

# VAKIFBANK GLOBAL ECONOMY WEEKLY

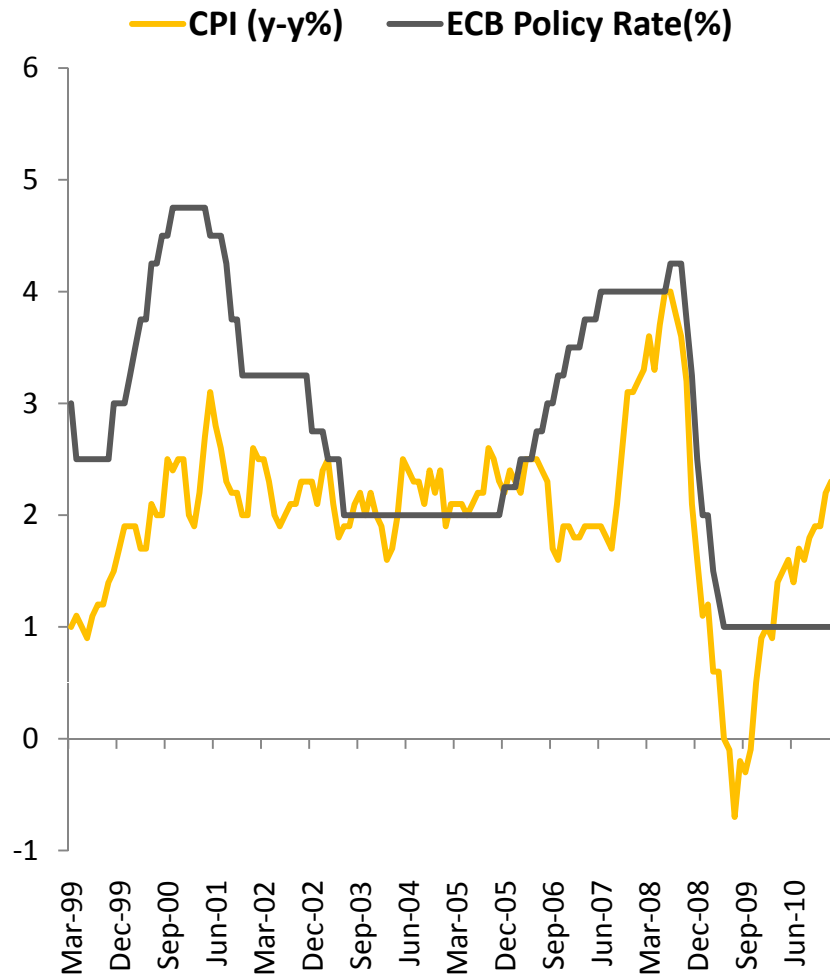
**Is there a new ECB monetary  
policy?**



T. Vakıflar Bankası T.A.O



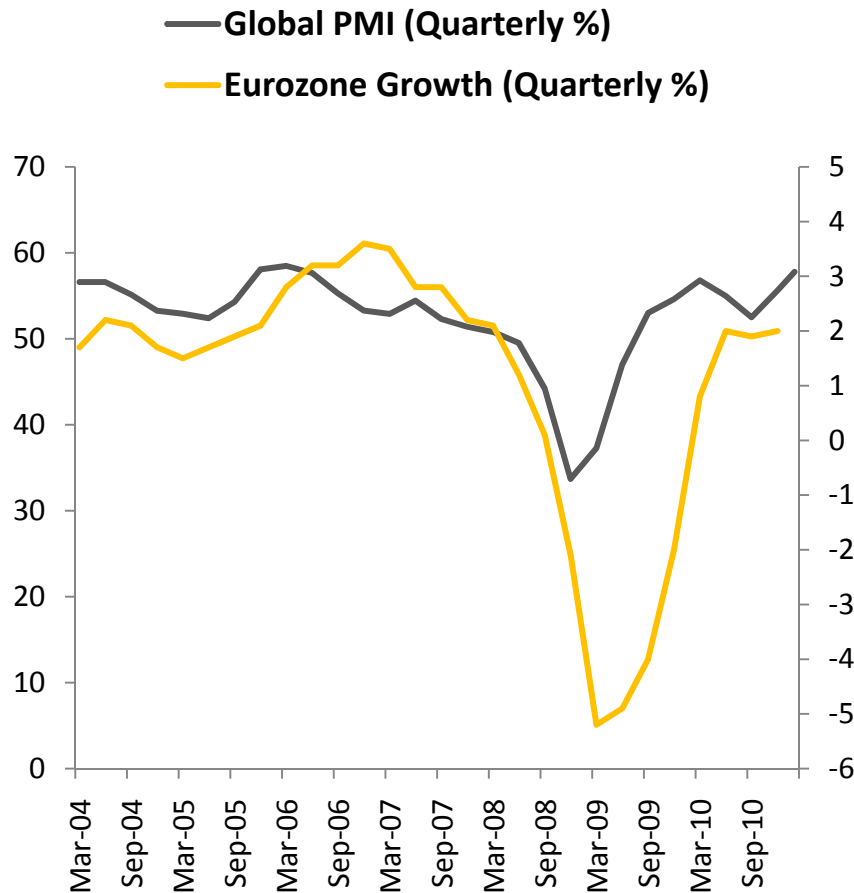
## Rate hike is on the top of ECB's agenda...



