

ECB Keeping Alive Expectations of Higher Interest Rates

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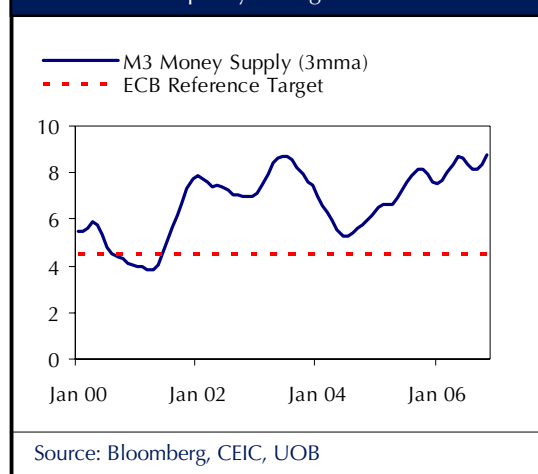
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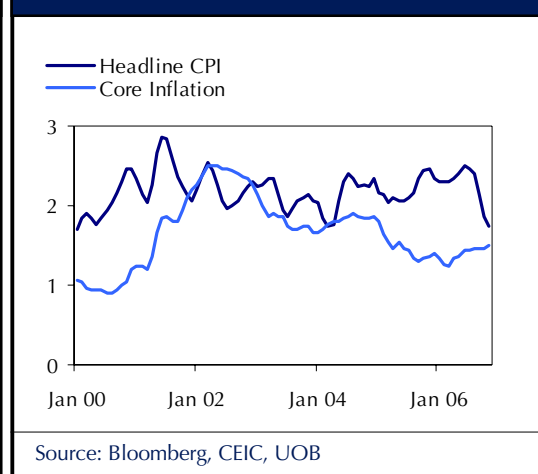
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- ECB holds its next policy meeting next Thurs (Jan 11), where market expectations lean towards steady rates at 3.5%. ECB Pres Trichet's speech at the press conference (post policy meeting) would be closely watched for clues for a Feb or March rate hike. While mostly in agreement of ECB rates at 3.75% end March, players appear divided over the timing of rate increases.
- Watch for Changes in ECB Rhetoric: Reiteration of Dec's phrase "monitor very closely" all developments to price stability, would indicate a March move. Whereas, upping ECB's hawkish stance to "strongly vigilant" would indicate the CB's intention to deliver an imminent move to 3.75% in Feb. Watch for heightening concerns over wage inflation ahead of German pay talks. A major German trade union recently called for pay increases up to 6.5% to compensate for higher VAT (up 3% to 19% on Jan 1), strong economic growth and higher inflation. ECB Liikkanen noted that if pay increases outweighed productivity, risks are towards pick up in wages and higher inflation. Any significant pick up in wage inflation should keep ECB increasingly alert on the interest rate trigger.
- ECB Walking the Talk: ECB's hawkish rhetoric has kept alive market expectations of higher interest rates in the pipeline. Notably, ECB Weber said that ECB rate at current 3.5% was still accommodative. Most recent, ECB Liikkanen warned that as economic growth strengthened, risks were towards stronger pricing power by corporates, resulting in higher 2nd round effects of energy prices on inflation. ECB Bin Smaghi further added that the CB would have to deliver higher interest rates if economic growth continued in 2007.
- Accommodative Monetary Conditions: Despite past rate hikes (150bps increase in current tightening cycle), recent economic data continue to point to accommodative conditions. M3 measure of money supply growth (3mma) jumped to 8.8%/y/y in Nov vs 8.4%/y/y the previous month, persisting above the 4% target ECB considered in line with price stability over the medium term. Loans to non-financial corporations rose 13.1%/y/y in Nov after an already robust 12.9%/y/y rise in Oct. Overall private sector loans (including corporate loans) again rose 11.2%/y/y in Nov, and was slightly weighed by slower lending for housing loans. With excess liquidity and high credit conditions pointing to accommodative conditions posing upside risks to inflation, the ECB is likely to hold firm its intention to normalize rates (seen in the region of 3.75-4.5%) compared

Excess Liquidity Posing Inflation Risks



Softer Inflation on Decline in Oil Prices



to present 3.5%. Nonetheless, some signs of tighter monetary conditions starting to weigh on housing – mortgage lending eased a tad to 10.2%/y/y vs 10.4%/y/y and 11.0%/y/y in Nov and Oct respectively. In addition, with CPI at 1.9% in line with ECB's target of "close to, but less than 2%", the CB appears to have some breathing room to allow more time to assess the impact of past rate hikes and recent VAT increase on overall eurozone economy. We believe the ECB would wait till March to deliver another 25bps increase to 3.75%.

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