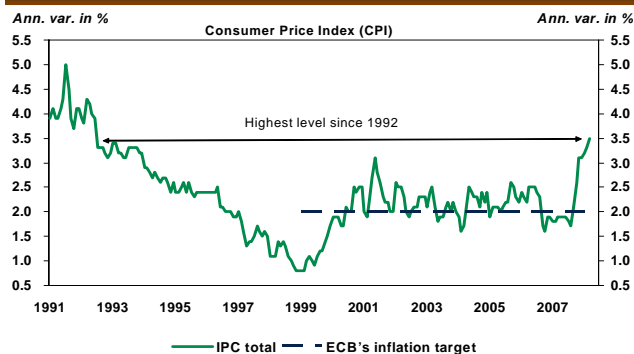


## Is the European Central Bank's hawkish tone inflationary?

Despite the evident stresses in the global credit market and the economic slowdown in the United States, the ECB is showing little intention of initiating a monetary easing cycle. The reason is very simple; consumer price inflation, which reached 3.6% in the euro zone in March, is evolving well over the ECB's upper limit of 2.0% (Graph 1).

**Graph 1 – Total inflation jumped to its highest point in the last 15 years**



Sources: Datastream and Desjardins, Economic Studies

Thoroughly entrenched in its dogmatism, the ECB has repeatedly reiterated that its only mandate is price stability, to the point that the market has done a complete about-face in terms of its monetary policy expectations. From the approximately 75 basis points of cuts expected at the beginning of the year, the market is now anticipating that the next movement will be upward, by about 50 basis points (Graph 2).

The ECB is worried that elevated inflation will have an impact on wage negotiations and lead to an inflation spiral. Such monetary rectitude, though laudable in and of itself (no one wants runaway inflation), poses several problems, however.

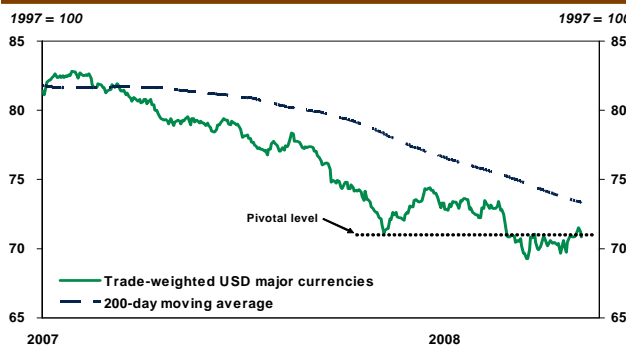
**Graph 2 – The market expects interest rate hikes in the euro zone**



Sources: Datastream and Desjardins, Economic Studies

Intimating that the euro zone rate cuts will not happen in 2008, or worse, that the next change could be an increase, means that the pressure on the greenback remains clearly tilted to the downside (Graph 3).

**Graph 3 – At best, the U.S. dollar will continue its period of stabilization**



Sources: Datastream and Desjardins, Economic Studies

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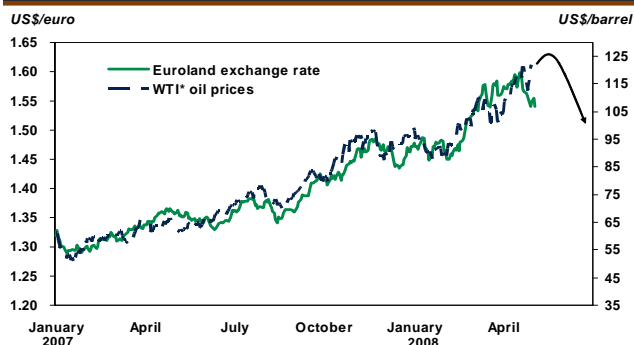
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As commodities prices are denominated in U.S. dollars, market speculation could push oil prices to levels that are well over its equilibrium value (Graph 4).

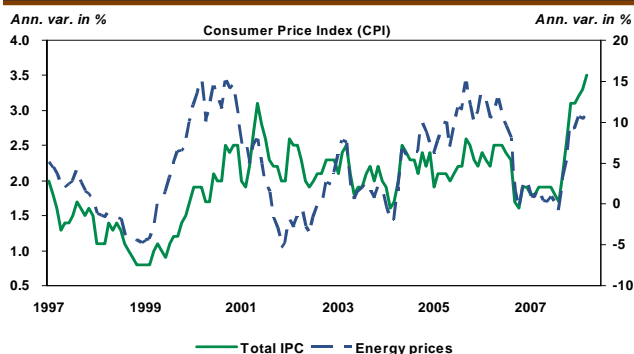
**Graph 4 – A euro correction would take oil prices back to a level more in line with fundamental determinants**



\* West Texas Intermediate.  
Sources: Datastream and Desjardins, Economic Studies

The problem is that inflation in the euro zone primarily reflects the increase in energy prices (Graph 5). This means that the euro's rise against the greenback does not offset the appreciation in oil prices. As a result, the ECB's monetary rectitude could maintain (rather than contain) the sources of inflation.

**Graph 5 – Euroland inflation is primarily a reflection of rising energy prices**



Sources: Datastream and Desjardins, Economic Studies

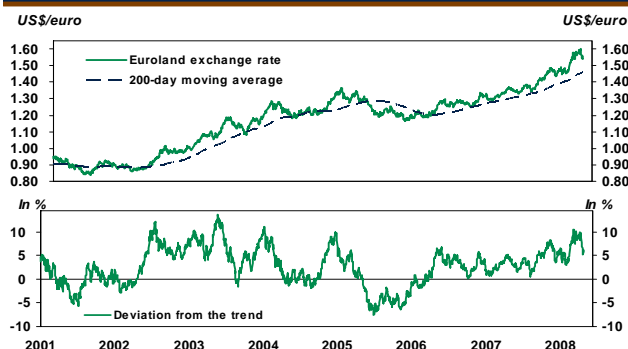
For now, Euroland's monetary authorities have tried to manipulate the currency's movement by showing their concern about the extreme volatility on the exchange market. But it is increasingly clear that the global slowdown and credit crisis will demand concerted effort from the major industrialized economies.

