

Flash Comment

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ECB: Preview of July 3 meeting

At its meeting in June, the ECB caught everybody by surprise when Mr Trichet said, "... we could decide to move our rates (by) a small amount at our next meeting (in July)". Having sounded this warning, it is hard to see the ECB not pulling the trigger without losing credibility.

However, we do not expect a hike in July to mark the beginning of a new hiking cycle. The ECB still has to perform a difficult balancing act between dwindling growth prospects with downside risks and high inflation with upside risks and fears of second-round effects. In our view, a hike would contribute to an even more pronounced weakening of the economy. Should inflation expectations go up, though, further rate hikes cannot be ruled out. By raising rates in July, the ECB clearly signals that it will not tolerate any damage to its credibility. If sustained, the recent increases in oil prices might trigger further increases in the leading rates. Uncertainty surrounding our call on the ECB rate is unusually high.

Overview

The ECB is in a difficult position. The central bank is being forced to hike rates by sharply rising inflation against a backdrop of a rapid decline in economic activity.

At the ECB press conference in June, Mr Trichet was very hawkish compared to previous months. He mentioned that the ECB is "in a state of heightened alertness", as risks to price stability over the medium term have increased further and that "... we could decide to move our rates (by) a small amount at our next meeting". Thus the ECB sent a clear signal that rates were to be increased at the meeting in July.

The ECB gave itself an escape route if economic developments were to disappoint during the next month by omitting "strong vigilance", which is the phrase usually used by the ECB when a decision to change rates at the next meeting has been made. However, floating the idea of an interest rate rise in July means the ECB is under intense pressure to deliver, and we do not feel that the data have been sufficiently weak for the ECB to back down.

Activity in both the manufacturing and service sectors contracted in June. PMI fell below 50. The German economy now also seems to be affected by the strong headwinds that have been hitting the Euroland economy. German business confidence fell markedly in June, to its lowest level since December 2005 - with the Ifo index at 101.3 from 103.5 in May mirroring a sharp decline in the ZEW index (to -52.4 from -41.4). Furthermore, both German Manufacturing PMI (down from 53.6 to 52.6) and consumer confidence were weak. French PMI is in freefall (with manufacturing PMI going from almost 54 to just above 49 in 4 months), and consumer confidence hit a record low for the sixth straight month at -46. Spanish consumer confidence also hit a historic low. Italian consumer confidence tumbled, and Italian manufacturing PMI is at its lowest since 2001. Thus the Euroland economy is clearly cooling very fast at the moment.

In our view the ECB is not planning a succession of rate hikes. The economy simply looks too weak. Our view is supported by comments made by both Mr Trichet and by several members of the board. For instance, Mr Trichet, in his session at the European Parliament in June, mentioned that "(I) did not say that we envisaged a series of increases. That being said ... of course we never pre-commit". The latter sentence is of the utmost importance, as it highlights that the leading rates could be raised further, though this is not on the cards at the moment.

On the other hand, the inflation pain keeps getting worse in Euroland as oil prices continue to rise. Inflation remains well above target, hitting a record high of 4% in June. Furthermore, if oil prices stay at current levels, inflation is likely to edge even higher and stay elevated for longer. This could force the ECB to raise rates more than once despite the weak growth projections. What is important for the ECB is that the high inflation rates do not feed through to wages and long-term inflation expectations, which would endanger ECB credibility. After months of relative stability, the Commission's economic survey showed that industry selling price expectations jumped to 16 points from 13 points in May, and consumer inflation expectations for the next 12 months also jumped, rising to 31 points from 28 in May. Furthermore, wages, which the ECB is monitoring closely for signs of knock-on inflation effects, jumped in the first quarter as hourly labour costs increased 3.3% year-on-year.

We expect the ECB to express its concern about this development and once again highlight that the period of elevated inflation could be even more protracted. It will likely continue to clearly warn that it will not tolerate second-round effects. The bank is likely to say that it finds the rate adjustment appropriate for doing the job, but that they do not pre-commit. We also expect the ECB to use a somewhat milder rhetoric than in June to ensure that it does not feed expectations of a rate hike in August. After all, if the ECB follows its usual schedule, any additional change in rates is not likely before the meeting in October.

Market interpretation

If the ECB increases its leading rates it will come as no surprise, so the move will have no major impact on the markets. Pivotal to market reaction will be any comments concerning possible future changes in rates. However, what the interpretation of the statement and the press conference by the financial markets will be is a tricky matter at the moment. We do not expect the ECB to make very conclusive remarks on future rates, but rather to repeat that it never pre-commits. Thus the ECB will leave the door open and not rule out a further hike later this year, depending on the incoming data. A slightly more concerned view on growth balanced by even greater inflation worries is the general expectation.