Source: Bloomberg

- ▣ European Central Bank (ECB) President Jean-Claude Trichet announced that they decided to keep policy rates stable in March, but he stated that there might be a rate hike in April.
- ▣ Trichet said that they should take the right decisions at the right time because of increasing inflation risk. He used the word string “strong vigilance” to emphasize ECB’s attitude to current situation.
- ▣ ECB Governing Council Member Nowotny expressed that price stability is their prior goal and stated that if the oil price increase settled down, they might not raise interest rates.
- ▣ ECB’s strategy path since 2010 is as follows:
  - 1) Wait and See
  - 2) Monitoring
  - 3) Attention
  - 4) Vigilance

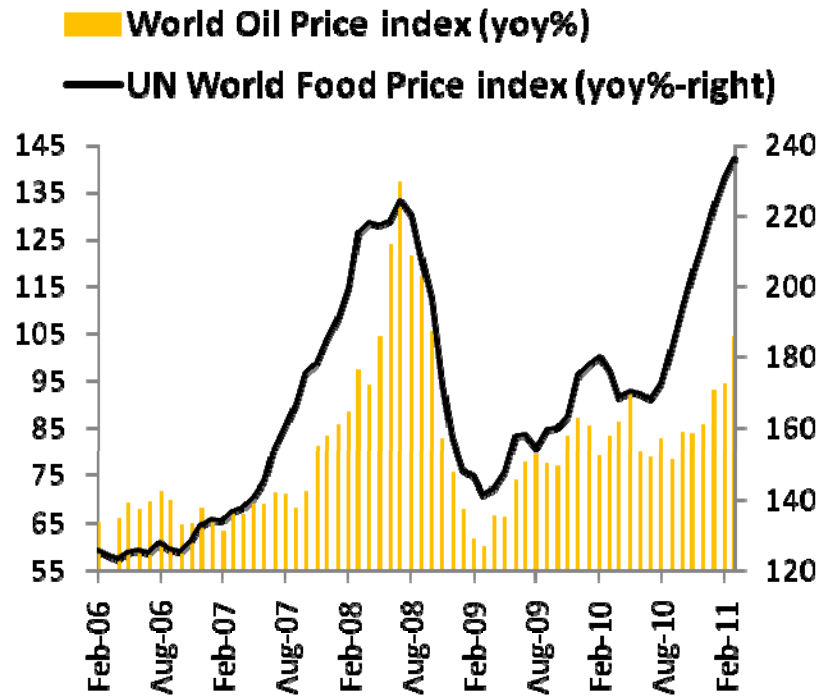
# FED will not act as fast as ECB...