In our opinion, it will take a change of course by the ECB to reintroduce calm and bring an end to the speculation that is rampant in many commodities. With much of the American monetary easing behind us, the U.S. dollar is likely to stabilize. However, a major rebound will only occur if the U.S. economy

starts up again if the ECB announces that it is in a position to lower its own interest rates.

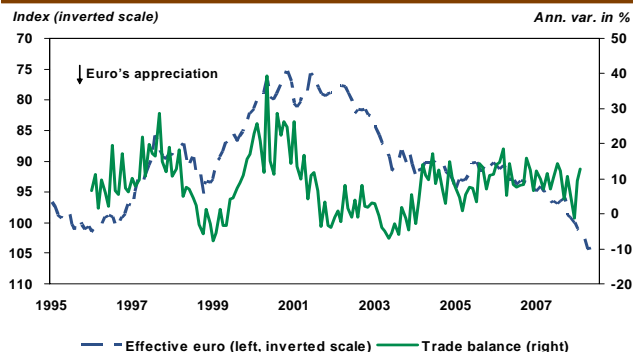
As the euro appears to be well overvalued, according to a number of measures (Graph 6), rate cuts would immediately translate into a sharp correction by Euroland's currency. This would kill two birds with one stone. On one hand, the adverse effects a strong currency is having on Euroland's foreign trade would ease off (Graph 7).

**Graph 6 – The euro appears overvalued once again**



Sources: Datastream and Desjardins, Economic Studies

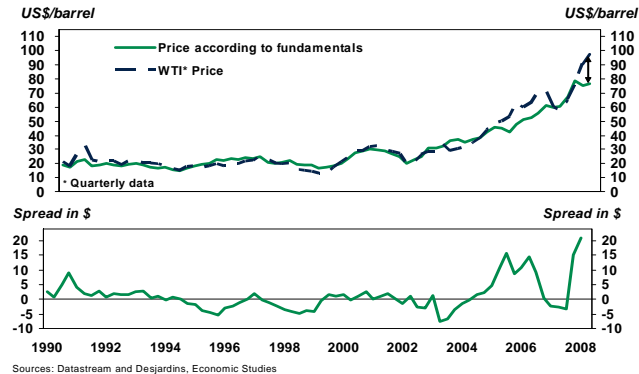
**Graph 7 – The high euro does not favour a strong contribution by exports**



Sources: Datastream and Desjardins, Economic Studies

On the other, euro zone inflation sources (energy prices) would ease. Although, in ordinary times, a country's monetary policy has little impact on oil prices (as they are set by global markets), a greenback rebound would inevitably lead to a drop in speculation on commodities prices, especially oil prices. With a premium of at least \$20, this could result in oil prices dropping back below US\$100/barrel (Graph 8)<sup>1</sup>.

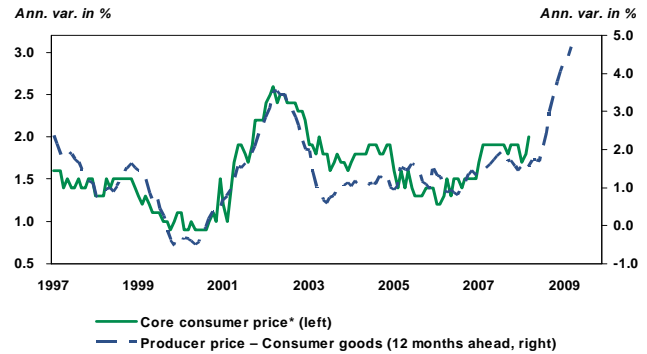
<sup>1</sup> See the *Economic Viewpoint* of April 30, 2008: «Are current oil prices justified?», Desjardins, Economic Studies.

**Graph 8 – The current price of oil holds a premium of around \$20 tied mainly to speculation**


Sources: Datastream and Desjardins, Economic Studies

We do not expect a change before next fall. However, contrary to the hawkish stance taken by ECB members (Weber and Mersch have said that rates will not come down in 2008 because inflation will stay above the 2.0% target this year and next year), we still think that interest rates will come down, in the fourth quarter.

It is still too early to look for rate cuts, but the signs of a slowing economy should gradually mount, allowing the ECB more leeway in developing its monetary policy. The decline by Germany's IFO index, an important barometer of economic activity in the euro zone, is one step in that direction. The bad euro zone retail sales results for March is another. But rate cuts will certainly not see the light of day until there is some concrete deceleration by inflation. Here, the monthly decline by Germany's harmonized index of consumer prices, which took annual inflation down from 3.2% in March to 2.5% in April, is encouraging. However, although energy prices pass-through to core inflation remains limited, the ECB will continue to opt for prudence over the next months. We are confident that producers will be able to absorb higher energy costs over their profit margins, but the increase in producers' consumer goods prices, which suggest that a marked hike in core inflation could arise, is nothing to reassure the ECB (Graph 9).

**Graph 9 – The increase in production costs is not reassuring**


Sources: Datastream and Desjardins, Economic Studies

Under these circumstances, patience is called for. Clearer opportunities for steepening by Euroland curves or narrowing of rate spreads between the euro zone and the United States should develop in the months to come.

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