Tax cuts could delay ECB rate cut

FRANKFURT, Germany (Reuters) --The European Central Bank is poised to hold interest rates steady on Thursday and plans by European governments for major tax cuts to boost growth complicate rate cuts later this year.

Some ECB watchers are warning that fiscal stimulus programs in Germany, Italy and France -- the three major economies of the euro zone -- without clear promises to cut budgets threaten the ECB's goal of price stability and create investor uncertainty.

Against this backdrop, they argue, ECB policymakers may well prove more reluctant to cut interest rates again in September or even October, especially if inklings of an economic recovery are starting to emerge.

"Unsustainable government debt levels pose a serious threat to the bank's mandate of keeping inflation at a low and stable level," said Wim Koesters, economics professor at Ruhr University Bochum and a member of the ECB Observer think tank.

One major hedge fund manager, who asked not to be named, also said he is betting on no ECB rate cut in September while governments sort out their 2004 budget plans.

The ECB meets on Thursday to discuss interest rates and holds its final press conference before a summer break. In a Reuters poll this week, no ECB watchers forecast a cut in euro zone rates, already at record lows of 2.00 percent following a half percentage point cut last month.

Most analysts expect a September rate cut, but financial markets are growing more dubious. Euribor futures are pricing roughly a 50 percent chance of a 25 basis point move in September, and a 75 percent chance by December.

Shots over the bow

ECB President Wim Duisenberg fired a broadside about fiscal laxity last week, warning the European Parliament worried about sluggish growth: "We have done our part, and it is now the case that governments can no longer hide behind the ECB."

Bundesbank Chief Economist Hermann Remsperger in a newspaper interview this week also warned that monetary policy making would be made more difficult if Germany again breaches the European Union's Stability and Growth Pact rule to keep budget deficits below 3.0 percent of Gross Domestic Product.

ECB Observers in a report on Tuesday threw their academic weight behind the need for fiscal austerity. Abandoning the budget rules threatens the very economic framework that underpins the ECB -- achieving price stability through fiscal and monetary discipline.

That is a growing challenge, it warned. Weak growth, high unemployment and low inflation are all reasons for politicians to demand an inflationary monetary policy rather than pursue politically painful spending cuts or tax increases.

Ansgar Belke, economics professor at the University of Hohenheim, said his economic formula called the option value of waiting shows that delaying budget reforms only harms growth prospects by adding to economic uncertainty.

Businesses and consumers know that tax cuts eventually must be paid for, so they delay economic decisions. They increase their savings and do not take advantage of cheaper money. ``Hence it makes more interest rate cuts ineffective," he said.

Julian van Landesberger, economist at HVB Group, agreed budget issues are a problem. "Fiscal laxity is definitely going to be worrisome for the ECB," he said.

But if governments accompany the sugar pill of tax cuts with the harsh medicine of pension and labor market reforms, as Germany is doing, the ECB will be sympathetic, he said.

Moreover Anthony Thomas, European economist at Dresdner Kleinwort Wasserstein, said the ECB will not have the luxury to delay cuts too long.

"Chance would be fine thing," he said. "The European economy is so weak it needs all the stimulus it can get."