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Economic News

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ECB leaves repo rate on hold at 4%, but bias towards rate hikes

It is all as expected again today at the European Central Bank, with the main marginal lending, repo and deposit rates maintained on hold for the fifth consecutive month, at 5%,4% and 3% respectively.

The European Central Bank President Trichet's press conference does little to alter our assessment for Eurozone rates: **a wait and see approach to monetary policy is likely to be prolonged over the next few months** but if anything, **the ECB is more likely to RAISE than CUT interest rates at this stage.**

This view is also well supported by the ECB's updated growth and inflation forecasts: as we suspected, the expected 2008 GDP growth range was revised to the downside, with a median now at +2% (from +2.3%) and with the 2009 GDP growth forecast median at +2.1%. More importantly in terms of guiding the near-term monetary policy bias is the inflation forecasts: we have a median at +2.5% for 2008, up from +2% in the previous ECB forecasts. For 2009, the inflation profile shows a median at +1.8% y/y. Basically, Eurozone inflation is expected to stay well above the 2% ceiling next year and this is presuming that wage inflation remains under control.

	CPI		GDP	
	Dec forecasts	**Sep forecasts**	**Dec forecasts**	**Sep forecasts**
2007	2.0 - 2.2	1.9 - 2.1	2.4 - 2.8	2.2 - 2.8
2008	2.0 - 3.0	1.5 - 2.5	1.5 - 2.5	1.8 - 2.8
2009	1.2 - 2.4	-	1.6 - 2.6	-

Indeed, in its policy statement, **Mr Trichet called for moderate wage growth several times** and warned that the monetary authorities are alert and **will not tolerate second round effects**. Apart from second round wage effects, other inflation risks referred to included high oil and agricultural prices. Meanwhile, medium-term upside inflation risks include continued strength in monetary growth - no change there.

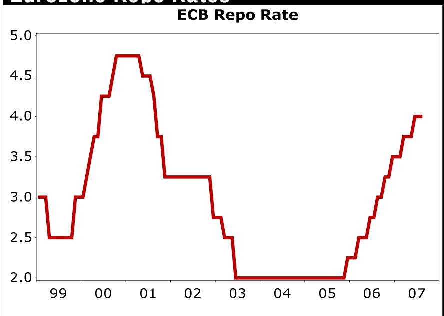
As for the real economy, the ECB acknowledged downside growth risks related to the financial market disruptions, with high uncertainty, but 'The scenario of sustained GDP growth broadly in line with trend potential' is confirmed and '.. based on the expectation that the global economy will remain resilient'.

Importantly, the ECB President indicated that rate hike talks were discussed today, with some (most likely the Germans) supporting an immediate rate hike.

Overall, this confirms that the rate cut option is clearly not on the agenda for the time being in the Eurozone. For now, we stick to a no-change monetary policy outlook for the near-term, but **should financial market conditions normalise early next year, the rate hike risk scenario could increase.** The ECB has an inflation policy mandate, Eurozone growth is hovering close to trend and inflation is well above target: the risk has to be to the upside for rates. In the end, we believe that next year's wage negotiations (due in Germany in February) will prove crucial in influencing whether a one last rate hike scenario eventually materialises... **For now, it is wait and see but in the current environment, we continue to believe that Euro bonds should under-perform most of their G7 counterparts and the rate outlook remains euro supportive**.

Audrey Childe-Freeman

Eurozone Repo Rates



Source: Reuters EcoWin

Interest Rate Forecasts

	Current Level	Next Move	Timing	Q108	Q208	Q308	Q408
Bank of England	5.50%	-25bp	Q1-08	5.25%	5.00%	5.00%	5.00%
European Central Bank	4.00%	Unch	Unch	4.00%	4.00%	4.00%	4.00%
Federal Reserve	4.50%	-25bp/ -50bp	Dec-07	3.75%	3.75%	3.75%	3.75%

Source: CIBC WM