

23 June 2008

Economic news

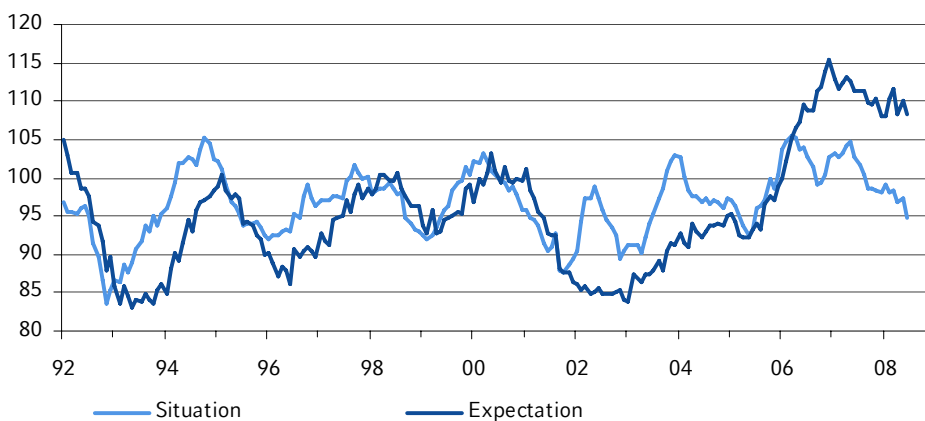
IFO BUSINESS CLIMATE AND JUNE PMI

Weak Ifo Index will not prevent ECB from raising rates

The Ifo business climate index for Germany and purchasing managers indices for the Eurozone declined much more strongly in June than expected. Accordingly, significantly weaker growth can be expected for the remainder of the year. Nonetheless, we believe the ECB will raise its policy rate by 25bp to 4.25% on 3 July.

- The **Ifo business climate** declined much more significantly in June than expected. After its surprisingly increase in May, the Ifo index fell from 103.5 to 101.3 points. The **business expectations** subindex for the next six months plunged dramatically from 97.2 to 94.7 points, dropping below its long-time average for the first time since mid-2005. This suggests a slowdown in the pace of growth for the winter half-year to below the potential rate of 1½ to 1¾%. Although the assessment of the **current business situation** likewise deteriorated compared to May, it remains good at 108.3 points.
- There are more than enough reasons for the much more downbeat assessment of business expectations. In addition to the firm euro, the slowdown in global growth and the fallout from the financial market crisis, the never-ending oil price hikes and the increasing likelihood of a tightening move by the ECB are likely to have been negative contributing factors. The prospects for the coming months in manufacturing and retailing in particular were viewed more sceptically.
- The **purchasing managers indices in the eurozone** also fell much more sharply in June than expected. The manufacturing PMI dropped to 49.1 points and the service PMI sank to 49.5 points. Both indicators are therefore pointing towards diminishing economic performance. At the same time, the assessment of new orders in the manufacturing industry slipped to its lowest level since 2003. According to service sector survey results, business expectations had never been so sceptical.

Ifo business climate and expectations



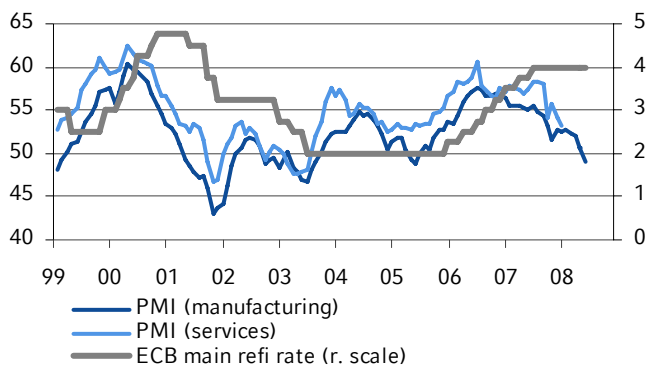
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Source EcoWin, WestLB Research

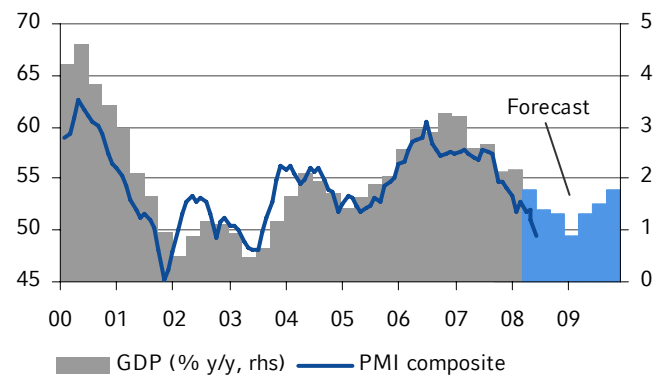
- **What do the results mean for the ECB?** We are still not convinced that higher key rates are justified in the eurozone given the current climate of economic risks, heightened inflation and tension on the money market. However, the monetary policymakers obviously take a different view. Various ECB council members have issued statements since chairman Trichet signalled the possibility of a rate hike on 5 June. While some have attempted to dampen market expectations of several rate hikes, no one has given any indication that the ECB council could decide against monetary tightening at the next meeting on 3 July. Despite today's very weak Ifo index and PMIs, the ECB is likely to raise the key rate by 25bp on 3 July with all the risks and side effects that this may involve.
- There is a possibility of further rate hikes. The eurozone inflation rate could certainly continue to rise in the summer, even if the oil price does not climb any further. According to the ECB's current reasoning, it would then be logical to increase the policy rate again to curb inflation expectations. Key rate hikes to 4.5% or 4.75% would severely weigh on the already fragile economy, which would make rate cuts very likely next year.

EMU: purchasing managers indices and policy rate



Source EcoWin, WestLB Research

EMU: PMI and GDP



Source EcoWin, WestLB Research

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