Has the ECB started the rate hike game?

The ECB has finally raised interest rates after almost two years of status quo. The reason given has been to tackle inflation which was over the comfort level of 2%. The ECB has gone ahead with this move on its own even though both USA and UK have kept interest rates unchanged with inflation being above 2%. In fact, for UK it was as high as 3.8%. There is also serious talk of the Federal Reserve going in for further quantitative easing (QE) to ensure that the economy is back on rails.

For the layman, the question really is who is getting it right or wrong as the conditions are the same in all these three geographies; yet the bankers think differently on inflation and hence interest rate action.

Is this justified?

There are divergent views on this subject. While the ECB feels that inflation is beyond its comfort level and that it would follow its policy independent of what the USA or UK does, there is a different view expressed by critics. Inflation is high only due to higher commodity prices and hence higher rates will not be effective. It would be justified provided wages start increasing which in turn leads to excess demand being generated. However, this has not been witnessed in any of these countries, including Germany, which means that the ECB could have waited for some more time. The markets were expecting such an increase and hence the hike did not create a stir when announced.

This may be compared with the RBI action where the central bank in India has been aggressive in raising rates 8 times since last March to combat inflation which has been mainly on the supply side. However, with core inflation also showing signs of increasing, the RBI has taken such pre-emptive measures even though there are no firm signs of the economy getting overheated with industry in particular showing at best stable growth.

The table below gives some comparative numbers on growth and inflation for some of the comparable countries.

Indicators for 2011 (%)

Country	GDP Q4 2010	Inflation
USA	2.8	2.1
Japan	2.2	-0.1
China	9.8	5.0
UK	1.7	3.8
Euro	2.0	2.2
Germany	4.0	1.9

Source: Economist March 26, 2011

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What does this mean?

More hikes expected

While the ECB has said that this was not to be interpreted as the beginning of a series of interest rate hikes, the market expects them to continue until the refinance rate touches 2%, which means 100 bps increases is what is factored in.

The peripheral nations will be affected for sure

Higher rates will affect all the Euro nations on the periphery such as Greece, Spain, Portugal and Ireland where debt levels are high and are sensitive to interest rate changes. These are the nations which are grappling for survival and higher interest rates will intuitively put pressure on their economic packages that are being implemented. This is also probably an indication that the ECB would not be too keen to provide assistance to Portugal, which is looking for support to the EC and other countries. It is especially vital for the ECB; being the central bank of a monetary union, to balance varying monetary targets and policy tools of member economies. In a situation where world economies are uncertain of stability and economic recovery in the Euro zone, this step may be viewed as the ECB indicating a proactive stance after a period of silence.

Will it work?

Impact of growth will be different within this zone

Higher rates will definitely affect the credit markets by lowering growth in credit as individuals as well as industry will borrow less. There is however, a possibility that this will impact growth at a time when the region has come out from the crisis years. There will be a differential impact with countries like Germany probably slowing down leading to lower inflation. However, those on the fringe will have difficult times if such interest rate hikes are persevered with during the year. The move of the ECB is hence well calculated as in the present situation most central banks have been loath to increase rates lest it comes in the way of growth. Australia and Canada have done it as has the RBI.

On the other hand commodity prices, especially oil will continue to increase and the inflation numbers globally will be in the higher trajectory. Clearly, central bankers will have to act depending on local conditions, and a single rule may not be applicable. However, given that the Euro is a set of 17 countries, the meaning is different as there would be multiple concerns.
