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ECB’s Bonello Urges Caution With Rates as Debt Crisis Persists
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By Jeff Black

April 18 (Bloomberg) -- European Central Bank council member Michael Bonello said policy makers mustn’t raise interest rates at the expense of economic growth in debt-strapped euro- area nations if inflation expectations remain contained.

“In uncertain circumstances like these, we need to balance doctrine with pragmatism,” Bonello, who heads the Central Bank of Malta, said in an April 15 interview in Valletta. “We must be careful not to make it more difficult for countries to grow out of their debt problem.”

The comments contrast with the inflation-fighting rhetoric of some ECB officials and suggest there are diverging views on the 23-member Governing Council over the pace and extent of policy tightening. Since the ECB raised its benchmark rate on April 7, yields on Greek and Portuguese bonds have soared to records amid speculation Greece may be forced to restructure its debt, and Ireland’s credit rating was cut two levels by Moody’s Investors Service.

“The sovereign debt crisis is not yet behind us, and the banking sector in some countries -- which is a key to finding a solution to the crisis -- is still very fragile,” Bonello said.
“We could still see an accentuation of the negative feedback loop from the financial sector to the real economy via the sovereign debt channel. The risks to growth could well be tilting to the downside.”

That’s a departure from the ECB’s official line that risks to the economic outlook are “balanced.”

Criticism

The ECB’s decision to start raising borrowing costs during Europe’s debt crisis has attracted criticism from commentators including billionaire investor George Soros and Nouriel Roubini, the economist who predicted the global financial slump.

The U.S. Federal Reserve and the Bank of England have so far kept their key rates at record lows, saying the oil-driven increase in inflation will prove temporary.

“The dynamics of inflation have become more complex given that a lot of this inflation is now imported inflation about which we can’t do very much,” Bonello said. “The council will continue to monitor closely the relevant information as it comes in to see what, if anything, needs to be done. Particularly at this time, it is important to preserve all options.”

Euro-area inflation, which accelerated to 2.7 percent last month, has been in breach of the ECB’s 2 percent ceiling since December. In response, the Frankfurt-based central bank lifted its key rate to 1.25 percent from 1 percent, the first increase in almost three years.

Inflation Fighters

While the move was justified by “growing upside risks” to price stability, Bonello said a cautious approach is warranted “as long as inflation expectations remain well anchored, monetary growth remains moderate, which it is, and there is no clear sign of second-round effects.”

The ECB nevertheless appears set on raising rates further, with Vice President Vitor Constancio saying officials remain determined to fight inflation and Executive Board members Juergen Stark and Lorenzo Bini Smaghi saying the bank will gradually normalize borrowing costs.

Investor expectations for two more quarter-point increases in the benchmark rate this year, taking it to 1.75 percent, are “well founded,” ECB council member Ewald Nowotny told Bloomberg News in Washington on April 16. Fellow council member Luc Coene said in an interview yesterday that monetary conditions “are too accommodative.”

Bonello suggested the next tightening move could include a re-widening of the ECB’s rate corridor to encourage interbank lending. That might involve raising the benchmark and marginal rates while leaving the deposit rate at 0.5 percent, thus increasing the penalty banks incur if they park money with the ECB overnight instead of lending to other institutions.

‘Less Attractive’

A case could be made “quite soon for normalizing the width of the corridor between the deposit and the marginal lending rate,” Bonello said. “There are signs that the market funding conditions are improving, and one would want to encourage that.
One way of doing it would be by widening the corridor and making it less attractive for banks to use the deposit facility and instead go to the interbank market.”

Bonello also indicated that the ECB may be prepared to suspend collateral requirements for Portugal, as it did for Greece and Ireland, after it joined them in seeking a European Union rescue.

“It is relevant to note that we’ve had similar situations in the past two years and the Governing Council on those occasions decided to suspend the rating threshold in the collateral eligibility requirements,” he said. “But we only did that once we’d made a positive assessment of the agreed program.”

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