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GLOBAL ECONOMIC RESEARCH

EUROPEAN ECONOMIC PERSPECTIVES

November 28, 2005

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European Economic Perspectives

After the First Rate Hike: What Happens Next?

After holding interest rates at a record low 2.0% for 30 consecutive months, the European Central Bank (ECB) has signalled its intention to raise interest rates at its meeting on December 1, probably by 25 basis points. This is not surprising given the ECB's heightened concerns about upside risks to inflation and the firmer tone of recent euro-area data. But while an early rate move is now well discounted by financial markets, there is still a big debate about how far and how fast interest rates will rise in 2006.

In recent days, the market has taken some comfort from an interview in which ECB President Jean-Claude Trichet stated that the ECB is "not, *ex ante*, planning a series of (interest rate) rises". But, in our view, it would be unwise to read too much into this. Indeed, Mr. Trichet's comment should be balanced against the ECB's assertion that a rise in rates would only "withdraw some of the accommodation which is embedded in the current monetary stance".

It is significant that the ECB has tried, in the past, to avoid any suggestion that monetary policy is on a pre-determined path. We would read Mr Trichet's comments in this light. Indeed, when the ECB began its last tightening cycle in November 1999, one of the main reasons cited for raising rates by 50 basis points was that a smaller move would have led to intense speculation about further hikes. According to the ECB, this "was precisely a phenomenon which we did not want". In a similar fashion, the ECB also downplayed the prospect of additional rate cuts when it started its last easing cycle in May 2001.

The fact that the ECB is not "planning" rate hikes several months in advance does not mean they will not occur. The ECB will continue to assess whether interest rates are "appropriate" at its monthly policy meetings and will then act accordingly. The fact that the ECB downplayed the possibility of future rate hikes in November 1999 did not stop them raising rates by an additional 175 basis points over the next 11 months (**Display 1**).

A tightening of the magnitude seen after November 1999 is highly unlikely in 2006. Nonetheless, with growth likely to be close to trend in coming quarters, we expect the ECB to gradually withdraw monetary accommodation. We continue to see the refinancing rate at 3.0% by December 2006, slightly higher than markets expect.

A useful guide to the possible scale of future rate hikes in the euro area is the natural, or neutral, level of interest rates. A recent ECB paper concluded that the neutral real interest rate for the euro area has fallen through time and is now slightly below 2%. Combining this with the ECB's inflation target, of below but close to 2%, would give a neutral nominal interest rate of around 3.75%.

Another way of trying to gauge the neutral nominal interest rate is by reference to nominal GDP growth. As **Display 2** highlights, there is a strong medium-term relationship between nominal GDP growth and short-term interest rates in most major industrial countries. Over the last 10 years, euro-area nominal GDP growth has averaged 4.0% per annum and the average short-term interest rate has been 4.1%. Over the next few years, we expect nominal GDP growth in the euro area to average 3.5%, suggesting that the neutral nominal interest rate is also close to 3.5%.

In our view, 3.5% is a good estimate for the euro area's neutral nominal interest rate. Of course, there are many reasons why actual rates can remain some distance from this level for prolonged periods. This has been the case in recent years, with the ECB holding rates well below our estimate of the neutral rate and nominal GDP growth (**Display 3**). But with growth now on a firmer footing, the ECB is likely to favour moving rates back closer to neutral. In this respect, it is worth noting that our 3.0% forecast for the end of 2006 would still leave rates slightly below their neutral level.

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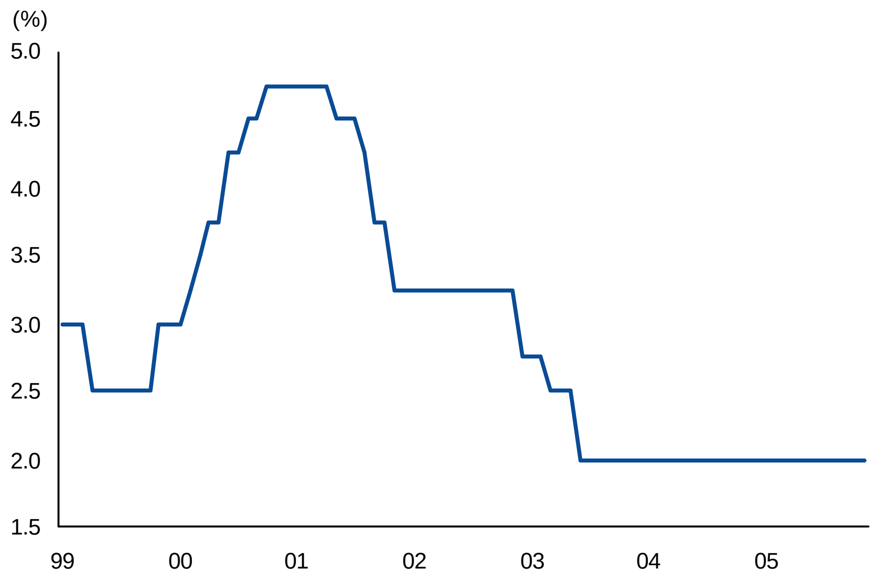
Display 1: Euro-Area Rates Have Been on Hold for 30 Months