Meanwhile, markets are well ahead of the ECB, pricing almost 80bp worth of rate hikes over the coming year. Should Trichet make very conclusive comments (whether it is "no more hikes" or "more hikes to come") they would have a considerable market impact.

Selected comments made by members of the ECB Council since the meeting last month

Weber, June 5

"The ECB is not split -- we have sent a clear message to the markets about what to expect in the near future ... we have to let deeds follow words".

Mersch, June 6

...an increase on Thursday (at the meeting in June) would have been a surprise for financial markets and the ECB did not want to increase the tense market situation further. (Not quoted directly).

Weber, June 6

"The Governing Council has sent a clear signal to markets and to the broader public yesterday, which seems to have been well understood ..."

"While we will see a moderation in growth rates over the coming quarters, both in the euro area and also in Germany, already at the turn of the year we will have reached the trough"

Liikanen, June 10

"The medium-term risks to price stability have increased further. We have to ensure that inflation expectations remain firmly anchored to the objective of price stability."

Noyer, June 11

"I do not see a clear link between what the president of the ECB said in the name of the Governing Council and (market) expectations". (Thus questioning markets post-summer rate views).

Stark, June 11

"However, we are not talking about a series of rate increases"

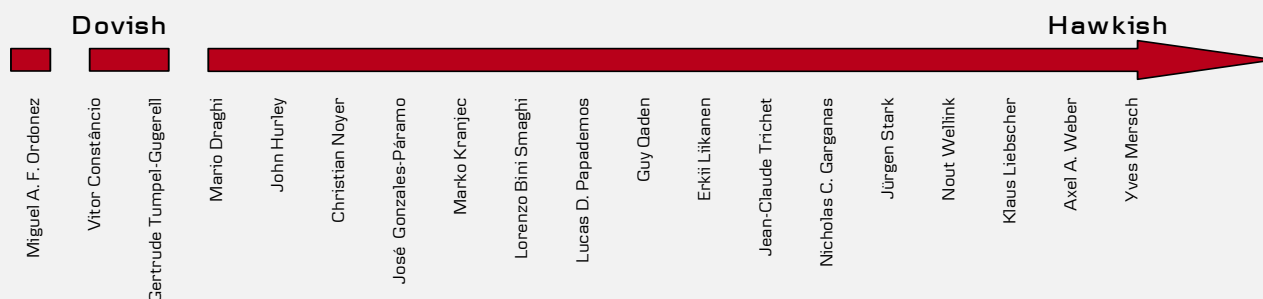
Bini Smaghi, June 12

"Markets do their own valuations and it's up to them (to do them but) indications given last week were for next month, not beyond ..."

Trichet, June 25

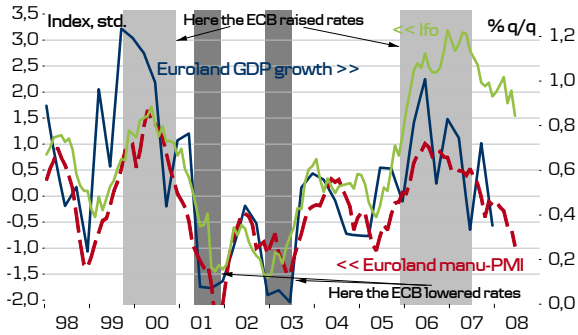
"I did not say that we envisaged a series of increases That being said ... of course we never precommit"

ECB Hawkometer:

