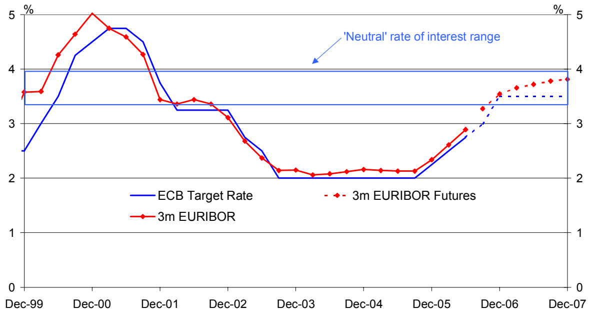
Eurozone Rates, Money and Credit

- ***The ECB Governing Council decided to leave the July key ECB interest rate unchanged at 2.75%, having raised rates by 25 basis points in December, March and June.***

Chart 1: Interest rates and forecasts



- ***Headline inflation is now running at around 2.5%, so the key ECB interest rate is still around zero per cent in real terms.***
- ***Money and credit growth have slowed recently, but is still very strong and the ECB's monetarists believe this will lead to stronger inflation in the medium to longer term. Moreover, this is generating significant (possibly destabilising) asset price growth.***
- ***We therefore expect the ECB tightening to continue with 25 bps rises in August, October and December to take rates to 3½% by year's end – in line with estimates of 'neutral' and similar to the path implied by the futures market.***
- ***Further rate hikes in early 2007 would not be surprising, but the ECB risks tightening into a slowdown.***

Eurozone money is practically free.

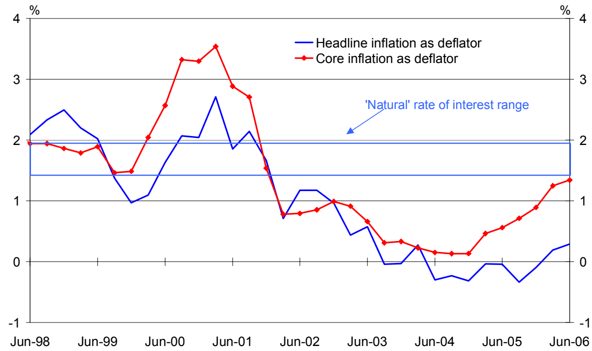
The ECB left interest rates unchanged at the historically low level of just 2% for over two years. They are now at 2.75%, following rises of 25 basis point in December of 2005, and March and June of this year.

Inflation has been over 2% throughout this period and is now running at around 2.5%, which means that real rates have been maintained at around zero.

Clearly, this is a very low rate of real interest – well below the 'natural' range. Indeed, in this sense, money is free in the Eurozone.

Other commentators may point to real rates calculated using core inflation, which is running at around 1.4%, however, the ECB has stated their preference for the headline measure of inflation.

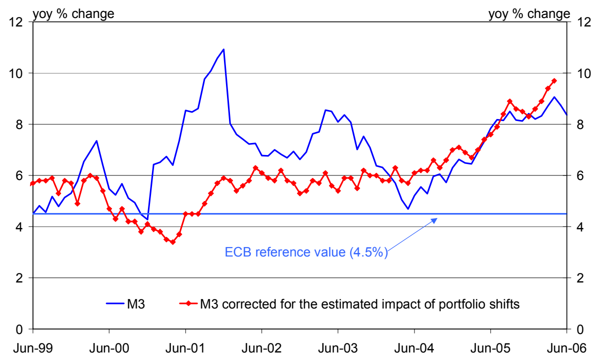
Chart 2: Real interest rates



So monetary aggregates are growing strongly.

The prevailing low level of interest rates has propelled M3 growth well above the ECB's reference rate. The series adjusted for the effects of portfolio shifts continues to accelerate, but the ECB will have been relieved to see yearly M3 growth slow over the past two months. This shows that past interest rate rises have had an effect – six months after they began to tighten, which is in line with our expectations. Nevertheless, both measures of M3 growth are still very strong and the ECB will not be deterred from raising rates further.

Chart 3: Monetary aggregates



Tom Taylor
Head of Economics - International
(613) 8641 3475
Tom_Taylor@nab.com.au

James McKinlay
Economist - International
(613) 8641 4304
James_McKinlay@nab.com.au

National Australia Bank

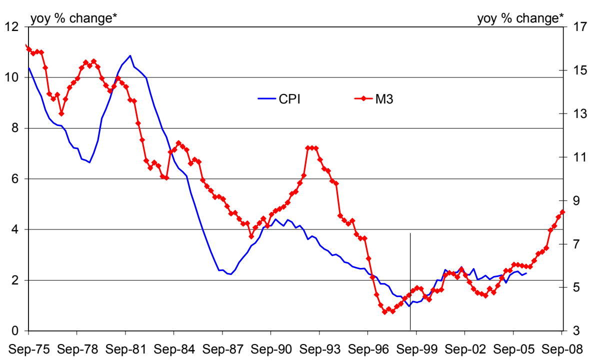
The ECB looks to monetary growth as a precursor to inflation.

The ECB's monetarists look closely at monetary aggregates from the perspective of the quantity theory of money. Making a few assumptions, this says that inflation is determined by money in the long run.

The ECB board and staff look at charts similar to that presented below, which (after some adjustments) shows that monetary growth does broadly lead inflation over the long run.

