

Monetary Policy Stance in the Euro Area



EUROFRAME – European Forecasting Network

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Monetary Conditions Are Favourable

- **Most indicators** of monetary conditions more or less **unchanged**
- One exception: **Small effective appreciation of the euro**
- **Key interest rates** continue to be **unusually low** by most standards
- **Real short-term rates** still close to **zero**
- Taylor rule suggests that rates could be some **100 basis points higher** ...

$$i = r + \pi + 0.5 (\pi - \pi^*) + 0.5 (y - y^*)$$

- ... given that the **output gap is small**: About **-0.5 %** in our model

Gradual Tightening Ahead

- The ECB has repeatedly **prepared markets for rate hike** ...
- ... but there have been **negative surprises** in terms of GDP growth
- **Reasons for tightening**: Low rates, high liquidity, asset prices
- **First rate increase later this year** when economy will have picked up
- **Money market rates** are assumed to rise to **2.9 % by the end of 2006**
- Timing may change with speed of **recovery** and the **euro**