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# EUROPEAN ECONOMIC PERSPECTIVES

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# European Economic Perspectives

## ECB: Rising Concern, But Still Watching The Data

Recent comments from the European Central Bank (ECB) point to growing concern over the long-term risks to price stability stemming from high money-supply growth. However, it is important to put these comments in perspective. The money supply may be telling the ECB that rates are too low from a longer-term standpoint, and it may be right to regard this as an implicit bias to tighten. However, the money supply is telling us little about the shorter-term risks to price stability that will ultimately determine the timing of the first interest-rate hike.

The ECB's monetary-policy strategy is based on two "pillars." The first pillar covers monetary analysis and assesses medium- to long-term inflation trends. The second pillar covers the real economy and assesses short- to medium-term inflation trends. The ECB believes that "cross-checking" between the two pillars gives it a more comprehensive picture of the overall risks to price stability than a narrow focus on real-economy data.

The importance of the money supply in the ECB's decision-making process has varied through time. As the first pillar, the monetary analysis was initially used as the starting point for communications with the public. This changed in May 2003, when the ECB downgraded the role of the monetary analysis, placing it behind the economic analysis during its regular communications.

The rebirth of the money supply is due to a number of factors, not the least being an analysis published last year confirming that the money supply is a powerful leading indicator of inflation over longer time frames. However, this would be of academic interest only were it not for the recent acceleration of M3 and credit growth (**Display 1**).

### What Is the Real Data Telling Us?

The ECB's latest forecasts show inflation at 1.9% this year and 1.6% in 2006. This is broadly in line with its target of "below but close to 2%." Economic growth is expected to average 1.6% this year and 2.1% in 2006. This implies average growth of 0.5% (trend) per quarter this year and a touch higher than this in 2006. If these forecasts are correct, then the ECB is likely to raise interest rates later this year.

However, it is not yet clear that the ECB's growth forecast will be correct. The economy is receiving powerful stimuli from world trade growth and very low interest rates. However, growth is not yet self-sustaining and the economy remains vulnerable to headwinds from higher oil prices and a further appreciation of the euro.

Survey data, such as the Purchasing Managers Index (PMI), are an important part of the ECB's economic analysis. This reflects their close historic correlation with economic growth and the lack of reliable and timely hard data for the euro area. Most of the main surveys currently suggest that growth has recovered from the extreme weakness seen late last year. At the same time, however, they suggest that growth is still running below trend, at around 0.4% per quarter **(Display 2)**.

We have argued in the past that business surveys (as a timely indicator of economic growth) are a better guide to ECB rate decisions than headline inflation. This does not mean that the ECB does not care about inflation. Rather, it reflects the fact that economic growth is a better indicator of future inflation than the current headline rate of inflation.

This point is illustrated in **Display 3**, which plots the manufacturing PMI against headline inflation at the time of ECB interest-rate changes. While there is no consistent relationship between interest-rate changes and inflation, every rate hike has taken place when the manufacturing PMI has been above 55 and (with one exception) every rate cut has taken place with the PMI below 50. At 51.9, the manufacturing PMI is currently in the middle of the neutral zone.

The relationship between the manufacturing PMI and interest rates is not mechanical. Hence, the ECB will not necessarily need to see the PMI move above 55 before raising interest rates. However, the ECB will need to see a sustained improvement from today's levels, and that is likely to be several months away.

## Conclusions

Rising money and credit growth mean the ECB is increasingly uncomfortable holding interest rates at record low levels. As a result, the ECB is likely to raise interest rates later this year if growth develops in line with its expectations. At present, however, growth is still below trend and is not self-sustaining. This makes the economy vulnerable to headwinds such as a rising oil price or a higher exchange rate.

On balance, we continue to expect the ECB to raise interest rates by 25 basis points in the third quarter and by a further 25 basis points in the fourth. As the market is likely to view this as a pre-emptive move, the impact on longer-dated yields is likely to be modest. Nonetheless, we expect 10-year yields to rise to 4.0% on a six-month view, roughly in line with trend nominal GDP growth.

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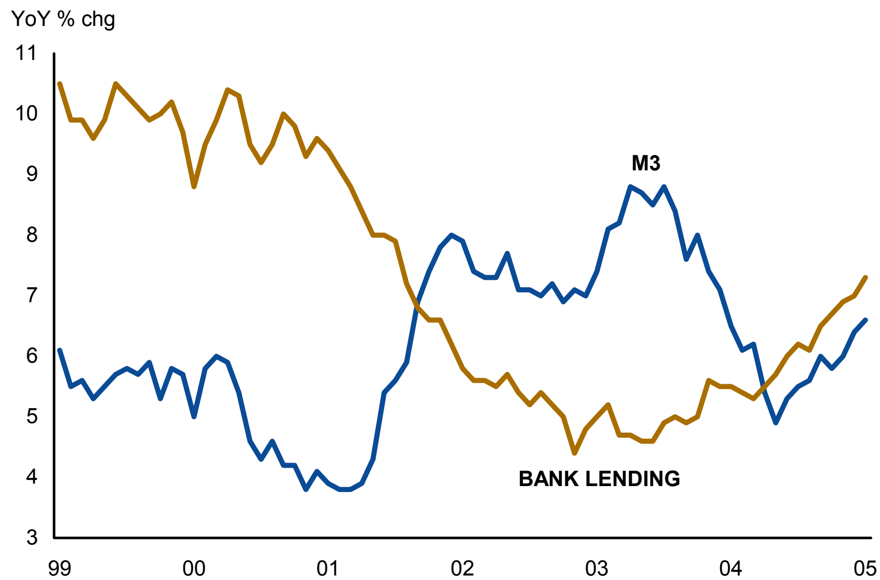
**Display 1: The ECB Is Worried About Rising Money and Credit Growth**
Euro-Area Money Supply M3 and Bank Lending to the Private Sector

