

EZA713/28Nov05: ECB 1 December Council Preview

RATE RISE CLEARLY INDICATED FOR THURSDAY, WITH ONE-OFF 50 bp SIGNAL MORE SUITED TO ECB'S WORRIES THAN 1 OR MORE 25 bp MOVES

- **Rate rise on 1 December clearly signalled by Trichet**
- **Main causes of ECB concern are persistent inflation above 2%, continuing strong monetary growth, negative real interest rates and signs of rising inflation expectations (though these are now receding).**
- **Markets expect 25 bp hike in December, further 25 bp in February/March.**
- **EZA sees 25 bp too timid a signal, given strength of ECB's concerns: we expect a one-off 50 bp rise on Thursday, but 25 bp a possible compromise.**
- **With little in latest economic data to warrant immediate action, we expect ECB to emphasise need to pre-empt materialisation of inflation risks.**

OVERALL ASSESSMENT

1. This November being a 'short' month for data, only a very limited amount of new information has so far become available since the ECB Governing Council's 3 November meeting, but several key indicators are due to be released between now and Thursday's meeting: monetary aggregates in October, the first detailed break-down of GDP growth in Q3, the European Commission's indicator-based forecasts for GDP growth in 2005 Q4 and 2006 Q1 and its survey-based confidence indicators for November, and Eurostat's 'flash' estimate of 'headline' inflation in November are all due for release on Wednesday 30 November. Unemployment data for October (of growing significance now) are due on the morning of the meeting.

2. The apparent strength of real GDP growth in Q3 - Eurostat's 'flash' estimate of +0.6%, published on 15 November - probably came as a surprise as much to the ECB as to anyone else: the Commission had only a month earlier been predicting 0.4% (+/- 0.2%). The limited number of other indicators published since the 3 November meeting present a rather more patchy picture of recent economic activity. The volume

of retail sales and industrial production both fell back in September, whereas industrial new orders perked up. Furthermore, latest inflation data do not suggest that the persistence of high energy prices and 'headline' inflation are generating significant pass-through or second-round effects so far: 'core' measures of inflation and industrial producer prices have crept slightly higher but remain very subdued.

3. It is thus not obvious why Trichet should have so clearly signalled, at a conference in Frankfurt on 18 November and again at his quarterly appearance before the Economic and Monetary Affairs Committee (EMAC) of the European Parliament on 21 November, that the Governing Council was about to abandon the policy stance that was deemed 'appropriate' at their 3 November meeting and to raise rates on 1 December. The clue probably lies in Trichet's reference, when responding orally to questions from the EMAC, to four areas of concern.

4. First, Trichet mentioned the "*accumulation over time of 'headline' inflation* being over and above [the ECB's] definition of price stability which is *per se* a risk". It is also

important to note in this context that Trichet later was rather dismissive of the fact that 'core' inflation remained subdued: "What exactly is the meaning of the calculations that some are making by only taking into account 'core' inflation? They omit the prices that are going up and they maintain in their analysis of inflation the prices that are going down".

5. The other three concerns that Trichet drew to the attention of the EMAC were:

"the *dynamism of the monetary aggregates* in the third quarter nobody here can say there is a lack of liquidity in Europe";

"*real interest rates* [which] have been *slightly negative for a long time*";

"signs of an *upward trend [in inflation expectations]* both in our *surveys* and from *break-even inflation*".

6. Trichet also said that "it would not be a good *ex ante* working assumption to think that we are at the start of a series of rate increases". But, in response to the suggestion that this implied that the ECB was planning only one rate rise, he added "We will do what is necessary. I can not say that the good rates will be much higher or that we are at start of a long series of increases".

