



Macroeconomics



Industry & Commodity



Markets

Eurozone Monetary Policy – July 2006

- *ECB Governing Council decides to leave the July key ECB interest rate unchanged at 2.75%, having raised rates by 25 basis points in June.*
- *Monetary and credit growth have recently accelerated. Surveys continue to post strong results – pointing to above potential growth this year. Headline inflation remains high at 2.5%.*
- *Trichet said that the Council thought that ‘a progressive withdrawal of monetary accommodation remains warranted’ and hinted that the next rate rise could come in August. This signals an increase in the pace of monetary tightening from the once-a-quarter pace established since December of last year.*
- *We expect the ECB to tighten with 25 bps rises in August, October and December to take rates to 3½% by year’s end – in line with estimates of ‘neutral’.*
- *Further rate hikes in early 2007 would not be surprising, but the ECB risk tightening into a slowdown. Indeed, they are adding to the downside risk for 2007: the Euro is strengthening, the world is slowing, fiscal policy is constrained, and the Germans intend to raise their VAT by 3%. And, in that sense, their renewed ‘vigilance’ may be seen as myopic.*

Inflation is expected to remain above the ECB’s desired rate. Year-on-year CPI inflation rose to 2.5% in May – well above the ECB’s target of ‘below, but close to 2%’. This is in contrast to core inflation, which is around 1.3% and has been around that rate for over 12 months. The substantial 1¼ percentage point difference between the two measures reflects strong energy inflation, due to the oil price rises.

The two main drivers of core inflation are both acting to keep it low. Unit labour costs are rising at an extraordinarily low rate of around 1%. Wages are rising by around 2%, and this is being partially offset by productivity growth of around 1%. Added to this, the Euro/USD appreciated slightly over the past year.

Looking forward, the June Eurosystem Staff Projections for 2007 inflation remain around 2.2%. Core inflation is likely to rise slightly from its current low, with an added risk that currently high inflation will feed into

inflationary expectations and wages. Indeed, the ECB sees core inflation as a lagging indicator. The contribution from oil price inflation is expected to wane; however, the introduction of additional indirect taxes will add to inflation in that year.

Chart 1: Headline and Core Inflation

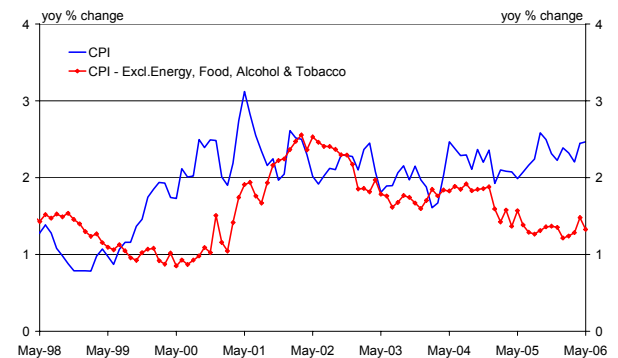


Table 1: Eurosystem staff CPI projections

Year-average percentage change

	2006		2007	
	Mar	Jun	Mar	Jun
High	2.5	2.5	2.8	2.8
Average	2.2	2.3	2.2	2.2
Low	1.9	2.1	1.6	1.6

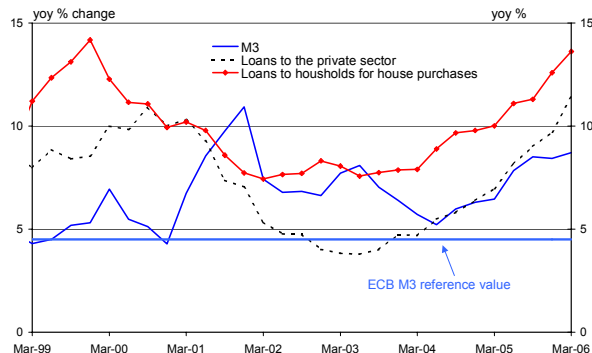
Monetary aggregate and credit growth continue to accelerate.

