

EUROPEAN ECONOMIC PERSPECTIVES



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Darren Williams

Europe Economist
Global Economic Research

European Economic Perspectives

ECB: Growing Concern About Credit And House Prices

The European Central Bank (ECB) is becoming increasingly concerned about rising money and credit growth. At its last press conference, the ECB suggested that excess liquidity in the euro area is a “real, real cause for vigilance”. The ECB added that “ample liquidity and strong credit growth could, in some countries, become a source of unsustainable price increases in property markets”.

While economic growth remains below trend, the ECB probably will tolerate rising money and credit growth. As the economy begins to recover, however, the ECB is likely to become much less comfortable. In our view, the market continues to underestimate the importance of money and credit growth in the ECB’s decision-making process. As a result, it is probably overestimating the pickup in growth needed for the ECB to start raising interest rates.

The ECB is concerned about a number of monetary developments. First, it has been worried for some time about the excess liquidity that has built up in the euro area as a result of persistent above-target money supply growth (**Display 1**). Second, private-sector credit growth is accelerating and beginning to broaden out (**Display 2**), which may signal a pick up in domestic demand. Finally, the ECB is worried that low interest rates may be encouraging house-price bubbles in some euro-area countries.

It is often argued that the ECB sets interest rates that are too high for Germany. Much less attention is paid to other euro-area countries, where interest rates are probably set too low. In Spain, for example, real short-term interest rates currently stand at -1.2%. The average over the last two years has been -0.9% and they have averaged just 0.1% since the European Economic and Monetary Union (EMU) started in 1999. In a country with a history of very high real and nominal interest rates, it is no surprise that this has stimulated strong credit and house-price

growth. Spanish house prices rose by 15% last year and have risen by 130% since 1999.

This phenomenon is not confined to Spain (**Display 3**). House prices in the euro area outside Germany rose by 10% last year and have risen by 80% since 1999. French house prices have been very buoyant recently, with prices rising by 30% over the last two years and by 80% since 1999. Although euro-area economies are generally thought to be less sensitive to rising house prices than, for example, the UK, there is evidence of some spill-over effects. French purchases of household equipment rose by 14% last year, while housing permits are surging in the euro area outside Germany (**Display 4**).

There have been some insights into how the ECB might react to a perceived housing bubble. Last year, ECB Vice President Lucas Papademos argued that central banks should not react “asymmetrically” to asset-price bubbles and suggested that “leaning into the wind” as asset prices rose could help to maintain price stability over the medium term. These thoughts were echoed by President Trichet at the ECB’s latest press conference when he said the ECB would react to rising asset prices “before the bubble is burst”.

Conclusion

The ECB’s mandate is to deliver price stability for the euro area as a whole, not to target asset prices in individual euro-area countries. With inflation likely to move below 2.0% in coming months and growth still below trend, the ECB is unlikely to tighten monetary policy in the very near future.

However, we do think the ECB is sending a clear signal that it will be unwilling to tolerate rising money and credit growth once the economy has gained momentum. With activity data beginning to look more encouraging, we continue to expect the ECB to start raising interest rates in the third quarter.

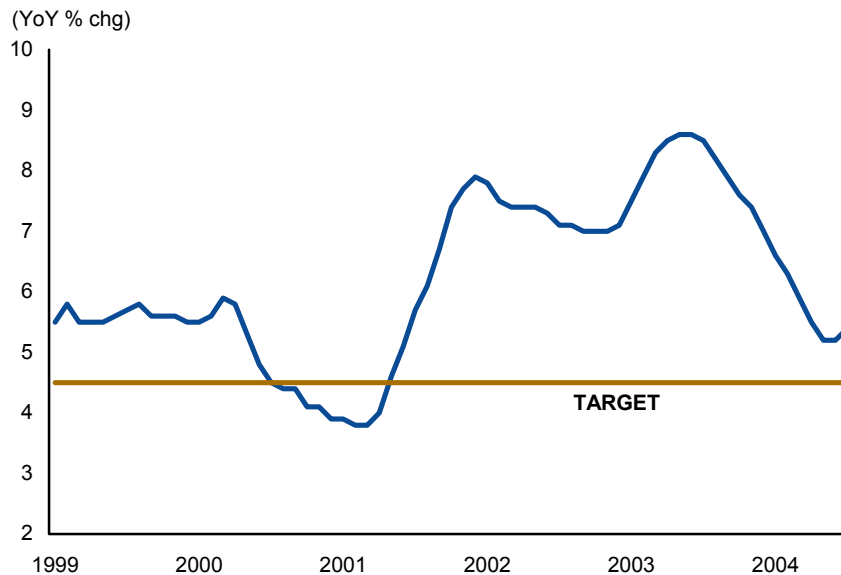
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Display 1: M3 Growth Has Been Persistently Above Target and Has Led to a Build-Up of Excess Liquidity in the Euro Area

