



**ECB Has Market on Tenterhooks**

The ECB meets for the first time in nearly a month on Thursday. Expectations for a rate cut, the first since May, are running high. Over the last month conditions certainly have moved in favour of easing. There has been a marked appreciation in the euro against the dollar, headline inflation (HICP) has moved down from May's peak of 3.4% and data continue to indicate a weakening in economic activity. Last Tuesday's decision by the Fed to reduce US rates by another 0.25% should also encourage the ECB. Given that the US economy remains weak, markets are even pricing in a further 0.25% reduction at the next meeting in October. A gloomier tone to the ECB's August monthly report, which acknowledged that the eurozone economy is suffering from the global slowdown, has further reinforced expectations of an easing in policy.

With the market discounting a rate cut there is considerable scope for disappointment on Thursday. Although the odds are moving in favour of an easing in policy, we feel that there is still only a 50% chance that the ECB will actually reduce rates this week. ECB board members have been very quiet over the last three weeks, leaving us with little real indication of whether or not there has been a change in the central bank's view. While the majority of eurozone economic indicators argue in favour of easing, there have been some notable exceptions. July's German Ifo business climate index surprised on the upside with eurozone industrial production for June also coming in ahead of expectations. Other data showed that the Germany economy stagnated in the second quarter of the year. However, the data revealed more resilient consumer spending than had been expected.

The eurozone headline inflation rate has started to decline, but at 2.8% is still well above the ECB's 2.0% target. Preliminary German and Italian CPI data indicate that the rate is likely to decline to 2.7% in August. The ECB may well decide to wait for the September data, which is expected to show a deceleration to 2.5%, before announcing any rates changes. M3 money supply growth (the ECB's second pillar of stability) is also well above reference levels. The annual rate of growth in M3 in June was 6.1%, up from 5.1% in May. The three-month average rate increased to 5.3% from 4.8%. July's data, which are due for release on Tuesday, are expected to show the 3-month average rate at 5.8%, well above the ECB's reference rate of 4.5%. As the M3 numbers are distorted by calculation methods there is a tendency to dismiss them. Nevertheless, the trend may worry some council members.

If the ECB does decide to leave rate unchanged, we are likely to see some unwinding of the euro's recent gains. Although much of its rally has been based on disappointment in the US economy's failure to respond to aggressive monetary easing, the euro has also been supported by expectations that the ECB is finally ready to cut rates. The dollar continues to face some major hurdles but steady rates from the ECB could be enough to prevent the euro from making a break for \$0.93.

**Geraldine Concagh, 24<sup>th</sup> August 2001**

