



Macroeconomics



Industry & Commodity



Markets

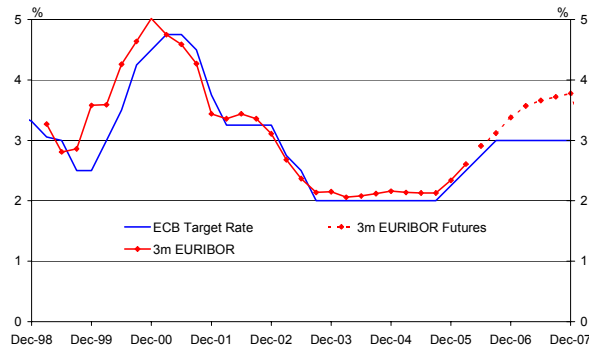
Eurozone House Prices and the ECB

ECB President Trichet hinted strongly that the ECB will next raise rates by 25 basis points in June, which follows 25bps rises in December and March.

Our analysis of the ECB's outlook for economic growth and inflation suggests a further 25bps rise in the September quarter and then the ECB pauses at 3%.

However, the market is pricing in further rises to around 3¾% by the end of 2007. The case for such rises can be built on monetary, credit, and house price growth, and the ECB may raise rates further in 2007.

Chart 1: Market expectations



Some commentators and presumably some within the ECB are concerned that monetary and credit growth will still be too high, even after the rate rises we expect. This could affect financial system and price stability if conditions worsened in future.

They see the potential for this to generate a damaging 'boom-bust' cycle in the housing market.

Central banks can react to such concerns through a number of means. The ECB has expressed a preference for raising rates higher than might otherwise be required, to 'lean against the wind' – i.e. pay the price of slightly lower output in the short term, rather than risk a bust further down the track.

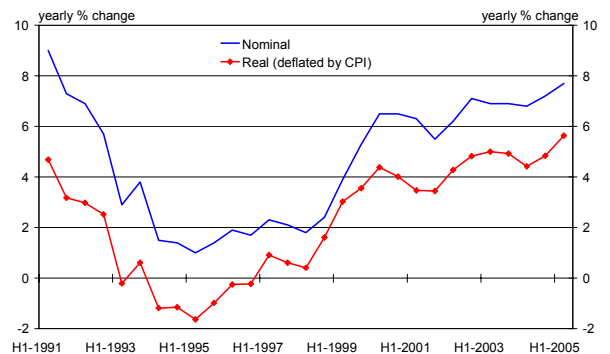
The monetary pillar of the ECB's policy deliberations provides it with an advantage in dealing with these concerns, and provides us with a useful guide to the ECB's likely actions.

We estimate that they will have to lift rates to 3.75-4% if they want to slow M3 growth to the ECB's reference rate of 4.5%.

Determining whether a housing bubble exists is extremely difficult.

House price growth has accelerated consistently for several years, and according to the ECB, it reached 7.7% over the year to the first half of 2005. This is not that fast compared with the rates recorded at times in other markets – such as the UK, Australia and NZ – but it is the highest rate recorded in the Eurozone since the first half of 1991 (when ECB data began).

Chart 2: Eurozone house price growth



Even so, it's still not clear that this represents any cause for concern. Any asset value (and its growth rate) needs to be compared to the future stream of income (growth) – rental or household income in terms of housing.

Calculations, based chiefly on the Bank of International Settlements database, suggest that the Eurozone average house price ratio to per capita disposable income since 1975 is 10.1, whereas the ratio in the second half of 2005 was 10.4 – only a small change.

There are several other factors that should also be considered – assessing housing prices is extremely difficult. Most of these factors were discussed in an ECB article in the February 2006 Bulletin and it didn't really present a case for immediate concern either.

The ECB was only able to surmise that there are 'tentative signs of a growing risk of overvaluation in some regions of the euro area. This calls for a close monitoring of house price developments'.