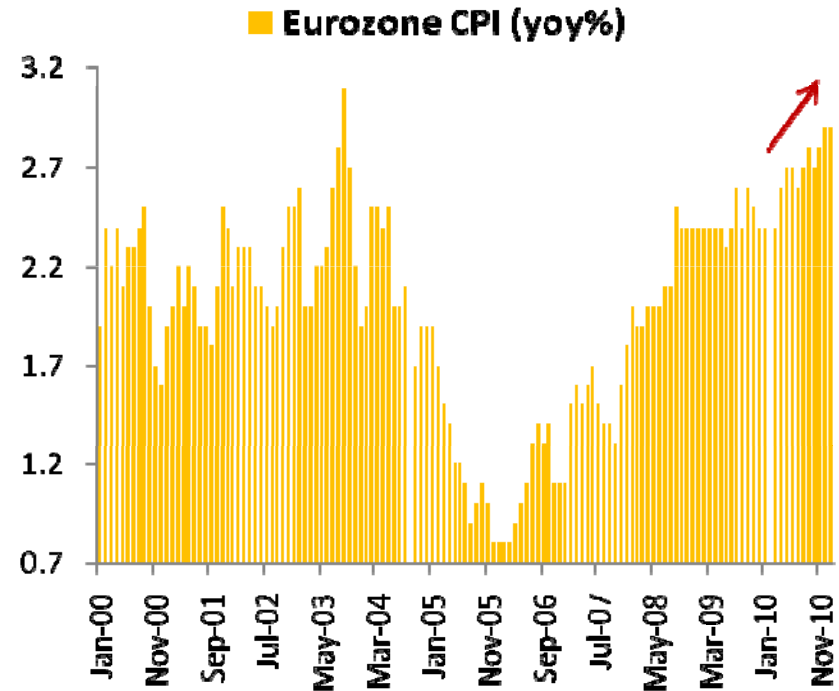
Source: Bloomberg

- ✔ Examining past increases in commodity prices between 2007-2008 we see that Eurozone inflation rose %4 y-y. At the moment, %2 inflation target has already been exceeded.
- ✔ For the first time in ECB history, President announced ex ante policy changes to measure the response of market.
- ✔ 25 basis point rate hike is expected in April.
- ✔ Strong demand will increase inflationary pressures, too. Due to current demand conditions, recovery is expected to be more quick. February PMI data also support the described figures.
- ✔ FED is monitoring core inflation, but ECB is watching headline inflation to seize the price signals. Therefore, ECB is expected to act much before the FED and put rate hike on the agenda.
- ✔ FED, also take employment data and house prices into consideration in policy decisions. As a consequence, rate hike is not necessary for the FED in the short term.

