

Dieter Wermuth

Wermuth Asset Management GmbH

60329 Frankfurt am Main, Mainzer Landstrasse 47
Phone -49-69-95 92 54 85 , Fax -49-69-95 92 54 86
E-mail: dwermuth@wermutham.com

What a flatter yield curve will do to the euro area economy

January 13, 2006

1. As expected, the ECB has left rates unchanged yesterday. While recent economic data had mostly been strong and could have been used to justify the next rate increase, markets would have been very surprised by a rate hike. **There had been no signals from Frankfurt, and at least one important statistic, Germany's preliminary GDP growth rate of 0.3% q/q for the fourth quarter, had been outright disappointing.** The ECB did not see any reason to give up the policy of carefully preparing the markets for the next policy action. Moreover, if a rate hike had come just a month after the one in December, analysts would have concluded that the ECB was in a hurry to reach neutrality by a series of monthly 25 basis point steps. There was simply no need to act so soon.
2. Just to recall, **it is not so long ago that the ECB was quite convinced that a rate level of 2% was appropriate. But then the central bank had panicked when oil prices exploded and headline inflation shot up as a result.** In September consumer price inflation hit a high of 2.6% y/y and industrial producer prices rose by 4.3% y/y. According to French inflation-linked bonds inflation expectations which the ECB aims to anchor at below 2% had also crept up to well above this mark. It did not help that core inflation continued to be subdued at around 1 ½% y/y, that wage inflation was of the same low order of magnitude, without any sign that it might accelerate, or that the euro area GDP deflator stood at merely 1.4% y/y (Q3).
3. **The ECB is in tightening mode but is unsure about timing. The wording of the press statement was more dovish than in December,** with the term "strong vigilance" replaced by "we will continue to monitor very closely all developments with respect to risks to price stability over the medium term." Before December, the monetary policy stance was described as "very accommodative", now it is just "accommodative". This de facto excludes a rate hike in February but leaves the door open for a move on March 2. As always, there can be unforeseen events which require a new assessment and a faster response, but in the absence of that investors can be fairly certain that the refinancing rate will stay at 2.25% for at least another seven weeks.
4. **The most recent inflation numbers show that last fall's acceleration of inflation was not the beginning of a new trend at all. Next week, on January 19, the harmonized index of consumer prices (HICP) will probably show that December inflation had been either 2.1 or 2.0% y/y.** The core index which will be released simultaneously could be as low as 1.0% y/y, assuming a 0.1% m/m increase of the index from November. Pipeline inflation is also on the retreat after the stabilization of oil prices and the euro exchange rate. December's producer price index may still have been 4 ½% y/y but on a month over month basis it is now falling.

5. **As inflation expectations improve bond yields will fall as well. While the yield curve remains quite steep, with the yield differential between 10 and 1-year government bonds at 58 basis points, it is almost certain that it will continue to flatten.** Markets presently expect that short-term rates will go up by 25 basis points in March and September, and then again in the summer of 2007. The implication is that the ECB is not seen to be dead-serious about tightening the screws. A neutral level of short-term rates is probably in the neighbourhood of 4% which is the medium-term growth rate of nominal GDP. When there is a lot of slack in the economy, as today, some lower target interest rate seems plausible, but not those 2 ¾% implied by interest rate futures.
6. **More crucially in the flattening process, rate hikes by the ECB will lead to the expectation that inflation will decline even more.** It is already very low to start with. In the nearer term – which allows one to ignore the effects of the fairly rapid growth of money supply – at least four factors will have a positive impact on the price index: the likelihood that the nominal effective exchange rate of the euro will either move sideways or appreciate, very subdued wage increases caused by high unemployment and very intensive international competition, an acceleration of productivity growth as the rate of capacity utilization does no longer fall, and a deceleration of energy and commodity price inflation, if not price declines.
7. This leads to a flatter curve: **at the short end rates are pushed up by the ECB, and at the long end positive inflation surprises pull them down.** In the past, curve flattening processes and curve inversions had occurred in inflationary environments: central banks used to push up policy rates very fast, but long rates rose as well, if more slowly, because market participants were just as afraid of future inflation.
8. **So it will be different this time around. The flattening takes place at unusually low levels of headline and core inflation and in the absence of wage inflation. Moreover, domestic demand and GDP growth are so slow that the large output gap has not significantly shrunk so far.** Will such a kind of flattening have the usual negative impact on output growth, and bring about a further decline of inflation? In the past, the flattening and/or inversion of yield curves were equivalent to a tightening of monetary conditions, which was then followed by a significant slowdown of activity or a recession. In the US, the lead time has been between four and six quarters. Changes in the slope of the yield are statistically significant leading indicators for real activity most of the time.
9. **The main argument is that a rise in short-term interest rates induced by monetary policy will lead to a slowdown of real economic activity and the demand for credit** - which then reduces expected short-term interest rates. Since long-term rates can be defined as a string of those expected short-term rates, this causes them to fall and thus brings about a flatter yield curve. That long-term rates typically rise during a curve inversion process results from the simultaneous deterioration of inflation expectations. **As dynamic theoretical models have shown, there are also influences in the opposite direction: from economic activity to the yield curve.** The slope of the yield curve contains expectations of future activity which are affected by current monetary policy which in turn is influenced by the current situation of the economy.
10. In the present context of well-contained inflation expectations **the coming increase in policy rates will have a small or even negligible impact on economic activity** because long-term rates will probably not rise. It is quite likely that they will fall, even in real terms. This acts as a countervailing effect to the higher borrowing costs at the short end. In other words, the ECB

will probably not succeed in tightening monetary conditions in a noticeable way. Once the realignment of foreign exchange rates, ie the appreciation of the euro, sets in in earnest, it may be glad it didn't.

- 11. To sum up, the coming flattening of the euro yield curve is historically without precedent, as far as I can see, and will not lead to a slowdown of economic growth. Monetary conditions will not get tighter even if the ECB raises rates to 3% or beyond because long-term rates are likely to fall. The main risk for real activity is a significant appreciation of the euro. If that happens the ECB may even be forced to reverse course again. For now, bond holders can sleep peacefully, and equities are also not negatively affected. Corporate earnings are much more exposed to moves in the exchange rate – which is not near dangerous territory at this point.**