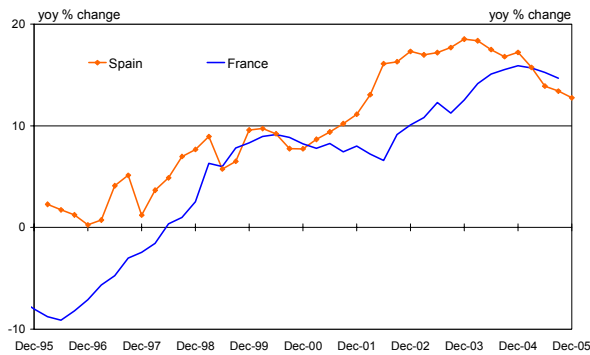
Take note: 'some regions of the euro area'. Commentators have expressed concern over very large rates of house price growth in some member nations, such as Spain and France. However, other nations,

including Germany, have recorded very slow rates of house price growth.

This may be put down to convergence: brought about by the free flow of capital, economic integration, some greater convergence in income levels and the absolute convergence to low levels in interest rates. Such large differences will disappate when this process of convergence is completed.

At any rate, the ECB cannot control for developments in member nations, just as the Federal Reserve cannot concern itself with the different states within the USA – they must look at the overall economy.

Chart 3: Spanish and French house price growth

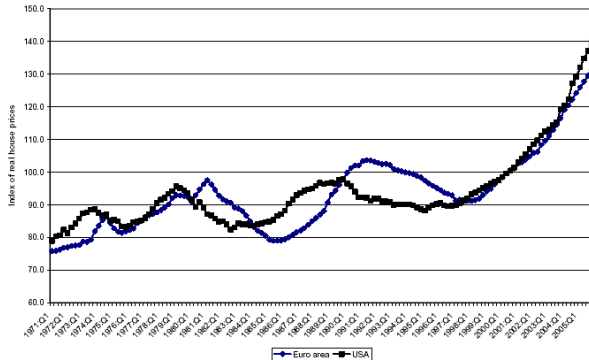


One argument that may hold was presented recently by Daniel Gros of the Centre for European Policy Studies in a working document (No. 239/Feb 2006).

He showed that the Eurozone aggregate index of real housing prices has risen almost as much as that of the US and is about 40% above its 30-year average.

Many commentators have recently suggested that there are risks around the US housing market and therefore the outlook for the US economy. Caveats abound, but this chart does suggest that those concerns may also be valid for the Eurozone.

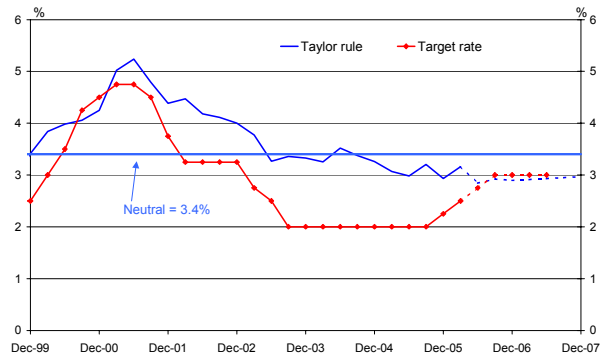
Chart 4: Real US and Eurozone house price levels



The ECB is concerned that they're nourishing house price growth.

We do not know the counterfactual – what growth and inflation would have been without such an accommodative setting – but we estimate that the ECB's monetary policy rate has been around one percentage point (pps) lower than the Taylor rule over the past 4½ years.

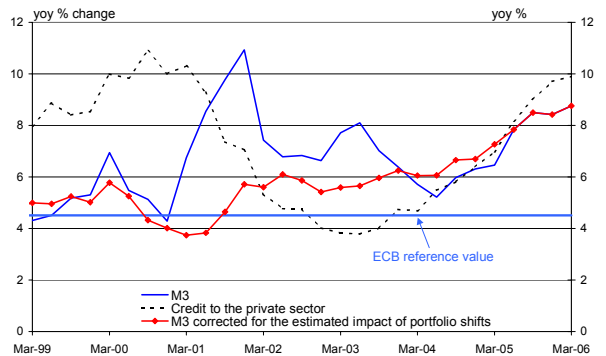
Chart 5: Taylor rule



The ECB had been keeping rates abnormally low as a kind of insurance against the risk of recession. That risk is now far lower, with world growth remaining solid and recent partials and business surveys from the Eurozone all strong.

