EUROPEAN CENTRAL BANK

The ECB stays on course: Inflation control takes precedence!

ACCORDING TO THE EUROPEAN CENTRAL BANK (ECB)

- Recent events have confirmed that there are strong short-term upward pressures on inflation. The risks to inflation are thus still tilted to the upside.
- Eurozone’s economic fundamentals remain sound. However, risk on the financial markets is continuing to rise, introducing uncertainties as to its potential impact on the real economy. The risks associated with economic growth are tilted to the downside.

COMMENTS

As expected, despite intensifying tensions on the financial markets, the ECB opted to stay on course, keeping its key rate at 4.0% this morning. With annual inflation up 3.0% in November, more than one point above the Bank’s upper target, the Bank is still clearly concerned about inflation risks. In particular, growth by the supply of money and credit remains very vigorous. With the ECB’s December inflation estimates for 2008 at somewhere between 2.0% and 3.0%, it is very likely its stance will remain hawkish in the coming months. Under the circumstances, it seems the ECB is not ready to fall into step with the U.S. Federal Reserve, the Bank of England, and the Bank of Canada. The ECB also says it is ready to counter upside risks to price stability.

Under these circumstances, although the euro zone is not safe from credit risks, it will take a lot more for the ECB to drop its legendary dogmatism (inflation control mandate) and show a little more pragmatism. However, we believe the ECB will initiate a monetary easing cycle soon. Note that the leading indexes indicate that Eurozone’s economy is heading for a slowdown. In addition to a euro that is close to US$1.50, the American economy’s softness will have eventual repercussions for the euro zone. To that effect, the ECB has downgraded its growth forecast to 1.5% to 2.5% for 2008. That said, the ECB will want to make sure that inflation’s acceleration is temporary before it takes action.

This could easily take us into the spring of 2008 before seeing the first rate cuts.

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[...] On the basis of our regular economic and monetary analyses, we decided at today’s meeting to leave the key ECB interest rates unchanged. The latest information has confirmed the existence of strong short-term upward pressure on inflation, with the HICP inflation rate reaching 3.0% in November. It has also fully confirmed our assessment that there are upside risks to price stability over the medium term. Against this background, and with money and credit growth remaining very vigorous in the euro area, the Governing Council stands ready to counter upside risks to price stability, as required by its mandate. The economic fundamentals of the euro area remain sound. However, the reappraisal of risk in financial markets is still evolving and is accompanied by continued uncertainty about the potential impact on the real economy. We will therefore monitor very closely all developments. By acting in a firm and timely manner on the basis of our assessment, we will ensure that second-round effects and risks to price stability over the medium term do not materialise. Firmly anchoring medium and long-term inflation expectations in line with price stability is all the more important at times of financial market volatility and increased uncertainty. As regards the financial markets, we will continue to pay great attention to developments over the coming weeks. [...]