



Meeting: October 4th 2007
October 4th 2007

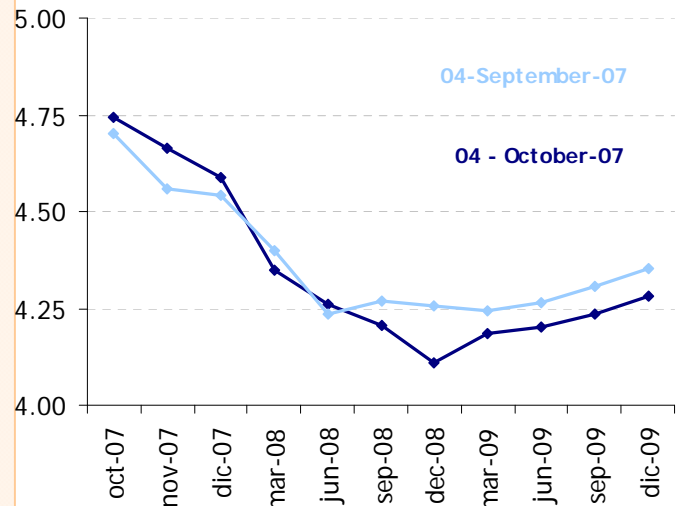
The first step towards the U-turn

- At today's meeting, the ECB Governing Council left official rates unchanged at 4%.
- Despite upside risks on inflation, the stance of monetary policy is not described as "accommodative", suggesting a more neutral stance.
- Uncertainty surrounding the current environment has reinforced the risks to the baseline scenario, mainly related to confidence and financial market conditions.
- As we expected, the ECB has made some changes in the "wording" towards a more neutral code. It seems to be the first step in order to pave the way for an eventual rate cut. We expect the ECB to cut rates to 3.75% at the end of the year.

In the statement: *removing the old wording towards a neutral tone.*

- The code word "accommodative" has been suppressed, suggesting a more neutral monetary policy stance, and has been replaced with a new expression: "monetary stance ready to counter upside risks to price stability".
- Overall, the text puts a particular emphasis on the rise in "uncertainty". This, together with the reference to the fact that "only a limited range of new economic data have become available", reduces the confidence level on today's economic assessment.
- The wording "monitor very closely" has survived to the removing of the "old wording" since risks to the inflation outlook are still on the upside.
- The base macroeconomic scenario is still valid. However, the tone of the assessment seems less confident than previously, given the outcome from the latest economic data. Risks remain on the downside and have apparently intensified. And, more importantly, for the first time they are explicitly mentioned to be dependent on the impact of tensions in financial markets on agent's confidence and on financing conditions.

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- Inflation risks remain on the upside. Here, two aspects deserve special attention. First, inflation is expected to remain “significantly above 2% in the remaining months of 2007 and in the early 2008, before moderating again”, suggesting that inflation should be under control in 2008. Second, “capacity constraints” have re-appeared as a main risk, despite latest data pointing to a moderation of these constraints.
- On the monetary side, less significance is given to the latest developments in money and credit. In particular, these have been associated to “a number temporary or special factors”, which could be overstating the underlying rate of money and credit expansion.
- Finally, it was pointed that the economic outlook was sustained by “good” instead of “strong” fundamentals and that the current context was characterized by a “heightened level of uncertainty”

The Q&A session: *stressing on the upward bias to inflation.*

- The most repeated question related to the exclusion of the code word “accommodative”. To this regard, Mr. Trichet refused to provide an interpretation to this change in wording and also avoided any comparison with the wording “neutral” or “appropriate”. He argued that it was aimed at putting a major emphasis on upside risks to price stability. In his words, *“when there are risks to price stability, whether or not accommodative at all, we might increase rates...”*
- Mr. Trichet did not make any comment when asked whether the Governing Council had discussed the possibility of cuts in policy rates. In particular, he emphasized the fact that risks on the inflation outlook were on the upside. In addition, there was no question or mention to the unanimity of the decision.
- About recent interventions in money markets, Mr. Trichet confirmed that the ECB would *“continue to do what is necessary to help money markets”*.
- Unexpectedly, Mr. Trichet advanced some results from the upcoming ECB Bank lending survey (it will be published tomorrow, one month in advance), pointing to a net tightening in credit conditions for households and especially for large firms.
- Lastly, the president was asked several times about the euro. As usual, Mr. Trichet referred to the G7 communiqué, and pointed that high volatility was “very counterproductive”, while there no comments on eventual interventions in FOREX markets.

