According to the European Central Bank:

- The ECB’s key rate was increased by 25 basis points to 3.25%.
- All in all, the economic recovery now appears somewhat stronger than it did earlier, and the conditions are in place for growth to remain solid.
- Harmonized annual inflation fell to 1.8% in September 2006, reflecting the base effects from the marked increase in oil prices a year ago and the decrease in oil prices last month. However, due to less favourable effects in 2007, inflation risks remain to the upside in the medium term.
- If our assumptions and baseline scenario are confirmed, it will remain warranted to further withdraw monetary accommodation.

Commentary:

As we expected, the ECB (European Central Bank) increased its key rate by 25 basis points this morning, to 3.25%. A little earlier, members of the Bank of England’s Monetary Policy Committee decided to maintain rates at 4.75%.

Despite the inflation of consumer prices slowing to below the ECB’s target ceiling of 2.0% in September, it would have been surprising for the ECB not to move forward with a rate increase at the October meeting. It should be said that the ECB had reintroduced the notion of “strong vigilance” in the statement accompanying its September meeting, a signal which has preceded its last four rate increases.

If total inflation in the Euro zone benefits from the current dip in oil prices, it is probable that less favourable base effects will come into play in early 2007. In the face of these developments as well as the impact of the three-percentage point increase in Germany’s value added tax in January of 2007, inflation could rebound sharply early next year. Under these conditions, it is likely that the ECB will increase its key rates again a little later this year. As usual, the ECB will proceed gradually and with great transparency. Here, the fact that the concept of “strong vigilance” was left out this morning puts the next rate hike off to December at the earliest.

For the time being, the majority of economic indicators, which augur sustained growth in activity from now until the end of the year, are compatible with continued monetary tightening. However, the leading indicators point toward an economic slowdown beginning in 2007. Therefore, unless there is a strong rebound in oil prices, which would sustain the bank’s concerns regarding inflation risks, it is likely that the ECB will keep pace with the U.S. Fed and opt for a period of status quo as of 2007.

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At today’s meeting, we decided to increase the key ECB interest rates by 25 basis points. [...] Also after today’s increase, the key ECB interest rates remain at low levels, money and credit growth are strong, and liquidity in the euro area is ample by all plausible measures. Our monetary policy therefore continues to be accommodative. If our assumptions and baseline scenario are confirmed, it will remain warranted to further withdraw monetary accommodation. The Governing Council will therefore continue to monitor very closely all developments so as to ensure price stability over the medium and longer term.

All in all, the economic recovery now appears somewhat stronger than on the basis of earlier data. It has become more broadly based and is mainly supported by domestic demand. [...] Looking ahead to the remainder of 2006 and 2007, the conditions remain in place for the euro area economy to grow at solid rates around potential, with some volatility in the quarterly growth rates likely to emerge around the turn of the year. [...] As regards price developments, according to Eurostat’s flash estimate, annual HICP inflation fell to 1.8% in September 2006, from 2.3% in August. Although no detailed breakdown is available as yet, this relatively sharp decline seems to be the combined result of favourable base effects, given in particular the strong rise in oil prices a year ago, and the recent significant fall in oil prices. While the outlook for energy prices is uncertain, on the basis of current energy prices and the higher quotations on futures markets, but overall inflation rates are likely to increase again towards the end of the year and in early 2007. As a consequence, we expect a considerable degree of short-term volatility in the annual HICP inflation rate, while the overall inflation rate will remain elevated at levels above 2% on average in 2006 and is likely to remain so in 2007. [...]