# Flash Comment

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## ECB: Preview of meeting on April 10

***The ECB's dilemma just keeps getting worse. Inflation has increased again and is well above target, clearly making it impossible to cut rates at the moment. On the other hand the economic outlook continues to deteriorate as headwinds get stronger and there are increasing signs that risk scenarios are materialising in some Euroland countries. We expect that the ECB will remain roughly neutral with a "wait and see" stance on Thursday. However, the ECB will undoubtedly preach a fire and brimstone sermon on inflation risks.***

*Overview*

Inflation hit 3.5% in March, continuing to rise well above the ECB's target. Commodity prices continue surging higher, and risks to inflation in Euroland clearly remain on the upside in the medium term even if the surging euro is a mitigating factor. There is little to alleviate the ECB's fear of second-round effects. Recently ECB has been playing down the importance of the German wage negotiations, pointing to low wage growth in previous years and improved competitiveness. But the ECB has stressed the importance of German wage increases not spreading to other countries. Trichet will once again emphasize the ECB's commitment to price stability along the lines of last month's "we have only one needle in our compass".

The high inflation and upside risks remain countered by a deteriorating economic outlook with clear downside risks. Growth is heading lower with risks clearly on the downside. Recent data show a widening gulf between Germany and some peripheral countries like Italy and Spain. This adds further to the ECB's dilemmas. Focus on the troubles in Southern Europe could be dovish.

One interesting aspect of the April meeting is that ECB has the new Bank Lending Survey for Q1 available. Further increases in the net tightening of credit standards will reflect the deterioration of financial market conditions and the worsening of the bank's situation. Bank of England recently released its Q1 Credit Conditions Survey, which painted an increasingly gloomy picture of credit conditions in the UK – we do not expect the trend to be much different in Euroland. If the Bank Lending Survey is brought up it will probably be a dovish factor.

Other subjects that Trichet is likely to be asked about are the surging Euro, wage negotiations, the IMF's quite negative outlook for Euroland and its call for cuts from ECB, and the upcoming G7 meeting this weekend when coordinated action to solve money market problems could be on the agenda.

*Market interpretation*

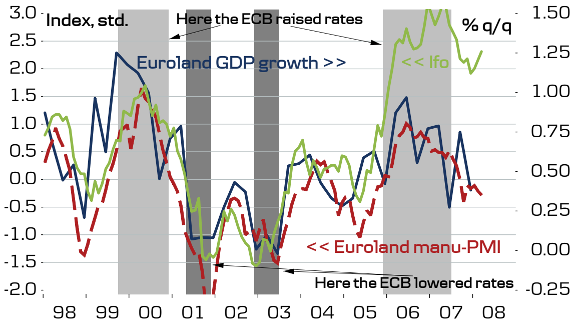
The market is clearly expecting Trichet to deliver a sulphuric speech on inflation. The sentiment is currently for higher rates and yields on the back of the abating financial crisis and the rising equity markets. However, markets have moved a lot in a short time and do not expect the ECB to cut rates at the next meetings. With the latest move in markets, the first cut is now priced in Q4. Markets have a clear tendency to hear what they want to hear from the ECB, and they may very well choose to focus on the tough inflation rhetoric. But, there are also a couple of dovish themes that could catch the markets' attention namely the Bank Lending Survey, and the troubles in Spain and other countries, which makes the market reaction fairly unpredictable.

Overall, the market movements following the meeting will probably be rather small compared to recent meetings and we see risks in both directions. We remain sidelined ahead of the decision.

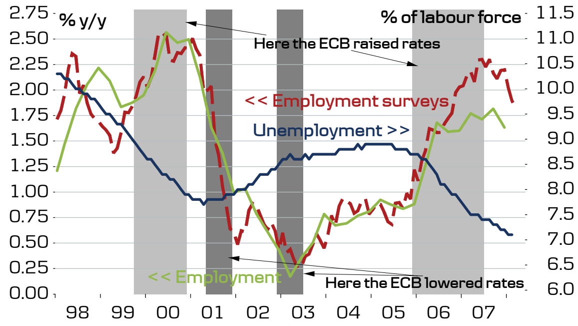
| **Main news since last ECB meeting, 6 March 2008** | | |
|---|---|---|
| Growth | → | Overall the indicators have not changed much. Most significant was a better-than-expected German ifo. German industrial production was also strong. Euroland composite PMI on the other hand fell slightly still pointing to below trend growth. Still large divergence between a strong Germany and a very weak picture in Spain, Italy and Ireland. On demand components Euroland retail sales was weak again. Export numbers have in general been positive. Unemployment rate was unchanged at 7.1%. |
| Inflation: | ↑ | The flash estimate of Euroland inflation hit a new high in March rising to 3.5%. Importantly consumers' inflation expectations (measured in the consumer confidence survey) fell slightly in March. |
| Wage growth: | ↑ | The main theme on wages is German negotiations. On 1 April the service union Verdi struck a deal with the government for just below 8% over two years (5% in 2008 and 2.8% in 2009). The work week was increased by ½ hour to 39 hours; hence wages per hour rise on average 3.3% per year. This should not alarm the ECB. The comments from ECB's Trichet have been that this is acceptable for Germany which has shown wage moderation for many years but that this should not be copied in other countries. |
| Money and credit: | ↓ | M3 moderated to 11.3% in March from 11.5% in February. M3 peaked at 12.4% in November last year. M1 growth moderated from 4.3% in February to 3.7% in March. This is a very low level historically. Credit growth moderated slightly from 12.7% to 12.5% y/y and the 3mth rate is showing stronger moderation. This is driven by lower credit for house purchases whereas corporate credit growth has stayed strong – possibly related to some substitution of bank lending from the breakdown of securitisation. |
| Euro currency: | ↓ | The trade-weighted euro has strengthened by another 2% since the last meeting. It has strengthened close to 10% since the crisis broke out last Summer. OECD estimates a 1:6 ratio between short-term interest rates and trade weighted currency in terms of effect on economic growth. Hence a 10% strengthening corresponds to 1.65 percentage points of tightening in rates. |
| Global growth picture | ↓ | The global picture has worsened slightly. In the US consumer confidence has fallen strongly, payrolls have been weak and ISM new orders softened. In UK falling house prices are a rising threat to the economy. In Asia indicators have been mixed with still strong export data but weaker Japanese numbers on industrial production and Tankan survey. |
| Financial crisis | → | Credit spreads have tightened and equities rebounded giving some relief. On the other hand money market tensions have increased with libor rates going up. ECB has introduced a 6mth tender since last meeting to alleviate some of the pressures. |

