# ECOMENTARY™



## Immediate Easing of ECB Monetary Policy Not Likely

**Policy Statements from three sources in prior week suggest strong ECB reluctance**

Duisenberg Speech to the IFO Conference in Munich 6/26

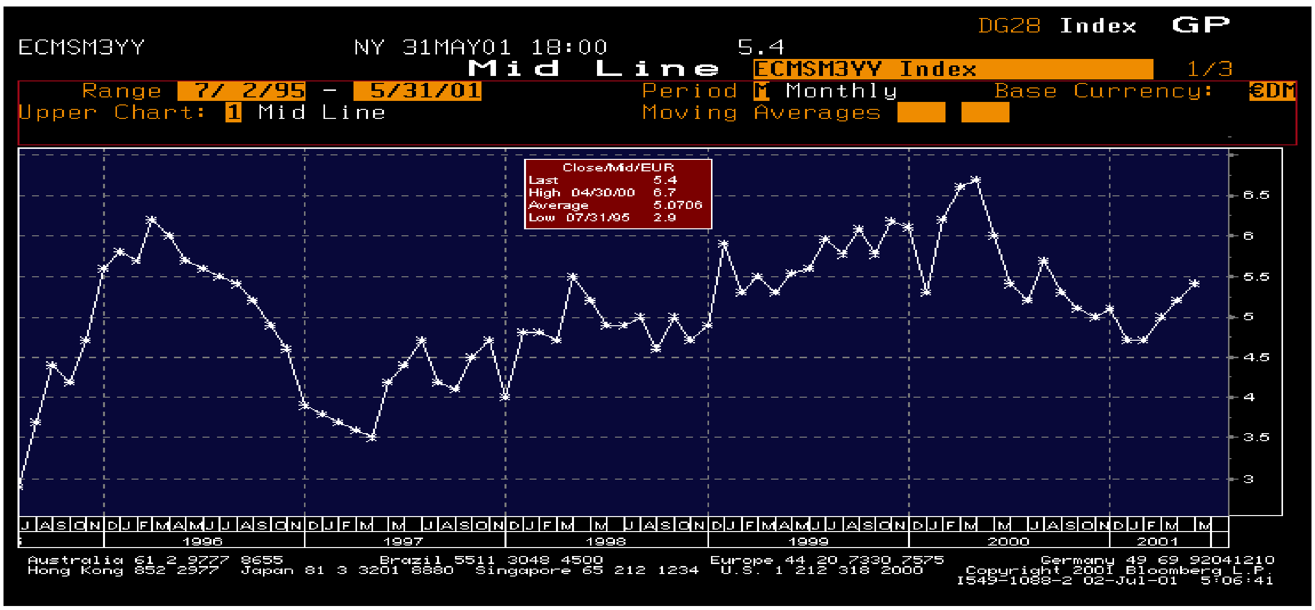
IMF Mission Statement on Euro Area 6/27

Issing Statements at the Austrian National Bank 6/29

**Look at the behavior of Euro Area HICP for the Signal to further ECB easing**

**Hear but not listen** was the claim of the ECB. Some thought it was a basis to charge the ECB with poor monetary policy management. Duisenberg laid out a reasonably clear analysis of the ECB position in his June 26th speech to the IFO conference in Munich. In that speech, he emphasized the critical role played by chianges in M3, but also the context in which such changes are interpreted by the ECB Governing Council. This continues the earlier efforts on the ECB to distinguish between euro-area resident holders of M3 and holdings of non-residents. It had appeared that the rate of M3 growth, and the adjustments that the ECB wishes to make to M3 would allow the ECB an opportunity to move toward an easing pattern. **"The reference value for M3 constitutes the anchor for the analysis and communication of monetary developments in the euro area,"** and then he went on to set this into the context of both the interpretation of changes in M3 and the connection between changes in M3 and the ECB's preferred measure of inflation. The problem of easing at this point was intensified when the already increasing rate of growth of M3 jumped in May to 5.4%!

**YEAR ON YEAR % CHANGES IN EURO M3**.



The IMF consultation statement of June 27th suggested that the ECB was carrying out its monetary policy mandate effectively**. "And monetary policy acted properly, first to raise interest rates to preserve price stabiity and, in May, to ease as prospects for medium-term price stability improved in the face of slackening M3 growth, continued wage moderation, and softening activity."** So said the IMF Mission reviewing economic policies of the Euro Area on June 27, 2001.

In our view, this provides more than sufficient cover for the ECB to delay any easing at its July 5th meeting, if it so chooses. In spite of the fact that the IMF stressed a need "for a pragmatic application of the underlying policy frameworks…," it is "a turning point in HICP inflation that will support the expectation of headline inflation falling below 2 percent next year and allow room for an interest rate cut."