7. It is likely, too, that the Governing Council at their mid-month meeting on 17 November would have been given a preview of the Euro system/ECB Staff's December macro-economic projections, which will almost certainly have revised upwards the inflation figure of 1.9%

shown for 2006 in last September's projections. They may also have been given an early sight of the monetary aggregates for October which are due to be published on 30 November and are likely to show continuing rapid liquidity growth

8. **Our reading of Trichet's remarks, together with our analysis of the economic data (see below), thus still leads us to conclude, as in our recent inter-meeting up-date (EZA Report 712/24Nov05), that only a 50 bp rise - as a clear one-off signal - would be fully consistent with the ECB's current concerns. A 25 bp rise would surely not be sufficient to address these adequately and at least one more, if not two, 25 bp rises would then be needed. Even so, it is possible that not all of the 18 members of the Governing Council are yet persuaded that a 50 bp move is needed now and that some might still argue for a smaller move or a slight delay. If this were the case, a 25 bp rise might emerge on Thursday as a compromise in order to reach a consensus. EZA concludes, therefore, that the odds on a 50 bp hike now are around 70%, with 25% on a 25bp rise and 5% on a delay to January.**

9. We recognise that this is out of kilter with most market thinking. Financial markets are pricing in a 25 bp rise on 1 December and a further 25 bp two to three months later. Most market analysts think likewise. Financial Times Deutschland's latest monthly interest rate survey of leading economists in major banks, for example, shows all 19 participants this month expect a 25 bp increase at this meeting, with 11 expecting a further 25 bp rise by February. Such a signal, we believe, would be too timid to match the ECB's present concerns.

The Economic Analysis

Costs and prices

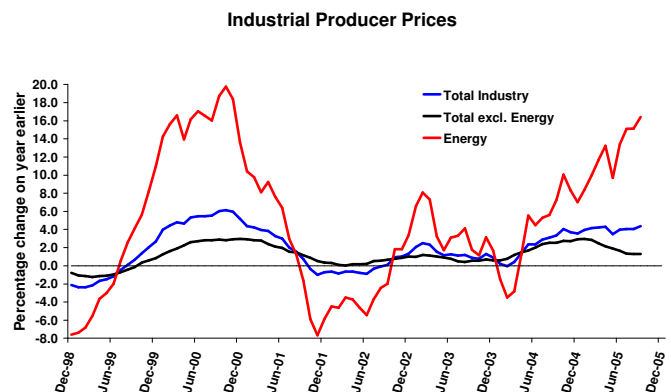
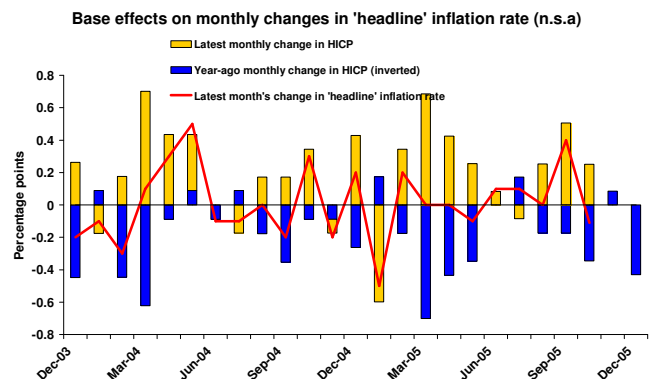
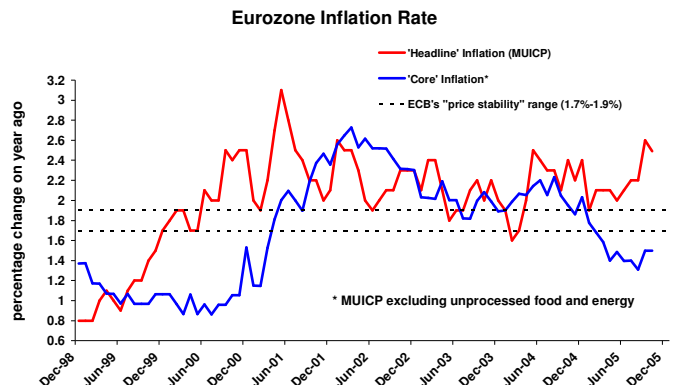
10. The *MUICP 'headline' rate of inflation*, which had shot up from 2.2% to 2.6% in September, edged down to 2.5% in October as predicted in Eurostat's earlier 'flash' estimate. This slight moderation in the annual rate was more than accounted for by a quite strongly favourable year-ago base effect: the month-on-month increase in prices this October was 0.25%, compared with 0.5% in September.