# The ECB and economic data

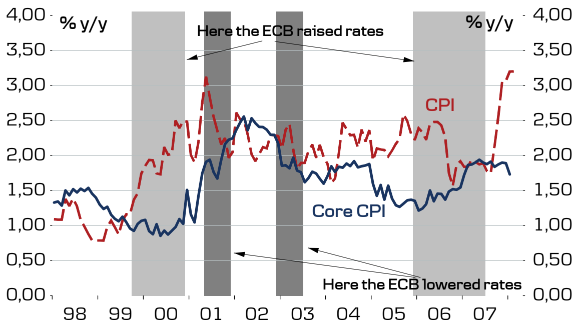
Business surveys: Growth is easing



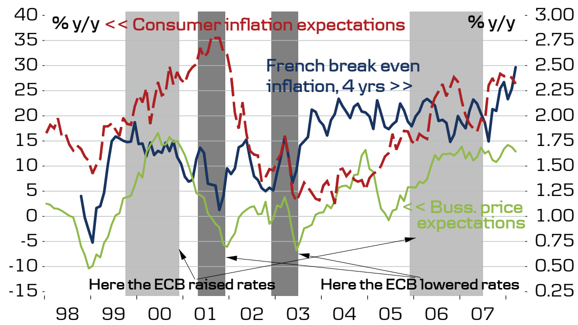

Labour market remains strong



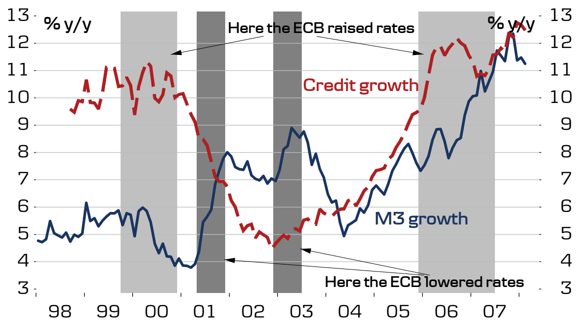

Inflation way above 2%



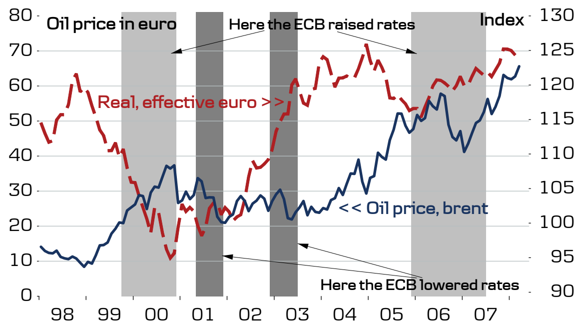

Inflation expectations quite high



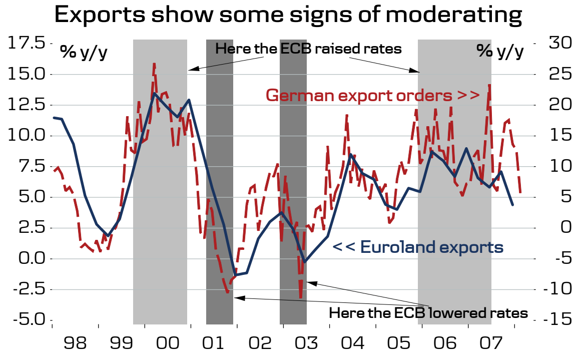

Money growth stabilising - credit growth up



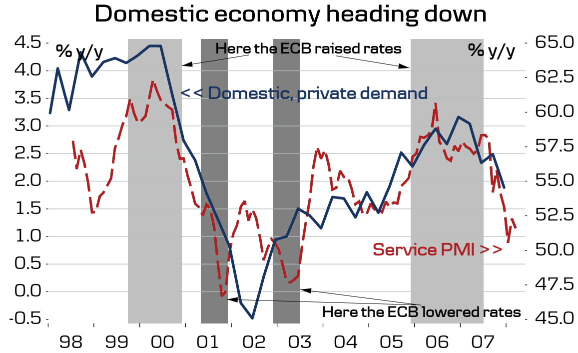

The euro strengthening - oil rising




Exports show some signs of moderating

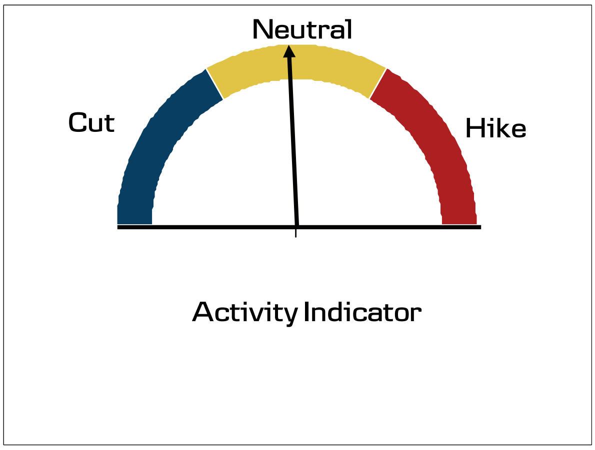



Domestic economy heading down

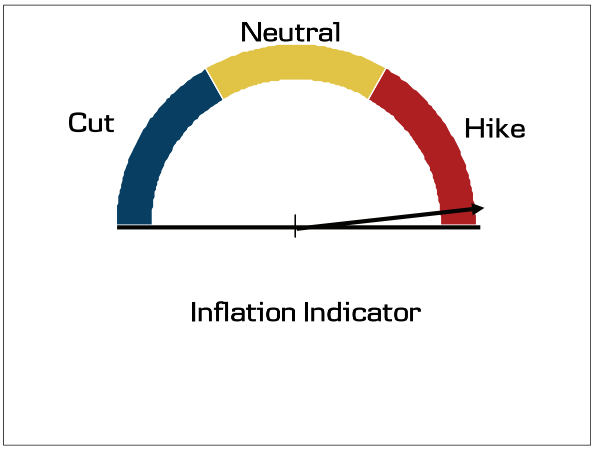


