Servicio de Estudios Económicos

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ECB watch

**Meeting: April 10th 2008**
**Next meeting: May 8th 2008**

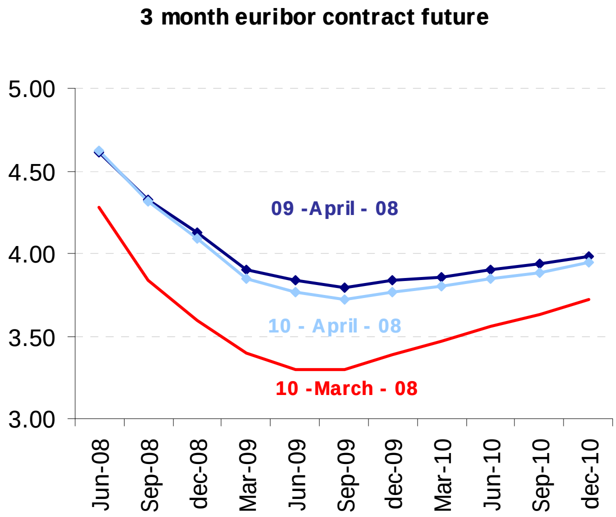
# A financial-real conundrum?

- The ECB left the key rate unchanged at 4%, as expected.
- Also as expected after the inflation flash for March, inflation risks take more prominence in the statement.
- Risks to activity have diminished for the ECB, while risks derived from financial market turbulence seem more important; however, the ECB does not seem convinced that the tightening of credit conditions will eventually affect growth.
- We think the ECB will cut rates in September and December as growth prospects deteriorate and inflation falls.

**In the statement:** the softening of language from past month has been partly reversed.

- Inflation concerns are upgraded in the introductory paragraph: the Governing Council "confirms the existence of strong short-term upward pressure on inflation", as last month, adding that "we are experiencing a rather protracted period of temporarily high inflation [...] the latest information also clearly confirms our assessment of prevailing upside risks to price stability". Clearly, the firm anchoring of medium to longer-term inflation expectations is of the highest priority to the Governing Council and "there is certainly no room for complacency in this regard." Again, there is an emphasis on the need of avoiding second-round effects and, thus, "it is imperative that all the parties concerned meet their responsibilities."

- On GDP growth, the Governing Council continues to believe that "the euro area economy has sound fundamentals and does not suffer from major imbalances", although growth risks are now "high" instead of "unusually high". In contrast, the financial turmoil has raised the level of uncertainty, which "remains unusually high and tensions may last longer than initially expected." The Statement points that this situation "could last longer than initially thought and could have a broader than currently expected impact on the real economy."




Source: Bloomberg and BBVA

Pedro Álvarez-Lois
pedro.a_lois@grupobbva.com

Miguel Jiménez
mjimenezg@grupobbva.com

César Miralles
cesar.miralles@grupobbva.com

- The monetary analysis is very similar to the one spelled out last month. Despite the tightening of credit standards reported in the bank lending survey for the euro area, "there is little evidence that the financial market turbulence has strongly influenced the overall dynamics of broad money and credit aggregates." Particularly, the growth of time deposits remains extremely strong, a reflection of the relatively flat yield curve. The growth of household borrowing has moderated, but loans to non-financial corporations continue to grow at a strong pace.
- Finally, with respect to fiscal issues, the Statement indicates that "further fiscal pressures are likely to arise as overly optimistic macroeconomic assumptions are revised downwards".

**The Q&A session***: no answer on the transmission of financial turbulence to the real economy.*

- The decision was unanimous.
- Despite the accent put in the statement on enhanced risks form financial market turbulence, Mr Trichet did not provide an answer to the question on how would this affect the real economy, and when commenting the reasons why credit growth to non-financial firms remains strong he mentioned at possible explanations a lower recourse by firms to primary markets, accumulation of liquidity by some firms, or higher demand.
- On the apparent disconnection of credit data with the answers provided by banks in the the Bank Lending Survey, he said he was "not surprised at all by the response we are receiving from banks". "It seems very normal in the current situation that banks are very cautious".
- Mr. Trichet signalled that the ECB would deliver price stability in line with their definition after a lag time of 18 months.
- On whether ECB should permit mortgage-backed securities as collateral, Mr. Trichet considered that the ECB currently have all the instruments that are necessary and that at this stage they were reasonably satisfied with the present framework

Markets reaction: The curve of three-month interest rate futures' contracts decreased by about 6bp. The euro remained anchored at 1.58.

## Concluding remarks

There are not many changes with respect to our expectations and to the last month's statement. The ECB is worried about inflation outturs (particularly after the significant jump in March) and continues to stress its commitment to attaining medium term price stability using its well-known rethoric. This month the news is the enhanced emphasis on financial crisis concerns and the downgrade of activity growth risks. This seems to us correct, since incoming indicators for the Euro Area are relatively good thus far, while tensions in financial markets continue. However, we think that these tensions, also reflected in the BLS, will eventually have an impact on credit growth and thus on real activity, while the ECB seems more reluctant to make this connection. We maintain our projection of lower growth, falling inflation and rate cuts for the second half of the year (September and December).

