AIB Group Treasury
Economic Services Unit

Why The ECB Is Delaying Eurozone Rate Cuts

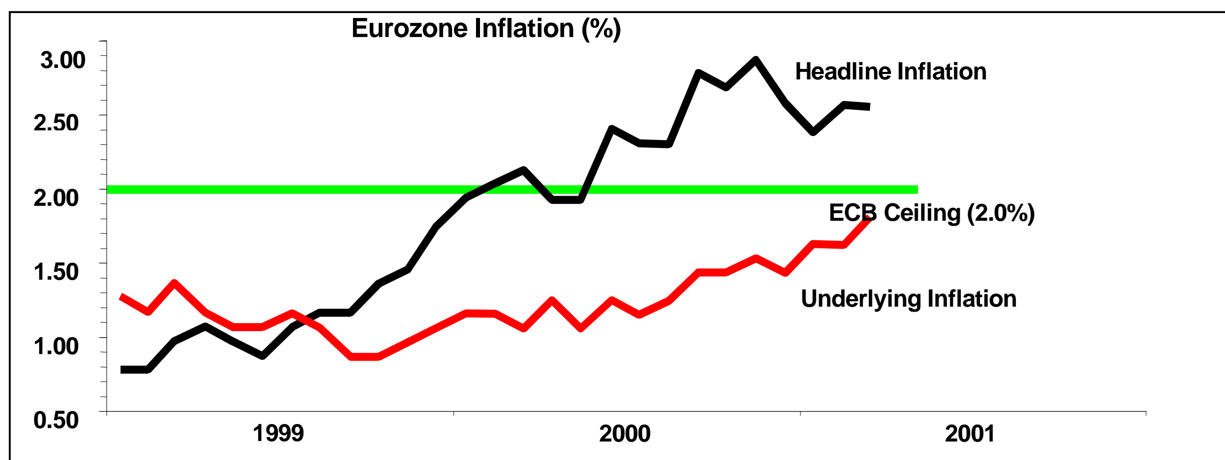
1. Inflation pressures in the eurozone are more acute than anticipated
2. Money supply growth remains above target
3. The euro is still a weak currency
4. Growth is only returning to trend levels

The ECB has stood alone amongst the major world economies in refusing to sanction an easing of monetary policy. In its statements, press conferences and monthly bulletins the central bank has defended its refusal to cut interest rates, a decision that has brought repeated criticism from the US administration, the IMF and European politicians, businesses and trade unions.

The primary objective of the ECB is to maintain price stability. It uses “two pillars” to achieve its monetary policy objective, inflation and money supply. It considers a medium term inflation rate of below 2.0% and money supply growth of 4.5% as being consistent with price stability. The ECB’s sole policy objective is the biggest single difference between it and the US Federal Reserve, which is not only charged with keeping inflation low but also has to maintain a high level of employment and sustain economic growth. Therefore, for the Fed, signs of economic weakness, in the absence of any clear inflationary threat, will provoke a very quick monetary response. The same is not true of the ECB.

Inflation Pressures Are More Acute Than Anticipated

Inflation in the eurozone has been above the ECB’s 2.0% comfort level since July 2000. Over the last year prices have been negatively influenced by the weakness of the euro on the foreign exchange markets and higher oil prices. Contrary to expectations, neither of these pressures have abated. The euro remains weak and on a trade weighted basis is only 2% higher than it was in April 2000.



Oil prices have not eased to any great extent either. In the first four months of last year oil prices traded in a range of $21-$33. For the same period this year, prices have traded in a range of $22-$30, leaving little room for improvement in year-on-year inflation rates. The problem of higher inflation has also been compounded by problems in the food industry with the BSE and foot and mouth crises putting upward pressure on prices. Driven by unexpectedly high prices in Germany and Italy, eurozone inflation in April seems set to rise to 2.8% from 2.6% in March. The ECB had expected that inflation would be back below 2.0% by the second half of this year. It is now saying that it may be early next year before this happens.

The ECB has acknowledged that the risks to inflation are more balanced this year than last. However, with headline inflation stuck above 2.0% and core inflation (excluding food and energy) also rising, the ECB is worried about second round wage effects and as a result is very reluctant to cut interest rates.