Indeed, it suggests that inflation will accelerate by up to 2 percentage points. While we do not believe this will be the case, it does point to upside inflation risks and thus the ECB will continue to raise rates.

Chart 4: Inflation and M3



* Annualised eight-quarter growth. M3 is adjusted for the effects of portfolio shifts from the start of 1999, and moved forward by nine quarters.

Low interest rates are also driving rapid credit growth.

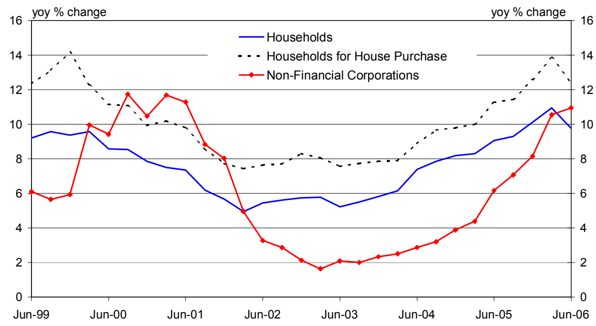
Growth of loans to the private sector slowed from a peak of 11.5% in March, but still remains strong at 11% in June – consistent with the pattern for M3 growth.

Loans to non-financial corporations have accelerated substantially in the past year: from just over 4% at the start of 2005 to over 11% currently. This credit will be largely directed to business investment.

Thus, the overall slowdown was driven by household credit; down from 11% to 9¾% in June. In turn, this was attributable to loans for housing purchases, which slowed from almost 14% to 12.5%.

The ECB will take heart from this result, and it will go some way to allay their concerns regarding house price growth.

Chart 5: Credit

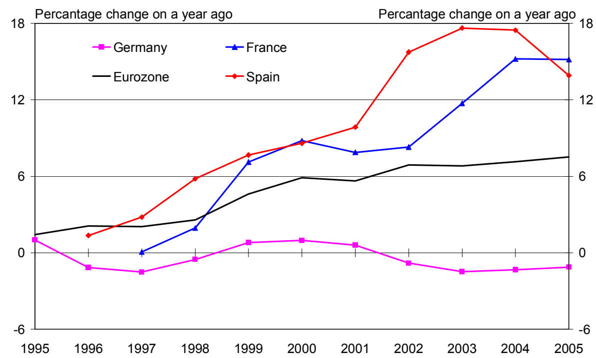


Strong credit growth is driving asset price growth, risking a boom-bust cycle.

Ample credit has seen housing price growth steadily accelerate in the Eurozone for many years to around 7% currently. This is not a worrying number in itself, but some commentators have argued the level of housing prices to be unsustainable.

Moreover, housing markets within some member nations of the Eurozone, such as Spain, have seen housing price growth rocket along at double-digit growth for some time, which is of concern to the ECB.

Chart 6: Housing prices



The ECB will be watching closely to ensure that this asset price growth does not lead to a boom-bust cycle in the Eurozone. They have previously indicated their preference to 'lean against the wind' to deal with such a possibility – i.e. raise rates to slightly above where they'd otherwise be as a precaution.

All of this reinforces the outlook presented by the housing credit numbers: that further rate rises may be expected.

Macroeconomic, Industry & Markets Research

Australia

Alan Oster	Group Chief Economist	+(61 3) 8641 3464
Jacqui Brand	Personal Assistant	+(61 3) 8641 4179
Jeff Oughton	Head of Economics – Australia & Industry	+(61 3) 8641 3469
	Economist – Australia	
Dean Pearson	Senior Economist - Industry & Commodities	+(61 3) 8641 3474
Gerard Burg	Economist – Minerals & Energy,	+(61 3) 8641 3984
John Sharma	Economist – Property, Business Services, TMTs	+(61 3) 8641 3473
Ian Gordon	Economist – Transport, Healthcare, Retailing	+(61 3) 8641 3472
Skye Dixon	Economist – Agribusiness	+(61 3) 8641 3442
Dean Wickenton	Economist – Manufacturing	+(61 3) 8641 3672
Tom Taylor	Head of Economics – International	+(61 3) 8641 3475
Robert De Iure	Economist – Country Risk	+(61 3) 8641 3445
Carolyn Fraser	Economist – International	+(61 3) 8641 3694
James McKinlay	Economist – International	+(61 3) 8641 4304
Robert Henderson	Chief Economist Markets - Australia	+(61 2) 9237 1836
Spiros Papadopoulos	Senior Economist – Markets	+(61 3) 8641 0978
David de Garis	Senior Economist – Markets	+61 (2) 9237 1180

New Zealand

Tony Alexander	Chief Economist – BNZ	+(64 4) 474 6744
Stephen Toplis	Head of Market Economics – BNZ	+(64 4) 474 6905
Craig Ebert	Market Economist – BNZ	+(64 4) 474 6799
Dean Ford	Market Economist– BNZ	+(64 4) 474 6923

London

Tom Vosa	Head of Market Economics – Europe	+(44 20) 7710 1573
Kris Bernie	Market Economist – Europe	+(44 20) 7710 2910

	Foreign Exchange	Fixed Interest/Derivatives
Sydney	+800 9295 1100	+(61 2) 9295 1166
Melbourne	+800 842 3301	+(61 3) 9277 3321
Wellington	+800 64 642 222	+800 64 644 464
London	+800 747 4615	+(44 20) 7796 4761
New York	+1 800 125 602	+1877 377 5480
Singapore	+(65) 338 0019	+(65) 338 1789