Markets reaction: The overnight remained unchanged at 3.8%. Both the three months interest rate and the yield on 10-year bonds decreased by 4 and 2bp, respectively. The euro-dollar exchange rate depreciated marginally and stayed at levels around 1.41 EUR/US\$.

Concluding remarks

Today’s exclusion of the term “accommodative” may be interpreted as a more neutral stance. This, together with a more than likely downward revision in the economic outlook, supports our view that the most likely scenario is a cut in policy rates.

Box 1: ECB Statements

	July 5 th	August 2 nd	September 6 th	October 4 th	Concluding remarks*
Monetary policy stance	Monetary policy is still on the accommodative side , with overall financing conditions favorable... and liquidity ample . The Governing Council will continue to monitor closely all developments...	Strong vigilance is therefore of the essence to ensure that upside risks to price stability do not materialize. I re-emphasize, we never pre-commit	still on the accommodative side with money and credit growth vigorous... the Governing Council will monitor very closely all developments	Our monetary policy stance ready to counter upside risks to price stability..... the Governing Council will monitor very closely all developments.	An implicit neutral stance
Growth	Conditions are in place for the euro area economy to continue to grow at a sustained rate... domestic demand is expected to maintain its relatively strong momentum... investment should remain dynamic .	Recent economic developments and survey indicators confirm that a sustained economic growth continued in the euro area through the second quarter	Is continuing to expand at sustained rates... Projected real GDP growth for 2007 has been revised slightly downwards. Risks ...on the downside	... confirms our main scenario I... the uncertainties have increased. Downside risks relate mainly on confidence and financing conditions	Still favourable but downside risks intensifying
Inflation	On the basis of the current level of oil prices and oil futures... inflation rates is likely to fall only slightly in the months ahead before rising significantly towards the end of the year.	No special comment.	Rates are likely to increase again to above 2%... projected to lie between 1.9% and 2.1% in 2007, and between 1.5% and 2.5% in 2008	Inflation rates to remain significantly above 2% in the remaining months and early 2008, before moderating again... around 2% on average in 2008.	Some moderation during 2008
Risks	Risks remain on the upside. Capacity utilization is high and labour markets continue to improve... pricing power, administered prices and indirect taxes, wage developments, further unexpected oil prices rises... and potentially procyclical stance of fiscal policy in some countries.	Rising oil prices and emerging capacity constraints and the potential for stronger cost and wage dynamics among other factors imply risks to price stability over the medium term.	Indirect taxes, further increase in oil prices and prices for agricultural products . More fundamentally... wage developments and the increase of the pricing power. Risks to this outlook for price developments lie on the upside.	Remain on the upside...further increase in the prices of oil and agricultural products... administered prices and indirect taxes... existence of capacity constraints... pricing power.	Upside risks
Monetary analysis	Moderate expansion in M1, loans to private sector stabilizing. But given the continued vigor of money and credit expansion there are clear risks to price stability... and liquidity remains ample.	The existence of upside risks to price stability over the medium to longer term is confirmed by the underlying trend of monetary expansion	Confirms prevailing upside risks to price stability... the underlying rate of monetary and credit expansion remains strong... volatility in financial markets can temporarily exert considerable influence over monetary dynamics	Confirms prevailing upside risks to price stability... the underlying rate of monetary and credit expansion remains strong... influenced by a number of temporary or special factors... may therefore overstate the underlying rate	Strong growth in monetary and credit aggregates.
Movement	0.0	0.0	0.0	0.0	0.0
"Refi" rate	4.00	4.00	4.00	4.00	4.00

* BBVA interpretation of the ECB opinion according the statement and the press conference

Relevant events before the next ECB meeting (October 8th)

October 5 th	Bank Lending Survey 3 rd Quarter
October 11 th	GDP Q2/2007 2 nd release
October 12 th	August Industrial Production
October 11 th	Monthly Bulletin
October 16 th	September Inflation (HIPC)
October 30 th	September Money Supply
October 31 st	October Inflation (HIPC-flash estimate)
October 31 st	September Unemployment
October 31 st	October Business and Consumer Survey
November 6 th	September Industrial Producer Prices