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ECB's storm warning for euro raises fears

But bank shows no sign of cutting rates

By Carter Dougherty

FRANKFURT: The European Central Bank is raising concern that the impact of hurricanes in the Gulf of Mexico could push up not only oil prices but eventually the euro as well, dealing a double blow to exporters who have been one of the few bright spots in Europe's economy.

In an interview, Lorenzo Bini Smaghi, the newest member of the bank's executive board, warned that hurricane-related cleanup costs, coupled with the high cost of fuel, could exacerbate U.S. budget and trade deficits that are already bloated, despite repeated promises by the Bush administration to reduce them.

"The immediate impact of high oil prices plus Katrina plus higher budget deficits will mean in all likelihood that the adjustment of the current-account deficit is further postponed into the future," Bini Smaghi said.

The current-account deficit is the broadest measure of trade, including items like interest payments made to foreigners holding U.S. bonds.

Concern about Hurricane Katrina and the threat posed by Hurricane Rita to the U.S. Gulf Coast drove the dollar to its lowest level in three weeks against the euro on Wednesday, with the euro rising to $1.2219.

Highlighting the already precarious state of the euro-zone economy, the International Monetary Fund on Wednesday cut its growth forecast for the region to 1.2 percent from 1.6 percent. The IMF again urged the ECB to consider cutting interest rates if inflation remained under control.

The ECB has held its benchmark rate at a historic low of 2 percent since June 2003, and bank officials have so far rejected calls for a rate cut.

Bini Smaghi gave no indication that a cut was being considered. The bank's primary focus is on inflation, but he said that for now price pressures are confined to oil, allowing the ECB to keep its rate low.

"We can maintain accommodation if we are credible that this accommodation will not fuel inflation," said Bini Smaghi, the ECB's director for international affairs. "It must be clear that this accommodation will be withdrawn as soon as any systematic inflationary pressure comes up."

But the nightmare for Europe would be a sharp decline in the dollar vis-à-vis the euro and other currencies. The threat stems from America's voracious appetite for foreign capital, driven by a federal deficit that hit $412.5 billion last year.

Central bankers, though loath to say so publicly, have long worried that a sudden fall in the dollar, apart from roiling financial markets, would force the U.S. Federal Reserve to abandon its "measured" approach in raising interest rates, putting the brakes on U.S. growth and hitting other countries, like the 12 nations of the euro zone, that depend on exports to the United States.

The IMF also noted that the outlook for the U.S. current-account deficit had worsened notably since its last gathering in April. It is now projected to rise to more than 6 percent of gross domestic product.

Bini Smaghi said that the prospect of even higher U.S. deficits "raises the question of the extent to which the rest of the world is willing to buy U.S. assets to finance the deficit." This trend "should continue for some time," he added.

But the IMF warned that such capital flows "will not continue forever and finding out just when it might end is an experiment best not undertaken."

Worries that investors will lose their appetite for the American currency is one reason why the dollar has remained relatively weak against the euro, despite political turmoil in Europe that now extends to an inconclusive German election, analysts said.

"It's very possible we're at the beginning of a current-account deficit that is going to widen substantially," said David Bloom, a currency strategist with HSBC Holdings in London.

The subject is likely to come up again when the Group of 7 industrialized countries meet on Friday, just before the semiannual meetings of the IMF and the World Bank in Washington.

Bini Smaghi said that G-7 officials, while grappling with their responses to high oil prices, would also be examining what he called the minimal impact of China's decision on July 21 to revalue its currency.

Chinese officials had worried about squelching their own economic growth, but Bini Smaghi said those fears have proved unfounded, especially since the appreciation of the yuan amounted to only 2 percent.

At the same time, Bini Smaghi said that the G-7 would not lay down specific demands for the Chinese to fulfill.

"What is important is that the Chinese feel the responsibility for making the next steps and to take the initiative for that," he said. "It's not right to put too much pressure on them on the specific timing."

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Chris Warde-Jones/Bloomberg News

Bini Smaghi worries about delays in adjusting the U.S. current-account deficit.

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