# Because of the rapid rise in commodity prices, there is an upward pressure on inflation ...



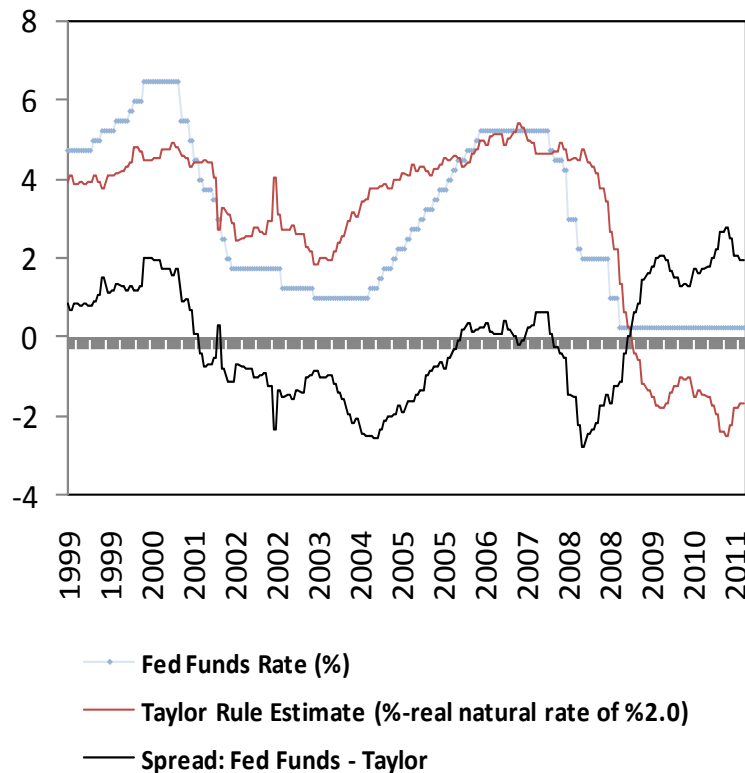
Source: Bloomberg



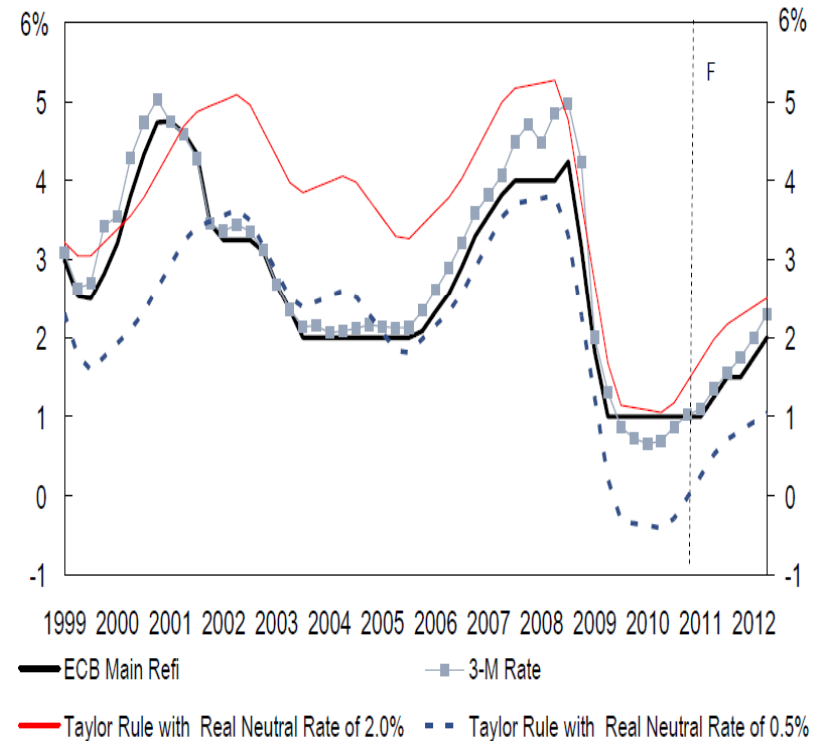
Source: Bloomberg

- Due to the recent unrest in North Africa and Middle East region and rapidly increasing world food prices, inflation concerns have increased.
- Contribution of food prices to Eurozone inflation has been in an increasing trend since July 2010. Concordantly with this increase, inflation started to rise during this period, which validates the concerns of ECB's official view.




