Editorial: The ECB was right to show its flag! But what should be done next?

On July 3rd the ECB raised its key interest rate by 25 basis points. This step was discussed very controversially throughout the Euro area. Many politicians as well as economists have argued that inflation is mainly caused by the oil price hike and that monetary policy measures of the ECB would not make the oil exporters to increase their production. Thus, the interest rate rise would put a drag on the Euro area economy, but help little to reduce inflation. However, the ECB's primary goal is, according to the European Treaties, maintaining price stability. This goal is endangered now as it has never been since the ECB took the responsibility for monetary policy. In June, Euro area inflation surpassed for the first time 4%, which is far beyond the target of the ECB. Moreover, there are signs that the increase does no longer reflect higher energy prices only but also other prices obviously started to rise. Core inflation, which excludes energy and unprocessed food price, is now above 2%. Even worse for the ECB, inflation expectations move upward, too.

The negative effects of the recent monetary decision on the real economy can be expected to be very limited for several reasons. First of all, the ECB raised the interest rates "unofficially" already for some time. The marginal lending rate was clear above the minimum rate, which was raised now. Therefore, at the best, the July 3rd decision could even be without consequence for money market rates. Secondly, it is also far from clear to what extent a more restrictive monetary policy in the Euro area will give a boost to the Euro exchange rate. Central Banks all over the world face similar inflationary trends, and also the Federal Reserve, e.g., has changed the communication on its monetary policy in the meantime. It cannot be excluded that other Central Banks will follow sooner or later.

To see that the ECB was right to send out a clear signal, one must imagine what could happen if it had done not. In this case, inflation expectations most probably would have continued to rise, and all economic agents would assume higher price levels than they are today. They would react accordingly. Workers would claim higher wages, and employers would be less hesitant to pay more, as they expect being able to pass through higher costs. Wage increase will accelerate and a wage-price-spiral will be started. For sure, the ECB would be forced to react much stronger to curb inflation in such a situation, and the dampening effects on the real economy would be more severe, too. Hence, the ECB was right to show its flag now.

However, the question for the ECB is what to do next? If inflation will continue to be as high as it is, the latest interest rate step will most probably be not enough to curb inflation expectations. Indeed, the money markets have already priced another 25 basis point rise in. At the same time, the growth expectations have diminished markedly. This should keep wages and cost pass through contained. As the current slowdown is felt globally, this should also trigger a stabilisation of oil and food prices. Under these assumptions, inflationary should start to ease by year-end and the ECB could be more relaxed then. However, it cannot be excluded yet that the dilemma for the ECB will even become greater. This will be the case if economic activity slows more quickly than expected, with inflation expectations continuing to rise.

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The EUREN Forecast Summer 2008

Slowing of the global economy

The slowdown in global growth, triggered by the housing and credit crises in the United States, increasingly dampens economic activity in the global economy. Nevertheless, World-GDP grew still rather strongly in the first quarter (graph 1). Some regions – in particular Germany – experienced a rebound after a weak forth quarter in 2007. Furthermore, the downturn in the United States and many industrialized countries had not yet fully reached the rest of the world. Thus growth in the emerging economies continued to grow strong, but at a slower pace than in the recent past. However, indicators hint at a weaker second quarter in 2008. At the same time inflation is of growing concern in almost all countries, as oil prices register all time highs, and food prices are still showing an upward trend. Emerging countries are facing a particularly strong inflationary pressure which constitutes a serious threat for the growth prospects.

Nevertheless, with oil demand in emerging economies expanding steadily , high political uncertainty in certain oil-producing countries and supply constraints unresolved, energy prices are expected to remain at high levels during 2008 and 2009, fuelling serious concerns about global inflation.

