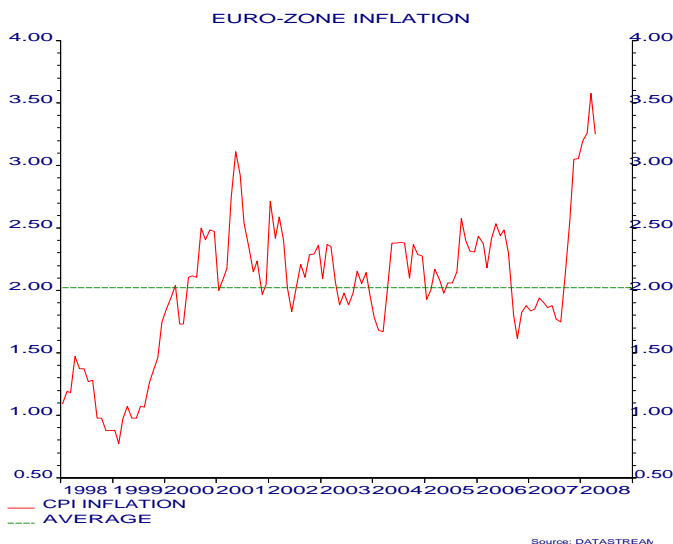


Tough times for the European Central Bank

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The European Central Bank (ECB) is ten years old. During its first decade it had to deal with the technology bubble and its subsequent collapse, fears of global deflation, Euro weakness and Euro strength and the recent credit crisis. Arguably, it met these challenges successfully.

The Bank set itself the target of keeping inflation close to, but below 2 percent. It has come very close to achieving this aim. Over the last decade inflation averaged exactly 2 percent and was, for the most part, within ½ percent of this level. Meanwhile, real GDP growth over the period averaged 2¼ percent – in line with most estimates of its trend rate – and recession was avoided.



As the ECB's leading figures will be well aware, however, there is no scope for complacency. The situation now facing the Bank is as serious as any that it faced over the last ten years.

The good news is that the additional liquidity it pumped into the financial system over the last six months appears to have stabilised money markets,

which were threatening to seize up in the wake of the credit squeeze.

The bad news is that inflation pressures in the Euro-zone are greater than at any time since the early 1990s. The inflation rate in April was 3.3 per cent and, unless there is a sharp reversal in oil and food prices in coming months, it could well reach 4 per cent before the end of the year.

The ECB has to decide how to deal with this situation. The last time food and energy prices rose sharply, in the early 1970s, Germany's Bundesbank fought increasing inflationary pressures with higher interest rates. As a consequence the inflation rate in Germany peaked earlier and at a lower rate than in other major economies.

Comments from senior members of the ECB suggest that they are inclined to follow the Bundesbank's lead from 35 year ago. Although the ECB has not changed its key interest rate since last June, when it was raised to 4 percent, it has been dismissive of the notion that interest rates should be cut. Despite falling business and consumer confidence, which are usually signs that economic growth is slowing, the Bank remains wholly focused on the inflation threat.

Fortunately, the chances of higher food and energy prices leading to a permanent rise in inflation are lower now than they were in the early 1970s thanks to globalisation and reduced levels of indexation and unionisation in European economies. However, if wage inflation should start to rise in response to higher price inflation, the ECB would probably increase interest rates to make clear its continued commitment to the inflation target. In the short-term, this is likely to be bad for economic growth and would do nothing for the Bank's popularity. But it would probably be the right decision for the medium-term health of the Euro-zone economy.

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