Such excessive accommodation has helped feed very strong monetary and credit growth. The ECB have previously assessed that M3 growth of 4½% is consistent with stable inflation over the medium to long term. However, M3 growth reached 8¾% over the year by March 2006.

Chart 6: Monetary and credit growth

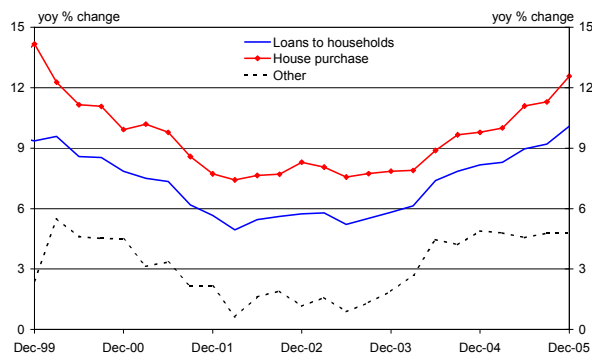


Adding to the concern, credit to the private sector has accelerated, growing by almost 10% over the past year.

It would appear that this acceleration has been largely driven by credit to households for house purchases up by over 12% over the year to December, compared with just over 10% a year prior.

Trichet has made reference to this as a concern: 'the growth of borrowing – especially mortgage loans – remains very robust. In this context, price dynamics in a number of housing markets need to be monitored closely'. Clearly, this credit growth is directly linked to the growth in house prices.

Chart 7: Household credit growth



Further to this assessment, Trichet has stated that 'empirical evidence confirms the link between money and credit developments and asset price booms.'

Trichet went on to state that 'a comprehensive monetary analysis will detect those risks to medium and long-run price stability. The fact that the ECB's monetary policy strategy has this property is, in my view, a significant advantage in light of the current challenges facing modern central banks.'

The ECB will therefore bring rates back to 'normal', and may even choose to 'lean against the wind'.

In this light we should go back to looking at the ECB's conduct in terms of monetary aggregates and credit growth to determine how they'll deal with any concerns regarding house prices.

At the very least, the ECB should to 'normalise' rates – i.e. remove the excess accommodation from the current stance of monetary policy, shown in Chart 5.

Trichet hinted strongly that the ECB would next raise rates by another 25bps in June. We expect a further 25bps rise in the September quarter and then the ECB to pause at 3% till the year's end.

However, they may choose to target M3 growth itself. We estimate that the ECB will have to raise rates to 3.75-4% to pull M3 growth back down to the reference rate of 4.5% – roughly speaking (and it's not strictly linear), a 1pp rate rise lowers M3 growth by 2pps.

It seems that this would be the way the ECB will justify any rate rises above 3%, which may occur in 2007.

Removing the accommodation from policy, and going further to removing accommodation of monetary and credit growth is the first step in the policy of 'leaning against the wind'.

Central banks can react to asset price concerns in a number of ways. There is the orthodox view of assigning no special role for asset prices, targeting asset prices, pricking asset bubbles, or, in the case of the ECB, 'leaning against the wind'. This is the approach they have specifically endorsed in speeches and research papers:

'The leaning against the wind principle describes a tendency to cautiously raise interest rates even beyond the level necessary to maintain price stability over the short to medium term when a potentially detrimental asset price boom is identified.'

'The central bank conducts a slightly tighter policy in order to better ensure price stability over extended horizons by possibly containing the future growth of the bubble - or at least not to accommodate it - than it would otherwise if confronted with a similar macroeconomic outlook under more normal market conditions. By doing so, the central bank would tolerate being significantly below its definition of price stability. This behaviour has been compared to buying insurance against a potentially harmful asset boom-bust cycle, where the insurance premium to be paid is some additional tightening leading to a lower level of inflation than would be required by the monetary policy strategy.'