Table 1

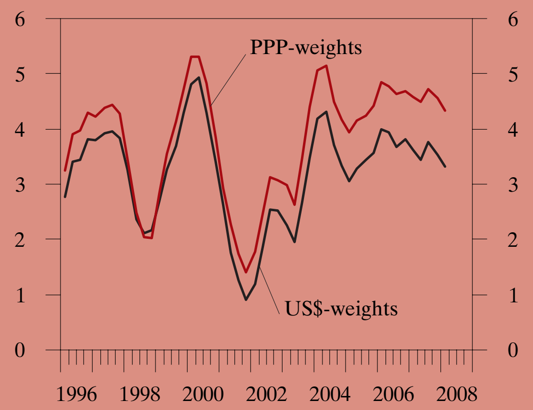
Exogenous and international variables
Percentage changes unless otherwise indicated

	2005	2006	2007	2008
World trade	9.1	6.4	5.5	6.0
United States				
GDP	2.9	2.2	1.4	1.8
3m interest rates	4.8	4.5	2.0	2.7
10y Gvt bond yield	4.8	4.6	3.9	4.9
Japan				
GDP	2.4	2.0	1.6	1.5
3m interest rates	0.3	0.8	0.4	0.4
10y Gvt bond yield	1.7	1.7	0.6	0.6
China, GDP	10.9	11.6	10.0	9.5
US dollar/euro	1.3	1.4	1.5	1.5
Yen/US dollar	116.3	117.8	104.3	109.8
Oil price Brent				
US$/barrel	65.2	72.7	117.1	125.0
Percentage changes	20.1	11.5	61.1	6.7

Sources: OECD, IMF, EUREN forecast.

Graph 1

World-GDP Growth
1996-2008, yoy in %



Source: FERI. – GDP of 43 countries, aggregated using 2005 weights.

Therefore, world trade growth is expected to decelerate in response to higher prices and lower world output. Taking into account the increasing importance of emerging countries, world trade is likely to grow at 5.5% in 2008 and 6.4% in 2008, well below the average of recent years.

An economic slowdown with inflation means a challenge for policy makers because it poses limits to the ability of monetary policy to respond to the problems in the financial sector still prevailing. Against the background of accelerating inflation we expect the Federal Reserve to shift its attention to fighting inflation, keeping short-term interest rates unchanged during 2008 and increasing them gradually in 2009. In consequence, we expect the Dollar/Euro rate to remain at 1.5 in 2008 and to decline slightly during 2009.

The U.S. economy is adapting to these changes by a surge in exports and by lower import growth. However, given the very low confidence of American consumers, GDP growth is expected to decelerate significantly in 2008. Taking into account the positive effect of fiscal stimulus, the EUREN institutes expect that the US growth to be around 1.4% in 2008, and to regain some momentum during 2009, remaining however below its trend rate at 1.8%.

For Japan, the EUREN institutes expect a slowdown of GDP growth in 2008 and 2009, Main reason is a slower growth in private consumption, combined with a continued tight fiscal policy stance. The external sector's performance will continue to be strong. For China growth moderation is forecasted to 10.0% in 2008 and 9.5% in 2009. It partly reflects the more restrictive monetary stance aiming to control inflation.

Diverging developments in the Euro area

In the first quarter, GDP in the Euro area grew stronger than expected at a quarter on quarter rate of 0.7%, which is 0.3 percentage point stronger than in the previous quarter. Compared to the same quarter in the last year the increase was 2.1%. Growth was mainly supported by gross fixed capital formation, whereas private consumption once again was weak (graph 2)

However, these quite positive looking figures reflect above all an unexpectedly accelerated expansion in Germany. Here gross capital formation grew strongly, driven also by the change in inventories. However the quarter on quarter GDP-rate of 1.5% may also mirror statistical factors. Due to the mild winter seasonal adjustment procedures might lead to exaggerated growth figures, and the working day factor was particularly strong in the first quarter.

Other Euro area countries like France and Italy also show improved quarterly rates, but they are less buoyant than in Germany, and the year on year rates still show a deceleration. On the other side, GDP growth slowed significantly in countries like Spain, Portugal, Ireland and the Netherlands. Here the financial crises had a negative impact on growth, above all on investments. The deceleration was particularly strong in Spain, where the housing boom came to a sudden end because of the deteriorating situation in the financial sector and the high indebtedness of many economic agents.

