As upheavals unfurl globally, Europe pursues a rate increase

FRANKFURT

BY JACK EWING

Nuclear reactors in Japan are spewing radiation, a tsunami has killed thousands of people and devastated coastal regions, and political tremors continue to shake the Middle East and the oil markets.

Is this really such a good time to raise interest rates?

This month, the European Central Bank all but promised a rate increase when its governing council meets on April 7. There is no sign yet that the earthquake in Japan and its terrifying aftermath have dislodged E.C.B. policy makers from their view that rates must rise to pre-empt inflation.

Ewald Nowotny, governor of the Austrian National Bank and a member of the E.C.B. governing council, told Reuters on Monday that the E.C.B. remained in a state of "strong vigilance" toward inflation risks. That is the central bank's code for "rate increase ahead." Analysts expect a rise of 0.25 percentage point next month, which would be the first of several increases toward as much as 2 percent by the end of this year or early in 2012. The benchmark rate is now 1 percent.

Even before the catastrophe in Japan, many economists regarded a rate increase as ill-advised when growth in much of Europe was still slow and Spain, Ireland and other countries on the periphery of the euro zone were struggling with debt crises.

A rate increase would raise borrowing costs for those countries when they already have trouble selling debt at rates they can afford. It would also increase

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MORE FINANCIAL PAIN FOR PORTUGAL

Portugal was forced to offer higher rates at a debt auction as it fought to avoid emergency E.U. funding. *PAGE 1*

E.C.B. presses its plan to raise interest rates

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monthly payments for many homeowners with adjustable-rate mortgages.

"An already-too-tight E.C.B. monetary policy is about to get even tighter, with potentially devastating consequences," Michael T. Darda, chief economist at MKM Partners in Stamford, Connecticut, said in a note last week. "We do not believe the periphery can withstand what appears to be an imminent series of E.C.B. rate hikes."

Economists say that the direct economic effects of the earthquake and tsunami on Europe are not huge. But they warn that the prospect of a nuclear disaster, along with continued fighting in Libya and high fuel prices, could further unsettle consumers.

"We see from consumer surveys that people don't think things are getting better," said Charles Wyplosz, a professor of economics at the Graduate Institute in Geneva. "People feel threatened."

As usual, the E.C.B. president, Jean-Claude Trichet, has left his options open. A rate increase "is not certain but it is possible," Mr. Trichet said after the governing council's meeting on March 3.

The bank could postpone action if the economic aftershocks from Japan grow worse. But it is also possible that the E.C.B., with its relentless focus on inflation, could decide that it needs to act decisively to prevent shortages of energy or Japanese-made components from driving up prices.

"If anything, the effect on global commodity markets could put upward pressure on inflation as the demand for raw materials is increased by the reconstruction efforts," Peter Westaway, chief economist for Europe at Nomura in London, said in an e-mail. "That could put pressure on central banks to raise rates more quickly, not less."

It is unusual for the E.C.B. to move on rates ahead of the U.S. Federal Reserve,

CHRISTIAN HARTMANN/REUTERS
Jean-Claude Trichet's aim is price stability.

which on Tuesday left its benchmark rate near zero. The E.C.B. is also ahead of the Bank of England, which has kept rates steady even though inflation is higher in Britain than in the euro zone.

More than for its counterparts, the E.C.B.'s prime directive is to protect price stability. So while much of the world is riveted by dramatic images from Japan, the bank's policy makers may focus more on the news Wednesday that inflation in the euro zone was at an annual rate of 2.4 percent in February, above the official target of around 2 percent.

"The E.C.B. will be very aware that the European Commission's latest survey shows rising consumer inflation expectations and rising company pricing expectations," said Howard Archer, chief European economist at IHS Global Insight in London. "We doubt that the horrific and tragic events in Japan will deter the E.C.B. from acting."

Members of the governing council may also believe that their credibility is on the line. During the past two years the E.C.B. has supported banks by providing unlimited short-term loans at 1 percent interest, and it has prevented a meltdown in the sovereign debt market by buying bonds from troubled euro zone members on the open market.

