

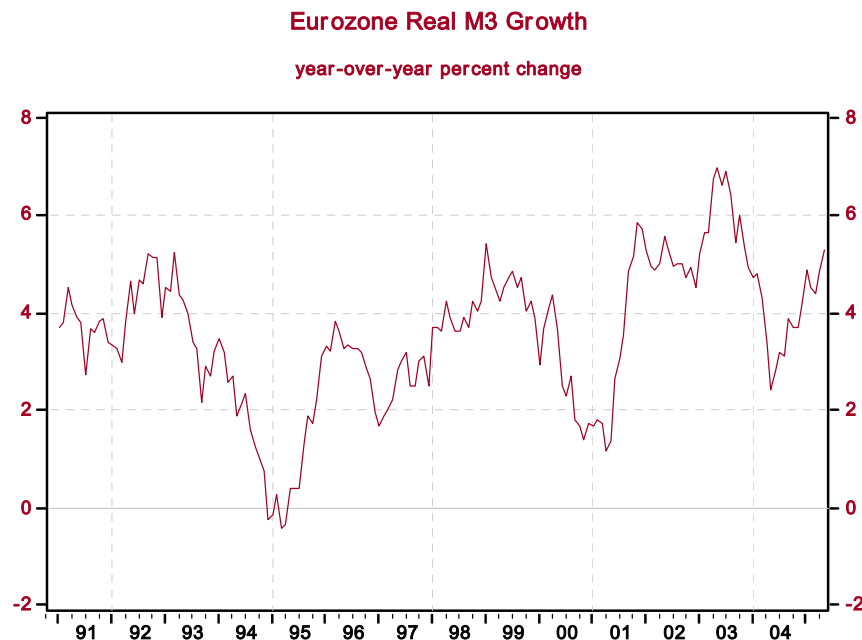


Is Restrictive Monetary Policy What Ails The Eurozone?

The eurozone economy is struggling. Political pressure is mounting to persuade the European Central Bank (ECB) to cut its policy rate from its current level of 2%, the implication being that eurozone monetary policy is restrictive. Is it?

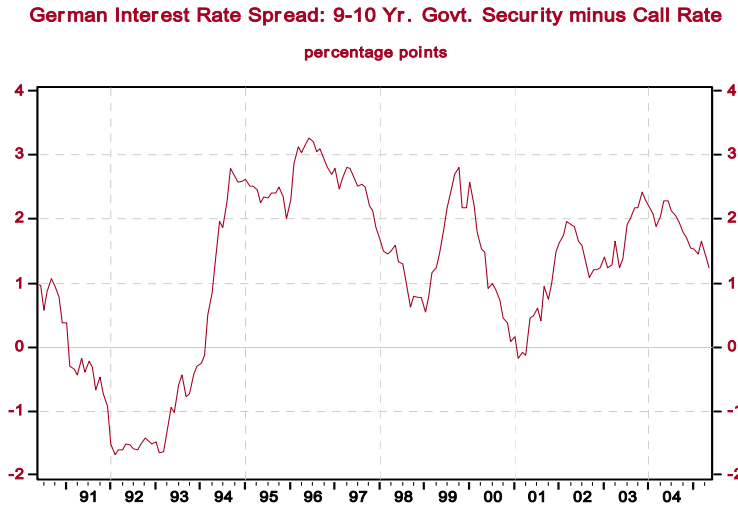
Let's examine three common indicators of the thrust of monetary policy – real money supply growth, the spread between the yield on a government bond and the central bank policy rate, and the inflation-adjusted policy interest rate. Plotted in Chart 1 is the year-over-year percent change in the eurozone nominal M3 money supply minus the year-over-year percent change in eurozone all-items CPI. In May 2005, the year-over-year growth in the eurozone real M3 was 5.3%. In May 2004, the year-over-year real M3 growth was only 2.4%. So, eurozone real M3 growth is trending higher and, as shown in Chart 1, is not currently low in an historical context.

Chart 1



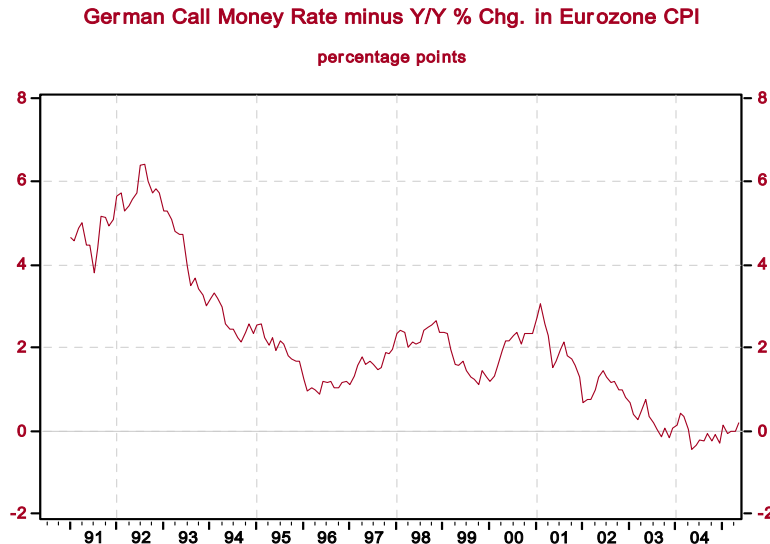
What about the spread between the eurozone 10-year government bond yield and the ECB policy interest rate (hereafter referred to as the "spread")? Because the ECB policy rate has a short history, I have substituted the German call money rate for it in calculating the spread. (The correlation between the two is 1.00.) Also, I have substituted the yield on German government 9- to 10-year bonds for the eurozone 10-year bond yield. The spread is shown in Chart 2. In May 2005, the spread was 123 basis points. Although the spread is down about 100 basis points from year ago, still, in an historical context, it is not signaling an overly restrictive monetary policy.

Chart 2



Lastly, what about the inflation-adjusted ECB policy interest rates? Again, because of a longer history, I am using the German call money rate as a substitute for the ECB policy rate. In May, the call money rate was 2.07%; the year-over-year increase in the eurozone all-items CPI was 1.90%. Hence, the inflation adjusted interest rate was a mere 0.17%. As Chart 3 shows, this inflation-adjusted call money interest rate has been trending lower since 2001 and is low in an historical context.

Chart 3



Although it is not clear that the ECB will be able to withstand the political pressure being applied to it to cut its policy interest rate, the indicators of monetary policy discussed above send the message that it is **not** an overly restrictive ECB monetary policy that ails the eurozone economy. But, in today's anchorless fiat money global monetary system, governments and voters have been conditioned to expect that all economic challenges can be overcome by central banks simply "printing" more money. When and how will it end?

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