drop which was largely due to favourable base effects stemming from

the fact that oil prices were rising in the spring of 2006. Mr. Trichet said that inflation would likely rebound but he failed to acknowledge one journalist's comment that this rebound would likely be driven by similar base effects albeit acting in the opposite direction

This argument is largely a device to justify raising interest rates further against a backdrop of falling inflation. Softer than expected Spanish and Greek inflation data carry the possibility that the final inflation figure for January and/or the preliminary February number could be as low as 1.8 per cent. A further decline towards 1.5 / 1.6 per cent might materialize through the spring. So, the ECB has already begun to argue why it feels compelled to tighten policy further.

ECB hawks still in the driver's seat

Euro area inflation has repeatedly surprised on the downside in recent months. So, the ECB references to the risk that higher oil prices would feed into broader price pressures looks far smaller than it did a year or even six months ago. As a result, the ECB's justification for repeated references to the same sources of upside risk to inflation looks less plausible than it did. That said, the fact that the ECB is warning of inflation threats now with just the same intensity as it did when it began its hiking cycle tells us clearly that many on the Governing Council feel the looming rate rise in March should not be the last.

A second, small but significant comment included in today's press statement referred to the fact that 'survey measures of capacity utilization are approaching the peak levels reached in 2000'. This hints that the ECB feels growth is too strong for comfort and could prompt a pick up in inflation. Again, Mr. Trichet sidestepped a journalist's assertion that if, as the ECB expected, growth were merely to continue around potential, this should not translate into higher inflation. References to capacity pressures arise because the ECB will find it difficult to argue that it needs to raise rates simply because

growth has recovered from the exceptionally poor record of the 2000-2005 period.

As the French election draws closer, any ECB actions that could be interpreted as being anti-growth will come in for considerable scrutiny. In any event, growth may be far less threatening to the inflation outlook than the ECB seems to think. While today's press statement acknowledged that the rise in German VAT had not boosted inflation in January as much as expected, it did not make any comment on why this might be the case. The failure of the feared price surge to materialise raises some interesting issues. If German companies feel unable to pass higher indirect taxes on to consumers even at a time of very strong economic growth, this may suggest the inflation climate is far less threatening than ECB rhetoric would suggest.

To be fair, the ECB is in an awkward position. It still feels lending growth is too strong for comfort and it is also worried about a possible inflationary impulse from the current German pay deal. However, lending growth on its own – particularly in the light of a slowdown in household borrowing, would not provide sufficient justification for higher interest rates. Similarly, the ECB has to be careful not to be seen as trying to prevent workers from gaining wage increases. In circumstances such as these, the ECB may feel it has to rely more heavily on increasingly less plausible arguments about generalised price pressures.

Conclusion

In summary, Mr. Trichet clearly signalled that rates will rise on March 8th. The tone of today's press statement suggests many on the ECB Governing Council think a further rate rise will be necessary later in the year. Ultimately, the outcome of the current German pay round may well be the swing factor. On productivity grounds even fairly substantial pay increases would not imply significant inflation risks for Germany or the broader Euro area. However, the ECB seems to be threatening it will act even against shadows. Next months updated projections may provide clearer evidence on ECB thinking as whether, when and by how much policy rates might need to change after the clearly signalled increase in March.

A further rate hike to 4% by September remains our basis scenario, which is currently also the market consensus. So, even while some question marks may be put after the rationale behind the upward risks on inflation, the reality is that the inflation threat is still believed by the markets. This should keep 2-year yields in their established range between 3.85% and 4% in the months to come.

Austin Hughes, IIB Dublin
Bob Maes, KBC 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
Peter Fontaine	+32 2 417 56 11	Institutional Desk	+32 2 417 46 25
Bob Maes	+32 2 417 51 94	London	
Dublin Research (IIB)		Frankfurt	+44 207 256 4848
Austin Hughes	+353 1 6646892	Paris	+49 69 756 19372
Prague Research (CSOB)		New York	+33 153 89 83 15
Jan Cermak	+420 2 6135 3578	Singapore	+1 212 541 06 97
Magdalena Stredova	+420 2 6135 3579	Prague	
Zdenek Safka	+420 2 6135 3570	Bratislava	+420 2 6135 3535
Jan Bures	+420 2 6135 3574	Budapest	+421 7 5966 8436
Bratislava Research (CSOB)		Warsaw	+36 1 328 99 63
Marek Gabris	+421 2 5966 8400	Warsaw	
Silvia Cechovicova	+421 2 5966 8405	+48 22 634 5210	
Warsaw Research (Kredybank)			
Piotr Radzewicz	+48 22 6345 946		

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