Trend Macrolytics, LLC
Donald Luskin, Chief Investment Officer
Thomas Demas, Managing Director
Lorcan Roche Kelly, Chief Europe Strategist

TRENDMACRO LIVE!

On Europe's July Rate Decisions

Thursday, July 7, 2011

Lorcan Roche Kelly

The new contagion? Inflation monomania drives the core to impose risks on the periphery.

As expected (see "On the June ECB rate decision" June 9, 2011), the ECB increased the main refinancing rate by 25 bp to 1.5% today.

- ECB president Jean Claude Trichet, at the post-decision press conference used the code-phrase "monitor very closely," which strongly suggests the next rate is not likely until October.
- The more surprising news was that the ECB is to waive its ratings requirement on Portuguese collateral for repo operations. This follows from similar decisions in relation to Greek and Irish debt.
- In answer to a question, Trichet said that the waiver was "an immediate response to ratings agency action." On ratings agencies in general, Trichet said that there is "an element of pro-cyclicality to ratings agency decisions that is not optimal," and that a solution to this problem "is a work in progress."
- It seems clear that the ECB is trying to curtail the power of the ratings agencies, while also reducing contagion risks form Greece (the Moody's rationale for the Portuguese downgrade contained specific references to Greek contagion).
- We infer from the Q&A session that Trichet has left the door open for the Greek central bank to engage in extraordinary liquidity assistance (ELA) to support Greek banks if the ECB cannot accept Greek sovereign debt due to default. Even absent default, ELA may be necessary in Greece to deal with the ongoing deposit-run on its banking system that we have noted (see "Black Wednesday in Greece" June 16, 2011).
- When asked about ELA, Trichet said it was not a decision for the ECB, rather it was a decision that would have to be made by "all Greek authorities, not just the government, but all Greek authorities." Presumably, "all Greek authorities" includes the Greek central bank. With this in mind, we will be monitoring the financial statements of the Bank of Greece to see any unusual asset growth -- that would be the tell-tale sign of ELA, as it was earlier this year for Ireland (see "The Libyan Connection" February 22, 2011).
- As we have previously noted (see "EUicide" April 7, 2011) ECB rate hikes disproportionally affect borrowers in the periphery, who are much more likely to have mortgages that track ECB interest rates. In Portugal and Spain in particular, rate-hikes drive significantly higher debt-service obligations as a fraction of GDP

Update to strategic view

ECB, BOE, EUROPE MACRO: The ECB has raised rates by 25 bp, as expected. Trichet also announced the waiver of ratings on Portuguese debt offered as collateral for repo operations -- a direct response to Moody's downgrade. The BOE, in the absence of meaningful UK growth -- and dismissing seemingly high inflation as merely "imported" -- maintained rates at 0.5%. The BOE's policy posture is appropriate for its sluggish growth -- the ECB's is not, with a monomaniacal focus on inflation making an already dangerous situation in the periphery even worse.

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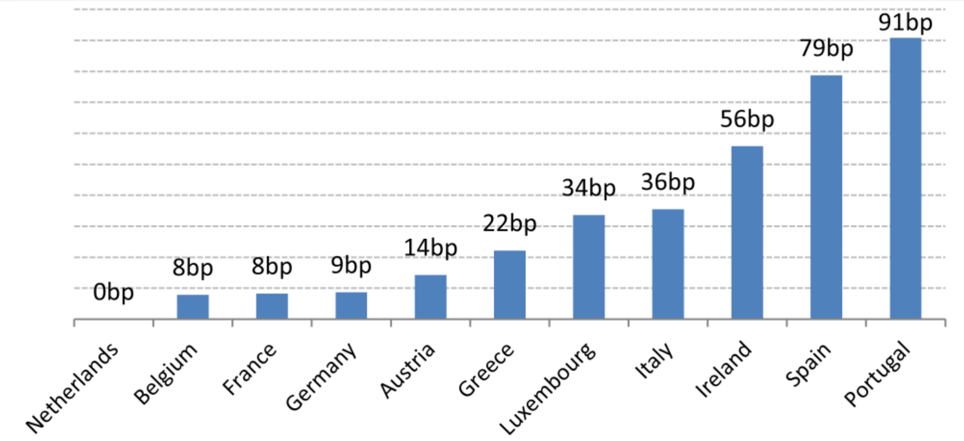
(please see the chart below), Trichet responded to questions on this issue only by saying the ECB sets rates appropriate for all of the Euro area.

