Eurobank Research
www.eurobank.gr/research
research@eurobank.gr

Eurobank EFG

GLOBAL ECONOMIC & MARKET OUTLOOK

July 11, 2011

Focus Notes

The ECB continues its tightening cycle

Written By:

Vasilis Zarkos:
Economist Analyst
vzarkos@eurobank.gr

DISCLAIMER
This report has been issued by EFG Eurobank Ergasias S.A. (Eurobank EFG), and may not be reproduced or publicized in any manner. The information contained and the opinions expressed herein are for informative purposes only and they do not constitute a solicitation to buy or sell any securities or effect any other investment. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees may perform for their own account, for clients or third party persons, investments concurrent or opposed to the opinions expressed in the report. This report is based on information obtained from sources believed to be reliable and all due diligence has been taken for its process. However, the data have not been verified by EFG Eurobank Ergasias S.A. (Eurobank EFG), and no warranty expressed or implicit is made as to their accuracy, completeness, or timeliness. All opinions and estimates are valid as of the date of the report and remain subject to change without notice. Investment decisions must be made upon investor's individual judgement and based on own information and evaluation of undertaken risk. The investments mentioned or suggested in the report may not be suitable for certain investors depending on their investment objectives and financial condition. The aforesaid brief statements do not describe comprehensively the risks and other significant aspects relating to an investment choice. EFG Eurobank Ergasias S.A. (Eurobank EFG), as well as its directors, officers and employees accept no liability for any loss or damage, direct or indirect, that may occur from the use of this report.

- The ECB delivered the second rate hike of the current tightening cycle, raising its policy rate by 25bps to 1.50%. We expect the policy rate to reach 1.75% by the end of the year.
- The ECB has suspended the collateral requirement rules for Portuguese government bonds after they have been downgraded to below investment status by Moody's.
- ELA facility could be used for liquidity provision to Greek banks if government bonds fall to default status.
- Divergent growth pattern complicates monetary policy, as higher rates put a further burden on public and private finances in the periphery.
- Risks to inflation remain on the upside, implying that a more aggressive tightening cycle might materialize.

Another rate hike despite weaker data.

The ECB continues the tightening cycle with another unanimous hike by 25bps, bringing its policy rate to 1.50%. Further tightening of monetary policy comes at a time when the euro area economy is loosing strength, as is evident by both soft and hard data. Accommodative monetary policy bodes well with modest money supply (M3) growth (Figure 1), which is likely to remain subdued due to weaknesses of the financial sector. However, ECB officials focus on price stability, implying that headline inflation is the preferred measure of price developments, as opposed to the FED, which focuses on the progress of the economic recovery and core inflation. As is evident by Figure 2, headline inflation picks up very fast any change in energy prices, which justifies the ECB's pre-emptive action to tame inflationary pressures due to elevated commodity prices.

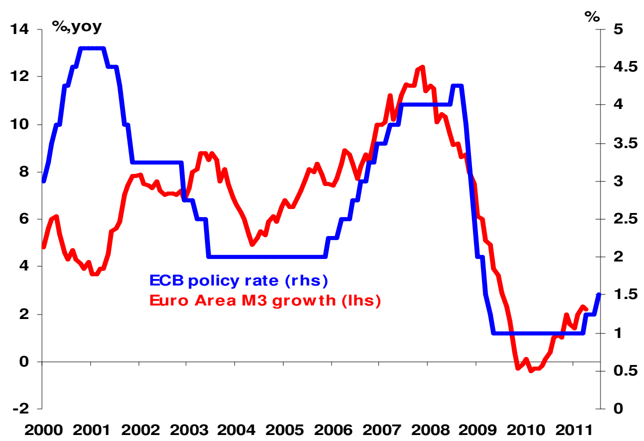
While the ECB has acknowledged the recent decline in economic growth momentum, the "monitor very closely" signal in Trichet's Introductory Statement implies that this rate hike is not the end of the current hiking cycle. Based on our assessment of a rebound in economic strength in the second half of the year, we expect the ECB to deliver one more rate increase in October, raising the main refinancing operations rate to 1.75%.