Mr. Trichet has made it clear that the E.C.B. wants political leaders to carry more of the burden of safeguarding the euro. He expressed disappointment Tuesday at their efforts so far: After European Union finance ministers agreed to toughen fiscal rules for euro zone governments, he dismissed the proposals as "insufficient."

Whether intentional or not, a rate increase would be a signal to European leaders that the E.C.B. has its own priorities. Elected officials cannot expect the bank to forever take the lead in dealing with the sovereign debt crisis.

"Inflationary pressure are on the horizon," said Dennis Snower, president of the Institute for World Economics in Kiel, Germany, "The problem is that the E.C.B. has been very much engaged in the stability of financial markets and didn't have to worry about inflation, and now there is a conflict of interest between these two goals."

He added, "If the E.C.B. wants to defend its inflation-fighting credentials it needs to send a signal."

Some analysts worry that the bank is poised to repeat the mistake it made in July 2008, when it raised the benchmark rate a quarter point, to 4.25 percent, amid a gathering financial crisis. In October that year, after the implosion of Lehman Brothers and the collapse of the money markets, the E.C.B. swiftly reversed course. By May 2009 it had lowered the rate to 1 percent, where it has remained ever since.

"They reacted in 2008 at a point where cooling was already in the pipeline," said Michael Heise, chief economist at the German insurer Allianz. "That is evidence that the E.C.B. shouldn't react too aggressively."

E.C.B. critics say there is no need for the bank to act against inflation that is largely caused by rising oil prices, especially when European factories are still not running at capacity. Even Germany, the Continent's powerhouse, has still not recovered the economic output it lost during the steep recession of 2009.

A rate increase could be particularly tough on Spain, where unemployment has soared to 20 percent and many people already struggle to meet their mortgage payments.

Luis de Guindos, director of the Center for the Financial Sector, an institute run by the IE Business School in Madrid and PricewaterhouseCoopers, estimated that about 95 percent of Spanish mortgages had floating rates. If market interest rates rose one percentage point, the additional cost to homeowners could amount to 0.6 percent of Spanish gross domestic product, he said.

But Mr. de Guindos said that such an additional burden was unlikely to result in a surge in foreclosures because, unlike in the United States and some other countries, Spanish mortgage holders are held liable for their entire personal wealth. They have a powerful incentive to continue making payments.

"The pain will be real, but the default rate will not get anywhere near that of the U.S.," Mr. de Guindos said.

The main question may not be what the E.C.B. will do next month, but what it will do in the months to follow. Mr. Wyplosz of the Graduate Institute in Geneva said that a single quarter-point increase would probably not have a significant effect on European growth. But if the bank follows up with a series of increases, growth could slow.

Raphael Minder contributed reporting from Madrid.

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Policy makers would be mistaken to delay fiscal tightening. PAGE 20

More financial pain for Portugal

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needed to meet its target of reducing the budget deficit from an estimated 7.3 percent of gross domestic product last year to 4.6 percent this year. Over the past year, Portugal has been among a handful of euro nations in investors' line of fire after reporting a record deficit of 9.3 percent in 2009.

Concerns over Portugal are mounting even after European leaders agreed last weekend to strengthen the European Financial Stability Facility, as well as allowing it to purchase government debt on some conditions. The credit downgrade also had been anticipated, after Moody's recently cut the sovereign debt ratings of Greece and Spain, two other ailing economies in the euro zone.

Analysts at RBC Capital Markets described the timing of Moody's rating cut for Portugal as "rather unfortunate," given that the Portuguese minority government might lose the support of the opposition Social Democrats for its latest spending cuts.

"The combination of these developments might push Portugal to seek financial aid from the E.F.S.F. rather sooner than later," the RBC analysts said in a note to investors, referring to the E.U. stability pact.

Speaking in Parliament on Wednesday, Fernando Teixeira dos Santos, the finance minister, said current market conditions would be "unsustainable" in the medium and longer term. However, he insisted that Portugal could continue funding itself from the market for some time. Although the auction Wednesday forced Portugal to pay higher rates, it remained below a record 5.28 percent that the country paid at an auction in December, when it appeared that the German government and others might refuse to bear the cost of another bailout, following the rescue of Greece and Ireland.