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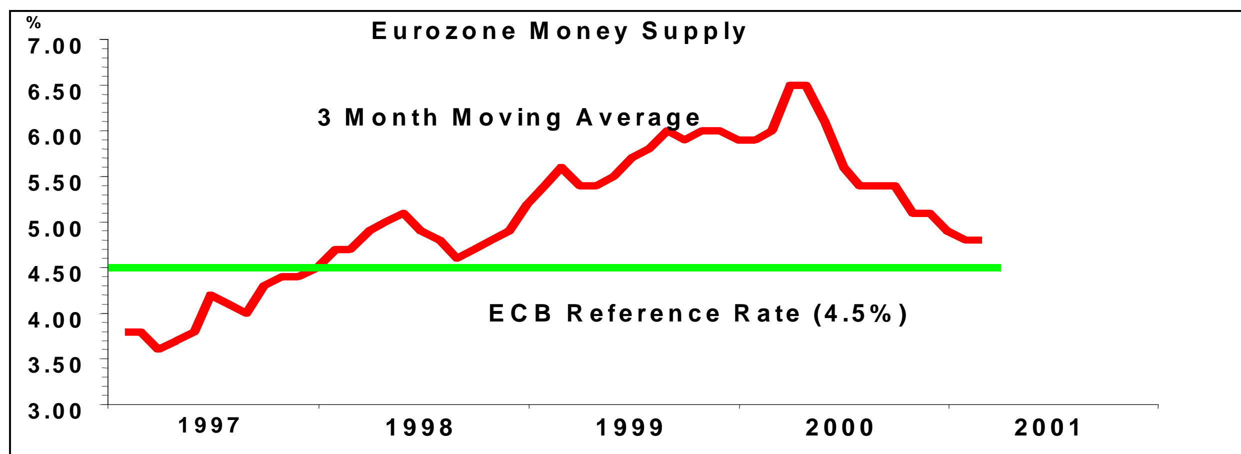
Money Supply Growth Remains Above Target

March's eurozone M3 money supply data also served to underscore the comparatively limited scope for pro-growth monetary easing that the ECB has. M3 growth, a key guide because it signals future inflation risks, accelerated to 5.0% in March from 4.7% the previous month. This was well ahead of a consensus forecast of a slowdown to 4.4%. The more closely watched three-month moving average remained unchanged at 4.8%, still above the ECB's 4.5% reference rate. The central bank said that it had taken the data into account when leaving rates unchanged at its last meeting on 26 April.

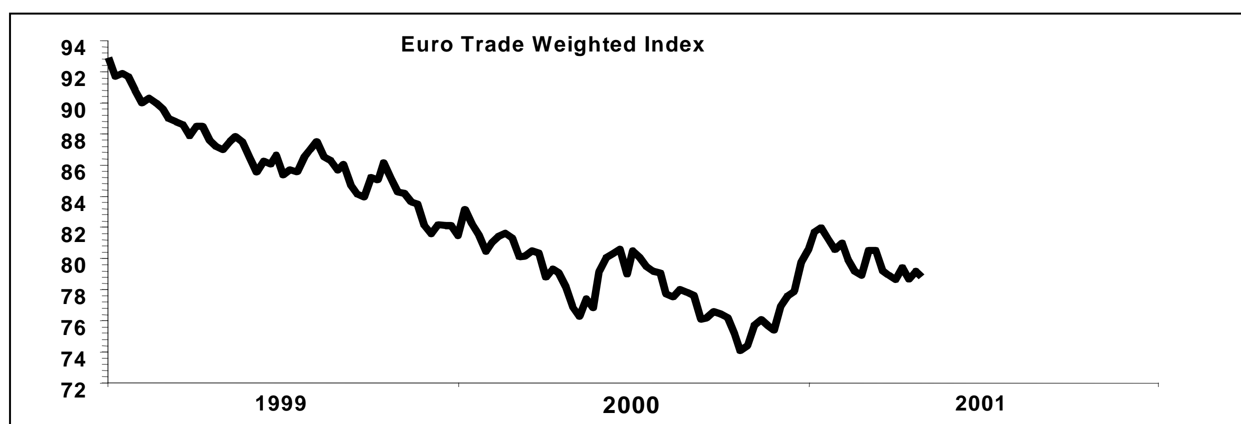
Still, the month-over-month rise in M3 was due entirely to higher short-term deposits (+0.6%) and to marketable instruments (+2.0%). This increase may reflect the shifting of money from the shaky stock markets to liquid instruments. Also, both of these may contain a significant amount of money held by non-eurozone residents. Thus, the March M3 figures may be exaggerated somewhat, as previous months' data have been. A possible revision of the statistical calculation of M3 to exclude holding by non-eurozone resident, could result in a significant downward revision of M3 growth, but is not expected to be released until later this year.



