Written by Bruce Walker on July 8, 2011

EU Bank Raises Rates, Accepts Portugal’s Junk Bonds as Collateral

While Trichet recognized that this hike in interest rates might slow down the world economy, he stated that controlling inflation remained the bank’s most important task at present. He hinted that another raise might be in store in future months, noting that the bank would “monitor very closely” price developments, which has been a code for suggesting that interest rates would not be raised the next month. “Our monetary policy stance remains accommodative," he assured. "It is essential [that] recent price developments do not give rise to broad based inflation pressures over the medium term.” Marc Ostvald, an market strategist at Monument Securities, advised: "A further quarter point rate hike probably in October or November still appears to be the central scenario."

Trichet announced that the European Central Bank had suspended its collateral rules for Portugal, meaning that Portugal can tap the European Central Bank for cash even though its government bonds have been downgraded to junk status. The bank has already extended this privilege to both Greece and Ireland, whose bonds have also been downgraded.

Trichet took questions from reporters, who zeroed in on the problems of sovereign debt in the PIGS, noting that higher interest rates will make it even more difficult for these nations to pay the interest on their debts. The ECB President repeatedly stated that his job — and that of his bank — is to act in the interest of all 330 million inhabitants of the euro zone’s 17 nations. He pointed out that Thursday’s decision by his bank was unanimous, but that the governing council didn't decide on a series of rate hikes. Trichet repeated that the central bank never pre-commits on future rate moves, adding that Thursday's decision to raise rates will help to keep inflation expectations firmly anchored.

Fielding a barrage of queries over Greece, Portugal, and the euro-zone debt crisis, Trichet assured the reporters that the ECB makes decisions for the whole of the euro area and that the rate increase will benefit all countries in the region.

Lombard Street Research economist Gabriel Stein noted of the bank’s action,

> That was the right thing to do — but for the ECB, another sign of retreat. Should, as we think likely, Greece or Portugal default, yet remain in the euro area, it seems just as likely that the ECB will have to accept defaulted bonds as collateral.

Sony Kapoor, managing director of Re-Define, an international economic think-tank, was more critical: "An unelected ECB is casting an increasing influence on the burden sharing between the private sector and taxpayers. This is problematic." Norbert Aul, a rate strategist at Royal Bank of Canada Capital, seemed to concur: "That’s the key thing. There will be a way around it so that even if the major rating agencies give Greece a selective default rating, the European Central Bank should still accept GGB (Greek Government Bonds) as collateral."

Gold futures rose for the third straight day on the news from Europe. Bob Haberkorn, senior market analyst at Lind-Waldock, commented on the rise: "It shows you just how strong gold is when even rate hikes can't tame it; there's no slowing it down right now."

Photo of Jean-Claude Trichet: AP Images