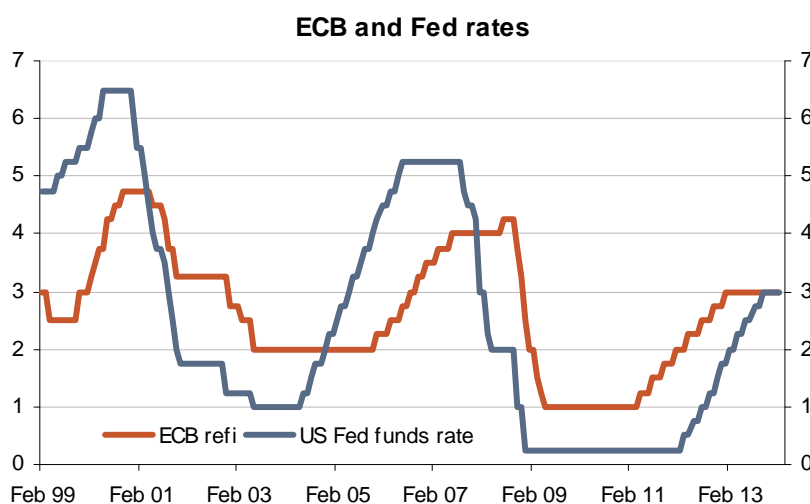


ECB: a good move

- The 25bps European Central Bank (ECB) rate hike today was probably just the start. As before, we expect the ECB to raise rates by 25bps each quarter until the main refi rate hits 3% in early 2013.
- The last time the ECB raised rates, it was a major mistake. This time, in our view, it is not. The key differences between now and the unfortunate 25bps hike in mid-2008 are obvious: the starting level of rates is now much lower, leading economic indicators are much stronger and the financial system seems to be less impaired now.
- For an economy that is no longer in an acute crisis but is recovering at a growth rate close to trend, the record low of 1% is no longer the appropriate central bank rate. At 1.25%, the ECB refi rate is still extremely supportive of growth.
- ECB president Trichet did not answer the question of whether today's move is the start of a series. However, the ECB's rhetoric today is consistent with a further 25bps rate increase in Q3, probably in July. The vow to monitor upside risk to price stability 'very closely' usually heralds a follow-up rate hike within a few months.
- Higher ECB rates could push the euro up further. However, we expect the US Federal Reserve (Fed) and other central banks such as the Bank of England (BoE) also to change their stance over the course of this year. This should limit any euro upside.
- Rate hikes and the recent rise of the euro on the back of such rate hike expectations add to the problems of the debt-ridden countries at the euro zone periphery – but we need to see that in perspective. The ECB merely reacts to the resilience of the overall euro economy. The underlying strength of core Europe is good for the periphery.

Chart 1: ECB and Fed rates



Source: ECB, Fed, Berenberg forecasts from April 2011 onwards

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7 April 2011

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ECB: the start of a series?

This time is different

The ECB's 25bps hike today was probably just the start. As before, we expect the ECB to raise rates by 25bps each quarter until the main refi rate hits 3% in early 2013.

Just the start

The last time, the ECB raised rates, it was a major mistake. This time, in our view, it is not. The key differences between now and the unfortunate 25bps hike in mid-2008 are:

Last time, the rate hike was a mistake

- Last time, the ECB raised rates from an above-average level of 4% to a somewhat restrictive 4.25%. This time, the ECB started from a record low of 1%.
- Last time, leading economic indicators had already been falling significantly for one year ahead of the hike. This time, leading indicators are at levels that signal strong growth.
- Last time, the US sub-prime crisis was taking an ever-increasing toll on euro zone banks. This time, the healing process in the banking system and the financial sector is far advanced.

This time, it is not

With the euro zone economy on track for growth close to the 1.8% trend rate in 2011, the emergency refi rate of 1% that the ECB adopted in the wake of the post-Lehman recession is no longer needed. Arguably, a modest rise in rates does not even reduce the effective monetary stimulus to the real economy. Eighteen months ago, the transmission of the monetary stimulus through the banking system was severely impaired. As recovering banks and markets are now better able to pass on the stimulus, the ECB needs to become less generous to the banking system. Otherwise, too much of the stimulus would find its way through the banking system to the real economy. At 1.25%, the ECB refi rate is still extremely low.

A 1% rate is too low for an economy expanding at roughly its trend rate

Hinting at a further rate hike to come

As expected, ECB president Trichet did not answer the question of whether today's move is the start of a series. However, the ECB's rhetoric today is consistent with a further 25bps rate increase in Q3, probably in July rather than September:

ECB vows to monitor inflation risks 'very closely'

1. The ECB warned that it will 'monitor very closely' upside risks to price stability.
2. Risks to price stability 'remain on the upside', according to the ECB's statement.
3. While Trichet explained that the ECB had not decided today to start a series of hikes, he emphasised that the ECB would continue to do what is appropriate in the future.

We cannot rule out the risk that the ECB may take the next step to 1.5% as early as June. On four occasions during the rate hike cycle that started in late 2005, the first use of the phrase 'monitor very closely' heralded a rate hike two months later. On four other occasions during that period, it pointed to a rate increase in three months' time.

Move in June not ruled out

Can the periphery stand higher rates?

Rate hikes and the rise of the euro on the back of such rate hikes add to the problems of the debt-ridden countries at the Eurozone periphery – but we need to see that in perspective. The ECB merely reacts to the resilience of the overall euro economy. The underlying strength of core Europe is good for the periphery, for which Germany and other parts of core Europe are major trading partners. For the time being, ECB rates are still extremely low.

Bad news for the periphery?

The ECB did not announce a new programme of emergency lending assistance to stricken Irish banks or any other initiative to wean struggling banks off the current ECB emergency facilities. The ECB also did not widen the corridor between the refi rate and the deposit and marginal lending rate, keeping the gap at 75bps either side of the main refi rate, instead of going back to the pre-crisis 1%. The resulting 25bps rise in the deposit rate to 0.5% will constrain the downside for EONIA. However, with the corridor still narrow, the marginal lending rate will also increase by only 25bps instead of 50bps. At the margin, this can be seen as a potential help for banks in trouble. But as the marginal lending facility is rarely used, this is not a major point.

Keeping the narrow rate corridor

ECB in the lead – others likely to follow

Of course, higher ECB rates could push the euro up further. However, we expect the US Fed and other central banks such as the BoE also to change their stance over the course of this year. If the Fed ends its bond purchase programme (QE2) at the end of June and then prepares markets for a first rate hike in December, forward-looking markets should discount this early enough to prevent a major surge in the euro. We still expect the BoE not to lag far behind the ECB, with a first rate hike possible in May. If the Swiss franc continues to come off its highs, the SNB may follow in June.

Expect other central banks also to scale back their monetary stimulus this year

Of course, risks abound. If oil and Japan hit the global economy much harder than the recent modest drop in sentiment indicators suggests, the ECB and other central banks would desist from such hikes. But that is a risk. For the time being, the available evidence points to resilient growth which no longer warrants the rock-bottom policy rates which central banks had adopted in the crisis of 2009.

Risks abound

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