European Central Bank Refinancing Rate

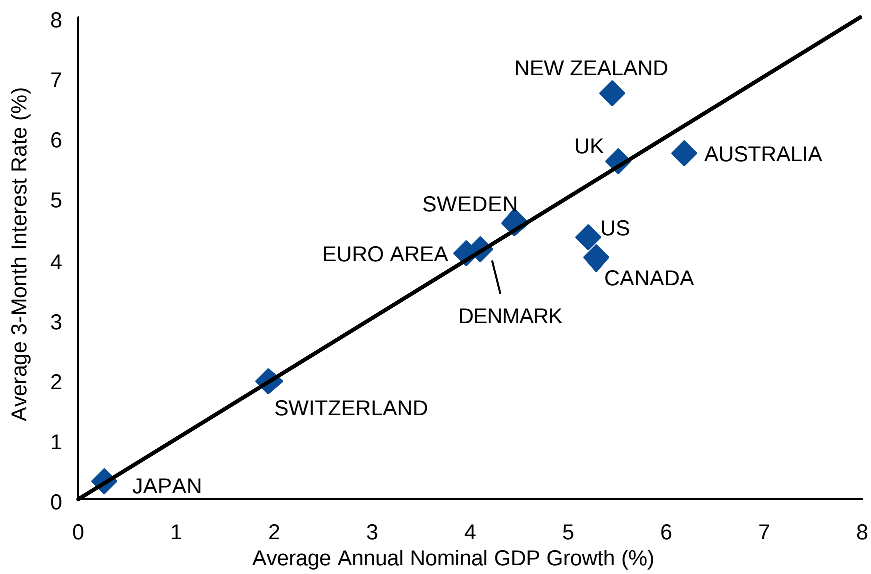


Source: Haver Analytics and Alliance Capital Fixed Income 11/28/05

The ECB's key refinancing rate has been on hold for 30 consecutive months, but a hike looks highly likely in December. The ECB has downplayed speculation that it may be planning a series of increases, but did the same at the start of the last tightening cycle in November 1999. This did not stop rates moving sharply higher over the following year.

Display 2: Around the World, Growth and Interest Rates Are Strongly Correlated

Medium-Term Relationship between Average Nominal GDP Growth and Short-Term Interest Rates (1995–2004 Average)

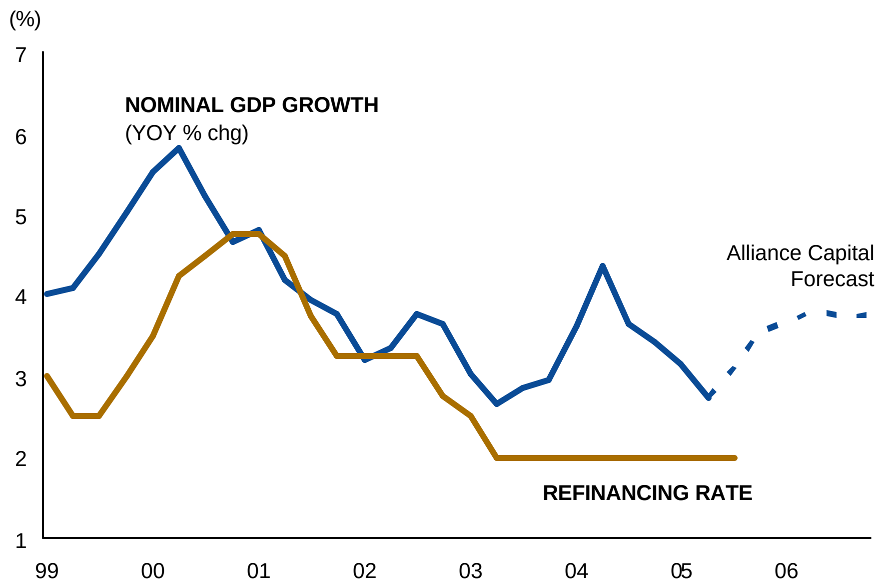


Source: Haver Analytics and Alliance Capital Fixed Income 11/28/05

Over the medium term, there is a strong relationship between nominal GDP growth and short-term interest rates for most industrial countries. Using this analysis, the neutral nominal interest rate for the euro area is probably close to 3.5%, our estimate for trend nominal GDP growth over the next five years.

Display 3: ECB Monetary Policy Has Been Very Accomodative

Economic Growth vs. ECB Refinancing Rate



Source: Haver Analytics and Alliance Capital Fixed Income 11/28/05

In the short term, actual interest rates and the neutral rate can diverge for prolonged periods. This has been the case over the last few years in the euro area. Looking ahead, our view that euro-area growth is likely to remain close to, or above, trend in 2006, suggests that the ECB will start moving rates back closer to their neutral level.