Inflation remains the primary concern

BANK OF ENGLAND (BOE)

To no one’s surprise, the BoE maintained its prime interest rate at 5.25% this morning, after cutting its rate by 25 basis points at the previous meeting. The last report on inflation indicates that the BoE anticipates tightening credit conditions, troubles in the real estate market and downward pressures on real income to halt consumption and investment in the United Kingdom over the next few months. However, the BoE also expects inflation to accelerate sharply, which could even exceed 3% in the short term following increases in the price of food and energy.

Implications: For the moment, nothing indicates that the gradual monetary easing, which began on December 2007, with a rate cut of 25 basis points at every other meeting, is over. However, significant inflationary pressures have forced the BoE to be cautious, preventing it from reducing its prime rate as aggressively as the U.S. Federal Reserve or even the Bank of Canada. We expect two more reductions of 25 basis points before the summer.

EUROPEAN CENTRAL BANK (ECB)

As expected, the ECB decided to stay the course and maintain its prime rate at 4.0% this morning. With annual inflation at 3.2% in February for a second consecutive month (according to quick estimates), the Bank is clearly concerned about the risks of inflation. The ECB, however, is being increasingly open about the risks to the economic outlook and continues to qualify the uncertainty of growth outlooks as « unusually high. »

Implications: The high level of inflation cannot be ignored, but more concrete signs of an economic slowdown in the euro zone or a deceleration of inflation would have to be seen before the ECB cuts its rates. However, the slowdown in the U.S. and the euro, which hit a record US$1.5345 this morning, should lead the ECB to enter into a cycle of monetary easing in the near future. We remain confident the ECB will show more openness toward this possibility at the meeting in April, meaning that a rate cut may take place in June, the first in five years.

United Kingdom – The BoE foresees a surge in inflation

Euro zone – The high level of total inflation remains the main concern of the ECB
EXEMPLARY FROM THE EUROPEAN CENTRAL BANK PRESS RELEASE
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[...] The latest information has confirmed the existence of strong short-term upward pressure on inflation. Incoming macroeconomic data point to moderating but ongoing real GDP growth. Yet the level of uncertainty resulting from the turmoil in financial markets remains high. Against this background, we emphasise that maintaining price stability in the medium term is our primary objective in accordance with our mandate. Looking ahead, in 2008 both domestic and foreign demand are expected to support ongoing real GDP growth in the euro area, albeit at lower rates than during 2007. The fundamentals of the euro area economy remain sound and the euro area economy does not suffer from major imbalances. Annual real GDP growth is projected to lie in the range of 1.3% to 2.1% in 2008, and to be between 1.3% and 2.3% in 2009. In comparison with the December 2007 Eurosystem staff macroeconomic projections, the ranges projected for real GDP growth in 2008 and 2009 have been revised downwards, reflecting weaker global demand, stronger pressure from commodity prices and less favourable financing conditions than were foreseen in December. Uncertainty about the prospects for economic growth remains unusually high. Downside risks to the outlook for economic activity continue to exist. They relate mainly to a potentially broader than currently expected impact of financial market developments. The March 2008 ECB staff macroeconomic projections foresee annual HICP inflation of between 2.6% and 3.2% in 2008, and between 1.5% and 2.7% in 2009. Compared with the December 2007 Eurosystem staff macroeconomic projections, the projected ranges for HICP inflation have shifted upwards, mainly reflecting significant additional increases in food and energy prices. [...]