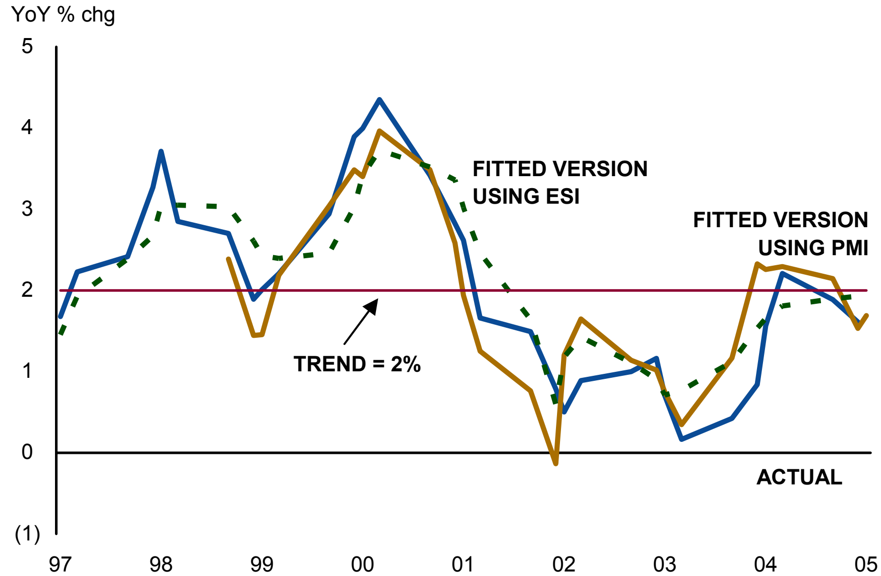



*Source: European Central Bank and Alliance Capital Fixed Income, March 18, 2005*

***The ECB was not too worried about high money supply growth between 2001 and 2003, believing it was in part due to precautionary portfolio shifts out of riskier financial assets into monetary assets. However, it is more difficult to explain the recent rise in M3 growth in this way, as highlighted by a parallel increase in bank-lending growth.***

**Display 2: Survey Data Are Consistent with Growth Just Below Trend**

Euro-Area GDP Growth and Fitted Versions Using Main Survey Indicators



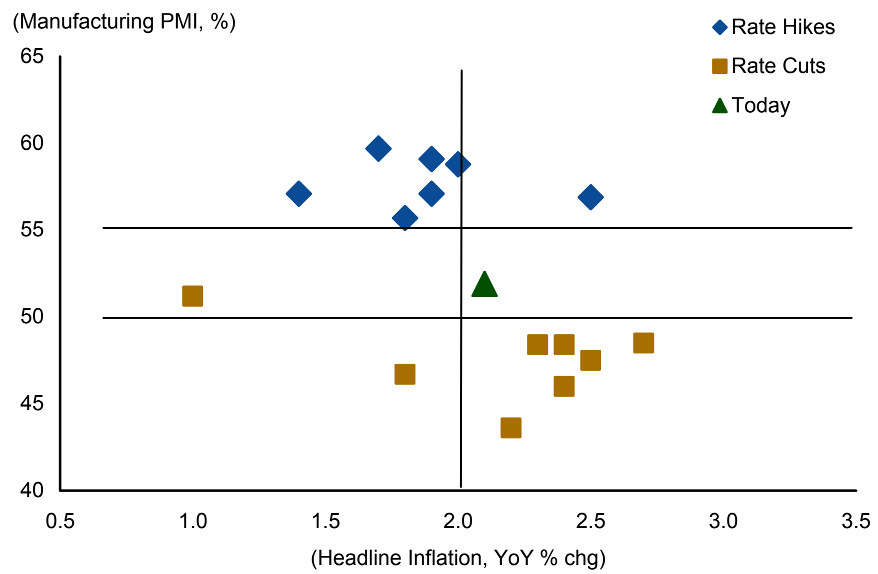

*Note: Fitted version using PMI is a simple regression using the Composite Purchasing Managers Index. Fitted version using ESI is a simple regression using the European Commission's Economic Sentiment Indicator.*

*Source: Haver Analytics, Reuters and Alliance Capital Fixed Income, March 18, 2005*

***Historically, the main business surveys have been good guides to euro-area GDP growth. This, plus a lack of timely hard data, mean the surveys are an important part of the ECB's economic analysis. At present, the main surveys are pointing to economic growth of 0.4% per quarter, which is just below trend.***

**Display 3: Growth Drives the ECB**

The Manufacturing PMI and Inflation at the Time of ECB Rate Changes




*Source: Haver Analytics, Reuters and Alliance Capital Fixed Income, March 18, 2005*

***The manufacturing PMI is a much better guide to ECB rate decisions than headline inflation. At present, the PMI is pointing to unchanged rates. Of course, this is not a mechanical relationship and, given its concerns about monetary growth, the ECB may not need to see the PMI move above 55 before raising rates. However, the ECB will need to see a sustained improvement from today's levels and that is likely to be several months away.***