[NB: Eurostat's 'flash' estimate for November - with a year-ago base effect that is mildly favourable - is due to be published on Wednesday, 30 November.]

11. Analysis of the underlying components of the 'headline' inflation figures continue to provide some re-assurance that there has so far been no serious oil-price pass-through beyond the energy sector and that inflation is still not yet endemic. *'Core' inflation* on the ECB's preferred measure (which excludes energy and unprocessed food), which had risen fractionally from 1.4% to 1.5% in September, continued at this subdued rate in October. On the narrower definition (excluding energy, food, alcohol and tobacco) preferred by some outside commentators, 'core' inflation edged up in October from 1.3% to 1.4%.

12. Latest data on *industrial producer prices*, released the day after the ECB's 3 November meeting, also suggest at most very limited feed-through from high energy prices. The aggregate figures show the monthly rise in producers' prices to have accelerated slightly from 0.4% in August to 0.5% in September, to a level 4.4% higher than a year ago. *Energy* prices, which had increased by 1.5% in August, rose a further 1.7% in September. *Excluding energy*, the rise in producers' prices accelerated only slightly, from 0.1% in August to 0.2% in September to remain just 1.3% higher than a year earlier.

[NB: Data for September are due to be released on Friday 2 November, the day after the Governing Council meeting.]



13. No new data on *total hourly labour costs* will be available before the 1 December meeting. Data released before the ECB's October meeting showed the annual rate of increase as having slowed from 3.0% in 2005 Q1 to 2.3% in Q2 and from 3.2% to 2.3% in industry. The ECB has long argued that the continuing high *unemployment rate*, oscillating between 8.8% and 8.9% for most of the past two years, was acting as a restraint on wage settlements despite the persistence of price inflation. According to Eurostat's latest data, however, there has been a gradual tightening of the labour market since April, with unemployment is now seen as having fallen back from 8.8% in April this year to 8.5% by July and to have fallen further to 8.4% by September.

[NB: Unemployment data for September are due to be released on Thursday, 1 December.]

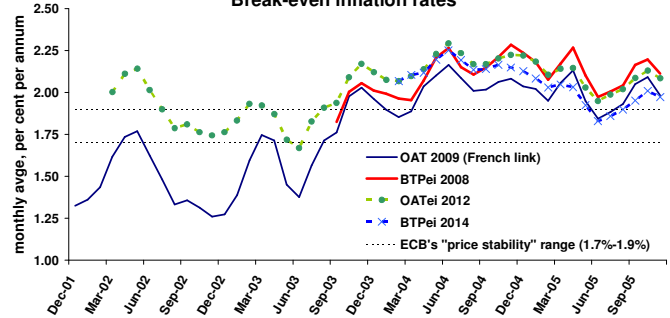
14. EZA's ECB Observer reports over the past couple of months have drawn attention to signs that external cost pressures and continuing high 'headline' inflation might be beginning to affect inflation expectations. Between March and June this year *break-even inflation rates* on indexed medium- to longer-term euro-zone government bonds had been subsiding towards, and even to within, the upper bound of the ECB's 1.7%-1.9% 'price stability' range. Over the following four months, however, the break-even rates drifted upwards by some 18-25 basis points. When questioned about this development at his monthly press conference both in October and in November, President Trichet conceded that it was something to which the Governing Council paid particular attention and was one of the reasons behind their call for 'strong vigilance'. Over the past few weeks, however, this should have become rather less of a potential cause for concern as expectations on this measure have drifted back a little towards, and even slightly below, 2%.

