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ECB: Downside risks not being acknowledged?

There was no surprise that the ECB kept the refi rate at 1.25% after its latest Council meeting, failing to add to the 25 bp hike made in April, the latter having ended the period of policy stability seen over the previous 23 months.

Rate hike flagged

However, equally expected was the clear flagging of a likely rate hike in July, with the return of rhetoric pointing to the need for 'strong vigilance' ie the kind of wording used in previous tightening cycles (and in March this year) to flag a move in the following month. Accentuating the rate hike warning, one that President Trichet underscored entailed neither pre-commitment nor any hint about the speed at which the tightening cycle might unfold, were reminders that inflation risks remain to the upside and that policy is accommodative.

Stretched rationale?

The rationale for the further hike that is seemingly looming looks stretched. Most likely, the ECB is saying it is reacting to the increased inflation risks it perceives and which it still suggests are on the upside. However, the updated economic projections that the ECB unveiled at this meeting still leaves the medium-term (ie 2012) inflation forecast in a range centered around a clearly below-target 1.7% (actually unchanged from that envisaged back in the last set of projections in March. In other words, while inflation risks are tilted to the upside, they remain so only from a continued below-target anticipated outcome. Moreover, there is nothing in recent data to suggest that the main inflation concern of the ECB, ie second round effects, is materializing. Indeed, the very opposite seems to be the case in relation to a wage-price spiral given the continuing, if not clearer weakness, evident in regard to consumer spending. Surely this weakness is a reflection of the damage to household spending power in the face of rising food and energy prices alongside an inability to achieve any increase in wages to offset the higher costs facing consumers.

In addition, the supportive picture that the ECB is painting regarding the monetary backdrop seems at odds with reality, with the Council ignoring the softer signs in both Eurozone broad money and corporate lending seen in recent months. Also somewhat hard to rationale was the assessment that the balance of risks to growth remains balanced. Instead, many would consider that growth risks have moved to the downside given signs of slower global growth and the heightened Eurozone sovereign debt backdrop, the latter which threatens a clearly still feeble Eurozone banking sector. Indeed, the ECB today implicitly recognized these (continued) banking sector risks by (unsurprisingly) deciding to retain unlimited liquidity for Eurozone banks for a further three months.

Adding to sovereign debt worries

Moreover, and perhaps, most notably, the ECB may be adding to the downside risks stemming from peripheral debt worries - and not just via the modest hiking it is flagging. In regard to the further bail-out that Greece needs, the ECB is yielding no ground in its opposition to anything but a voluntary roll-over of Greek debt, but may very well be discouraging the latter by clearly flagging that it would not participate in any such a roll-over. Instead, rather than the private sector contributing to any further Greek bail-out via voluntary roll-overs, the ECB seems to be hoping that any public money will be complemented by Greece successfully selling state assets to private investors. This is a very optimistic view given that Greek assets must now be carrying a non-negligible exchange rate risk, even for those in the Eurozone.