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MONEY SUPPLY, HOUSE PRICES AND THE ECB

The ECB downgraded the importance of monetary analysis back in 2003, but recently appears to have become more concerned about such developments again. These worries have been driven by a pick up in M3 growth, which has helped fuel a house price boom in some countries. In reality, however, M3 and house prices look very unlikely to push the ECB into raising rates. If the Euroland economy were picking up speed, these factors would undoubtedly encourage the ECB to tighten policy. But, as today's GDP's figures confirmed, it is not. The ECB will be very wary of hiking rates just to burst an asset bubble - particularly one distinctly absent from Euroland's large economy. In fact, recent house price gains are a much needed source of support for a depressed consumer. That said, the boost to spending will not be large, and the weakness of the underlying economy could yet lead to the ECB cutting rates later in the year.

The Monetarist Leanings Of The ECB

The ECB has always placed much more emphasis on monetary developments than most other central banks. Whereas the UK and US effectively abandoned monetary targeting as far back as the 1980s, due to the perceived breakdown in the relationship between money supply growth and economic activity, the ECB has remained true to the ideology of its forebear the Bundesbank. For the first four years of its existence, M3 growth was the central plank of the first of the ECB's two pillar strategy for maintaining price stability. This is maybe not so surprising as Otmar Issing, the ECB's chief economist, harks from the Bundesbank. In defence of its monetarist bias, Mr Issing has claimed that the demand for money in Euroland has remained stable despite the institutional changes associated with monetary union. All the same, in May 2003, the ECB bowed to popular criticism and downgraded the role of monetary analysis somewhat. In theory, it is no longer assigned a “prominent role” in the conduct of monetary policy. Rather “it mainly serves as a means of cross-checking, from a medium to long-term perspective, the short to medium term indications coming from economic analysis”.

In the last few months, however, the ECB has again shown signs of becoming more concerned about monetary developments. This largely reflects the fact that M3 growth has picked up significantly over the last year. The 6-month annualised growth rate was running at 7.9% in December, up from a low of just above 4% last spring. Equally important, the ECB believes M3 growth, which was boosted by investors shifting into liquid assets in 2001-2003, is now being artificially depressed as this switch is reversed. Adjusting for such portfolio shifts raises the annual growth rate of M3 from 6.4% to around 7%, well above the ECB's reference value of 4.5%. The counterpart to this acceleration has been a pick up private sector borrowing. Lending to corporations rose 5.4% y/y in December, while that to households was up 7.8% y/y.

The ECB's long-running worry has been that there is significantly more liquidity available than is needed to finance non-inflationary growth. It is concerned that “should a significant part of this excess liquidity be transformed into transaction balances, particularly at a time when confidence and real economic activity are strengthening, risks to price stability would rise over the medium term”. The implication is that M3 growth on its own is very unlikely to trigger a rate rise. But, if the economy were to pick up speed, it would certainly encourage the ECB to push up rates. However, it remains far from clear that this will happen. Today's Q4 GDP data only emphasised the fragility of the current recovery. Far from picking up again, as many had hoped, Euroland growth slowed further in Q4. GDP rose only 0.2% q/q, after a 0.3% q/q gain the previous quarter. Germany saw GDP fell 0.2% q/q after zero growth in Q3, and Italian GDP also declined 0.3% q/q. In mitigation, this data is all from the rear view mirror and business confidence has picked up in the last couple of months, suggesting a stronger Q1. All the same, this rise in confidence may not be sustained if the oil price continues to rise

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and the euro starts to appreciate again. The weakness of activity in Q4 will also make it that much harder for the ECB to argue that any recovery in growth in Q1 is the start of a more general upswing - rather than just a correction to an abnormally depressed Q4.

Recently, the ECB's concern over M3 has widened beyond the threat to price stability posed by excess liquidity. To quote this month's ECB bulletin, “the combination of ample liquidity and strong credit growth could in some parts of the area become a source of unsustainable price increases in property markets”. House prices are now rising at double digit rates in France, Spain, Italy and Ireland. In reality, however, this housing boom is not likely to be a significant factor driving ECB policy. Recent comments from Otmar Issing suggest the ECB very much adheres to the standard line that central banks should not target asset prices. The rationale here is that it is both difficult to identify a bubble and pop one without risking doing unnecessary damage to the economy. That said, there is an acknowledgement that central bankers should take into account asset price movements, at least to the extent they influence growth and inflation. It is also accepted that central banks should do their best to stop bubbles developing in the first place and limit their effects via appropriate micro-level policies. Unsurprisingly, Mr Issing this week also pointed out that the risks associated with asset price inflation are an important additional reason for paying close attention to money and credit.

A further reason why the ECB is unlikely to become too exercised by rapid house price inflation in some countries is that this house price boom does not extend to Germany, where property prices are flat or down slightly on a year earlier. Just as the ECB takes a determinedly pan-European approach in assessing growth and inflation, it should do the same with house price increases, which remains in single digits for Euroland overall. Even if German house prices were booming, however, this would hardly be a reason for raising rates. These gains might simply bring an end to the inexorable upward drift of the German savings rate, which has been caused by worries over pensions and labour market reform and has helped keep consumer spending so weak.

Indeed, the recent experience of the UK and US might suggest that, far from worrying about the housing boom, the ECB should actually be appreciative of it. Rapid gains in house prices in the US and UK were most likely a major reason why these economies were able to weather the global slowdown of 2000-2002 relatively well. While these two economies are now clearly well beyond the point where further gains in house prices are desirable, Euroland is a long way from that position. The recovery still needs all the help it can get. With fiscal policy turning to a small drag if anything and the euro liable to resume its appreciation, a period of house price inflation should be welcomed. As in Japan - and in contrast to the UK and US - personal savings rates are too high, rather than too low. Moreover, while the structural reform now being seen in Euroland may boost growth longer term, short term it depresses consumer confidence and personal incomes.

As to the risk posed by the build up of consumer debt, this appears small. The ECB itself admits there is limited risk of interest rate rises causing problems on the debt service front. Equally the knock on positive effects on consumption can be over-estimated. The leakage from the housing market to consumption is much smaller in Euroland than in the UK or US, as there is much less ability to borrow against housing equity. All the same, with the European recovery crying out for a stronger consumer, any boost is desirable. While the ECB is very unlikely to come round to seeing the pick up in M3 and the housing market in this light, the weakness of the recovery should prevent any misguided money/asset priced based tightening move from the ECB. Indeed, today's GDP data suggest a rate cut later in the year still cannot be ruled out.