# What does Taylor Rule say about ECB's monetary policy?..



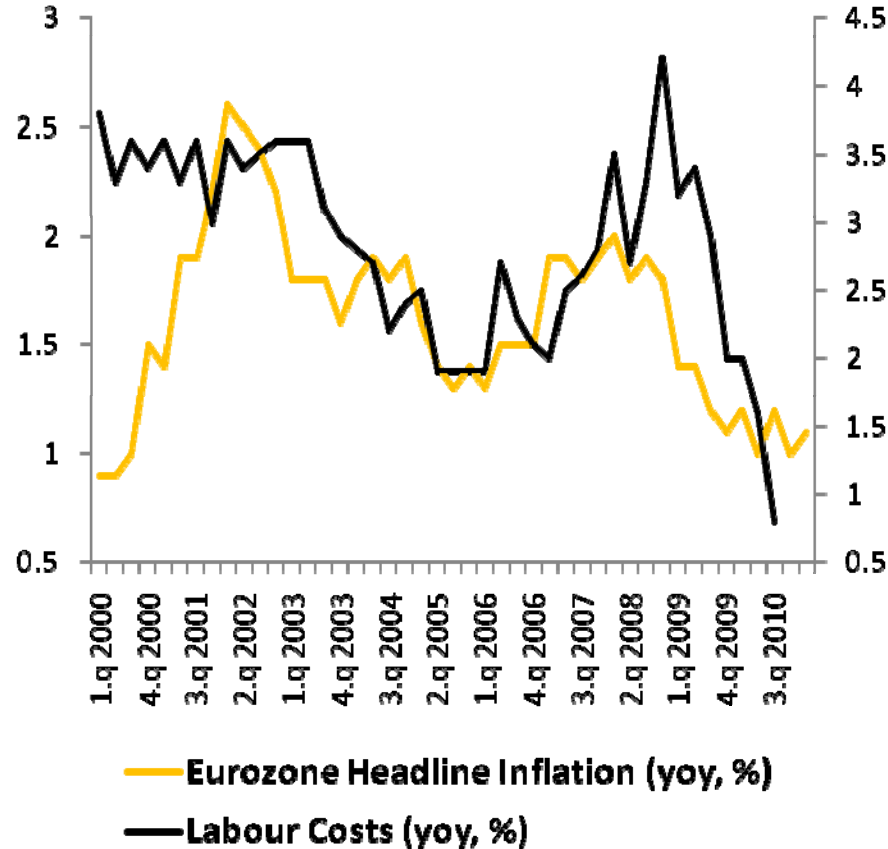
Source: Bloomberg







Source: ECB

-  Taylor Rule is a convenient policy rule for Central Banks who aim inflation and production stability.
-  FED's Taylor Rule (real natural rate of 2%) which is under FED funds rate exhibits a stable prospect.
-  Unlike FED, ECB's Taylor Rule (real natural rate of 2%) which is above ECB funds rate indicates that the ECB fund rate is below the level it should be.

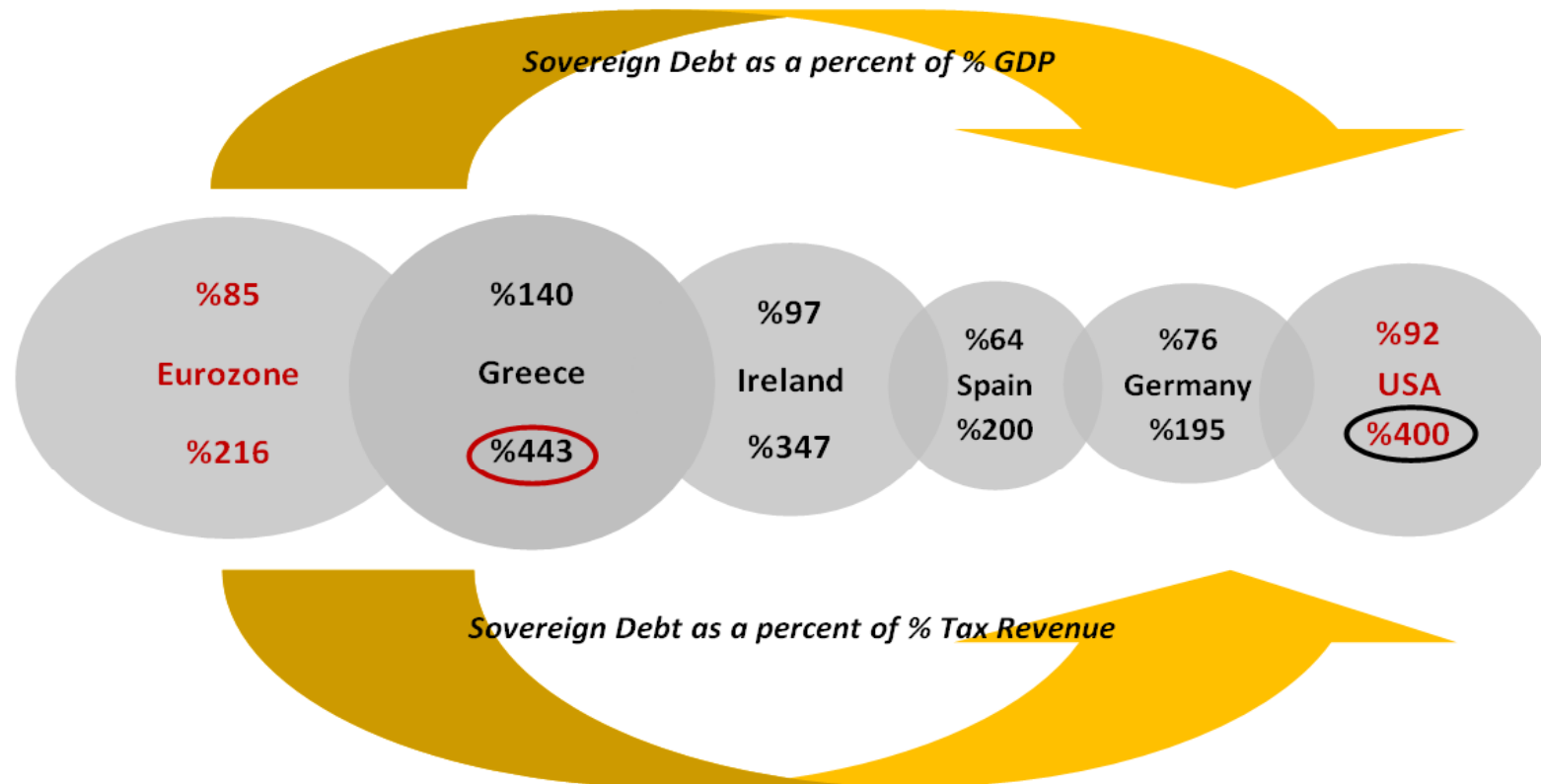
# Will ECB be able to compensate CPI by increasing interest rates?..