Collateral rules suspension for Portugal

As has been the case for Greece and Ireland, the ECB announced its decision to suspend the application of the minimum credit rating threshold in the collateral eligibility Figrequirements for marketable debt instruments issued or guaranteed by the Portuguese government. The suspension will be maintained until further notice.

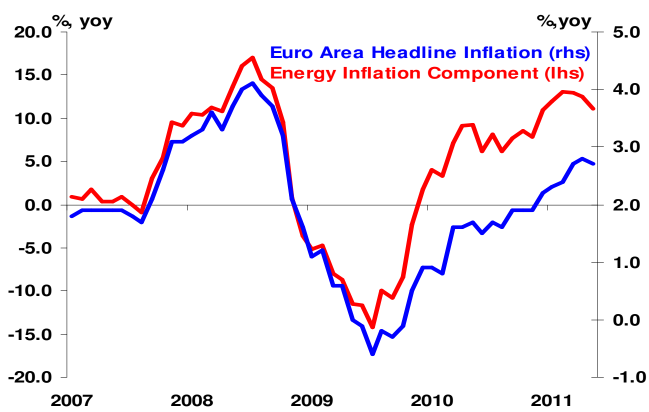
The waiver of the rating threshold for government bonds of program countries used as collateral has diminished the role of the rating agencies in the formation of monetary policy in the euro area. However, it remains unclear whether the ECB will accept Greek bonds if they are downgraded to default status by all three rating agencies. Trichet refrained from giving a clear answer, sticking to his "no to selective default" stance. We believe that if Greek government bonds fall to default grade, the Greek banking sector could continue having access to ECB lending through the Emergency Liquidity Assistance (ELA) facility. In that case, liquidity would be provided through the Bank of Greece, which will accept assets that the ECB does not accept as collateral, most likely imposing large haircuts.

Figure 1



Source: Bloomberg

Figure2



Source: Eurostat

Divergent growth pattern complicates monetary policy.

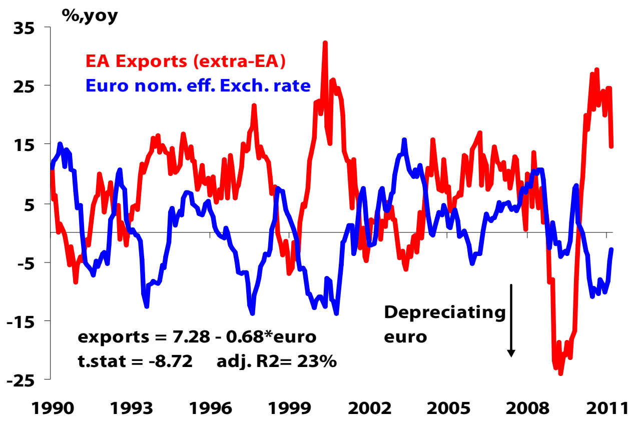
The ECB continues facing the "one size fits all problem" due to the divergent recovery pattern in the euro area. The current low level of policy rates does not look appropriate for Germany's outstanding performance. At the same time, the euro area periphery needs accommodative policy to breathe. Higher rates in the euro zone, coupled with strong headwinds to the US economy, have led to euro appreciation that affects adversely euro area exports (Figure 3). The strong euro also affects adversely periphery members' efforts to improve their competitiveness and rebalance their growth towards external demand. In addition, debt service payments for program countries, i.e. Ireland, Portugal and Greece, become heavier as they are tied to the Euribor. Finally, higher rates place a heavier burden on borrowers in several countries, such as Spain, Italy and Ireland, where the majority of mortgage loans are floating rate indexed to the Euribor. Overall, higher rates create a mix of tight monetary and fiscal policy which is unfavorable to growth in debt laden countries.

EA inflation outlook: Headline CPI has edged lower, but risks remain on the upside.

