

17:03 29Nov2006

Monetarists urge 4% ECB rates, see more inflation

FRANKFURT, Nov 29 (Reuters) - The European Central Bank should raise interest rates to 4 percent to counter inflation pressures driven by too much money in the economy, a group of German economists said on Wednesday.

Based on recent growth in money and credit, euro zone inflation is likely to run at 2.3 percent in 2007 and 2008, above the ECB's 2 percent tolerance threshold, said the ECB Observer panel, monetarists who have been analysing ECB policy since 2001.

"ECB monetary policy remains very expansionary," the panel said. "We recommend raising ECB rates further to around 4.0 percent ... reducing credit and money supply, thereby dampening inflationary pressure."

The ECB's benchmark rate currently is 3.25 percent and the central bank is expected to raise rates again next Thursday to 3.5 percent, but has given few hints about 2007.

Monetarists believe money and credit growth, rather than the amount of spare capacity in the economy, are the main determinants of inflation over the medium term.

Monetary analysis is one of the two "pillars" of ECB policy-making, while the U.S. Federal Reserve focuses almost wholly on real economic data like growth and unemployment.

At a recent ECB conference on money, ECB Vice-President Lucas Papademos said monetary analysis might one day be subsumed into a general economic model, while Governing Council member Christian Noyer said noise made money data difficult to read.

"I was somewhat horrified in this conference when they suggested that money demand might not be stable," said Thorsten Polleit, a panel member who lectures at Frankfurt's HfB business school and is an economist at Barclays Capital. Unpredictable demand would make money supply a poor guide to inflation.

ECB Executive Board member Juergen Stark on Wednesday also expressed some concern. "We have a two-pillar strategy which is understood more and more by market participants but not in academic circles," he told an investment seminar.

Polleit said money demand could be forecast well and money supply showed a good correlation with inflation over the past 30 years.

However since the mid-1990s, M3 -- the ECB's preferred measure of money supply -- has shown a stronger correlation with house prices than with consumer prices, the panel said.

Rather than making M3 irrelevant, this meant the ECB needed to focus on asset price inflation as well as consumer prices.

"The problem is not M3 but how to define inflation," said Polleit, who was speaking in a private capacity.

To resolve this, the ECB should work on an inflation index including assets like property which affect the cost of living, or develop a separate asset price index, the panel recommended.

((Reporting by David Milliken; Reuters Messaging: david.milliken.reuters.com@reuters.net; david.milliken@reuters.com; +49 69 7565 1209; editing by Ruth Pitchford))

Keywords: ECB/OBSERVERS

Wednesday, 29 November 2006 17:03:21RTS [nL29461969] {C}ENDS

David Milliken

ECB Correspondent

Reuters

Reuters Messaging: david.milliken.reuters.com@reuters.net

(t) +49 69 7565 1267 | (m) +49 172 662 5351 | (f) +49 69 752 840 Get the latest news at
Reuters.com