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TRENDMACRO LIVE!

On the June ECB Rate Decision

Thursday, June 9, 2011

Lorcan Roche Kelly

Trichet is poised to compound the ECB's suicidal policy error with a July rate hike.

As expected, the ECB maintained the benchmark interest rate at 1.25% today. There were two things to watch out for in Jean-Claude Trichet's post-decision press conference: would he use the word "vigilance" to signal a rate rise in July, and would he react to German Finance Minister Schaeuble's open letter calling for debt reprofiling for Greece, in light of the ECB's aggressive opposition to it?

At the prior decision, Trichet has used the expression "monitor very closely," signaling no rate hike next month. This morning he used the code-phrase "strong vigilance," so we can now expect the next ECB benchmark rate hike in July.

- Trichet said ECB staff projections for Euro area inflation for June have been revised upwards from March numbers, to a range of 2.5% to 2.7% for 2011.
- He reiterated the importance of not allowing inflation driven by higher energy and commodity prices to lead to second round price/wage effects.
- He also warned on price effects of indirect taxation due to austerity measures undertaken by Euro area governments due to fiscal rebalancing.

As to Schaeuble's letter, Trichet has insisted in every press conference recently that there is a plan in place for each of the countries receiving bailout money, and those countries must follow that plan. Today the language softened slightly -- in response to a question, Trichet said that "there is a framework" that the ECB has "strong determination" to follow.

- The ECB calls for avoiding any credit event. Schaeuble's letter calls for burden sharing with private investors. The ECB rejects this in all circumstances where the burden sharing is not 100% voluntary -- setting what amounts to an impossible condition.
- But whatever happens, the ECB will employ its rules and framework with regard to collateral for repo operations -- rules which it has already changed for Greece and Ireland, as it now accepts those countries' debt for repo without reference to those countries' ratings.

Update to strategic view

ECB RATE, EUROPE MACRO: The ECB has clearly signaled another rate hike for July. This will be a continuation of inflation-centric policy that allows no room growth to develop within the economies in the Euro area that are struggling the most.

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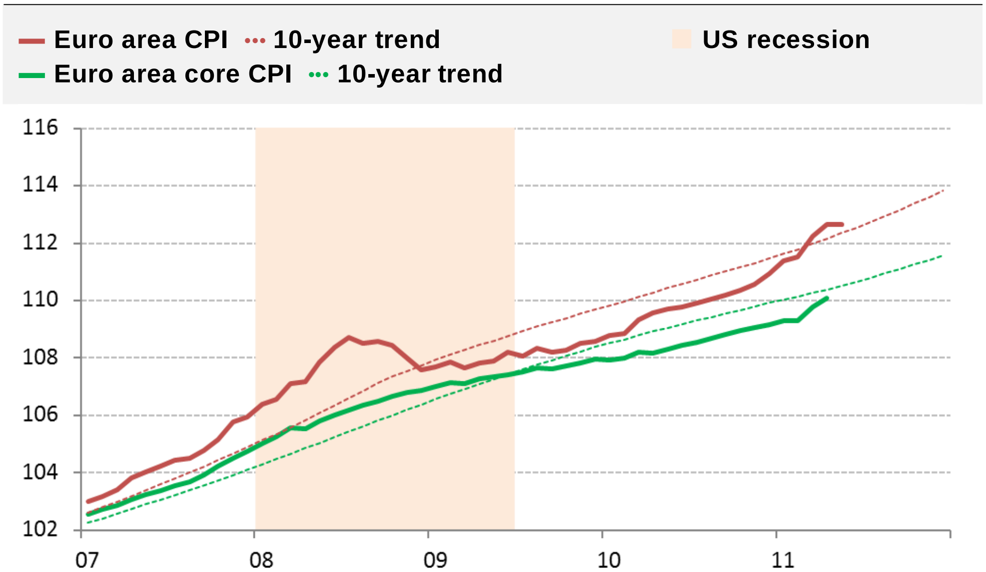
- Trichet sees that Greek privatizations are a better way of mobilizing private capital, than using that private capital to take losses on Greek debt. But we believe that Greece lacks the political will to do that, and also has little experience with foreign direct investment (see "Greece: Suicide, Not Murder" June 7, 2011).
- Trichet emphasized the ECB's "fierce independence." Yet this crisis has taught us that this independence should not be mistaken for intransigence, as the ECB has already bent many of its rules to accommodate policy decisions that are not allowed, according to strict readings of EU treaties.