15. Although last year's appreciation of the exchange rate will still be having some attenuating effect on external costs, the contribution from the euro's performance of over the past six months will have been broadly neutral. In recent weeks, however, the euro has shown a

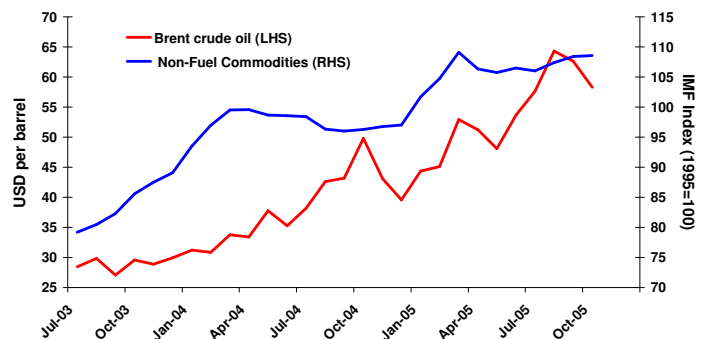
Total Hourly Labour Costs



Medium-term Inflation Expectations: Break-even inflation rates



Key commodity prices



slight weakening tendency. The *euro's effective exchange rate*, having eased back on average by 0.6% in September and by a further 0.3% in October, was down by a further 0.7% on average during the latest four weeks, at a level 4.7% lower than a year earlier but still only 0.5% lower than two years ago.

Demand, output and confidence

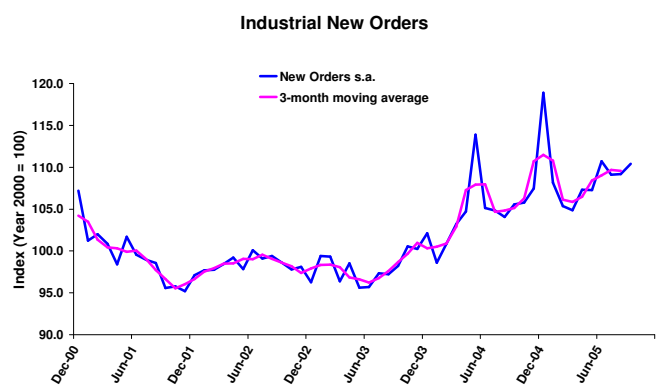
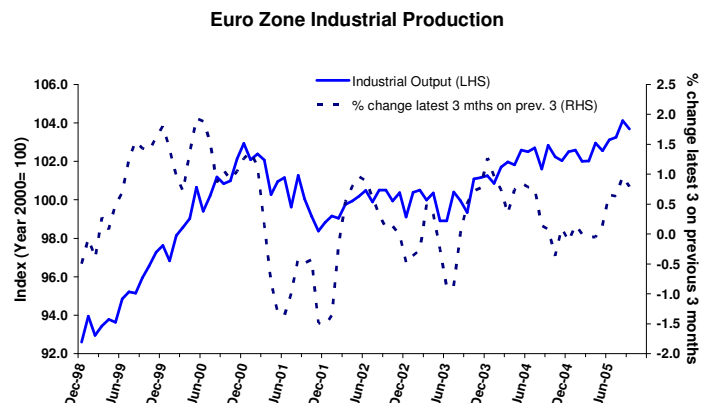
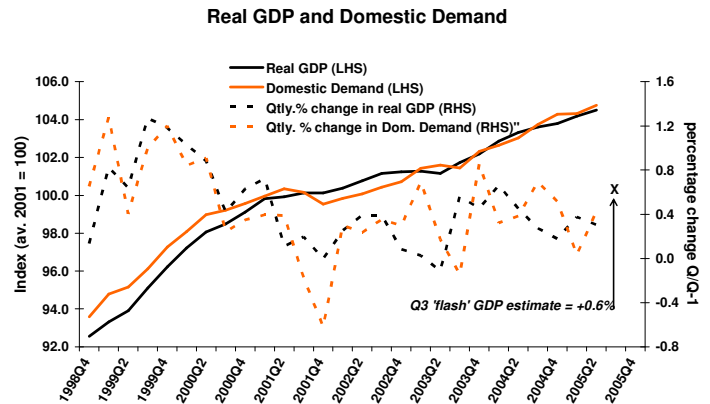
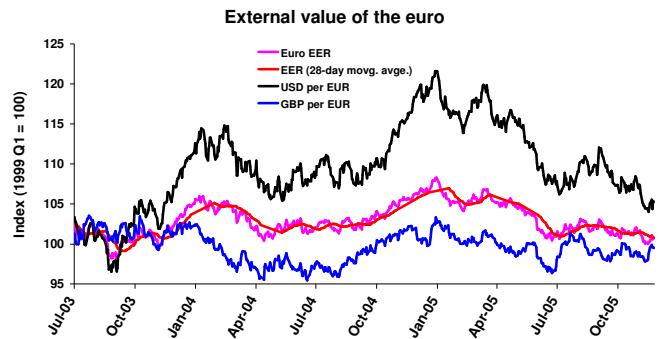
16. According to Eurostat's latest 'flash' estimate, *real GDP growth* picked up sharply to 0.6% in Q3, from 0.4% in Q1 and 0.3% in Q2, to a level 1.5% higher than in 2004 Q3. This 'flash' figure is at the top of the 0.2%-0.6% range forecast by the European Commission's indicator-based model a month earlier. There is as yet no information on whether the acceleration reflected a further strengthening of domestic demand or a renewed positive contribution from net external trade. In Q2, all the main components of domestic demand made (mostly modest) positive contributions, while the contribution from net trade turned negative.