Source: Bloomberg

-  Central Banks watch employment as well as the inflation data.
-  Accordingly, if inflation rise or production potential decrease, they choose to increase interest rates.
-  ECB's rate hike policy would decrease inflation indirectly as a result of appreciation of the euro.
-  Cost of labor has been falling since the end of 2008 in Eurozone. Hence this causes concerns regarding the ECB's capability in controlling inflation.

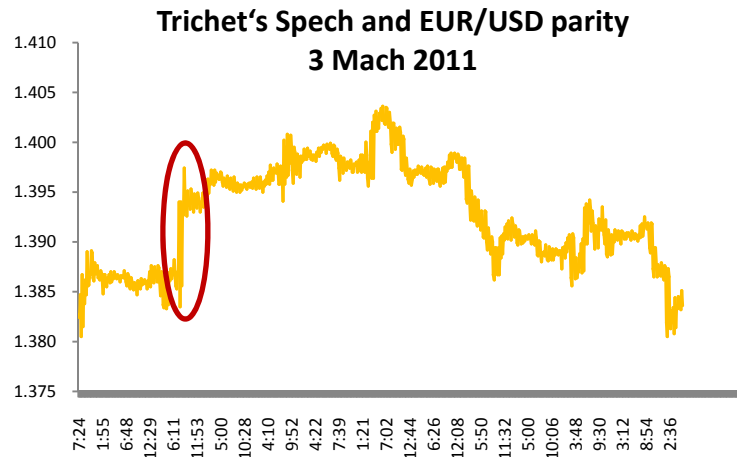
It's not surprise that Greece has the highest sovereign debt (%GDP) in Eurozone...



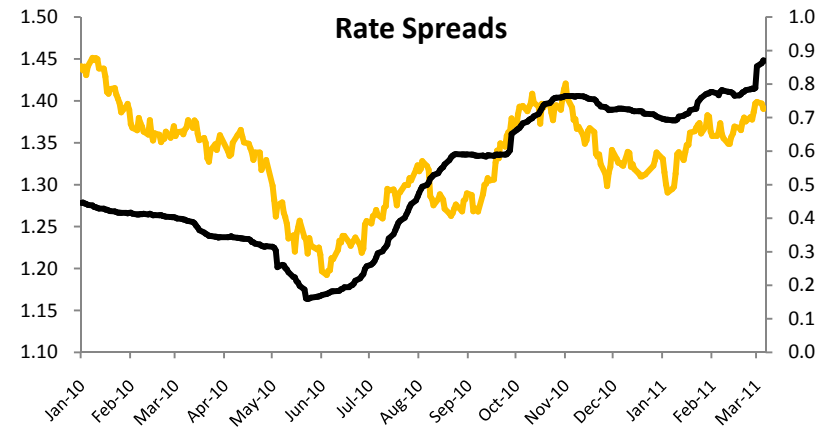
Source: Bloomberg, Eurostat

-  Unlike ECB tending to increase fund rates because of either rapid increases in CPI or sovereign debt problems, it draws attention that the FED doesn't change rates despite the record levels of the proportion of US Treasury's sovereign debt in tax revenues which has reached 400%.

