ACCORDING TO THE EUROPEAN CENTRAL BANK (ECB)

- March’s 3.5% inflation confirms strong past pressures and the recent acceleration of short-term upside risks to inflation, mainly arising from energy and food prices.
- The risks surrounding the medium-term inflation projection are still to the upside. There is a risk that prices and wage setting could add to the inflation pressures. Second round effects must be prevented. Indexing wages to prices could lead to an inflation spiral.
- There is still a lot of uncertainty about the prospects for economic growth and the downside risks are prevailing. They are mainly a reflection of the turbulence in the financial markets, which could last longer than forecast and have a more pronounced impact on the real economy.

COMMENTS

As expected, the ECB chose to hold steady, keeping its key rate at 4.0% this morning. With annual inflation up 3.5% in March, the ECB is still clearly concerned about inflation risks. Oil prices continue to oscillate at record levels and a number of unions have been able to negotiate sizeable wage agreements in the last few months. However, there is little pass-through by elevated energy prices to consumer prices as a whole. The annual change in the core consumer price index (CPI), which excludes food, tobacco, alcohol and energy, is below 2.0%. Moreover, the risks to the economic outlook are tilted to the downside. The International Monetary Fund (IMF) has cut its growth forecasts to just 1.4% and 1.2% for 2008 and 2009 respectively. Under these circumstances, while the Governing Council states that potential second-wave effects associated with elevated inflation must be prevented, we continue to believe that rate cuts will be ordered as of mid-year.

Implications: Elevated inflation is a concern, but the economic situation should lead to some deceleration in the next few months. However, it will take more concrete signs of an economic slowdown in the euro zone before the ECB initiates a monetary easing cycle. We are not ruling out a rate cut in June, but the ECB’s monetary rectitude (Jean-Claude Trichet has carefully reiterated that the ECB only had one needle in its compass and, as a result, the monetary policy was aimed at securing price stability) could mean that rate cuts would be put off until the summer.

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EXCERPT FROM THE EUROPEAN CENTRAL BANK PRESS RELEASE
APRIL 10, 2008

[...] 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. In fact, we are experiencing a rather protracted period of temporarily high annual rates of inflation, resulting mainly from increases in energy and food prices. The latest information also clearly confirms our assessment of prevailing upside risks to price stability over the medium term, in a context of continuing very vigorous money and credit growth. The economic fundamentals of the euro area are sound. Incoming macroeconomic data continue to point to moderate but ongoing real GDP growth. However, the level of uncertainty resulting from the turmoil in financial markets remains unusually high and tensions may last longer than initially expected. Against this background, we emphasise that maintaining price stability in the medium term is our primary objective in accordance with our mandate. The firm anchoring of medium to longer-term inflation expectations is of the highest priority to the Governing Council and there is certainly no room for complacency in this regard. We believe that the current monetary policy stance will contribute to achieving our objective. The Governing Council remains strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term. We will continue to monitor very closely all developments over the coming weeks. [...]