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Western European Indicators and Insights

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ECB: A key week ahead.

The ECB Council meets for its next regular meeting next Thursday, with much to discuss (and decide) in the wake of month that has brought fresh market turmoil alongside more weak economic data.

An understandable shift in thinking

As far as formal policy is concerned, no changes are envisaged. However, a clear shift in ECB thinking is likely as the Council discusses the extent to which fresh market turmoil threatens to intensify already-growing downside risks to the economy. In this regard, the ECB already seems to be shifting away from its previous hawkish thinking. Comments recently from ECB Council member Nowotny have pointed to a possible Japan-style period of weakness ahead that will inevitably curtail inflation pressures. More notably, President Trichet used a high-profile testimony earlier this week to signal that the ECB will use the update of its economic forecasts next week to reassess the inflation outlook, albeit very clearly hinting that the Council may no longer point to upside risks to inflation. Such a reassessment will very much validate the removal of further ECB rate hikes from market expectations seen in the last month, the question being the extent to which the budding pricing-in of rate cuts is accentuated or not.

In regard to the recent rate hikes being reversed, the ECB may be very guarded about encouraging any such speculation. Instead, the comments from the pre-prepared statement as well as those from the Trichet Q&A are likely to reflect the exasperation within the Council in regard to what measures Eurozone governments have taken.

(Growing) Greek concerns

There may be a clear rebuke to governments about the speed and manner in which the fresh Greek bail-out is being handled, especially in relation to alleged collateral demands made by the likes of Finland. However, while such collateral demands may partly be a reflection of far from unusual political differences among Eurozone governments, it may also reflect a clear wariness about lending any more to Greece given the increasingly parlous state of its debt situation. Indeed, recent reports have pointed to Greek debt dynamics as being out of control while more recent press speculation suggests that Greece may be resisting further austerity measures demanded of it. In this regard, the Greek backdrop could be seriously more concerning by the time the ECB actually meet next Thursday.

Italy frustration

Elsewhere, there may be explicit criticism of the lack of credible deficit cutting action by Italy, with the ECB upset that its decision to restart it bond purchase program last month was partly on the basis that clearer action would be forthcoming from Rome. Instead, policy-making in Italy is being hampered by political quarrelling within a Government where PM Berlusconi looks increasingly incapable. Regardless, there may be little beyond rhetoric that the ECB can do, fully aware that any threat to abandon Italian bond purchases may be very counter-productive, not least in further inhibiting the transmission mechanism of monetary policy.

EFSF exasperation

This frustration may be even more paramount in regard to the EFSF, the alleged enhancement of which on July 21 was probably instrumental in persuading the ECB to resume bond purchases. Instead, governments are being very slow to approve the changes, which would have allowed the Fund to take over the government debt buying role from the ECB. In addition to which, there are growing concerns that the proposed changes to the EFSF may not be sufficient. Indeed, with its limit of € 440 bln, the Fund might not be anywhere near as effective or speedy as the ECB in supporting markets: the EFSF firepower still exceeds the € 115.5 bln purchased by the ECB thus far, but its funds are also earmarked for recapitalization of banks and potential credit lines to troubled countries, as well as any further bailouts that might be needed in the future.

On the defensive

As a result, the ECB is likely to feel that government inaction has pushed it into a position where it cannot extricate itself from either government bond purchases or bank liquidity provisions, ie measures which it regards are extraordinary and therefore temporary, with the German contingent on the Council very opposed to buying Government debt. As a result, the ECB may be in no mood to offer any further sop to governments by hinting at rate cuts.

Even so, the ECB is likely to be on the defensive. Indeed, President Trichet will probably have to address criticisms made of late from the IMF, in regard to the speed of budget consolidation being foisted on certain countries as well as the extent to which Eurozone bank balance sheet problems may be understated. All of which makes the Council meeting next Thursday all the more interesting, with the hope (at least from the ECB) that neither the raft of key data due in the interim, nor further market turmoil, make it more attention-grabbing.