The IMF hopes that the turning point will soon be reached that would allow a change, but it does not wish to be fully chained to the first pillar of ECB monetary policy**. "Alternatively,a further weakening of prospects would also warrant monetary action , even if the inflation turn-around proved relatively slow in coming." (emphasis added).**

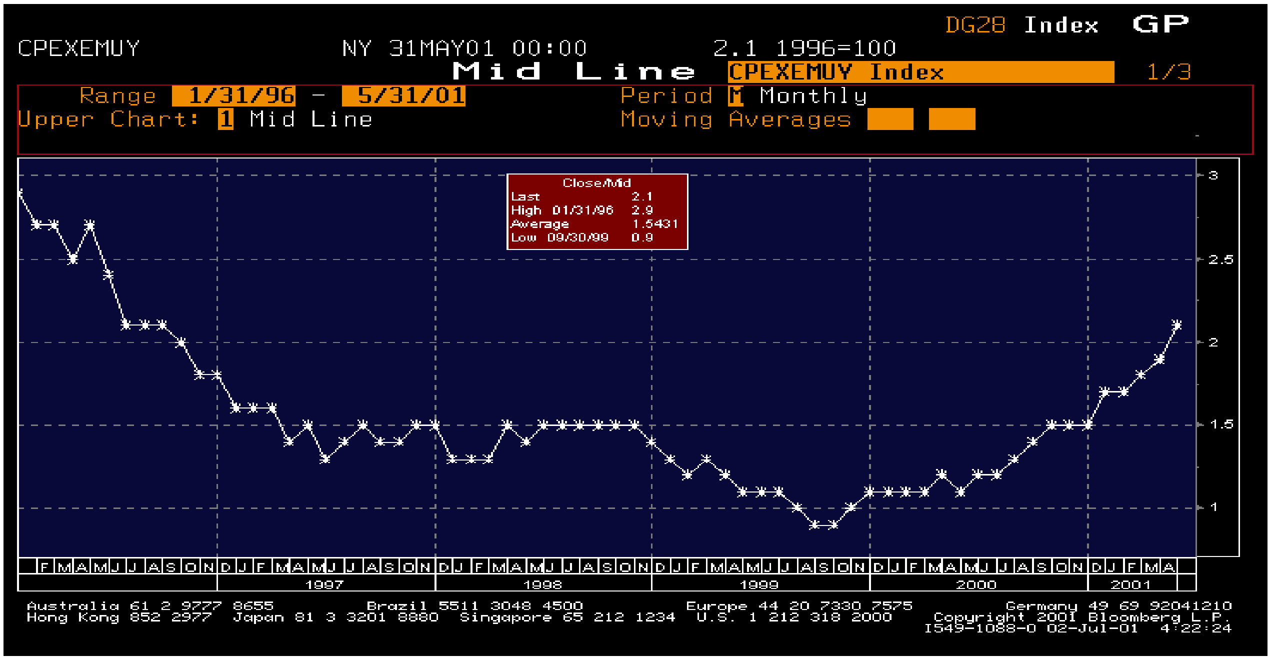
**Thus, at the end of the day, we are back to the same conflict between evidence between the two pillars.** It is clear that at least some of the Governing Council are opposed to a loosening at this date. While it is true that both the ECB and the IMF forecasts of last December underestimated the impact of the slowdown in the U.S. on the Euro area, the recent 3.4% annual percentage change in headline inflation is a sufficient stop sign on the road to ECB easing on July 5. Perhaps the recent energy price weakness will lessen top line inflation at shortly, and wage restraint in Europe is being praised by ECB officials, but it does not seem they are ready to follow the Fed into an easing pattern…as yet.

The broad-based pattern of increased top line inflation in the Euro Area has caused serious alarm bells to ring in Frankfurt. Even though the ECB's prime monetary indicator of future inflation (M3 % Change) seemed to be declining---particularly when adjusted for holdings by non-Euro area residents---it suddenly popped upwards to 5.4% on the last reading. Having made so much of the indicator of future inflation and not having achieved a compelling explanation of how the non-resident adjustments could do a better job of predicting future inflation, the ECB finds itself hoist on its own pre-occupation with top line inflation. While pre ECB meeting statements by Dr. Otmar Issing of the Governing Council have sometimes trapped observers into thinking that the ECB would not cut (e.g. the May 10th surprise), in Vienna on June 29th, he laid the inflation issue fairly clearly. **"this increase in prices, which is influenced by factors "[monetary policy cannot control] "is making us concerned. We will do everything to bring the rate of inflation down over the medium term."** And later, he issued the perhaps more optimistic and forward looking anticipation of a cooling of inflationary pressures, by saying **"The inflation rate in May of 3.4 per cent reached its peak." (**Quoted in Bloomberg News Service reports)

Some have argued that a hedonic measure of prices would be better, but that is not what is on the table. What is, discourages the ECB. Below, we show both the percentage changes on year-on-year basis and the monthly variation. The former read 3.4%, far in excess of the desired 2% maximum so often stated by the ECB. The latter gave some hope for the future, with the slight reduction in the monthly increase on a month-on-month basis. Some, but not sufficient, in our judgment at this moment.

Taken in conjunction, however, with the IMF consultation report, the forecast weakening of GDP in Europe, largely attributed now to the weakness in the U.S., will continue to produce criticism of an ECB policy process that allows the first pillar to dominate considerations of the second. The heat will grow on the ECB. Clearly, the Governing Council is betting that the inflation numbers get better and that they will get a better handle on M3 held by residents. That would make a move downward in rates easier. They are in agreement with European politicians on one score, the faster the better. We will take another look in two weeks.

## EURO- AREA YEAR ON YEAR TOP LINE INFLATION




## EURO- AREA MONTH-ON-MONTH TOP LINE INFLATION