# *Danske Bank's ECB Monitor*

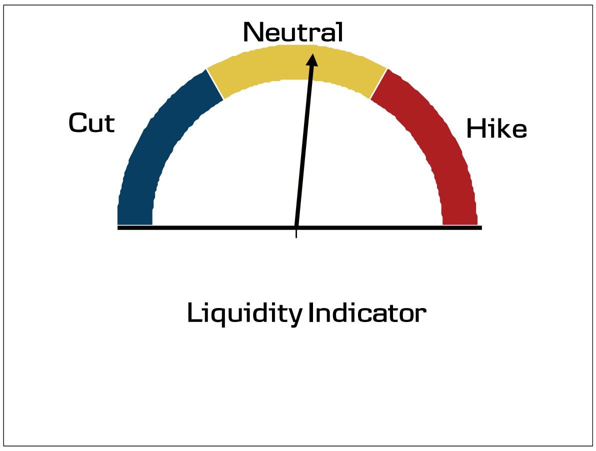
Activity is clearly slowing and is now firmly in the neutral zone



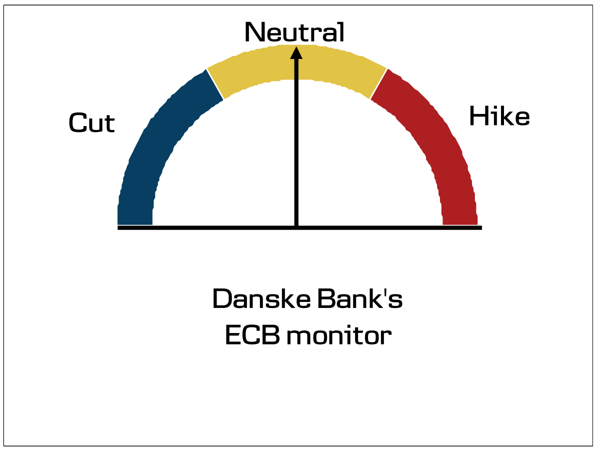

Inflation indicator strongly into hiking zone on energy and food prices, and inflation forecasts




Liquidity is showing signs of moderating




ECB is neutral, caught between the inflation and the growth outlooks




| ECB rate outlook | ECB minimum bid rate | | |
|---|---|---|---|
| | Danske Bank | Consensus | Markets |
| April 2008 | 4.00 | 4.00 | 4.00 |
| October 2008 | 3.75 | 3.75 | 3.87 |
| April 2009 | 3.25 | 3.50 | 3.59 |

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