

There's always next year. With home sales still languishing, sellers are looking to 2008 for the market to pick up. Many appear to be counting on cuts in interest rates next year to stop the slide in house prices and refuel demand.

The outlook for interest rates has been on a roller-coaster ride lately. As recently as July, another two or three quarter-point rate hikes were in the offing. After a decade of stagnation, the German economy was finally sucking diesel and inflation pressures were mounting. The European Central Bank by then had already increased its main policy interest rate to four per cent from two per cent in December 2005.

August brought the US subprime mortgage meltdown and turmoil in international credit markets. The ECB governing council has met twice since then--and both times left interest rates unchanged. They pointed to concerns that the credit squeeze may be damaging the economy.

Those decisions left some analysts confident that rates have peaked and that the next move by the ECB will be down. Hence the optimism on housing in 2008.

Alas, the prospects for interest rates became more clouded this week. Incoming data suggest that Germany's economic momentum may be underestimated. In addition, German inflation rose to 2.4 per cent in September. Two very senior ECB officials, Jurgen Stark and Axel Weber, signalled that rate rises might be back on the cards. The economy may have decoupled from developments in credit markets.

New data from the Central Bank remind us that interest rates may rise even if the ECB stays on hold. Figures for August show that banks here have started to pass on to borrowers the increased costs of getting funds on interbank markets.

Could a combination of German economic resilience and continued elevated interbank rates spoil the party in 2008?