The Euro is Still a Weak Currency

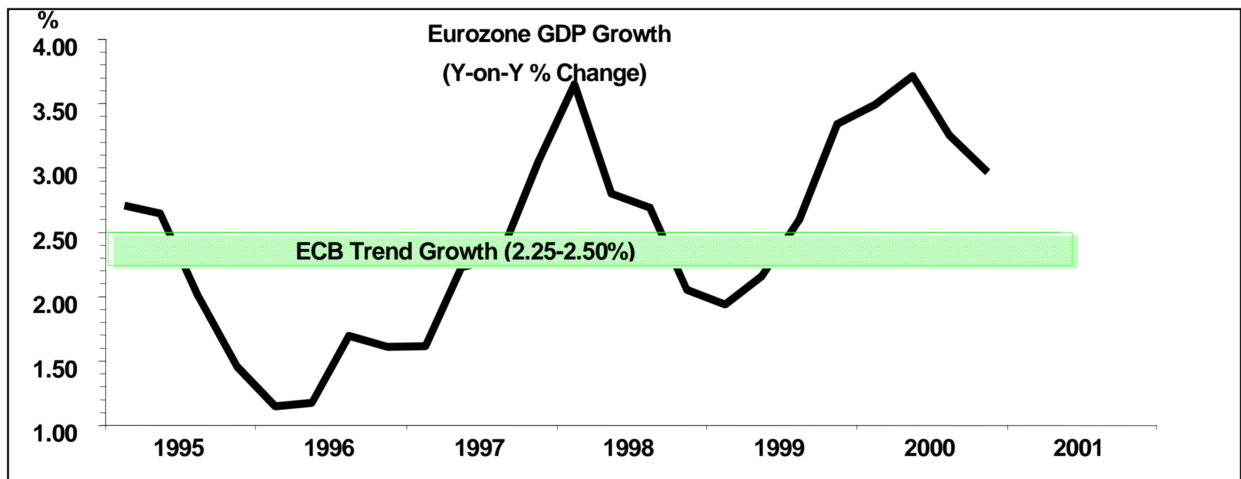
Monetary conditions in the eurozone have eased significantly since the inception of the EMU, mostly as a result of the depreciation of the euro. The USD/EUR rate euro traded around $0.89 during the month of April, about a cent lower than its average rate for the previous six months. A stronger currency would have afforded the ECB greater opportunity to ease interest rates.

Official interest rates in the eurozone were increased by 1.75% in the period November 1999 to October 2000. Over the same period the euro lost just over 10% of its value on a trade-weighted basis. The weakness in the euro means that much of this interest rate tightening was offset by the depreciation in the currency. Using a monetary conditions index (1) of 8:1 (i.e an eight percentage point change in interest rates is equal to a one percentage point change in the exchange rate) the 10% depreciation in the value of the currency equates to a 1.25% drop in rates. As the ECB believes that monetary conditions are not overly restrictive this provides a further rationale for why it has been so reluctant to reduce rates.



Eurozone Growth Only Returning to Trend Levels

The ECB believes that the trend growth rate for the eurozone is 2.25-2.50% and therefore views the recent slowdown in growth as a positive rather than a negative development. Monetary policy is not the appropriate tool to enhance growth potential. What is needed is a more structural reform-orientated policy. (This has been particularly lacking in the German economy). The responsibility for this lies with governments, as well as with the key national economic agents on the side of labour and industry. To increase potential output growth comprehensive structural reform policies aimed at an increased labour market participation rate and improved investment incentives are required. The still high level of unemployment calls for ongoing policy efforts to remove structural rigidities from the labour markets and to diminish adverse incentives provided by tax, benefit and pension systems.



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(1) A monetary conditions index is a weighted average of an interest rate and an exchange rate. It assesses the size of the impact of interest rates relative to the exchange rate. The value of this ratio varies inversely with the degree of openness of the economy, i.e. the more closed the economy is the less important is the impact on aggregate demand of changes in the exchange rate.