## Box: ECB Statements

| | January 10th | February 7th | March 7th | April 10th | Concluding remarks* |
|---|---|---|---|---|---|
| Monetary policy stance | **Strong short-term upward pressures on inflation**. Governing Council remains **prepared to act pre-emptively** … **risks surrounding the outlook for economic activity are on the downside** …will **monitor very closely** all developments. | Governing Council **remains committed to preventing second-round effects and the materialisation of upside risks to price stability** over the medium term… We will continue to **monitor very closely** all developments. | Governing Council **remains strongly committed to preventing second-round effects and the materialisation of upside risks to price stability** over the medium term… We will continue to **monitor very closely** all developments. | The Governing Council **remains strongly committed to preventing second-round effects and the materialisation of upside risks** to price stability over the medium term. We will continue to **monitor very closely** all developments. | **Still a hawkish tone** |
| Growth | **Fundamentals are sound. Risks lie on the downside…**relate to a **broader impact of the reappraisal of risk on financing conditions and economic sentiment... oil and other commodity price rises... disorderly developments due to global imbalances.** | **Fundamentals are sound**, **uncertainty** about the prospects for growth **is unusually high**… **risks** for activity have been **confirmed to lie on the downside** … relate …impact of **financial market developments on financing conditions and economic sentiment** | The economic **fundamentals of the euro area are sound**. Incoming macroeconomic data point to **moderating but ongoing real GDP growth**. Yet the level of **uncertainty** resulting from the turmoil in financial markets **remains high** | The euro area has **sound fundamentals**… **uncertainty surrounding this outlook … remains high, and downside risks prevail. The risks relate mainly to the financial market turbulence, which could last longer than initially thought and could have a broader than currently expected impact** | **Risks are on the downside relating mainly to financial market turbulences** |
| Inflation | Expected to remain significantly above 2% in the coming months … **likely to moderate only gradually in the course of 2008... more protacted than previously expected... Moderation assumes … reversal of recent oil and food price dynamics and no broadly-based second-round effects.** | Most likely remain significantly above 2% in the coming months and **moderate only gradually in the further course of 2008**… assumption … recent rises in **commodity prices will be partly reversed**… their impact on inflation do **not have broadly-based second-round effects.** | HICP **inflation rate ... to moderate only gradually in the further course of 2008**... the projections **assume** that recent oil and food price dynamics... **do not have broadly-based second-round effects on wage and price-setting behaviour**. | Inflation is **likely to remain significantly above 2% in the coming months, moderating only gradually over the course of 2008**. .. rather protracted period of temporarily high inflation. **Second-round effects… must be avoided** | **Likely to moderate only gradually under the assumption of no second-round effects** |
| Risks | **Fully confirmed to lie on the upside… include stronger than currently expected wage growth... pricing power of firms could be stronger than expected.** | **Confirmed to lie on the upside**… stronger than currently expected **wage growth**… **pricing power** of firms stronger than expected… further **rises in oil and agricultural prices** … increases in **administered prices and indirect taxes**. | Risks**... confirmed to lie on the upside**... include... stronger than currently **expected wage growth... pricing power of firms... further rises in oil and agricultural prices... administered prices and indirect taxes** | **Clearly on the upside**. These risks include further rises in **energy and food prices, in administered prices and indirect taxes… Most importantly, price and wage-setting behaviour** | **Upside risks and somewhat more hawkish** |
| Monetary analysis | **Confirms the prevailing upside risks** to price stability… Money and credit have grown **vigorously** in recent months… underlying rate remains strong… **little evidence that the financial market turbulence has strongly influenced** the dynamics. | **Confirms the prevailing upside risks** to price stability at medium to longer-term horizons… there is **little evidence that the financial market turbulence** … has strongly influenced the dynamics of broad money and credit aggregates | **Confirms the prevailing upside risks** to price stability at medium to longer-term horizons… there is **little evidence that the financial market turbulence** … has strongly influenced the dynamics of broad money and credit aggregates | **Confirms the prevailing upside risks** to price stability at medium to longer-term horizons… there is **little evidence that the financial market turbulence** has strongly influenced the overall dynamics of broad money and credit aggregates. | **Same as previous month: Aggregates growing vigorously; no sign of impact from financial markets** |
| **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 (May 8th )

| | |
|---|---|
| April 14 | February Industrial Production |
| April 16 | March Euro area Inflation |
| April 17 | February Construction Output |
| April 23 | February Industrial New Orders |
| April 29 | March Money Supply |
| April 30 | April Flash Estimate Euro area Inflation |
| April 30 | April Business and Consumer Survey |
| April 30 | March Unemployment |
| May 6 | March Industrial Producer Prices |
| May 7 | March Retail Trade |