M3 is up by almost 9% – well above the ECB’s reference rate of 4.5%. This strong rate of growth is all the more alarming for the ECB’s monetarists as it has been reached without the ‘portfolio shifts’ that explained the peaks in 2001-03.

Credit growth is galloping ahead with loans to the private sector rising by over 11% in the past year. This has largely been driven by loans to households for house purchases, which is up by almost 14%.

These developments point to upside risks to inflation over the medium term and the possibility of a boom-bust cycle evolving in the Eurozone housing sector – if it hasn’t already in some member-nation’s markets, such as Spain and Ireland.

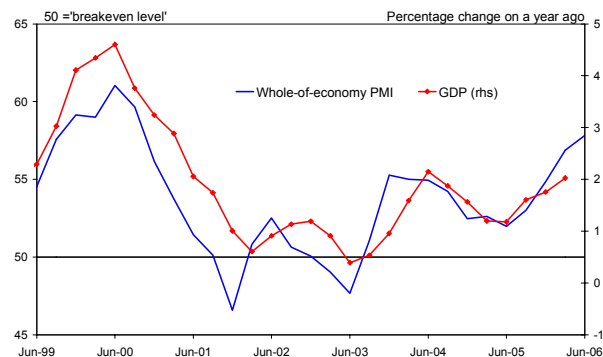
Chart 2: Monetary and credit growth



Economic growth will be at or above potential in the short term.

GDP rose by a robust 0.6% in the March quarter, to be 2.0% higher over the year. Looking forward, growth is likely to be strong in the June quarter as the various surveys, including the PMIs, continue to post strong results. The exports and investment-driven upturn is being supplemented with demand associated with the World Cup and ahead of the 3% increase to the German value-added tax in early 2007.

Chart 3: PMI and GDP



The Eurosystem staff GDP projections expect GDP growth to average 2.1% this year, with 0.5 percentage point rises for each quarter of the year. This profile may be pessimistic given the strong survey results for the June quarter.

Table 2: Eurosystem staff GDP projections
Year-average percentage change

	2006		2007	
	Mar	Jun	Mar	Jun
High	2.5	2.4	2.5	2.3
Average	2.1	2.1	2	1.8
Low	1.7	1.8	1.5	1.3

But downside risks are accumulating, which will close the window to tighten.

The Eurosystem staff expect GDP to rise by around 1.8% in 2007, with the additional 3% VAT in Germany expected to have an effect in the March quarter.

The principal driver of the current upturn – exports – will come under pressure, with the rising Euro and slower world growth. The Eurosystem Staff Projections are based on an assumption for the Euro exchange rate that is now 0.7% higher than the average for 2005.

Table 3: Exchange rate assumption (constant)

	Mar	change	Jun	change
Eur/USD	1.21	-1.2%	1.27	0.7%

*Change from the average for 2005

Additionally, the Eurosystem Staff have assumed that the world economy will slow in 2007, with the effects of higher oil prices and higher world interest rates.

Table 4: External growth assumptions
Year-average percentage change

	2006		2007	
	Mar	Jun	Mar	Jun
World Ex-Eurozone	4.9	5.0	4.5	4.5
Export markets	7.3	7.6	6.9	6.7

Looking to the domestic side, there should be enough momentum to carry investment and employment and thus real incomes and consumption growth for some time. However, the exports slowdown will eventually have an effect, as will the oil price and past interest rate rises.

Table 5: Interest rate assumptions
Year-average (%)

	2006		2007	
	Mar	Jun*	Mar	Jun*
Short-term 3m EURIBOR	2.55	3.1	2.55	3.9
Long-term 10y Bond	3.6	4.0	3.7	4.3

It is interesting to note that the Eurosystem projections are now based on the technical assumption that short-term market interest rates move in line with market expectations rather than, as previously assumed, remain constant over the projection horizon.

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