Mr. Sócrates had already threatened to resign last year during a lengthy standoff with the Social Democrats over his 2011 budget plan. The budget was finally endorsed, but the Social Democrats insisted at the time that they would not allow the government to take further measures that could push Portugal into a prolonged recession. In January, the Bank of Portugal forecast that the economy would contract 1.3 percent this year.

"Portugal's economy has been stagnant for years and this can only worsen given huge spending cuts," Arturo de Frias, head of banks research at Evolution Securities, said in a note to investors.

Portugal's latest problems are being most directly felt in Spain.

Luis de Guindos, director of the Center for the Financial Sector, an institute run by the IE Business School in Madrid and PricewaterhouseCoopers, said Portugal had until now acted as "an important firewall" for Spain. However, Portugal's deepening problems represented a double risk for Spain, he said, first psychologically because "if there is a bailout, markets will consider that Spain must come next," and second financially because Spanish banks had a €70 billion lending exposure to Portugal.

European tax proposal isolates Ireland

BRUSSELS

BY STEPHEN CASTLE

A new push to coordinate corporate tax policy in the European Union introduced Wednesday has heightened tensions between several member states and Ireland, which said it remained "skeptical" about the process.

The initiative would develop a common basis on which corporate taxes are calculated in the Union and allow companies to opt in to the system. The European Commission, which made the proposal, estimated the plan could save businesses €700 million, or $973 million, a year in reduced compliance costs and another €1.3 billion in tax benefits.

The commission has been trying for a decade to coordinate the bloc's corporate tax policy. Previous efforts have come to nothing because changes in tax policy require the agreement of all 27 E.U. member states.

But this time the politics have changed and — crucially — this plan could work with a smaller group of countries, because some think that those who adopt the proposal could reap competitive advantages rather than lose out.

The new plan is a contentious topic within the Union, where some countries regard the right to set their own tax rate as a cornerstone of national sovereignty. While the proposals outlined by the commission only cover the tax base, rather than rates, some nations fear the proposals could be a stepping stone to further coordination of tax policy.

ERIC VIDAL/REUTERS
Prime Minister Enda Kenny of Ireland, which is cool to E.U. efforts to coordinate tax policy.

If there is no consensus this time, France and Germany are expected to press for an accord among the 17 members of the euro zone. Ireland, which has already come under pressure over its low corporate tax rate of 12.5 percent, struck a noncommittal tone Wednesday.

"We remain skeptical about many aspects," the Irish Finance Ministry said in a statement. "But we will work constructively with the commission and other member states on the issue."

Last week, Ireland failed to secure a reduction in the interest it is paying on its €85 billion bailout from the Union because it refused to promise to work constructively on tax coordination.

In talks among the 27 E.U. members, Ireland has always had a powerful ally in Britain. But Britain is not a member of the euro zone, theoretically putting Ireland in a weaker bargaining position.

Moreover, were any group of countries to go ahead with the proposals, those that stayed outside might, potentially, lose out if large multinationals relocated some of their operations to a nation that took part.

A British government spokesperson, who asked not to be named in line with policy, said the plan would be considered on its merits.

"We would want to ensure that we are constructively engaged in discussions to help shape a C.C.C.T.B. given the implications for U.K. companies operating across the E.U.," the spokesperson said, using the abbreviation for a common consolidated corporate tax base. "However, we will not agree to a proposal that might threaten or limit our ability to shape our own tax policy."

Britain's response suggested that it was weighing whether there might be disadvantages to staying outside a system if others go ahead without it.

"Obstacles to cross-border activity in the field of corporate taxation hamper business development and the growth potential of the single market," said Philippe de Buck, director general of Businesseurope, a lobby group. "The proposal to develop a common consolidated corporate tax base could help and is welcome under the condition that it remains a competitive option for companies and excludes any form of tax rate harmonization."

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