



Daily Note: 6 March 2008

The ECB's single-needle compass

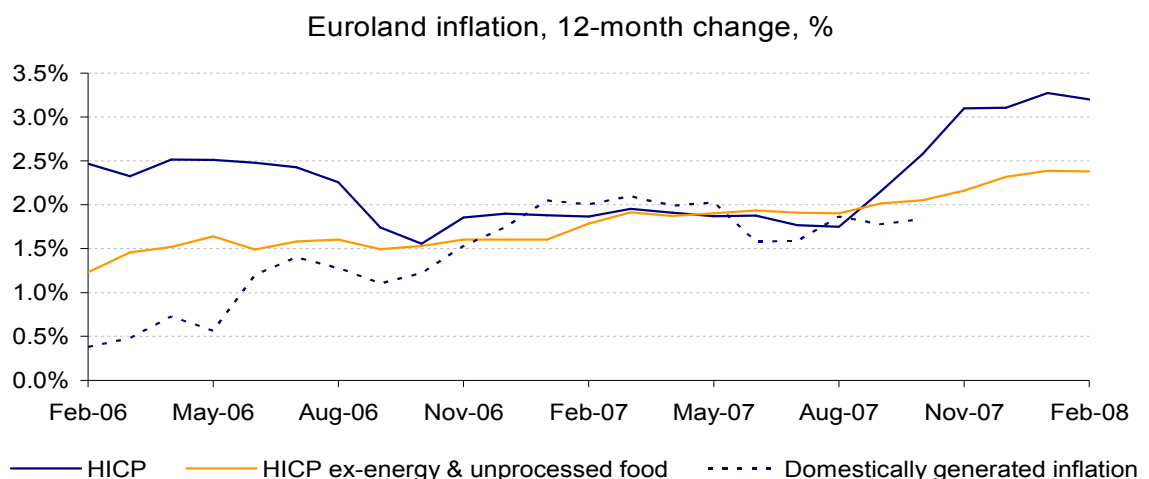
WE SUGGEST: ECB interest rate cut not yet on the horizon

SUMMARY: As expected, the ECB left interest rates unchanged today. While conscious of the downside risks to growth, the ECB is nevertheless happy with its current monetary policy. M. Trichet took every opportunity to distance himself from the Fed and note that US and Euroland circumstances differ. The ECB's next move is still down – but not for some time yet.

Unsurprisingly, the ECB left interest rates unchanged today. Perhaps somewhat more surprisingly, M. Trichet's message at the press conference following the meeting of the Governing Council, was fairly hawkish and uncompromising. He repeatedly stressed that the ECB has one mandate and took every opportunity to distance himself from the Fed and its actions, noting that the ECB only has one needle on its compass – price stability – as opposed to others who live in a 'two-needle compass' universe. The clear message from today's meeting and press conference is therefore that the ECB is in no hurry to cut interest rates.

It is still the case that the Bank's next move is more than likely to be down. But unless matters change rapidly, this interest rate cut won't come for a couple of quarters yet.

Is the ECB right to maintain monetary policy unchanged? Certainly from an inflation point of view. Headline inflation remained at 3.2% in February, the third month above 3%, compared with a target of 'close to but below 2%'. Moreover, M. Trichet also presented the new staff projections for growth and inflation over the next two years.



As expected, the growth forecast was revised down, to 1.3-2.1% in 2008 and 1.3-2.3% in 2009, with a mid-point therefore of 1.7% in 2008 and 1.8% in 2009. On Lombard Street Research estimates, the mid-point is broadly speaking at the euro-zone's trend

growth rate. However, the ECB is generally perceived to assume a 2% trend growth rate. This would put the mid-point somewhat below trend, but not significantly so. Moreover, as was also expected, the inflation forecast was revised up, to 2.6-3.2% in 2008 (mid-point 2.9%) followed by 1.5-2.7% in 2009 (mid-point 2.1%). While M. Trichet stressed that these are staff projections and not necessarily those of the Governing Council, they are clearly relevant inputs to monetary policy decisions.

Bearing in mind that inflation is above target and likely to remain so well into 2009, the impetus to cut interest rates for a Bank that stresses inflation-targeting as its sole mandate, is minimal.

This is not to say that the ECB is unaware of Eurozone weakness. The Bank is forecasting weaker growth than in 2007 (which, in turn, was weaker than in 2006). But, with a positive output gap, the Bank is also aware of the need for a period of below-trend growth to rein in inflationary pressures. In this context, recent wage trends (notably in Germany), beneficial though they may be for eventual consumer spending, are also acting to support the ECB's reluctance to ease monetary policy.

But what about accumulating signs of weakness in the eurozone? They are there. But they are possibly less overwhelming than is sometimes perceived. To look just at recent data: Eurozone household spending fell by 0.1% in Q4, the first fall since Q4 2001. But in January, Eurozone retail sales rose by 0.4% in real terms. German orders to manufacturing fell sharply in January as investment tax incentives ran out – but November and December were boosted by these same incentives and orders only reverted to September/October levels. Moreover, October factory sales were strong and even the construction sector PMI jumped in January, remaining above 50 for a second month. Equally, French retail sales picked up in December after a weak November and French unemployment fell to a 25-year low of 7.8% in Q4.

There are clearly worries about the Eurozone economy. Notably, the Spanish outlook is very bad, as is the Italian one. But Spain is balanced by buoyant Netherlands and Belgium, and Italy by steady France. This leaves Germany very much the key. If German households increase their spending, then the euro-zone should weather current travails with a limited (and desired) slowdown. If not, then the impact of weaker world environment and stagnant domestic demand will push growth further. If that happens, inflation will subside under the impact of a negative output gap and the ECB will certainly cut interest rates. But for the moment, the Bank is clearly happy with its current monetary policy stance.

In terms of key indicators for a possible change of view, we still stress broad money and credit growth, economic sentiment and possibly labour market developments. A collapse in any of those is likely to be met with decisive action. But only if inflation at least shows signs of moderating.

Gabriel Stein

gabriel.stein@lombardstreetresearch.com

Michael Taylor

michael.taylor@lombardstreetresearch.com