

“Interest Rate Update – The Vital Role of Money in ECB Monetary Policy”

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Executive Summary

- The Governing Council of the European Central Bank meets on Thursday of next week and a further 0.25% increase in official interest rates to 3.5% has been well signalled.
- This will be the sixth increase in interest rates by the ECB since December of last year.
- Further interest rate increases are on the cards in 2007.
- The ECB believes conditions remain in place for the euro area economy to grow at “solid rates around potential”.
- The ECB see inflation remaining above 2% on average in 2006 and at a similar level next year.
- The rate of monetary and credit growth remains “rapid”.
- Risks to the outlook for price stability “remain clearly on the upside”.
- Monetary analysis plays a central role in interest rate decisions by the Governing Council of the ECB.
- The monthly M3 and credit figures deserve much closer scrutiny by financial markets.
- The ECB will exercise “strong vigilance” and will act in a “firm and timely manner” to ensure price stability over the medium term.
- Despite six increases over the last twelve months the refinancing rate at 3.5% may be considered too low.
- If the ECB is correct and inflation remains at a level above 2% on average in 2007 and real GDP continues to grow at 2% or above, official interest rates are likely to rise to 4% by June of next year.
- Against this background, a failure to see a slowdown in money and credit growth to a level that is satisfactory to the ECB could result in a decision to push rates to 4.25% by autumn 2007.
- Irish private sector credit is likely to reach €325 billion or 186% of GDP by the end of this year.
- The ratio of private sector credit to GDP could rise to 206% in 2007 and to 244% of GNP.
- This rate of growth is unsustainable particularly against the backdrop of rising short term interest rates and a higher cost of longer term funds.

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Interest Rate Update – The Vital Role of Money in ECB Monetary Policy

The Governing Council of the European Central Bank meets on Thursday December 7th and a further 0.25% increase in official interest rates has been well signalled. This will be the sixth increase in interest rates by the ECB since December of last year bringing official rates to 3.5%. Further interest rate increases are on the cards in 2007. The ECB believe conditions remain in place for the euro area economy to grow at “solid rates around potential”. They see further declines in oil prices, if sustained leading to stronger demand and output growth than embodied in their current baseline scenario for economic activity. Thus their mindset with respect to favourable oil price developments appears to be on its potential growth implications rather than potentially positive inflationary implications.

Despite the fact, that inflation fell to 1.6% in October (from 1.7% in September and 2.3% in August), the ECB see inflation remaining above 2% on average in 2006 and at a similar level in 2007. Risks to the outlook for price stability are believed to “remain clearly on the upside.” Their monetary analysis also points to the upside risks for price stability. The annual growth in the money supply (M3) was 8.5% in October unchanged from September. The three month average of the annual growth rate of M3 rose to 8.4% over the period August 2006 to October 2006 from 8.2% over the period July 2006 to September 2006. Credit expansion remains “rapid” reflecting the “still low level of interest rates in the euro area” and strengthening economic levels of economic activity.

Lending to the private sector rose 11.2% in the twelve months to October (down from 11.4% in September). Within this total borrowing by households increased by 8.7% down from 9.1% annual growth the previous month (consumer credit up 7.7% and lending for house purchase up 10.4%) and lending to non financial corporations rose 12.9%. The growth in borrowing by non financial corporations at close to 13% annual growth is at its highest level since the early 1990's. Growth in private sector credit is the key driver of strong monetary growth. The ECB believe that “ample” liquidity exists in the euro area, and when combined with strong monetary and credit growth the risks to price stability are on the upside.

Jean- Claude Trichet published a very interesting article in the Financial Times of 9th November 2006. He takes strong issue with the academic view that monetary aggregates should have no part in monetary policy decisions. His view is that a model of monetary policy that “includes no role for money is incomplete in some important respects.” Mr Trichet asserts that an important role for money helps to give the policy discussion an appropriate medium to

longer – term orientation. He states “in practice, a thorough assessment of money has served well.” In particular, he cites recent ECB experience where cross checks with monetary analysis were extremely useful, namely; the decision not to lower rates below 2% in 2003/2004 and the decision to increase rates in December 2005. This article gives a very useful insight into the ECB decision making process and the central role played by monetary analysis in interest rate decisions. It provides a vital clue with respect to interest rate developments in the euro area which has not yet been fully discounted by financial markets.

In summary, the ECB sees:

- Inflation on average remaining above 2% in 2007 and the risks attached to this projection on the upside.
- The euro area growing at solid rates around potential.
- The rate of monetary and credit expansion remaining “rapid”.

Their cross-check of the economic analysis with that of the monetary analysis “supports the assessment that upside risks to price stability prevail over the medium to longer term.” This all points to a further withdrawal of monetary accommodation, if the Governing Council’s assumptions and baseline scenario prove correct. The ECB will exercise “strong vigilance” and will act in a “firm and timely manner” to ensure price stability over the medium term.

The fact that the Euro has risen above \$1.30 has given hope that Euro strength may act to alleviate the ECB inflationary concerns to some degree. However, a bilateral exchange rate movement cannot be taken in isolation and the nominal effective exchange rate (as measured against the currencies of 23 of the euro area’s important trading partners) is the appropriate benchmark. During October the nominal effective exchange rate was 0.8% above its average for 2005 and in line with the average of 2004. Thus, while moving in the right direction it is unlikely to have a significant dampening impact on inflation unless there is a sustained appreciation of the nominal effective index.

This analysis points to higher euro interest rates in 2007. At present the yield on a 10 year Bund (German government bond) is just above 3.7%. The markets are pricing in a further 50bp increase in short term interest rates from current levels. The markets are too complacent. At 3.25% official euro interest rates are “at still low levels”. Assuming a 0.25% increase is announced after the council meeting of 7th December, official rates will stand at 3.5% at the year end.

Despite six increases over the last twelve months the refinancing rate at 3.5% may still be considered too low. Using the October inflation rate of 1.6% translates into a real interest rate of 1.9%. However real GDP growth was 2.7% year on year in the second quarter and at 3.5% a neutral interest rate may not yet have been achieved. If the ECB is correct and inflation remains at a level above 2% on average in 2007 and real GDP growth continues at 2% or above, official interest rates are likely to rise to 4% by June of next year. Against this background, a failure to see a slowdown in money and credit growth to a level satisfactory to the ECB could result in a decision to push rates to 4.25% by autumn 2007.

Mr Trichet declared himself a follower of Friedrich Hayek whom he quotes “It is self contradictory to discuss a process [inflation] which could not take place without money..” The monthly M3 and credit figures deserve much closer scrutiny by players on the financial markets.

Meanwhile in Ireland private sector debt continues to mount. Private – sector credit is now in excess of €300 billion. By year end it may be close to €325 billion or 186% of GDP (220% of GNP). If we see private- sector credit growth of 20% in 2007 the ratio of private sector credit to GDP will rise to 206% and to 244% of GNP. This is unsustainable particularly against the backdrop of rising short term interest rates and an upward adjustment in bond yields as complacency is eroded which in turn will feed into higher longer term cost of funds.