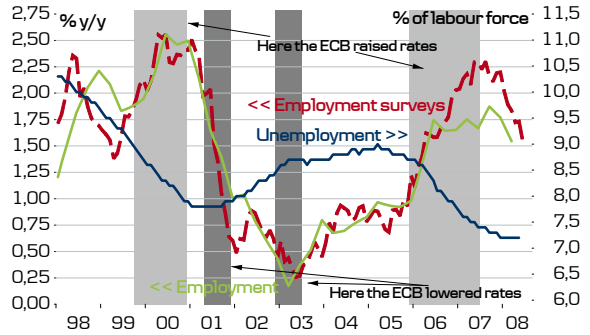


The ECB and economic data

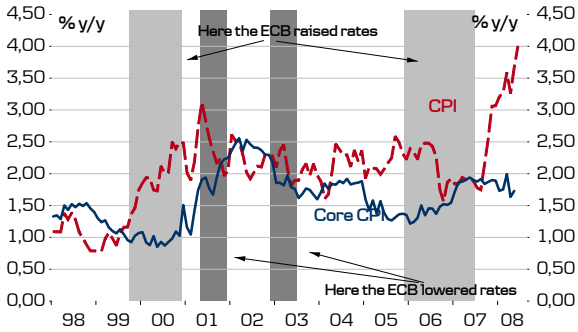
Business surveys: Growth is easing



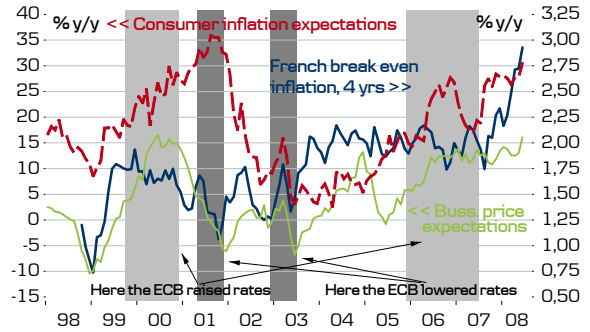
Labour market beginning to soften



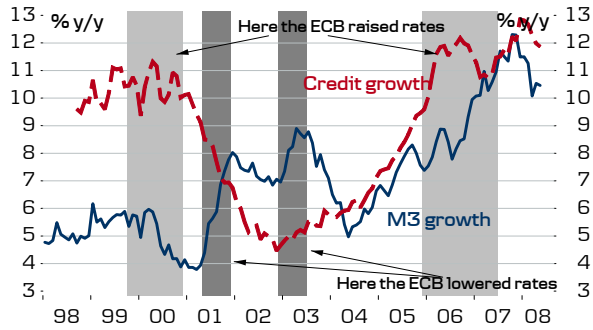
Inflation way above 2%



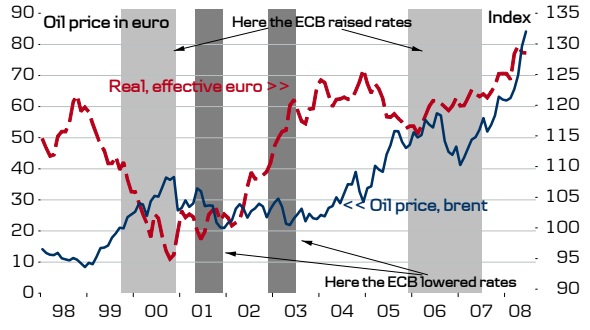
Inflation expectations moves higher



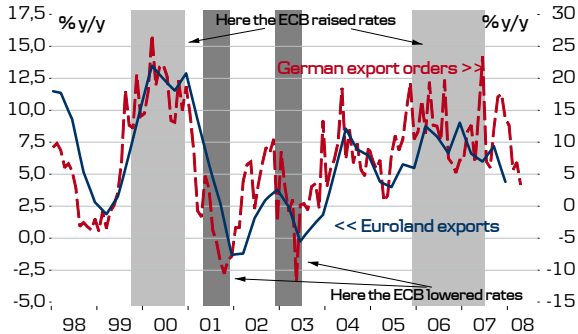
Money and credit growth still strong



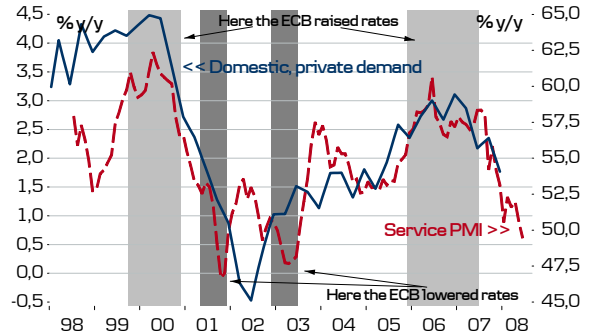
The euro is strong - oil rising



Exports show clear signs of moderating

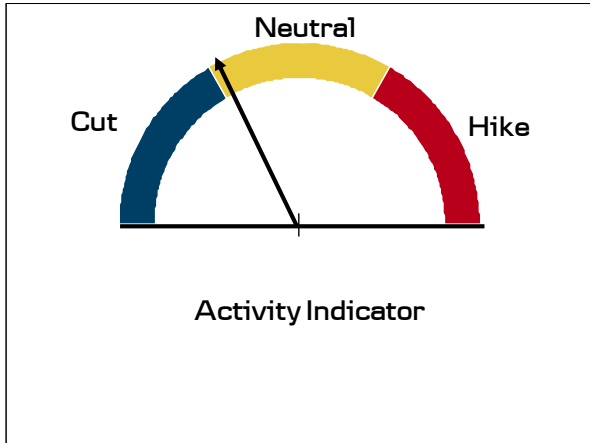


Domestic economy heading down

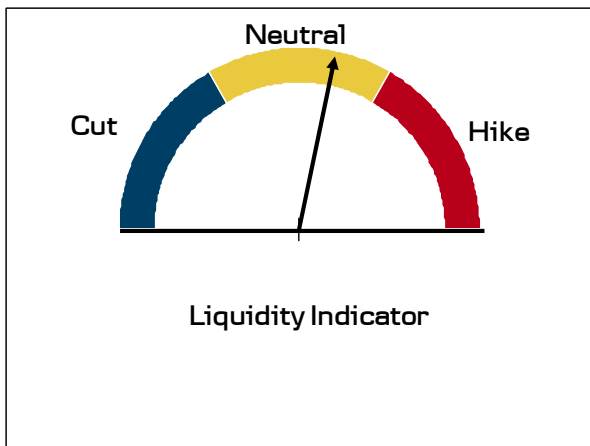


Danske Bank's ECB Monitor

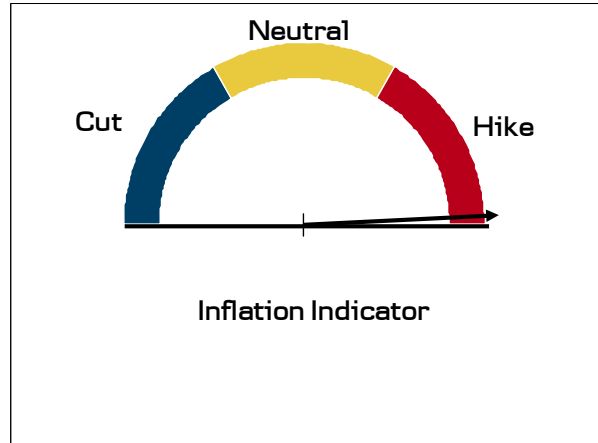
Activity is clearly slowing and is now firmly in the neutral zone



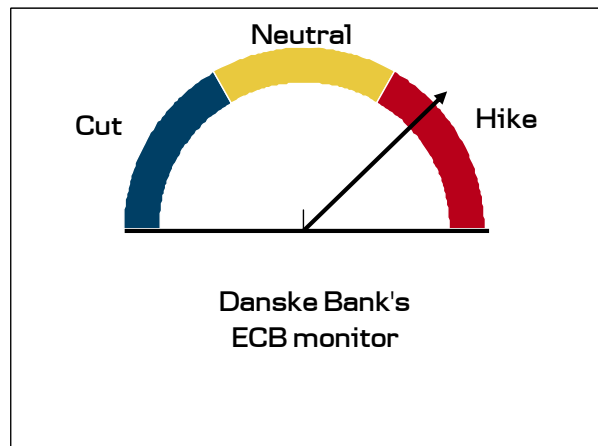
Liquidity is showing some signs of moderating



Inflation indicator strongly into hiking zone on energy and food prices, and inflation forecasts



Caught between the inflation and the growth outlook ECB choose to hike



ECB rate outlook	ECB minimum bid rate		
	Danske Bank	Consensus	Markets
July 2008	4.25%	4.25%	4.25%
Dec 2008	4.25%	4.25%	4.57%
July 2009	4.25%	4.0%	4.80%

Main news since last ECB meeting		
Growth	↓	Forward looking growth indicators have weakened markedly since the last meeting. Most significant was the larger-than-expected decline in ifo – hence there are increasing signs that the weakness is spreading to Germany. Euro PMI manufacturing also fell further. Although industrial production in April was impressive the overall trend suggest only a moderate production growth.