# After Trichet's rate hike announcement...



Source: Bloomberg



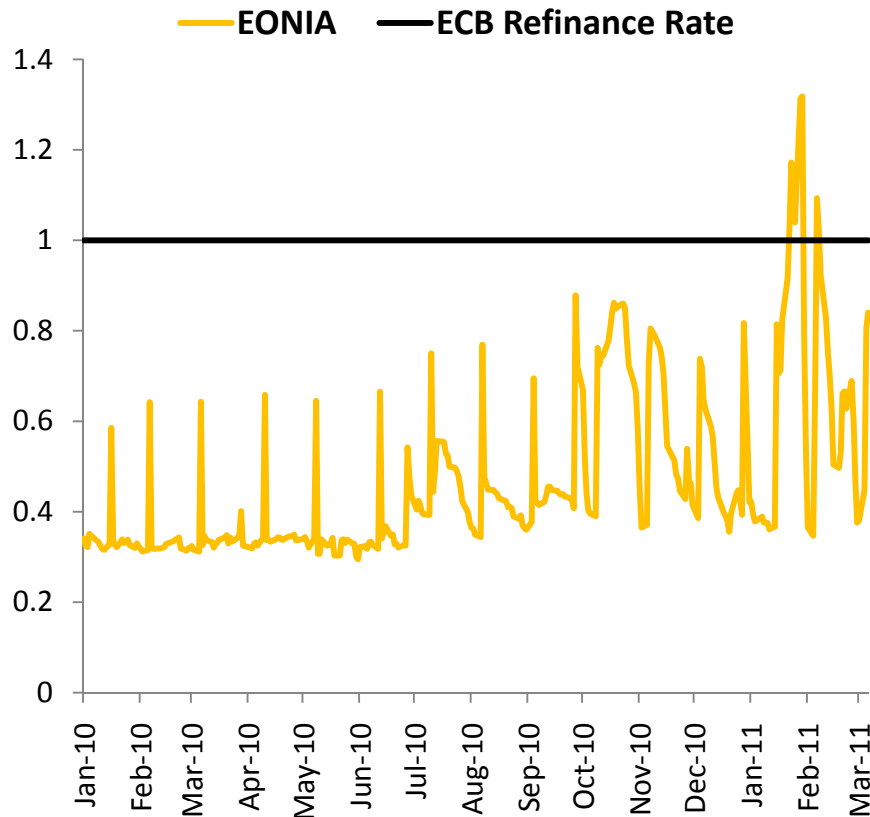
— EUR/USD Parity — 3m Euribor&US Libor Spread (Right)

Kaynak: Bloomberg

- ✓ ECB governor Trichet's announcement about a rate hike before April Policy Meeting has caused fluctuations in global markets especially in EUR/USD.
- ✓ As shown in the graph, his speech has caused a rapid upward movement in EUR/USD. The parity which was 1.3850 before the announcement increased sharply to 1.3950 and it has continued rising.
- ✓ But, in the ongoing process, because of rising oil prices related with the developments in the Middle East, EUR/USD parity has moved downwards.

- ✓ After this point, it seems important that to what extent the expectations of the ECB policies priced and how long will the increase in EUR/USD continue after a possible rate hike.
- ✓ Interest rate spread between Eurozone and US will become the most important factor on EUR/USD movements.
- ✓ As shown in the graph, there is a high correlation between EUR/USD and Eurozone and US interest rates. This spread has widened after the meeting announcement of the ECB.

## There are risks on ECB rate hike decision...



Source: Bloomberg

- Investors increased their borrowings, as they did not want to take in charge extra liability after rate hike. Therefore, market interest rates increased.
- With the recovery in the leading indicators of the growth and inflationary pressures arising from high commodity prices, ECB may hike policy rate in April.
- Another reason of the rate hike may be the increases in borrowing of households at low rates.
- Rate hike may trigger unexpected results for the Eurozone countries that struggle with the high debt stock and budget deficits. Therefore ECB is expected to formulate a new policy regarding these countries. However recent action of ECB indicate that it won't formulate monetary policy in a way to compensate failures of the countries implementing different fiscal policies.

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