

EZA Briefing Note:

EZA 586/01Mar04: European Central Bank



ECB policy outlook – unchanged policy remains most likely outcome in H1, 2004, barring further external shocks, but favourable headline inflation numbers means risks now skewed towards an easing later in 2004.

Market speculation has increased that the ECB may move to a bias to ease policy, or even ease outright, at next Thursday's meeting (March 4th), after provisional February inflation data for the eurozone, showing headline inflation dipping to 1.6%, comfortably below the ECB's 2% target. We find this speculation premature, given -

- (1) the comparative success of verbal intervention in stabilising the euro in February,
- (2) monetary policy remains expansionary with real interest rates close to zero,
- (3) the concerns raised by the ECB about fiscal policy in the February monthly report,
- (4) the ECB has generally not made pre-emptive policy moves, and
- (5) after the overt political pressure of recent days.

It is true that there remain doubts about both the durability and pace of the eurozone economic recovery. But the ECB is forecasting growth of only 1.7% in 2004 and is renowned for a cautious assessment of trend growth in the eurozone, of around 2%. So, if GDP growth pans out in the way the ECB is forecasting, and the ECB is broadly correct about trend growth, there is little reason to expect an early policy easing in H1, 2004, without external events forcing the change (eg, a rapid surge in the euro above 1.30 versus the US dollar). The weak Q4 GDP growth number of only 1.2% should be seen in the context of the ECB's modest expectations. Barring shocks, the ECB's revealed preference is to move cautiously, and await improved inflation numbers. In the context of a Taylor rule, the ECB's policy adjustments have generally proved gradualist, in response to deviations of output from trend and inflation from target anyway.

However, we would sound a note of caution. When external shocks have occurred – like the terrorist attacks in September 2001 – the ECB has moved quickly, so we cannot exclude a more rapid move if the ECB's central case is blown off course by either renewed and rapid euro appreciation or a sharper drop in inflation than currently seems likely - the risks to the central scenario would appear skewed towards an easing as a result.

February monthly report shows strong evidence of policy firmly on hold

The latest monthly report suggests the ECB is in no hurry to ease policy – there are repeated references to “the medium term outlook for price stability” and that the monetary policy stance remains appropriate (and expansionary). Indeed, concerns linger about monetary growth rates – since “...there is significantly more liquidity available in the euro area than needed to finance non-inflationary growth.” There is some cause for optimism in the ECB's reference to the fact that short-term increases in the HICP, excluding unprocessed food and energy, over the last 3 months seasonally adjusted, have

eased (this now stands at 1.9% y/y, after the January figure). The ECB seems to use this as a core inflation measure, but it is still within measurement error of 2%, at 1.9% (see table) and we will likely need to see numbers lower than this for a few months, to secure a policy move, without external events intervening.

Eurozone monthly inflation rates

Eurozone	Weights In index	Y/Y rates %						Latest Monthly rate
		Feb04	Jan	Dec03	Nov	Oct	Jan03	Jan04/Dec03
All items	(1000)	1.6	1.9	2.0	2.2	2.0	2.1	-0.2
Main components								
Food	(156)		2.5	2.6	3.0	3.0	0.5	0.7
Alcohol & tobacco	(39.2)		6.0	7.7	7.7	6.4	4.8	1.1
Clothing	(74.6)		-0.2	1.0	1.1	1.0	0.0	-7.2
Housing	(149.3)		1.9	2.3	2.5	2.4	2.5	0.6
Transport	(151.5)		0.9	1.9	1.8	1.2	4.2	0.3
Recreation	(95.7)		-0.2	-0.2	0.1	0.2	0.4	-2.2
Hotels & restaurants	(96.2)		2.7	2.8	3.0	3.0	3.7	-0.4
All items exc energy	(918.7)		2.0	2.0	2.1	2.1	1.8	-0.4
-exc energy, fd,dk,tb.	(723)		1.7	1.6	1.7	1.7	1.9	-0.7
-exc.energy, unproc fd.	(841.8)		1.9	1.9	2.0	2.0	2.0	-0.5
-exc.tobacco	(976)		1.6	1.8	1.9	1.9	2.0	-0.3
Energy	(81.3)		-0.4	1.8	2.2	0.7	6.0	0.9

The sharp decline in the headline all items index in February to 1.6% is almost certainly due to a combination of one-off effects - large and favourable base effects from energy particularly (as the sharp increases in energy prices in Q1 2003 drop out of the index) and also food and the stronger euro. The measure that the ECB highlights in the monthly report and emboldened above, which excludes energy and unprocessed food, is much more stable, as can be seen. Eurozone core inflation measures did fall below 1.5% in 1999/2000, helped by very subdued unit labour cost growth, around zero, and a strong exchange rate. However, since then, core rates have generally proved sticky around, or just above, 2%.

Looking ahead, headline inflation rates in the first half of 2004 could fall below 1.5% - as the food and energy base effects have full impact - but this does not guarantee an easing if accompanied by core rates still around 2%. Other factors to watch in this context will be any evidence of inflation expectations easing - the February ECB monthly report, points out that late-January survey evidence shows a modest increase in 2004 inflation expectations, to 1.8% from 1.6%, when the previous SPF survey was taken in Q4, 2003. In addition, the weak productivity performance of the eurozone economy means unit labour cost growth remains around 2.5% (Q3, 2003), even if the current wage round

looks likely to result in modest settlements in the 2 – 2.5% region.

Political pressure on ECB unlikely to prove successful

Finally, given the ECB's statutory independence, and desire to protect that independence, recent comments from Chancellor Schröder and French Prime Minister Raffarin are unlikely to have helped the cause of early ECB easing. Putting these factors together, it is difficult to see an early easing move from the ECB and the most that could be expected from the meeting on March 4th is a statement from President Trichet welcoming the recent improvement in inflation and stabilisation of the exchange rate.

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