Economic Research Department

BBVA

EMU

ECB Watch

Meeting: May 8th 2008
Next meeting: June 5th 2008

Waiting for more news

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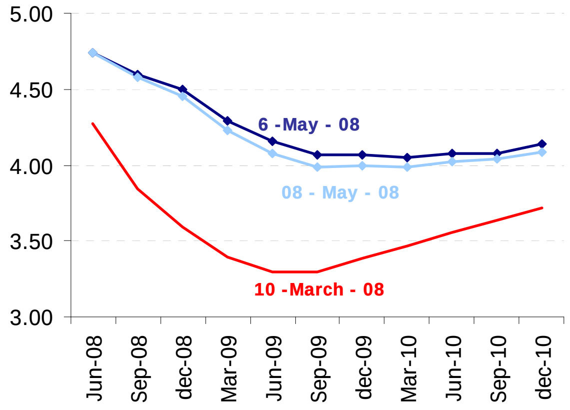
- The ECB left its key official rate unchanged at 4%, as expected. The tone of the statement barely changed.
- Warnings against second-round effects from current high inflation took some more prominence, while the accent on financial turbulences was somewhat less pronounced.
- Financing conditions tightened further in the first quarter of the year, as advanced in the press conference.
- We maintain our projection of rate cuts in September and December.

In the statement: *More insistence on risks of second round-effects*

- In the introductory paragraph there were only minor changes. The general view that the economic fundamentals of the euro area are sound and that upside risks to inflation prevail remains. The wording on the ongoing episode of high inflation changes, but the substance (present high inflation is a temporary phenomenon, and will remain high for a "protracted period of time") is still the same.
- Preoccupation about risks associated to the financial market turmoil is expressed in slightly softer terms: The turmoil in financial markets remains unusually high and tensions "still persist" instead of "may last longer than initially expected". Later on: risks related to the "potential for" (added) the financial market turbulence to have a "more negative" (instead of "broader") impact than previously anticipated. In the concluding paragraph, uncertainty remains "high" (not "unusually high").
- There are more references all around to risks related to second round-effects: "it is imperative that they do not become entrenched" in expectations; all parties concerned have to meet their responsibilities "in both the public and the private sector". A new warning is also included: "Wage-setting needs to take into account productivity developments, the still high level of unemployment in many economies, and price competitiveness positions. Moderate labour cost increases are particularly necessary in countries which have lost price competitiveness in recent years."

3 month euribor contract future



Source: Bloomberg and BBVA

- The monetary analysis is similar to the one in the previous statement, although now it is recognized that "some future moderation can be expected [in loans to non-financial corporations] in the light of tightening financing conditions and slower economic growth". The main line is that bank credit "has not been significantly impaired by the financial turmoil thus far."

The Q&A session*: further tightening of financing conditions in the first quarter of the year*

- As in the previous month, the decision was unanimous.
- Regarding the inflation outlook after the decline in April, Mr. Trichet said that "we didn't changed our vision today in relation with the last meeting …we have to remain very, very cautions and prudent … but that of course it will then gradually decline, that's absolutely clear".
- Mr. Trichet insisted that medium- to long-term inflation expectations were in line with the ECB's mandate and definition of price stability such that the current monetary policy stance would contribute to achieving their objective.
- When asked about the latest financial developments, Mr. Trichet suggested that activity was resilient in the first quarter of the year, adding that they were observing "elements [in financial markets] that are in some respects encouraging and seem to show that a number of markets are going progressively back to normal", though " it's not all the markets concerned".
- Mr. Trichet revealed that the ECB would publish the last bank lending survey the day after the meeting, advancing that they have seen continued increase in the net tightening of credit standards in the first quarter against the background of very dynamic growth.

Markets reaction: The curve of three-month interest rate futures' contracts decreased by about 3bp. The euro against the US dollar increased from 1.53 to 1.54.

Concluding remarks

There were not many changes this month. The news from this month's data (lower inflation, some confidence indicators pointing down) have logically not had an impact on the ECB's evaluation on the balance of risks, being too recent. The ECB has taken advantage from the absence of news to strengthened its warnings against risks of second-round effects, which we think are adequate. Regarding financial turbulences, the Governing Council seems slightly more optimistic, although the changes are not significant. In any case, they do not coincide with our view that financial variables will end up having an effect on real activity in the second half of the year. In this context, we maintain our projection of rate cuts for the second half of the year (September and December).

Box: ECB Statements

	February 7th	March 7th	April 10th	May 8th	Concluding remarks*
Monetary policy stance	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.	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 over the coming weeks	**Still a hawkish tone**
Growth	**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**	Fundamentals of the euro area are **sound**. The **uncertainty surrounding this outlook for economic growth remains high**, and **downside risks prevail**. In particular, risks relate to the potential for the financial market turbulence to **have a more negative impact** on the real economy than previously anticipated	**Downside risks prevail mainly to the impact from the financial market turbulences**
Inflation	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 remain significantly above 2% in the coming months, moderating only gradually over the course of 2008** ... rather protracted period. **Imperative that they do not become entrenched in longer-term expectations or lead to broadly based second-round effects**	**Likely to moderate only gradually under the assumption of no second-round effects**
Risks	**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**	**Clearly on the upside**. These risks include the possibility of **further rises in energy and food prices … in administered prices and indirect taxes**... Most importantly**, price and wage-setting behaviour** could add to inflationary pressures	**Upside risks**
Monetary analysis	**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.	**Confirms the prevailing upside risks** to price stability at medium to longer-term horizons. **Little evidence that the financial market turbulence … has strongly influenced the development of broad money and loans**.	**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 (June 5th)

May 14	March industrial production
May 15	April Euro area Inflation
May 15	Euro area GDP Q1/2008, Flash Estimate
May 19	March Construction output
May 22	March Industrial New Orders
May 29	May Business and Consumer Survey
May 30	April Money Supply
May 30	May Flash Estimate Euro area Inflation
May 30	April Unemployment
June 3	April Industrial Producer Prices
June 3	Euro area GDP Q1/2008, 1st release
June 4	April Retail Trade