[NB: The first detailed breakdown of GDP growth in Q3, and the Commission's indicator-based forecasts for 2005 Q4 and 2006 Q1, will be released on Wednesday 30 November.]

17. Other indicators of economic activity in Q3 present a somewhat patchy and fragile picture. *Industrial production* increased by 0.1% in July and 0.8% in August, but fell back by 0.45 in September to a level only 1.0% higher than a year ago. Over Q3 as a whole, however, production was 3/4% higher than in Q2.

18. Although industrial production was disappointing in September, the latest data for *industrial new orders* are more reassuring. Having fallen by 1.4% in July and by a further 0.1% (revised from -0.1%) in August, new orders increased by 1.1% in September to a level 4.6% higher than a year earlier. On average in Q3 new orders were 1.1% higher than in Q2.

19. The *volume of retail trade*, a series which also fluctuates quite widely from month to month, had shown signs of resuming an upward



trend since the spring but, having in August regained the 0.7% lost in July, sales volumes fell back by 0.4% in September to a level 0.9% upon a year earlier. Over Q3 as a whole, the volume of retail trade was the same as in Q2.

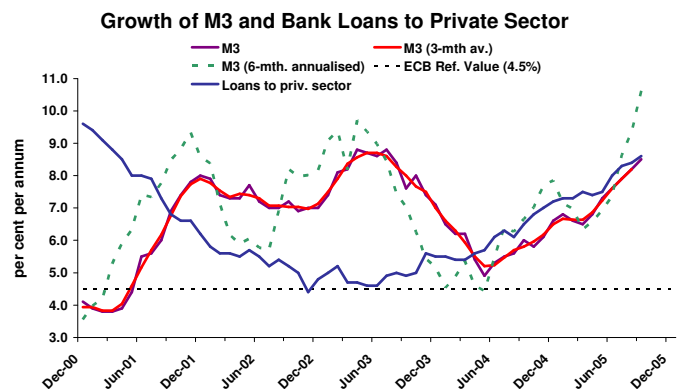
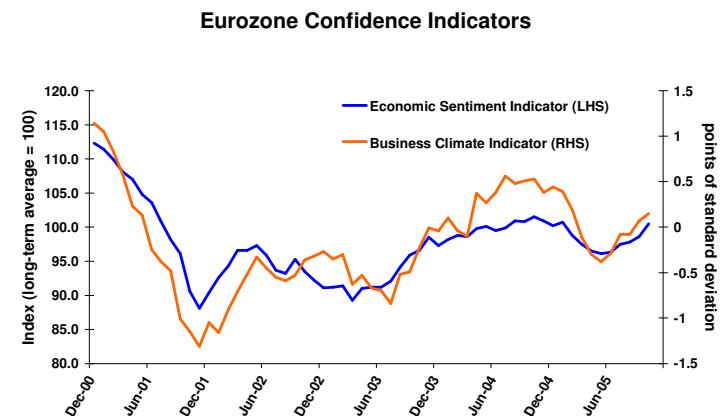
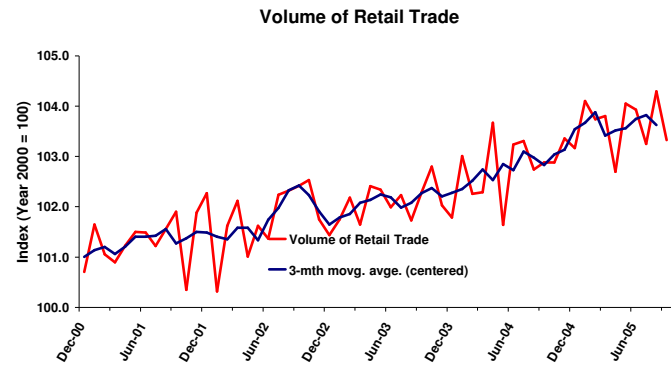
20. No new information is available so far from the European Commission's survey-based confidence indicators. Last month's *Business Climate Indicator* recorded a further 0.08 point rise to +0.15, its highest level since February, with a strengthening in all the components of the indicator. The *Economic Sentiment Indicator* also rose in October, by a further 1.9 points to stand 0.5 points above its long-term average. Particularly strong increases were registered in the services and retail sectors but confidence also grew in industry and among consumers.