As the labour market is concerned, employment still grew by 0.3% in the first quartr of 2008, which is slightly lower than the 2007 average of 0.5%. Here, too, significant differences appear at country level. In Germany, employment is still going up, in Spain, on the other hand, it decreases sharply in the mean time. All in all we assume that unemployment rate has reached a minimum at 7.1% in April, and we expect some increase in the coming months.

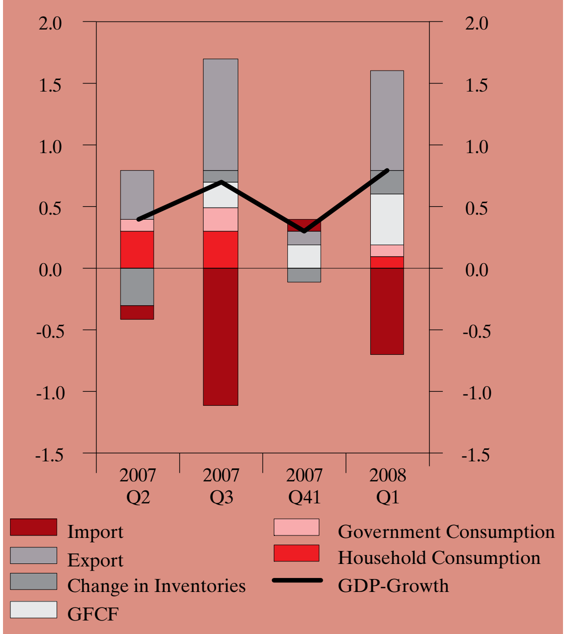
Inflation reached 4.0% in June which is the highest rate since rate since the start of the EMU. Up to now, it reflects above all the energy prices hike and the continuing increase of food and some other commodity prices. However, in the mean time there are some signs that the higher inflation also results in higher wages, in particular in those countries with wage indexation. The ECB indicator of negotiated wages stood at 2.7 in the first quarter of 2008 after 2.1 in the previous quarter.

For the near future all indicators hint at some moderation of growth, but the scenario could be gloomier given the unfavourable conditions in the financial and the energy markets. All indicators are falling since the summer of 2007, but the coincident indicators moderately only. So the

Graph 2

Euro area: GDP-Growth and its components

Contributions to Growth



Source: Eurostat.

PMI index is still close to 50 which is the border line between expansion and contraction. The ZEW coincident indicator, too, shows positive values. But expectations deteriorate more and more. The IFO business expectation index for Germany, e.g., fell significantly in June.

Surprisingly positive figures came from the export side. The strong expansion in quarterly exports (1.9%) shows that neither the sharp increase of the Euro nominal effective exchange rate, nor the global slowdown have dampened exports significantly hitherto.

Monetary Policy reacted to accelerated inflation

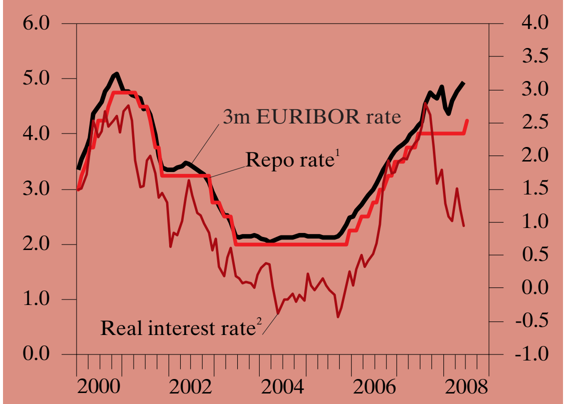
On July 3rd the ECB reacted to the increasing inflationary pressure and raised the main refinancing rate to 4.25%. This step had already been announced in June, and the markets had it obviously already priced in. The money market rate remained unchanged after the ECB decision. Thus, the spread between the 3mon EURIBOR and the rep rate narrowed somewhat despite remaining unusually large (graph 3). The risk premium on interbank loans continues to be high because markets are still in concern about the consequences of the problems in the U.S. real estate sector for the financial markets.

