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E.C.B. seen raising rates soon to ward off inflation

FRANKFURT

Central bank also rejects German call for lenders to share loss in Greek aid

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The European Central Bank left its benchmark interest rate unchanged Thursday but signaled that markets should expect an increase next month, despite the euro area's uneven economic recovery.

The euro fell against the dollar, however, after Jean-Claude Trichet, the E.C.B. president, set up a conflict with the German government by rejecting any suggestion that creditors of Greece should be required to share the burden of a rescue plan.

"We are not in favor of restructuring, haircuts and so forth," Mr. Trichet said at a news conference after the E.C.B. governing council's monthly meeting on monetary policy.

His statements were an implicit rebuke to Wolfgang Schäuble, the German finance minister, who said Wednesday that holders of Greek bonds should swap them for debt that the country would have longer to repay.

"President Trichet has gone on a collision course with the German government," Jörg Krämer, chief economist at Commerzbank in Frankfurt, wrote in a note after the news conference.

The Bank of England, meanwhile, kept its main interest rate at a record low amid concerns that the country's

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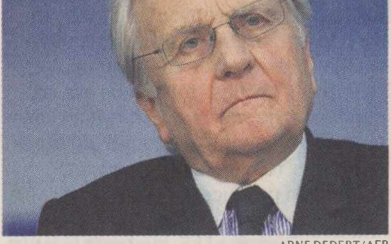

ARNE DEDERT/AFP

Jean-Claude Trichet of the E.C.B., warning Thursday of the threat of inflation.

E.C.B. signals interest rates will rise again in July

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economy was still too weak to cope with higher borrowing costs.

In the 17-nation euro zone, the E.C.B. has been more focused on inflation, which has been pushed up by rising food and energy prices.

"Strong vigilance is warranted," Mr. Trichet said. That language would indicate that a rate increase in July is probable, though the bank always leaves its options open. At the same time, E.C.B. economists slightly lowered their forecast for inflation next year, suggesting that the bank might feel less pressure to raise rates quickly.

On Thursday, the E.C.B. left its benchmark rate at 1.25 percent, after raising it in April from 1 percent, the first increase in two years. Inflation in the euro area was 2.7 percent in May.

"When I compare inflation today to interest rates I see a negative number," Mr. Trichet said.

The benchmark rate in Britain was left at 0.5 percent and the central bank also kept the size of its asset purchase plan unchanged at £200 billion, or about $327 billion.

The E.C.B. said it would continue its emergency support of euro zone banks by continuing to grant them unlimited low-interest loans at least through September.

With Germany, Europe's largest economy, growing so quickly that some economists fear overheating, the E.C.B. has been trying to nudge interest rates back to levels that would be normal in an upturn.

But the bank faces a dilemma because the Greek debt crisis still threatens growth in the euro zone as a whole. Economies in Spain, Ireland and other so-called peripheral countries remain sluggish. Higher rates could make it harder for those countries to recover.

Mr. Trichet argued that the best way to help the European economy was to make sure that prices were contained. "It is good for all countries," he said.

Questions about Greece dominated the E.C.B. news conference, but Mr. Trichet showed no sign of being willing to consider a Greek restructuring, unless it was completely voluntary on the part of creditors — an outcome that is difficult to imagine.

KAI PFAFFENBACH/REUTERS

Jean-Claude Trichet, chief of the European Central Bank, in Frankfurt on Thursday. "We are not in favor of restructuring, haircuts and so forth," he reiterated.

"President Trichet has gone on a collision course with the German government."

On the contrary, he implied that any restructuring of Greek debt might prompt the bank to stop accepting the country's bonds as collateral, a move that could be fatal for some Greek banks that depend on low-cost E.C.B. loans.

"It is difficult to see how this debate will be resolved," said Marie Diron, senior economic advisor to Ernst & Young, the consulting firm. "Someone, either the E.C.B. or the German government, needs to make some concessions to reach a compromise," she wrote in a note. "And this needs to happen soon as time is running out for Greece to refinance its debt."

Though it does not belong to the euro zone, Britain also remains fragile economically. Consumer confidence worsened in April as more people claimed unemployment benefits and as wage increases lagged behind inflation, weighing on living standards. Spending cuts and tax increases that are part of the government's austerity program made households even more reluctant to spend.

"The story of weak growth is still going to continue for a while," said James Knightley, a senior economist in London for ING Financial Markets.

Some economists had predicted that British rates would rise in May this year, but as the economic outlook deteriorated they have pushed that back to next February. Mr. Knightley expects an increase as early as this November.

The British economy stagnated in the six months through the end of March. The Bank of England governor, Mervyn A. King, has warned that inflation could accelerate to about 5 percent in the short term before cooling off again. Higher consumer prices, partly a result of higher commodity prices, have started to dampen household spending.

The Bank of England did not issue a statement Thursday. But Paul Fisher, a Bank of England official, argued last week that raising interest rates should be delayed until the economy was stronger.

The International Monetary Fund on Monday backed Prime Minister David Cameron's plan to cut Britain's budget deficit, which had been criticized by the opposition Labour Party as too strict and harming the economic recovery.

Though it was a formality, the E.C.B. officially endorsed Mario Draghi, governor of the Bank of Italy, as successor to Mr. Trichet, whose eight-year term expires at the end of October. European leaders are expected to officially nominate Mr. Draghi this month. In a statement, the E.C.B. called Mr. Draghi, "a person of recognized standing and professional experience in monetary or banking matters."

Julia Werdigier reported from London.

Greek economy weakens

Greece's economy shrank far more than expected at the start of 2011, signaling that a second wave of austerity measures demanded by the European Union and the I.M.F. would impose even more pain on a fractious society, Reuters reported Thursday from Athens.

Gross domestic product tumbled at an annual rate of 5.5 percent in the first three months of this year, the official numbers showed, far more than a earlier estimate of 4.8 percent.

Emilie Gay at Capital Economics said that the G.D.P. numbers boded ill for Greek attempts to meet targets for cutting the budget deficit, which the international lenders have prescribed.

"We expect the economy to contract by 5 percent this year," she said. "For us, this means Greece will fail to meet its targets as it did last year."

International lenders who bailed out Greece last year with a loan of €110 billion, or $160 billion at current exchange rates, said in a report Wednesday that they expected G.D.P. to shrink 3.8 percent this year and start growing in 2012.