Daily Note: 31 March 2008

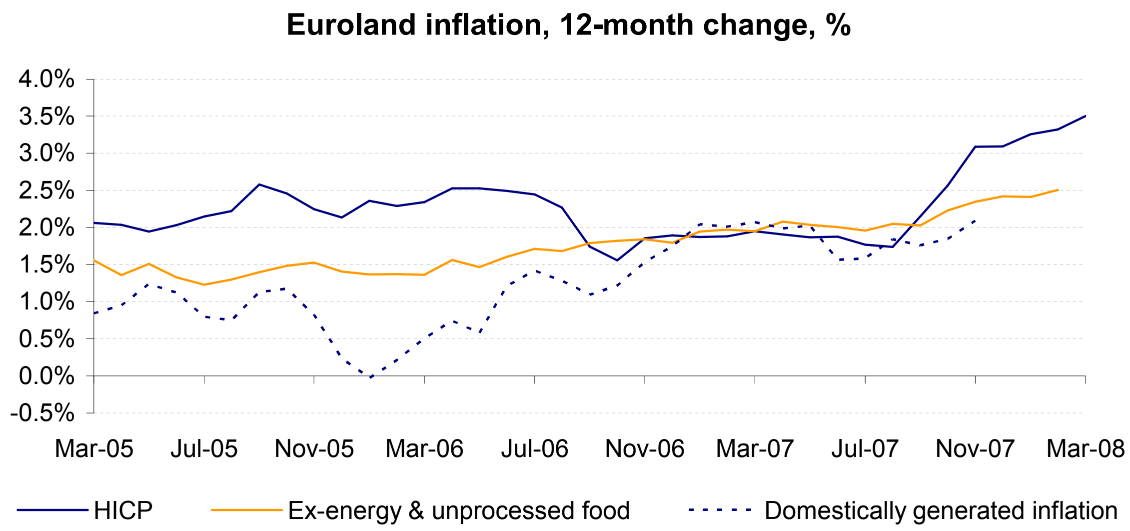
3½% inflation spells no rate cut

WE SUGGEST: ECB to leave repo rate at 4% on Thursday

SUMMARY: Euroland data is mixed. Sentiment is weakening, but the European Commission's business climate indicator rose in March. Broad money and credit growth are slowing, but remain rapid and above target. Crucially, inflation continues to accelerate. The ECB is not going to cut interest rates for some time.

The last day of the month is always full of Euroland data. The European Commission's business survey is published, as is the Commission's business climate indicator. There is also a flash indicator for the latest month's inflation. In addition, the ECB published the February broad money and credit numbers for February.

The message of the data varied. The business climate indicator rose slightly, off-setting the last two months' fall. But economic sentiment fell, going below its long-term average for the first time since late 2005. (Within this index, services and construction sector confidences fell, while industry, retail and consumer confidences were unchanged in the month.) Broad money growth slowed slightly, but at 11.3% it remained well above not only the ECB's 4½% medium-term reference value, but also above the 6½% that *LSR* estimates to be compatible with trend output growth. Moreover, although household credit growth continued to slow, the growth of non-financial business loans accelerated to another record high of 14.7%. M3 growth would have been even higher if banks were not currently (unsurprisingly) building up their capital and reserves.



But the most important number published today, at least for the near term, was the flash indicator of March inflation in the euro-zone. This showed inflation accelerating to a 15-year high of 3.5%. Euroland inflation has now been above 3% for five consecutive months. On a six-month annualised basis, a better guide to recent developments, Euroland consumer prices have been above 4% for three months and are now approaching 5%. Moreover, underlying inflation is also accelerating.

The ECB is, of course, a forward-looking central bank. M. Trichet recently clarified that the inflation target (a headline rate close to, but below 2%) operates with an 18-24 month horizon. The ECB does not necessarily have to act to bring down above-target inflation. Given the lag in the monetary transmission mechanism, the ECB can in any case do little to change the near-term inflation outlook. However, the longer inflation remains above target, the greater the risk that inflationary expectations become more firmly entrenched.

The current global environment, including a Euroland slowdown and euro strength, means that the ECB is most unlikely to raise interest rates. However, today's inflation and broad money numbers make it almost certain that there will be no interest rate cut in April, almost certainly not in May and probably not until very much later in the year – and maybe not even then.

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