For the second half of this year, the EUREN institutes expect no additional rise of the ECB repo rate. However, even if the ECB would lift the rate by another 25 basic points, this would be without mayor impact on money market rates, as it will most probably influence the spread between the EURIBOR and the ECB rates. Thus we forecast more or less unchanged money markets rates for the rest of this year. In the next year, money market rates could go down somewhat, if the situation in the financial markets improves.

Under these circumstances, government bond yields will rise somewhat. Thus the yields curve will have a positive slope again,

Graph 3

Euro area: Short term interest rates
2000-2008, %



Source: ECB. – [1]End of month. – [2]3mon EURIBOR minus HICP inflation.

Fiscal deficits will rise somewhat

In 2007, the fiscal situation in the Euro area improved both for structural and for cyclical reasons. In this year, deficits are going to rise. The European Commission forecasts a public deficit in the Euro area of 1% of GDP after 0.6% in 2007. The swing mostly originates from the cyclically adjusted balance, reflecting tax cuts in some countries e.g. in Germany. For 2009 the Commission predicts a deficit of 1.1% of GDP. All countries will comply with the deficit criterion of the Maastricht treaty. Only for France net borrowing is predicted to be quite close to 3% of GDP.

However, the question is how fiscal policy will react to the higher inflation. It is under pressure to increase social benefits for low income households to compensate the effects of higher energy and food prices. Therefore it might be realistic to expect higher cyclical adjusted deficits in this year and above all in the next compared to the European Commission projections. However, it is far from clear, what this will mean for the fiscal balance. With tax rates unchanged, public receipts will rise for inflation reasons, too.

Headwinds in front

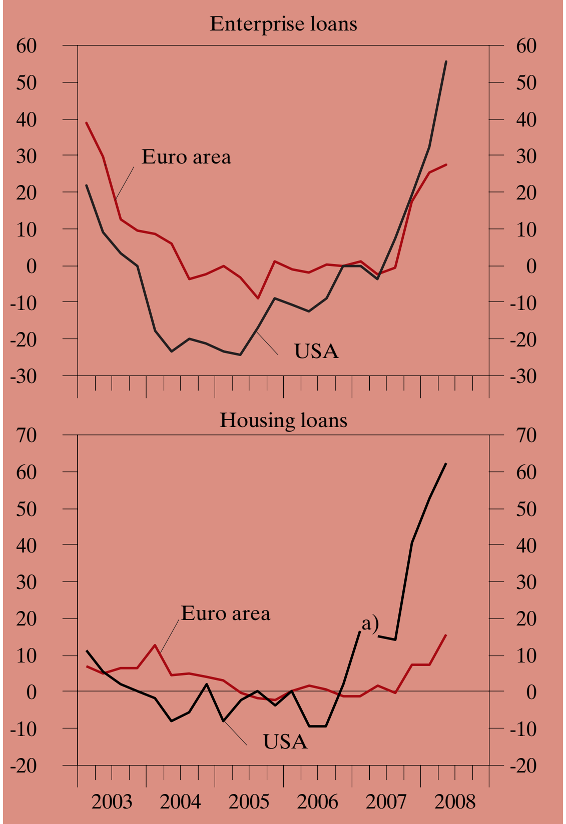
After having shown signs of resilience in 2008Q1, the Euro area economic growth recent indicators suggest that growth will be substantially weaker in the second quarter. The EUREN-CEPREDE indicator forecasts a quarter on quarter rate of 0.1% after 0.8% in the first quarter.

Partly, the slowing is a counterpart of the technical adjustments that that boosted growth in the first quarter of this year, such as the extraordinary mild weather that stimulated the activity in the construction sector above all in Germany. But first and foremost, the less favourable global environment, the high energy prices, the appreciation of the Euro against the Dollar and the problems in the financial markets will gain influence on Euro area GDP growth.

