



Macroeconomics



Industry & Commodity

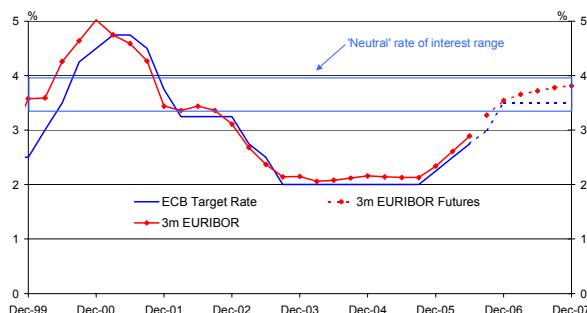


Markets

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.

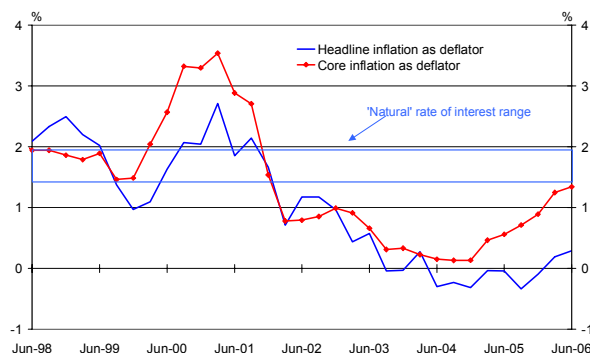
The ECB left interest rates unchanged at the historically low level of just 2% for over two years. They are now at 2.75%, following rises of 25 basis point in December of 2005, and March and June of this year.

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.

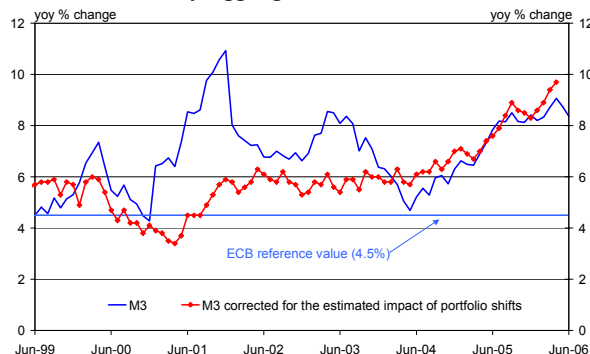
Chart 2: Real interest rates



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



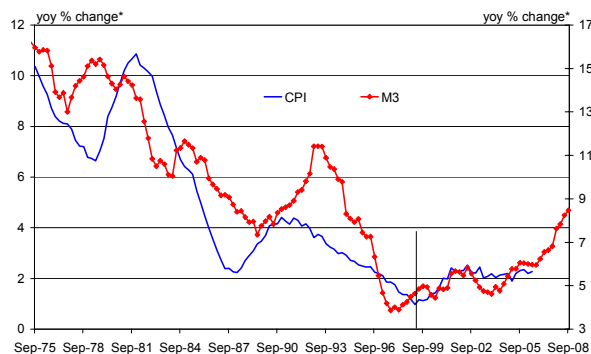
The ECB looks to monetary growth as a precursor to inflation.

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.

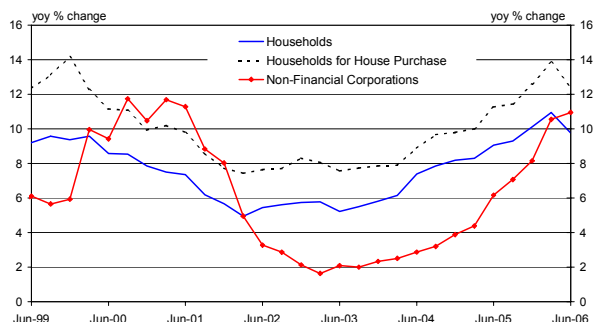
Growth of loans to the private sector slowed from a peak of 11.5% in March, but still remains strong at 11% in June – consistent with the pattern for M3 growth.

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

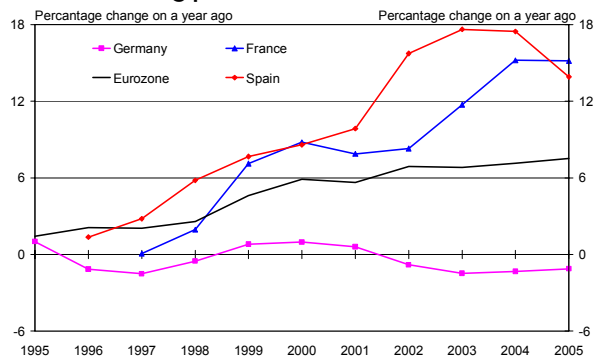


Strong credit growth is driving asset price growth, risking a boom-bust cycle.

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.

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