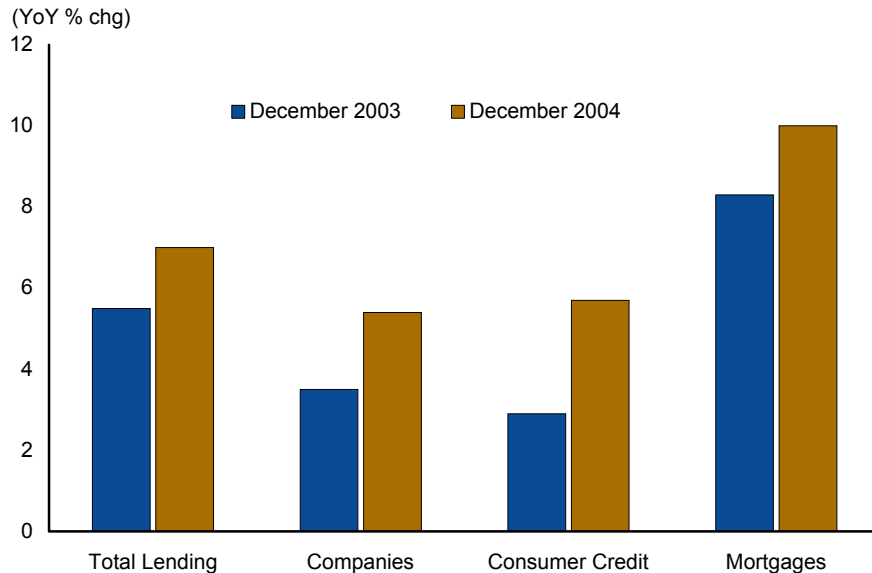
Euro-Area M3 Money Supply Growth Versus Target



Source: European Central Bank and Alliance Fixed Income, February 4, 2005

M3 growth has been above its 4.5% target for almost the whole of the last six years. This has led to the build up of significant excess liquidity, which the ECB believes could represent a risk to price stability over the medium term.

Display 2: Credit Growth Is Rising and Broadening Out Breakdown of Private Sector Credit Growth in the Euro Area

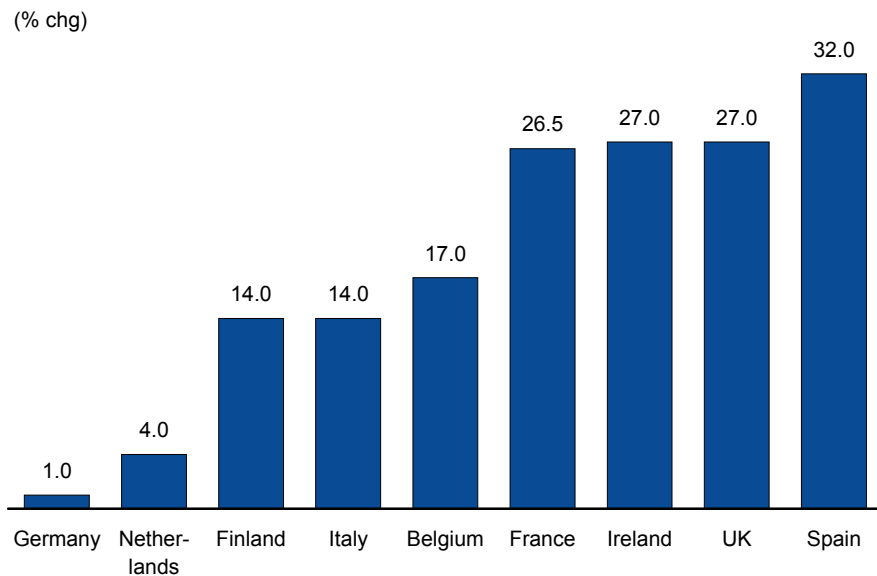


Source: European Central Bank and Alliance Fixed Income, February 4, 2005

Private-sector credit growth has risen strongly in 2004, with year-over-year growth reaching 7.0% in December. The pickup in credit growth is increasingly broadening out and may signal a pickup in domestic demand growth.

Display 3: Strong House-Price Gains Are Evident in Most Euro-Area Countries

Change in European House Prices Between 2002 and 2004

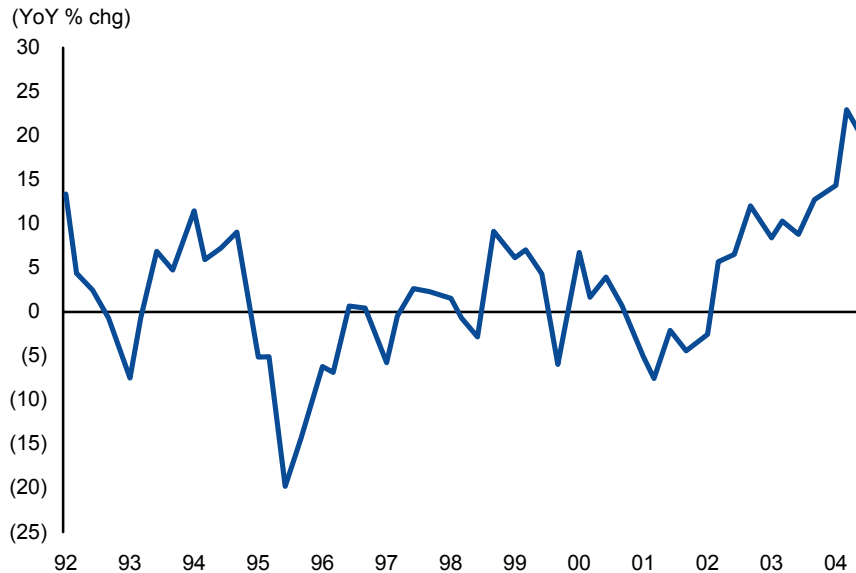


Source: Royal Institute of Chartered Surveyors, February 4, 2005

With the key exception of Germany, house prices are now rising strongly in most euro-area countries. For the euro area outside Germany, we estimate that house prices rose by 10% in 2004 and that they have risen by 80% since the start of EMU in 1999.

Display 4: House Building Is Booming Outside of Germany

House Building Permits in the Euro Area Excluding Germany



Source: Haver Analytics and Alliance Fixed Income, February 4, 2005

It is generally thought that house prices have a lesser impact on the euro-area economy than in countries such as the UK. However, it is clear that house building is booming in the euro area outside Germany.