[NB: November data for these two indicators are due to be released on Wednesday 30 November.]

The Monetary Analysis

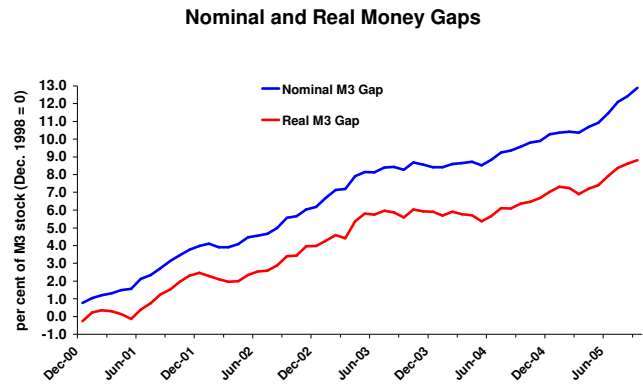
21. As yet there is no new published information on the behaviour of the monetary aggregates growth of liquidity poses risks to price stability over the medium to longer term as economic activity picks up. Data released just before the Governing Council's 3 November meeting showed the *annual rate of M3 growth* as having accelerated further in September, from 8.2% (revised up from 8.1%) in August to 8.5%. The *three-month average of the annual growth rates of M3* also continued to rise, from 7.9% in June-August to 8.2% in July-September, while the *six-month growth rate (annualised)* accelerated even more sharply, from 9.4% in August to 10.6% in September. The *annual growth rate of M1*, however, subsided a little from 11.6% to 11.1% in September.

22. Among the asset counterparts of M3, the annual rate of growth of *loans to the non-bank private sector* accelerated for the fifth month in a row, rising from 8.4% in August to 8.6% in September. Seasonally unadjusted data showed the rise in lending for house purchase to have slowed slightly in September but growth of consumer credit and of loans to non-financial



corporations as accelerating. The annual growth rate of *credit extended to general government* edged up from 1.1% to 1.2%.

23. The continuing strong rise in M3 was reflected in an ever expanding liquidity overhang in the eurozone. The *M3 Money Gap* widened yet again in September, both *in nominal terms* and *in real terms*.



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