Economic Flash

ECB: the case for going beyond 4%

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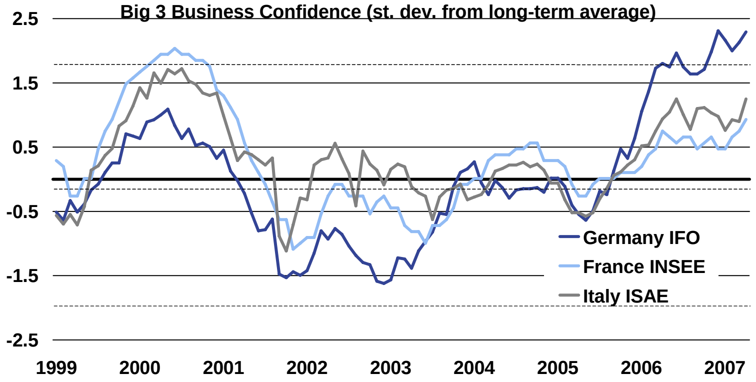
- ***At next Thursday's meeting the ECB will almost certainly leave rates on hold at 3.75%, but at the same time Trichet will give the all clear to the telegraphed June hike.***
- ***Eurozone growth has been resilient at the start of the year and upbeat sentiment indicators underpin the sanguine ECB view on the remainder of 2007 and 2008. Despite recent attempts to play down the importance of M3, liquidity growth is by all means a factor of worry for the ECB, whereas the euro appreciation has so far been limited and far from being out of control. Our EUR outlook tends to support the idea that currency moves will not hinder the recovery in coming quarters.***
- ***The market has fully discounted a 4.25% rates' level by year-end. The experience of this monetary cycle tells us that the final repricing toward our 4.50% projection should occur at the end of the summer, when the ECB will make clear that they won't be done at 4.25%.***

There are few doubts that next Thursday's press conference will bring relatively few surprises, with some of the key sentences of the last press communiqué – monetary policy on the "accommodative side", rates deemed as "moderate", etc. - bound to stay unchanged and, with the employment of the keyword **"strong vigilance"**, as usual, **functioning as the green light for the much-awaited June hike**. Furthermore, in the Q&A session Mr. Trichet, though far from any kind of commitment, should keep alive our and market's feeling that rates have not peaked yet. Unlike the previous tightening cycle in 2000-2001, when the ECB repeated that interest rates were low until they reached the end of the tightening campaign, this time probably the central bank will be more straightforward. An article on central bank's communication in the April Bulletin clearly stated that it would be "*desirable to give forward guidance to financial markets about future policy decisions*", particularly when rates approach a turning point. Since neither there has been any hint from ECB officials that monetary policy is close to be done, nor it can be said that the euro area cycle is bound to turn in the near future, then it can be inferred that the magic – in Mersch's words – **4% won't be the policy ceiling**. No one is arguing here that they will be clear-cut on the matter but - another crucial hint provided by the Bulletin article – we will know when the Council will start to be convinced on the appropriateness of their stance.

Departing from communication matters and focusing on recent macroeconomic developments, certainly the 2007-2008 policy outlook could be more debatable. Put it brutally, **it's growth & liquidity vs. exchange rate**. Which one is going to be the key driver in the ECB reaction function and, as such, determine the level of Eurozone official rates in the near term? Answering to this question means having a clearer idea on where markets are headed to in the remainder of the year. Over the intra-meeting period, economic evidence has kept underpinning the EMU-US decoupling story. Taking stock of the German resilience in Q1, we revised upward our 2007 growth forecast to 2.6% and the ECB will likely move in the same direction at the June meeting. In fact, in April, major national business surveys were surprisingly strong, confirming that the **economy entered the second quarter on a healthy footing**.

The most surprising recent development on the data side has been the spike to 10.9% in M3 annual growth, and the concurrent rise to 10.5% in the annual change in loans to the private sector. Though some voices are starting to question the link between money and inflation, **the ECB remains concerned that the tightening delivered so far has not resulted in any deceleration of money growth yet**. The central bank's staff has argued that rate increases since December 2005 have determined a substitution effect within M3: *de facto*, only the most liquid components of M3 have slowed, and their moderation has been more than compensated by the accelerating dynamics of marketable instruments – what the ECB labels as "speculative demand for money". Therefore, a breakdown's rebalance but no deceleration in money growth. Furthermore, looking at the monetary & financial institutions' (MFI) assets side, we have witnessed some slowing in the household borrowing's dynamics (especially in the mortgage sector) but, as a whole, only a negligible correction in loans to private sector that in March grew 10.5% yoy, very close to their historical peak of 11.4%.