European banks seemed not as concerned as the American one's by the subprime crisis. Nevertheless, it appears that they have suffered sizeable loses in the wake of the financial crisis, too. According to IMF estimates, Euro area banks would have to bear 17% of total banks losses due to the financial crisis, compared to 55% for the U.S., 15% for the U.K. and 9% for Switzerland.

Graph 4

Credit standards in the Euro area and in the U.S.
2003-2008, net percentages of banks contributing to tightening standards



Source: ECB and Federal Reserve. – [a]Break in series.

The main consequence may be tighter credit conditions, both in terms of volumes agreed and in terms of loan margins. In the most recent ECB Bank Lending Survey, Euro area banks indeed reported a tightening of credit standards, both for households and for enterprises, although to a lower extent than in the U.S. (graph 4). However, it must be mention that the survey only reports shifts in standards, but not the levels. Hard data do not confirm such fears yet. This is especially true for the corporate sector, as in April 2008 the year-on-year increase in the loans to non-financial corporations reached 14.9% showing no sign of deceleration. This could be explained by the fact that big companies can draw on existing lines of credit, with predetermined interest rates which were fixed before the crisis. Of course, once these credit lines are used the financial constraint will be much stronger as it is now. Another interpretation might be that other sources of financing are more difficult to obtain compared to bank credits, so that the intermediation is increasing. On the other hand, housing loans have strongly decelerated (+5.9% in April 2008, half of the rat reached at the peak two years ago) but it reflects demand adjustment as far as supply tightening.

Such an environment would have spoken in favour of loosening monetary policy if not other factors would have been an obstacle to do so. In the Euro area, as in most other countries, inflation has increasingly become a matter of concern, preventing the ECB from cutting its rates. The rise in inflation originated from price hikes resulting from tensions in the food and energy markets. It has a strong negative impact on the private household's purchasing power and at the same time has contributed to increase production costs of enterprises. For the ECB, the decisive question is whether there are signs of a second-round effects that could give an additional impulse to inflation.

Until now, core inflation, e.g. excluding food and energy, remained rather low. But most recent data on hourly wages show an acceleration which might indicate that wages have started to adjust to higher inflation (graph 5). If the tensions on world food and energy markets would diminish, which is the assumption of our forecast, the second round effects might be limited. But, if the tensions persist the risk of higher wages cannot be put aside.

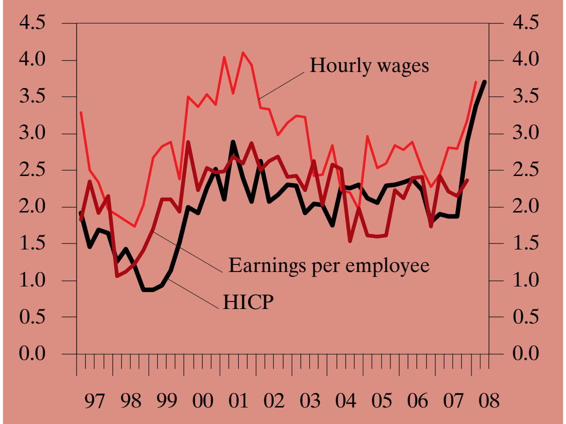
Therefore, the Euro area ecomomy has to burden three problems: the financial crises, a strong increase in raw material prices, and the downward adjustment of the business cycle especially on the housing market. Therefore heavy wheather is ahead.

Turning to the main demand components, it appears that private consumption will grow at a much lower rate in 2008 than it did in 2007 (0.9% against 1.6%). Under of the assumption of better conditions on energy and food markets, inflation might recede gradually in the second half of this year, but it will stay above 3%. Households' real income will be affected negativly by that. Moreover, the labour market will be less supportive than it has been in recent years, as companies will adjust gradually their staff to lower activity. After having decrease over the last three years, the unemployment rate will stabilise and even slightly increase in the second half of 2008 and in 2009. Furthermore, a severe adjustment of the housing market has begun, particularly dramatic in some countries like Spain and Ireland. This will also affect negatively the household's demand.