The recent decline in energy prices has caused headline inflation to edge lower to 2.7% in May, after peaking in April at 2.8% year-on-year. The energy component of the headline CPI has been sliding downwards since March, as elevated commodity prices have curbed global growth, which, in turn, led to a decline in oil demand and an unwinding of speculative positions in oil. We expect oil prices to remain flat for the next few months due to the soft patch of the global recovery. Our assessment is that euro area headline inflation has reached its peak and we expect it to turn out at 2.6% (average yearly growth). Nevertheless, risks for energy prices remain on the upside, suggesting that the ECB will monitor closely their impact on inflation. Global growth remains solid and is expected to regain momentum later in the year, pushing higher demand for energy. In addition, unrest in the Middle East/North Africa region is lingering and it could take a turn for the worse at any time. Furthermore, food prices are likely to remain on an upward trend due to unfavorable weather conditions.

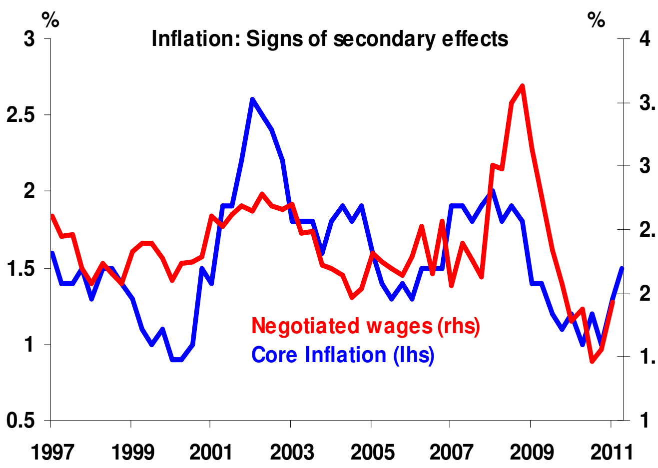
Signs of second round effects have emerged as euro area core inflation jumped to 1.6% in April from 1% in February, before slipping lower by 0.1% in May. Yet, the remaining economic slack is expected to keep core inflation pressures contained. While negotiated wages (Figure 4) have started increasing as labor unions push for higher compensation, unemployment remains high and is expected to recede at a very slow pace. However, wage developments in countries with tight labor market conditions, most notably Germany, deserve to be monitored as an indicator of future ECB monetary policy decisions.

Figure 3



Source: Ecowin

Figure 4



Source: Ecowin

Research Team

Editor, Professor **Gikas Hardouvelis**
Ch ief Economist & Director of Research Eurobank EFG Group

Financial Markets Research Division
Platon Monokroussos, *Head of Financial Markets Research Division*
Paraskevi Petropoulou, *G10 Markets Analyst*
Galatia Phoka, *Emerging Markets Analyst*

Sales Team
Nikos Laios, *Head of Sales*
Vassilis Gioulbaxiotis, *Head of International Sales*
Yiannis Seimenis, Ioannis Maggel, *Corporate Sales*
Stogioglou Achilleas, *Private Banking Sales*
Alexandra Papathanasiou, *Institutional Sales*

Economic Research & Forecasting Division
Dimitris Malliaropulos, *Economic Research Advisor*
Tasos Anastasatos, *Senior Economist*
Ioannis Gkionis, *Research Economist*
Vasilis Zarkos, *Economic Analyst*
Stella Kanellopoulou, *Research Economist*
Olga Kosma, *Economic Analyst*
Maria Prandeka, *Economic Analyst*
Theodosios Sampaniotis, *Senior Economic Analyst*
Theodoros Stamatiou, *Research Economist*

Eurobank EFG, 20 Amalias Av & 5 Souri Str, 10557 Athens, tel: +30.210.333 .7365, fax: +30.210.333.7687, contact email: Research@eurobnak.gr

Eurobank EFG Economic Research

More research editions available at http://www.eurobank.gr/research

- **New Europe**: Economics & Strategy Monthly edition on the economies and the markets of New Europe
- **Economy & Markets**: Monthly economic research edition
- **Global Economic & Market Outlook**: Quarterly review of the international economy and financial markets

Subscribe electronically at http://www.eurobank.gr/research


NEW EUROPE ECONOMICS & STRATEGY
GLOBAL ECONOMIC & MARKET OUTLOOK
ECONOMY & MARKETS