Upbeat sentiment



Source: IFO, INSEE, ISAE, Global Research (HVB)

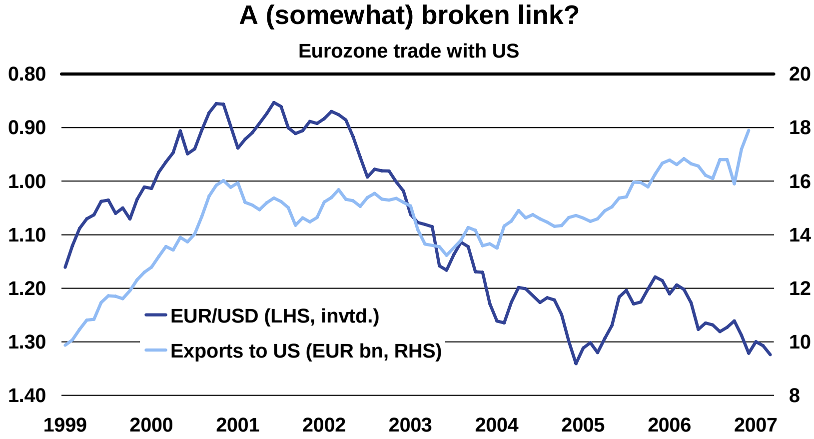
Against this background of above-trend growth and abundant liquidity, **prices risks can safely be considered as tilted on the upside**. Last month, inflation declined to 1.8% and, looking forward, it is bound to stay tame until the end of the summer, mainly thanks to an energy-induced base effect. Barring any steep decline in oil prices in months to come, inflation will be on the rise again starting in September. This U-shaped prices path – we forecast the peak at slightly above 2% at the beginning of next year – will impede any ECB relaxation, particularly now that core inflation is slowly drifting higher. Recent (Apr 30) Liebscher's comments on inflation – "*all in all, I have no reason to be relaxed*" – are clearly indicative, in our view, of certain Council's uneasiness on the medium-term inflation outlook.

Those who still think that 4% will be the peak of the ECB tightening campaign see the euro appreciation as the key risk factor. We are inclined not to overstate exchange rate movements, at least for the time being. First of all, instead of paying attention to news on brand-new "record highs vis à vis the dollar", one should focus on the effective exchange rate. Well, **since the beginning of the year, the ECB EER-24 has risen by "only" 1.6%, and at current levels it still stands some 0.8% below its historical peak hit at the end of 2004**.

Still below its peak

Source. ECB, Global Research (HVB)

According to most common rules of thumb, and consistent with our Financial Conditions Index (FCI) estimates, **such appreciation is equivalent to about 20bp of ECB tightening, therefore far from any sudden and decisive monetary overkill**. Moreover, the adverse price effect has been heartily offset by lasting strength in global demand. Even in the US, where growth is steadily marching at a below-trend pace, the demand weakness is mainly confined to residential investment, whilst private outlays have stayed firm even in Q1 when headline GDP growth bottomed out at 1.3%.



Source: ECB, Eurostat, Global Research (HVB)

Given that our FX forecasts point to a renewed dollar strength starting from the third quarter of this year, **we stick to our rosy growth outlook and tend to read the FX factor more as a risk rather than a key feature of our baseline scenario**. No doubt that financial conditions are becoming progressively tighter in Eurozone – since the beginning of the year our FCI has tightened by more than 30bp – but looking at how the recovery is unfolding, that is clearly not enough for the ECB. **The forward-looking stance adopted in Frankfurt has so far paid off, and we remain convinced that the ECB will not pull back from tightening to 4.25 in Q3 and to 4.50% in Q4 if the mid-term inflation outlook remains subject to upside risks**. Some Council members have recently explicitly acknowledged the possibility that monetary policy may undertake a restrictive course and that case will certainly apply if growth will be above trend for three consecutive years (2006-2008) and the economy remains flush with liquidity. With markets already discounting a 4.25% refi level, we think that only another step is required in order to achieve a fair ECB pricing. According to our strategists, that will occur by the end of Q3 when the ECB will likely make clear that they will stay in a tightening mood until the end of the year.

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