15:14 27Sep2005 UPDATE 1-Euro zone money supply accelerates in August

(Adds ECB Observer comments, market details, recasts)

FRANKFURT, Sept 27 (Reuters) - Money supply growth in the euro zone hit a two-year high in August, underscoring European Central Bank policymakers' fears of rising inflation pressures down the track.

The stronger-than-expected rise in monetary aggregates and a surprise improvement in German business confidence helped to heighten market expectations of an interest rate rise, although no change is expected until next year.

Economists said the data confirmed the ECB was more likely to tighten monetary policy than loosen it, but said the central bank would not tinker with its historically low 2 percent rates until the real economy improved.

"The fast pace of euro zone M3 growth must be causing sleepless nights at the ECB," Bear Stearns European economist David Brown said.

"It'll be used by hawks to try to switch tightening monetary policy much sooner than the market thinks. The problem is that the real activity indicator doesn't support it. It's an irresolvable loop."

ECB figures on Tuesday showed annual money supply, including cash and short-term bank deposits, grew 8.1 percent in August, from 7.9 percent in July. The last time annual growth was faster was in August 2003, when it hit 8.4 percent.

Credit growth also accelerated. Loans to the private sector picked up to 8.4 percent in August, from 8.3 percent in July, while loans to households rose 8.6 percent and borrowing to buy houses was up 10.7 percent compared to the previous year.

INFLATION RISK

ECB policymakers have recently stepped up warnings about the risk of money supply feeding into inflation, which is already under pressure from high oil prices, and said strong lending may fuel unsustainable house price rises in some countries.

Money supply has been growing faster than the ECB's 4.5 percent reference rate for four years now and a group of German ECB watchers said time was running out.

Research published in the latest ECB Observer bulletin, released on Tuesday, showed strong money supply growth tended to lead to higher inflation six years later.

Barclays Capital economist Thorsten Polleit and academics Ansgar Belke, Wim Koesters and Martin Leschke said the ECB should start raising rates towards a more neutral level of 3.5 percent.

"In view of a very high stock of excess liquidity -- which is growing at fairly strong rates -- and buoyant bank money creation, the policy recommendation for the ECB is to bring interest rates back from their exceptionally low levels."

Money markets are now pricing in a 70 percent chance of the ECB raising rates by June 2006, having discounted virtually no chance a few weeks ago.

Yields on the interest-rate sensitive two-year German Schatz tested six-week highs after the release of the money figures and Ifo's confidence indicator.

"Coming after Germany's September consumer prices rose by their fastest in four years, this will make the ECB more concerned about inflationary risks," said Jason Simpson, bond strategist at ABN Amro.

But other analysts said the ECB was unlikely to act on its warnings about inflation risks.

"The figures confirm the next move (for the ECB) is up but they don't tell us anything about the timing," said Citigroup economist Jose-Luis Alzola.

"They are not enough for them to hike rates immediately, the timing depends more on growth, the inflation projections that they have."

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