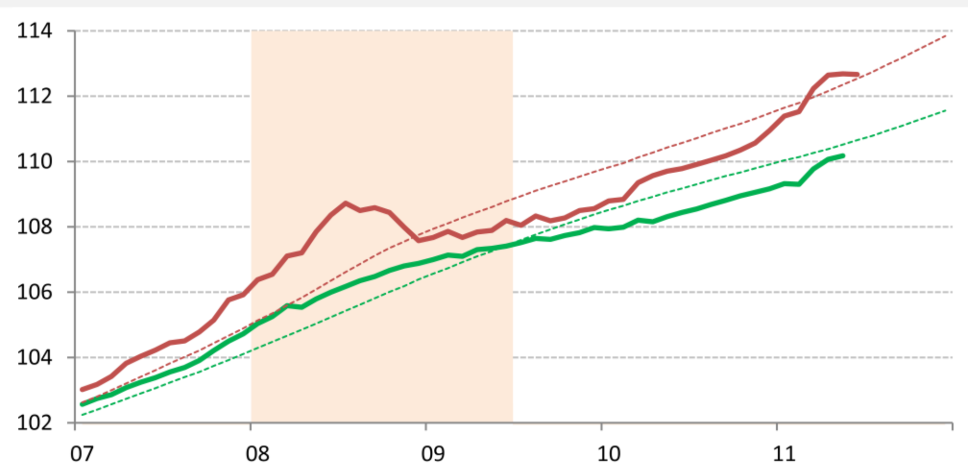
Estimated increase in annual mortgage debt service as percent of GDP, with 1% hike in ECB rate



Source: Various statistical bureaus, TrendMacro calculations

- [The ECB's mandate] is very clear -- it must maintain Euro area inflation "below, but close to 2%" in the medium term (unlike the Bank of England or the US Federal Reserve, it does not have a primary mandate on growth). Concerned not only with current inflation, but also with inflation expectations, the ECB acts much earlier in the inflation cycle than other central banks.
- But this particular cycle is dominated by the rise of energy and commodity prices, as Trichet has acknowledged. BOE governor Mervyn King has argued -- correctly, we think -- that such "imported" inflation cannot be reduced by monetary policy.
- Euro area core inflation has remained below trend, even as headline inflation has peeked above it. Now, with energy and

Euro area CPI ··· 10-year trend **US recession**
Euro area core CPI ··· 10-year trend



Source: Eurostat, TrendMacro calculations

Contact TrendMacro

On the web at [trendmacro.com]

Follow us on Twitter at [twitter.com/TweetMacro]

Donald Luskin
Menlo Park CA
650 429 2112
don@trendmacro.com

Thomas Demas
Charlotte NC
704 552 3625
tdemas@trendmacro.com

Lorcan Roche Kelly
Sixmilebridge Ireland
212 537 9067
lorcan@trendmacro.com

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Recommended Reading

The fear of contagion in Europe
Paolo Manasse and Giulio Trigilia
VoxEU
July 6, 2011

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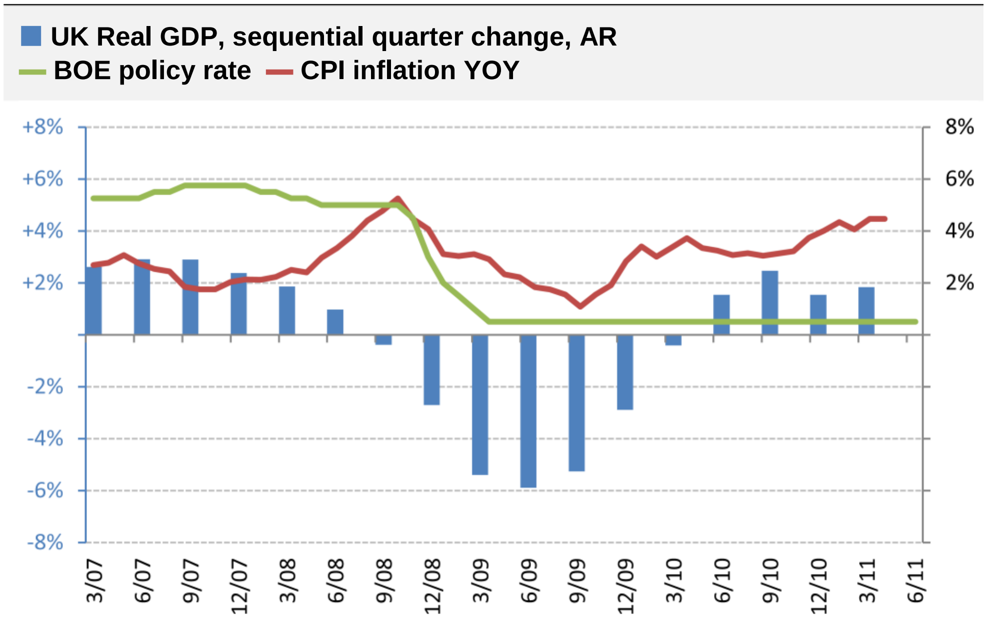
commodity prices easing over the last quarter, headline inflation has flattened out (please see the chart on the previous page). If King is right that rate-hikes are ineffective -- and if inflation is moderating anyway -- then it is foolish and dangerous for Trichet to continue to hike rates, putting the periphery at further risk.