We maintain the view that hiking interest rates will prove a disastrous mistake (see "EUicide" April 7, 2011).

- Trichet pointed to the May MUICP inflation flash estimate of 2.7% year-on-year (please see the chart below), which is down from 2.8% for April. From this we can infer that the month-on-month inflation rate for May works out to almost zero (0.27% annualized, to be precise).



Source: Eurostat, TrendMacro calculations

- Clearly, Eurozone inflation remaining above the target of "close to, but below 2%" is still driven by exogenous events -- as mentioned by Trichet in his comments -- with core CPI remaining below trend.

It remains our view that the ECB's mandated inflation crusade will continue to impose headwinds on the Euro area economy, with the peripheral economies suffering the most. They will have find growth in the face of higher interest rates, further austerity and increased indirect cost increases due to fiscal measures at a national level.

Greece is such a basket case that interest rate movements are unlikely to

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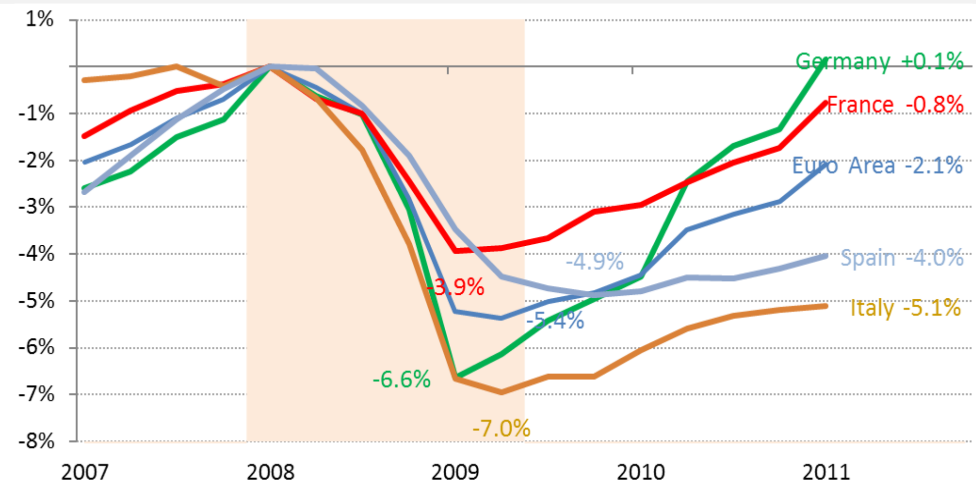
make much difference to that country's chances of survival. But, for Ireland and Portugal, interest rate increases still may turn out to be the straw that breaks the backs of those camels.

Other European central bank interest rates	
United Kingdom	0.5%
Switzerland	0.25%
Czech Republic	0.75%
Sweden	1.0%
Hungary	6.0%
Iceland	4.25%
Norway	2.25%
Poland	4.5%

For Spain and Italy, who are still far below trend growth (please the chart below), mistimed interest rate decisions are certainly going to make a return to growth less likely, especially as higher rates flow directly into higher mortgage debt-service costs (see "The Libyan Connection" February 22, 2011).

Real GDP, change from peak



Source: BEA, Eurostat, NBER, TrendMacro calculations

Bottom line

The ECB has clearly signaled another rate hike for July. This will be a continuation of inflation-centric policy that allows no room growth to develop within the economies in the Euro area that are struggling the most.