

No Surprise as ECB Delivers Expected 0.25% Hike in Rates

The European Central Bank acted as expected today by raising the official refinancing rate by another 0.25% to 2.75%. The ECB President, Jean-Claude Trichet, said that there was an overwhelming majority of Governing Council members in favour of a 0.25% hike rather than the 0.5% increase which had been touted in some quarters.

Now that we are at this point with rates 0.75% higher than in November 2005, the chances of an ECB rate hike of 0.5% has receded. The markets expect that the ECB will raise rates again in September by another 0.25% with a further increase of 0.25% likely in December. At that stage official rates would be at 3.25%. Trichet stated that if the ECB's economic assessment goes according to plan, further withdrawal of monetary accommodation would be warranted. At this stage, therefore, its fair to say that the ECB and the markets are in broad agreement.

Though eurozone inflation is well above the 2% level, money growth is strong and the economy appears to be on a sustainable growth path, the case for any more aggressive tightening than is currently anticipated by the markets is limited. There are significant short and medium obstacles to sustained growth in the eurozone. Fiscal policy has to be tightened in Germany and in Italy which will slow euro growth in 2007. There are also potentially serious geopolitical risks, oil price uncertainty and the exchange rate that could impair the euro area's economic expansion.

The ECB today released revised economic forecasts for the area for 2006 and 2007. The forecasts show that the ECB staff expect that the rate of economic growth will slow from 2.1 % in 2006 to 1.8% in 2007. The forecasts for 2007 are a little lower than those published in March.

What will keep the ECB on track towards higher interest rates will be their forecasts for eurozone inflation. The staff forecasts now project an annual average increase of 2.3% in 2006 and 2.2% in 2007. The latest 2007 inflation forecasts are unchanged from the March forecasts. The ECB remains very concerned about the risks to inflation and inflation expectations stemming from high and possibly even higher oil prices, eurozone credit expansion and the risk of higher wage demands on the back of rising headline rates of inflation, largely induced by previous rises in oil prices.

The ECB will also take some comfort from the positive contribution from consumer spending to overall GDP growth of 0.6% in Q1 2006. Personal spending added 0.4 percentage points to GDP growth in the first three months of 2006 which came as a bit of a surprise. Monthly indicators had not pointed to such a large contribution. However, the ECB will see this improvement as the start of a more widespread contribution to growth. Up to this point, growth had come mainly from trade and to a lesser extent from investment spending.

The ECB's decision to raise rates by 0.25% rather than by 0.5% has given a short term boost to the US dollar. However, this is likely to be reversed in the short term. The ECB's moderate pace of tightening may also give some relief to equity markets which have been shaken by fear and uncertainty in recent times.

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