- The ECB's monomaniacal attention to inflation is risking a new form of contagion within the Euro area. Rather than the fiscal indiscipline of the weaker countries hurting the stronger ones, the ECB's misguided attempt to control inflation in the stronger ones will extinguish any hope of growth in the weaker ones.

Meanwhile, the Bank of England's Monetary Policy Committee (MPC) voted to maintain rates at 0.5% -- unchanged since March 2009.

- UK inflation has been above the official 2% target rate since the end of 2009 -- it is currently at 4.5% (please see the chart below).

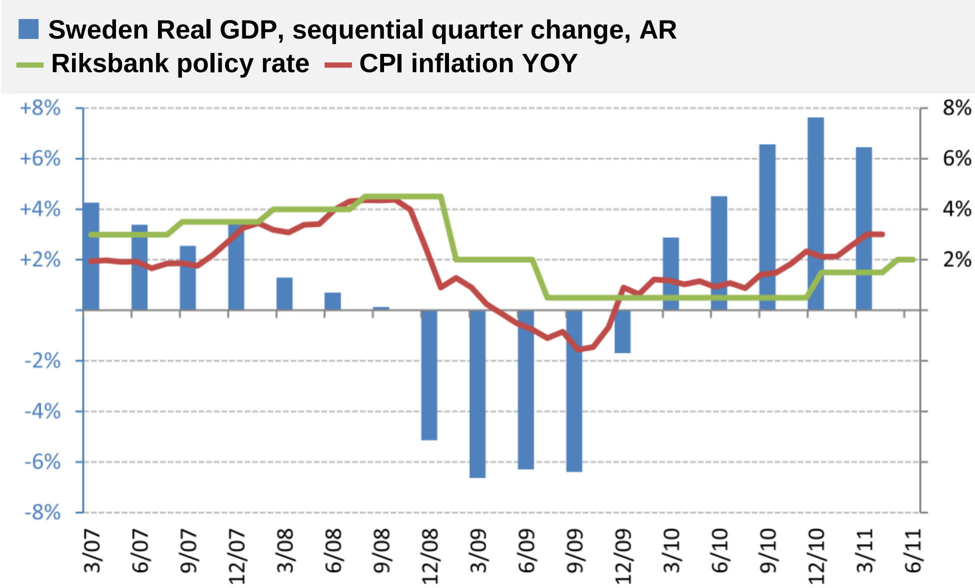


Source: ONS, TrendMacro calculations

- Under rules introduced following the BOE gaining independence in 1997, the governor of the BOE must write a letter to the Chancellor of the Exchequer (UK Treasurer) to explain inflation rates that deviate more than 1% from the target rate of 2%.
- King's latest letter the Chancellor blames imported inflation, VAT increases and energy prices for the higher than target CPI.
- While it is clear that CPI is above target, growth in the UK remains sluggish. The Chancellor's reply to the MPC's letter in May acknowledges the MPC's view that inflation will return to trend in the medium term, but highlights the risk posed to economic activity by any tightening in the short term -- a risk the ECB seems determined to ignore.

It is worth comparing the actions of the BOE with those of the Swedish central bank, the Riksbank -- and both of them together versus the ECB.

- While BOE rates appear to have become decoupled from inflation in the UK, the Riksbank policy rate continues to closely track Swedish inflation (please see the chart below).



Source: SCB, TrendMacro calculations

- The Riksbank's job has been made easier due to a much stronger return to growth in Sweden, but it was also very proactive during 2009 when inflation turned negative. As part of its policy response, it reduced its deposit rate to -0.25% (yes, literally a negative deposit rate!) and kept it there until September 2010. This rate is roughly equivalent to the US Fed's interest rate paid on excess reserves. By setting it below zero, the Riksbank was effectively flushing deposits on its balance sheet out into the economy.
- This week the Riksbank raised its repo rate 25 bps to 2%, its seventh hike since July 2010.
- While the BOE and the Riksbank share the inflation target of 2%, it seems that both increased inflation *and* increased growth are needed before they will take action that tightens monetary policy.
- The ECB, by contrast, has it exactly upside-down. There is little growth in the Euro area, and only "imported" headline inflation. Yet, monomaniacally, the ECB has tightened once again.

Bottom line

The ECB has raised rates by 25 bp, as expected. Trichet also announced the waiver of ratings on Portuguese debt offered as collateral for repo operations -- a direct response to Moody's downgrade. The BOE, in the absence of meaningful UK growth -- and dismissing seemingly high inflation as merely "imported" -- maintained rates at 0.5%. The BOE's policy posture is appropriate for its sluggish growth -- the ECB's is not, with a monomaniacal focus on inflation making an already dangerous situation in the periphery even worse.