However, explicit or aggressive 'leaning against the wind' is unlikely. Trichet stated that 'while such a policy is compelling in many theoretical aspects, in practice it is likely that the circumstances in which a policy-maker will embark with confidence upon an explicit leaning against the wind policy will occur rarely.'

**Speech by ECB President Jean-Claude Trichet: Asset price bubbles and monetary policy (08/06/2005)*

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 Economist – Australia	+(61 3) 8641 3469
--------------	---	-------------------

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

DISCLAIMER: "While care has been taken in preparing this material, National Australia Bank Limited (ABN 12 004 044 937) does not warrant or represent that the information, recommendations, opinions or conclusions contained in this document ("Information") are accurate, reliable, complete or current. The Information has been prepared for dissemination to professional investors for information purposes only and any statements as to past performance do not represent future performance. The Information does not purport to contain all matters relevant to any particular investment or financial instrument and all statements as to future matters are not guaranteed to be accurate. In all cases, anyone proposing to rely on or use the Information should independently verify and check the accuracy, completeness, reliability and suitability of the Information and should obtain independent and specific advice from appropriate professionals or experts.

To the extent permissible by law, the National shall not be liable for any errors, omissions, defects or misrepresentations in the Information or for any loss or damage suffered by persons who use or rely on such Information (including by reasons of negligence, negligent misstatement or otherwise). If any law prohibits the exclusion of such liability, the National limits its liability to the re-supply of the Information, provided that such limitation is permitted by law and is fair and reasonable. The National, its affiliates and employees may hold a position or act as a price maker in the financial instruments of any issuer discussed within this document or act as an underwriter, placement agent, adviser or lender to such issuer."

UK Disclaimer: So far as the law and the FSA Rules allow, National Australia Bank Limited ("the Bank") disclaims any warranty or representation as to the accuracy or reliability of the information and statements in this document. The Bank will not be liable (whether in negligence or otherwise) for any loss or damage suffered from relying on this document. This document does not purport to contain all relevant information. Recipients should not rely on its contents but should make their own assessment and seek professional advice relevant to their circumstances. The Bank may have proprietary positions in the products described in this document. This document is for information purposes only, is not intended as an offer or solicitation nor is it the intention of the Bank to create legal relations on the basis of the information contained in it. No part of this document may be reproduced without the prior permission of the Bank. This document is intended for Investment Professionals (as such term is defined in The Financial Services and Markets Act 2000 (Financial Promotion) Order 2001) and should not be passed to any other person who would be defined as a private customer by the rules of the Financial Services Authority ("FSA") in the UK or to any person who may not have experience of such matters. Issued by National Australia Bank Limited A.C.N. 004 044 937, 88 Wood Street, London EC2V 7QQ. Registered in England BR1924. Head Office: 500 Bourke Street, Melbourne, Victoria. Incorporated with limited liability in the state of Victoria, Australia. Regulated by the FSA in the UK.

U.S. DISCLAIMER: This information has been prepared by National Australia Bank or one of its affiliates or subsidiaries (collectively, "NAB"). If it is distributed in the United States, such distribution is by National Australia Capital Markets, LLC (NACM) which accepts responsibility for its contents. Any U.S. person receiving this information wishes further information or desires to effect transactions in the securities described herein should call or write to NACM, 200 Park Avenue, New York, NY 10166 (or call (877) 377-5480). The information contained herein has been obtained from, and any opinions herein are based upon sources believed to be reliable and no guarantees, representations or warranties are made as to its accuracy, completeness or suitability for any purpose. Any opinions or estimates expressed in this information is our current opinion as of the date of this report and is subject to change without notice. The principals of NACM or NAB and/or its affiliates may have a long or short position or may transact in the securities referred to herein or hold or transact derivative instruments, including options, warrants or rights with securities, or may act as a market maker in the securities discussed herein and may sell such securities to or buy from customers on a principal basis. This material is not intended as an offer or solicitation for the purchase or sale of the securities described herein or for any other action. It is intended for the information of clients only and is not for publication in the press or elsewhere.