Graph 5

Euro area: Consumer prices and wages

1997-2008, yoy change in %



Source: ECB.

The support from external demand will also become weaker. The international environment will continue to be less

Table 2

Euro area forecast

	2005	2006	2007	2008[1]	2009[1]	2008 I	2008 II[1]	2008 III[1]	2008 IV[1]	2009[1] I	2009[1] II	2009[1] III	2009[1] IV
	Annual % change (unless indicated otherwise)					q-o-q%, seasonal adjusted (unless indicated otherwise)							
Private consumption	1.7	1.9	1.6	0.9	1.2	0.2	0.2	0.3	0.3	0.3	0.3	0.3	0.3
Public consumption	1.5	2.0	2.3	1.6	2.0	0.4	0.5	0.5	0.5	0.5	0.5	0.5	0.5
Gross fixed capital formation	3.3	5.5	4.4	2.5	1.2	1.6	–0.5	0.0	0.0	0.3	0.3	0.3	0.3
Domestic demand	2.0	2.7	2.3	1.5	1.4	0.8	0.1	0.3	0.3	0.3	0.3	0.3	0.3
Exports	5.0	8.1	6.0	4.3	5.0	1.9	0.3	0.8	0.8	1.1	1.2	1.3	1.4
Imports	5.8	7.7	5.3	3.8	4.8	2.0	0.3	0.8	0.8	1.1	1.1	1.3	1.3
GDP	1.7	2.9	2.6	1.8	1.5	0.7	0.1	0.3	0.3	0.4	0.4	0.4	0.4
Unemployment (% of labour force)	8.8	8.2	7.4	7.2	7.2	7.2	7.2	7.3	7.3	7.3	7.3	7.2	7.1
Compensation per employee[2], yoy	1.8	2.2	2.3	2.6	2.8	2.5	2.5	2.6	2.6	2.8	2.8	2.7	2.7
Consumer price (HICP), yoy	2.2	2.2	2.1	3.4	2.5	3.4	3.5	3.3	3.3	3.1	2.7	2.2	2.0
Current account balance (% GDP)	0.7	–0.1	0.3	–0.6	–0.1								
3m interest rates (% per annum)	2.2	3.1	4.3	4.7	4.4	4.5	4.9	4.9	4.6	4.4	4.4	4.4	4.4
ECB repo (end of period)	2.5	3.5	4.0	4.25	4.25	4.0	4.00	4.25	4.25	4.25	4.25	4.25	4.25
10y Gvt bond yields (% per annum)	3.4	3.9	4.3	4.5	5.0	4.1	4.4	4.7	5.0	5.0	5.0	5.0	5.0

[1]EUREN estimates. – [2]Not seasonally adjusted.

favourable, and the lagged effects of the appreciation of the Euro will reduce price competitiveness of Euro area exporters.

In this environemt, business investment will also slow down. Capacity utilisation will be decline, reducing the need of expanding production facilities. At the same time. the financial situation will probably deteriorate, even if the share of profits in the value-added reached a high level historically in 2007Q4, which makes companies less dependent on external financing.

To sum up, Euro area GDP will probably nearly stagnate in 2008Q2. In the second half of the year, economic growth will remain very weak around 0.3% quarter on quarter. Under favourable assumptions on raw material prices and on international markets, a stabilisation of the Euro/Dollar exchange rate and an easing of the financial crisis, a slight recovery might take place in the course of 2009. However, growth will remain below its potential. On average, GDP growth rate will be lower in 2009 than in 2008 (1.5% against 1.8%, compared to 2.6% in 2007).

