The European Central Bank (ECB) has its hands tied. The Euroland economy is clearly on a downward trend: for a few months now, the leading indicators have been pointing to a slowdown and January’s stock market correction has shown that the euro zone is not as immune as we might have thought against the credit and liquidity crisis or the potential slump in the U.S. The problem is that at the same time, inflation jumped 3.2% in January, its highest level in 14 years (see graph 1).

In this Economic Viewpoint, we show that interest rates will ultimately have to fall. In the near term, the ECB will be prudent because its main mandate is to ensure price stability. However, gradually easing inflation and downward risks to growth will prompt the Bank to start relaxing rates. In the interest of transparency, the ECB will continue to soften its tone at its upcoming meetings, meaning that the rate reductions will probably not materialize before spring. However, the ECB describes the risks to growth as “unusually high”, which could translate into earlier than expected cuts and in turn, a sharper yield curve.

NO DECOUPLING

While we think a deep U.S. recession is unlikely, a sharp slowdown now seems inevitable. Real GDP growth fell from 4.9% in the third quarter to just 0.6% in the fourth, and the protracted housing slump could dampen consumer spending even more. The sudden drop in the January ISM non-manufacturing index, a gauge of activity in the service sector, is a good case in point. The situation is so critical that last month the Federal Reserve took the unprecedented step of trimming its key rate by 125 points in just eight days to prevent the economy from crashing (see graph 2).

Under these circumstances, America’s industrialized counterparts will very likely follow the Fed’s lead and either continue or begin their own monetary easing cycle. This is because while these nations and those with emerging economies are not immune to the problems in the U.S., the interconnectedness is such that a deep recession in America would have a significant impact on the rest of the world.
Economies have been largely spared the fallout of the U.S. housing slump (not import intensive), the repercussions of the second wave, i.e. the loss of wealth and anticipated increase in savings on consumer spending (highly import intensive), could very well have a ripple effect on the rest of the world (see graph 3).

Graph 3 – The relationship between global and U.S. growth is weaker than before

ECB Governing Council member Axel Weber recently stated that the effects of the U.S. slowdown on Euroland growth may be modest:

"If we face a slowdown [in the U.S.] then this will certainly affect the world economy. But I also think that the effects in the euro area could emerge with a time lag and that these effects will be less strong than in former times."

However, there seems to be absolutely no divergence with the U.S., and we consider the situation in the euro zone critical (see graph 4). Production indicators are already pointing to a slowdown and the economy is expected to slip further in the coming months.

Graph 4 – Decoupling? What decoupling?

The monthly increase in food prices is also of concern (see graph 6), although it has been largely limited to the "milk, cheese and eggs" and "bread and cereals" components due to global pressure on agriculture prices. That said, these increases are almost always short lived and agricultural futures are in fact betting that they will go down during 2008.

Graph 6 – Food prices are also up sharply

… BUT IS EXPECTED TO FALL IN THE COMING MONTHS

In the near term, the drop in the Harmonized Indices of Consumer Prices (HICP) will be modest, but the ECB predicts that the negative base effect on energy and non-energy prices could push inflation down by nearly a full percentage point by November of this year (see graph 7). At the same time, the
unfavourable base effects observed throughout 2007 as a result of the rise in Germany’s value-added tax began to dissipate in January.

Moreover, inflation is a lagging indicator of the economic cycle: with several signs pointing to a slowdown in the eurozone, inflation should fall going forward.

Although we expected retail sales growth to slip into negative territory in January due to the base effect associated with the 3% increase in Germany’s value-added tax in 2007, at -2.0%, the year-over-year change was twice as weak as anticipated. This figure, combined with the drop in consumer confidence, means spending is not about to pick up any time soon (see graph 8).

While the ECB does not say so outright in its press release, according to Axel Weber, its monetary policy remains accommodating:

"We have a positive economic outlook and as long as that doesn’t change I would say that rates are still in the accommodative side and in no way restrictive."

Still, given the economy’s growth potential of about 2% and an inflation target of less than 2%, current interest rates are at the higher end of the neutral rate range, estimated at between 3.25% and 4%.

Moreover, the Fed took the bull by the horns by slashing rates a total of 225 basis points since September 2007 and opening the door to more cuts in the future. Thus, with the Euroland rate now 100 basis points higher than the federal funds rate, there is upward pressure on the euro (see graph 10), a situation that could have negative consequences on net exports at a time of dampening global demand.

RESTRICTIVE MONETARY CONDITIONS
In these circumstances, and with core inflation under control at 1.5% in December, we still believe that interest rates are much more likely to be cut than raised, particularly since the previous hikes and the euro’s climb have led to very restrictive monetary conditions (see graph 9).
HEADING TOWARDS AN EASING MONETARY BIAS

Although the ECB will remain cautious in the near term, it will very likely change its tone if concrete signs of a slowdown emerge. In fact, its tone is already softer than in January when it said that it was prepared to take preventive action to ensure inflation does not spiral out of control, indicative of a restrictive monetary bias. Now, it is more open given the risks to economic growth. In these circumstances, the monetary bias is clearly more neutral. In this regard, ECB president Jean-Claude Trichet announced that neither hikes nor cuts were on the agenda at the February 7 rate-setting meeting.

Because of its price stability mandate, the ECB may continue its hawkish tone for a while yet, but we are willing to bet that the topic of rate reductions will be on the program as of the March meeting. While we are confident that the monetary authorities will become more receptive to lowering rates in the months ahead, the cuts may not actually materialize until spring. However, the use of the term "unusually high" in February’s press release to describe the risks surrounding the economic outlook means the situation could change fairly quickly for the ECB. If it does, inflation will not hold the Bank back, as we saw in May 2001 when, despite an inflation rate of 2.7%, the ECB did not hesitate to cut rates by a quarter point to prevent the U.S. slowdown from infecting the Euroland economy (see graph 11).

**Graph 11 – High inflation will not be an obstacle if concrete signs of a slowdown emerge**

* Consumer price index.
Sources: Datastream and Desjardins, Economic Studies

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