Inflation risks:	↑	The flash estimate of Euroland inflation jumped in June to 4.0% from 3.7% in May. Oil prices have continued to rise. If oil prices stay at this higher level inflation could approach 4¼% by September. Inflation expectations have been rising among consumers and businesses and break even inflation rates in the market have gone up.
Wage growth:	↑	Hourly labour costs jumped to 3.3% year-on-year in the first quarter.
Money and credit:	↓	M3 growth remained vigorous moderating slightly to 10.5% in May from 10.6% in April. M1 growth also moderated further from 2.5% in April to 2.3% in May. This is a very low level historically. Clearly, ongoing monetary expansion suggests that upward pressure for inflation stemming from monetary developments keeps building. Credit to euro area residents rose 9.5% in May down from 9.8% y/y in April. Bank loans to the private sector increased by 10.4% y/y slightly down compared to the previous month (10.6% y/y). Loans to non-financial corporations increased 14.2% y/y after 14.9% y/y last month. Loans to households rose 4.9% y/y down from 5.2% y/y.
Euro currency:	↑	Since the last meeting the euro has strengthened slightly against the dollar going from 1.55 to 1.57.
Global growth picture	↓	The global picture has weakened slightly since the last meeting. The main US data have send mixed signals. Global PMI have deteriorated. Rising oil prices adds to the downside growth risks.
Financial crisis	↑	The financial market situation seems to have worsened with declining stock markets and renewed widening of credit spreads. The rise in market uncertainty appears also to be related the rise in oil prices and the change to more hawkish rhetoric among major central banks.

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First date of publication

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