

Audrey Childe-Freeman (0207 234 6676) Senior European Economist
Jodie Tiller (0207 234 7325) European Economist

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

It was all as expected at the European Central Bank today which left its main marginal lending, repo and deposit rates on hold, at 5%, 4% and 3% respectively. This was the seventh consecutive month that the ECB opted for a wait and see policy decision, but unlike at the Fed or at the BoE, the bias is towards higher rates, still.

An analysis of the European Central Bank President Trichet's press conference is totally consistent with our assessment for Eurozone rates this year: it will either be unchanged or rate hikes on the monetary policy front, rate cuts are clearly off the agenda for now.

The assessment of the economy has not changed much since the time of the December Meeting, with GDP growth expected at around potential this year as *'fundamentals are sound, employment growth has been robust and profitability has been sustained'*. However, the ECB also acknowledges that *'...uncertainty about the prospects for economic growth remains high and the risks surrounding the outlook for economic activity lie on the downside'*. Mr Trichet also reiterated that *'...the ongoing reappraisal of risk is still accompanied by uncertainty'*, confirming that the ECB is paying continued attention to market developments. As for inflation, it was a familiar hawkish assessment too, with the ECB reiterating that *'The HICP inflation rate is expected to remain significantly above 2% in the coming months and is likely to moderate only gradually in the course of 2008'*. Crucially in terms of monetary policy direction, the ECB emphasised the importance of moderation in wage growth: *'The Governing Council is monitoring wage negotiations with particular attention. Any indexation scheme of nominal wages to prices should be eliminated'*. This reinforces our view that **should the ongoing wage negotiations** (in Germany the civil servants wage talks have started today, to be followed by IG Metall in early February) **lead to higher pay deals, then an ECB rate hike would become a serious possibility, notwithstanding the current US economic environment.**

When it comes to code words, there has been a slight change since December, when the Council *'was ready to act in a firm and timely manner'*, while the Council is now said to be ready to act *'pre-emptively'*. Mr Trichet also suggested that the ECB is in a position of total alertness and that **he would not tolerate 'wage-price spirals'**. So attention should now be on the coming rounds of wage negotiations throughout Europe and the tightness in the labour market clearly points to upside risks on that front. **All this confirms that a) rate cut is a non-option in Euroland for now and b) the rate hike risk should not be underestimated.** It is all euro bullish and consistent with an underperforming Eurozone bond market vs its UK/US counterparts.

Audrey Childe-Freeman