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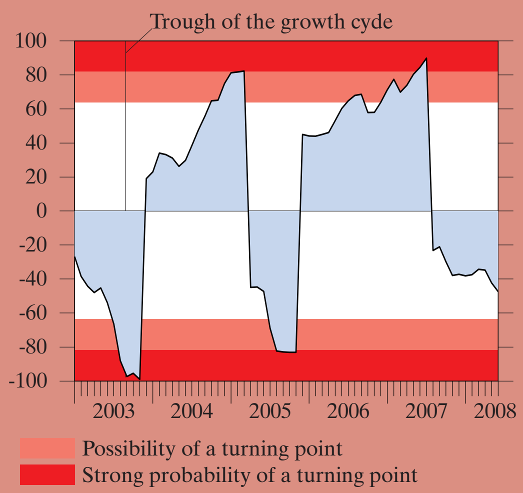
COE-Rexecode Leading Indicator for the Euro Area

Currently, the COE-Rexecode indicator is looking for the trough of a slowdown[1]. The leading indicator will have to overpass in turn the –60 and the –80 threshold to send a strong signal of an imminent economic recovery. In June 2008, the indicator stood at –47.4 and thus still far away from these thresholds. On the contrary, the "underlying" monthly growth in the euro area has been constantly decreasing since mid-2006 and is estimated at 1.4% on an annual basis in June 2008, according to the new Coe-Rexecode indicator. This is clearly below the Euro area trend growth rate estimated at 2.2%. A real-time recession indicator for the euro area[2] has climbed from 0 to 0.16 between January and April but will send a signal of recession only if the 0.5 threshold is over passed.

[1]An economic slowdown occurs when the current GDP growth rate decreases under its trend growth rate. – [2]This coincident monthly indicator is computed by Coe-Rexecode to detect in real-time the start and the end of an economic recession phase for the Euro area. The methodology is based on Markov-Switching processes popularized in economics by Hamilton. By using a set of four monthly time series, this start-end recession indicator (SERI) is able to reproduce all the recession phases experienced by the Euro area since 1970.



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Forecast of the EUREN/CEPREDE High Frequency Model

Last update: June 23rd, 2008

	07Q3	07Q4	2007	08Q1	08Q2	08Q3	08Q4	2008
jun-07	2.53 ; *0.35*		2.61					
jul-07	2.64 ; *0.50*	2.31 ; *0.57*	2.67					
aug-07	2.51 ; *0.45*	2.28 : *0.67*	2.61					
sep-07	2.34 ; *0.44*	2.16 ; *0.72*	2.51					
oct-07	2.41 ; *0.51*	2.13 ; *0.51*	2.56	2.07 ; *0.75*				2.05
nov-07	2.59 ; *0.69*	2.30 ; *0.51*	2.65	2.28 ; *0.78*				2.03
dec-07	[2.7 ; *0.7*]	2.27 ; *0.47*	2.67	2.23 ; *0.76*	2.15 ; *0.22*			2.04
jan-08		2.29 ; *0.49*	2.67	2.11 ; *0.62*	2.01 ; *0.20*			1.96
feb-08	[2.7 ; *0.8*]	[2.3 ; *0.4*]	[2.7]	1.93 ; *0.44*	1.82 ; *0.19*			1.79
mar-08				1.90 ; *0.46*	1.86 ; *0.25*			1.82
abr-08	[2.7 ; *0.7*]	[2.2 ; *0.4*]	[2.6]	1.87 ; *0.47*	1.90 ; *0.32*			1.85
may-08				2.00 ; *0.80*	1.79 ; *0.09*	1.49 ; *0.40*		1.75
jun-08	[2.7 ; *0.7*]	[2.2 ; *0.3*]	[2.6]	[2.2 ; *0.8*]	1.90 ; *0.10*	1.62 ; *0.42*	1.75 ; *0.43*	1.87

In brackets: GDP-Data published by EUROSTAT. In italics: quarter on quarter rates.

The June 2008 update of the EUREN/CEPREDE model forecasts a quarter on quarter rate for 2008Q2 significantly lower than in 2008Q1, where final figures were higher than expected. For the coming quarters, the model is forecasting some kind of stabilisation of quarter on quarter rates around 0.4 that would sum up an annual rate of 1.9%. Thus, GDP would grow below its potential. Looking at the change of the estimates during the last months, there were some downward revisions, but recent figures on the annual rate seems to be somewhat higher.

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