

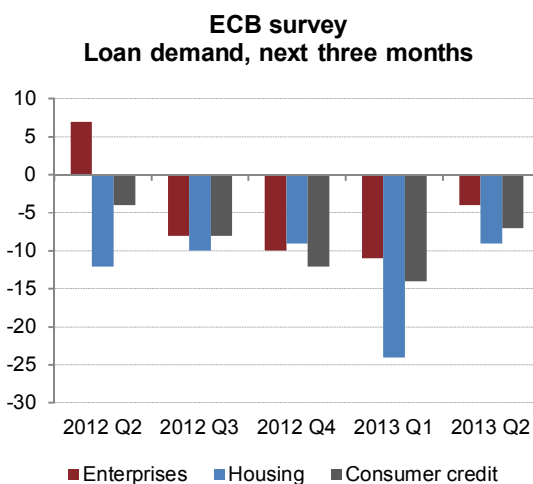
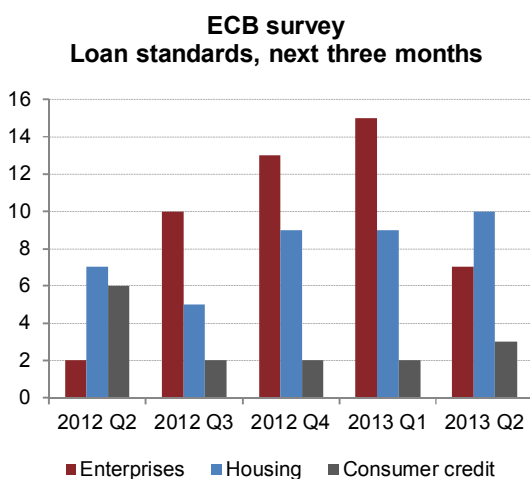
Money data highlight EA weakness

- **ECB likely to cut interest rates in May**
- **Impact to be minimal**
- **Key problem remains interest rate spread**

Yesterday Angela Merkel announced a startling discovery: the ECB's policy interest rate is not the right one for Germany, nor for some of the other euro area countries. It seems that one-size-fits-all really is one-size-fits-none.

Needless to say, this is not news. The fact that a monetary union must have the same interest rate and that this interest rate will be wrong for at least some, if not all, of its members, was proven in Germany in the early 1950s, when the Berlin Land attempted to have higher interest rates than the Federal Republic. It is also a point frequently made by critics of EMU.

What is more interesting is why Ms Merkel brought this topic up now. A recent slew of weak data, including PMI surveys and notably the German Ifo index for April has substantially raised the likelihood that the ECB will cut interest rates at its next meeting. That will of course exacerbate the misalignment of interest rates within the EA. One possible, but unlikely, reason is that she is preparing ground for some countries to leave EMU, enabling the ECB to raise interest rates to levels suitable for Germany. A more likely explanation could be that she is preparing the ground for further retreats on the austerity issue by making it clear that there is little more that monetary policy can do. Germany has already gone some way here, including accepting that France will miss its deficit target this year. There may be more to come as the EA growth outlook continues to deteriorate over the summer, although any overt moves away from sticking by austerity are likely to be minimal this side of the German elections in September.



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Recent EA monetary data adds to the bleaker outlook. M3 growth slowed to 2.6% in the year to March, from 3.1% in February. The March number was the lowest since February last year. On a six-month annualised basis, which is a better guide to recent trends, M3 growth was even slower, at 2.3%. Credit growth remained weak, with a further slowdown in both housing and consumer loans, only partially off-set by slightly stronger corporate borrowing. Worryingly, the ECB's Bank Lending Survey for Q2 shows that banks on balance expect to tighten lending standards further and also expect loan demand to continue to weaken over the next three months, even if in both cases at a somewhat slower pace.

Meanwhile, national broad money growth (to be more exact, the national contributions to EA M3) further highlight the spreading weakness. French M3 growth was 2.8% in the year to February and has been below 3% for most of the past six months. German broad money growth is stronger, at 5.8%; but a substantial share of the €60bn increase in German bank deposits over the past year (half the €130bn rise in German M3) is likely to be connected with the roughly €140bn fall in deposits in Spain, Cyprus and Portugal over the same period.

There is one positive series coming out of the EA. Corporate liquidity (ie, companies' bank deposits and cash divided by their bank loans) is rising. Not by much – but the trend is at least up. This is likely to be due to companies currently hoarding cash. But, in the medium term, this has historically eventually translated into good news for asset prices.

However, the near-term outlook for the EA remains weak. Although the ECB is likely to cut interest rates in May, a 25bp repo rate cut is unlikely to do much, not least because overnight rates are already lower than the repo rate and near zero. A more urgent task for the ECB is how to narrow the spreads between bank loans in different parts of the monetary union. In February the spread between the highest and lowest lending rate to non-financial companies for a loan in excess of 5 years was more than 440bps. Short of mandating maximum interest rates or targeted loans, it is difficult to see what the ECB can do about this. Yet this in a sense goes to the heart of the viability of the monetary union.

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