AIB Global Treasury
Economic Research

ECB SIGNALS SEPTEMBER RATE HIKE

The European Central Bank left interest rates unchanged at its monthly policy meeting today. The decision to leave rates on hold was widely expected. **The meeting was held via teleconference and was followed by a surprise press briefing.** Normally there is a policy statement and press conference but none had been scheduled for this month.

The ECB indicated at the press briefing that it is strongly vigilant in regard to the upside risks to price stability. In the past, vigilance has been the code word used by the ECB to signal that a rate hike was on the cards at its next monthly policy meeting. **Thus, it can be taken that rates are set to rise again in September by 0.25%, taking the key refi rate up to 4.25%.**

Based on comments by ECB council members over the past month, it had been clear that rates have not yet peaked in the eurozone. The ECB still regards monetary policy as on the accommodative side, indicating that rates have still not reached a neutral level. However, it was unclear until today whether the next hike in rates would come in September or October.

It may well be that a 4.25% level will represent a neutral policy setting for interest rates, which have been increased steadily from a level of 2% at the end of 2005. Given the continuing strength of activity, buoyant growth of monetary aggregates, tightening labour market and likely rise in inflation to well over 2% later in the year, the ECB can be expected at some stage to move policy to a somewhat restrictive stance. **Thus, we see rates being increased by another 0.25% in early 2008, if not by the end of 2007, bringing them up to 4.5%.**

Eurozone Interest Rate Forecasts

	Refi Rate	3 Mth	1 Year	2 Year	5 Year
Current	4.00	4.25	4.54	4.67	4.69
Sept 07	4.25	4.35	4.65	4.75	4.80
Dec 07	4.25	4.40	4.75	4.85	4.90
Mar 08	4.50	4.60	4.85	4.95	4.95

Forecasts are end month. Swap rates used beyond 1 year.

Current rates are sourced from Reuters, forecasts from AIB ERU.

STRONG INDICATORS POINT TO MORE TIGHTENING

The economy is continuing to grow at a strong rate. The ECB is forecasting GDP growth in 2007 of 2.6%, but this is likely to be surpassed. GDP growth in Q1 was revised up to 0.7% for a year-on-year gain of 3.1%. **The overall impression from recent eurozone economic indicators is that growth remains strong.**

The EC's economic sentiment indicator has retreated from its cyclical highs in the past two months and but it is still at levels consistent with very strong economic growth. The EC's industrial confidence indicator is also off its peak but remains at a high level, while consumer confidence has improved considerably. Meanwhile, the composite PMI indicator for the manufacturing and services sectors also remains at levels consistent with continuing strong economic growth.

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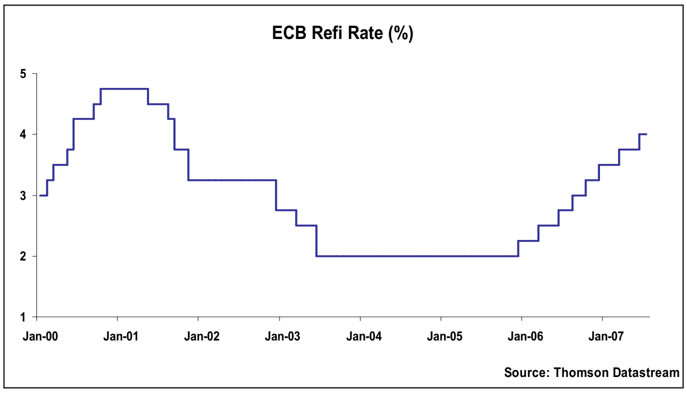
It would seem, though, that the engine of growth may be passing from the industrial to the services sector of the economy. The eurozone PMI for manufacturing fell to its lowest level in 17 months in July. Meanwhile, national indicators of business confidence, although still high, have declined in Germany and Italy in the past couple of months. By contrast, the eurozone PMI for services picked up strongly in June and July, while the EC retail sector sentiment index has also strengthened in recent months.

Overall, the strength of leading economic indicators suggests that growth will remain robust over the balance of the year. This strong economic growth is impacting on the labour market. Employment rose by 0.4% in Q1 for a year-on-year gain of 1.4%. The unemployment rate fell to 6.9% in June, down from 7.5% at end 2006 and 8.4% at end 2005. It is now at its lowest level in more than twenty five years.

Household spending has been weak to date in this upturn but the improving labour market conditions should eventually lead to a strengthening of consumer spending, offsetting an expected weakening of export growth. **Overall, real GDP could rise by around 2.9% this year, remaining well above the eurozone's non-inflationary growth rate of 2.25%, adding to the ECB's inflationary concerns.**

The annual HICP inflation rate has been confined to a tight 1.8-1.9% range since last November. However, with oil prices back above $75 a barrel, inflation in the eurozone is set to accelerate to around 2.5% over the autumn. Furthermore**, the ECB believes that over the medium term, the risks to inflation are on the upside.** It notes the increasing capacity utilisation in the euro area economy and points to the possibility of further oil price rises and additional increases in administered prices. **Wage increases in 2008 could be stronger than currently expected** given the strength of economic activity and marked improvement in the labour market.

ECB officials also believe that **the continued strong growth rate of monetary and credit aggregates poses another upside risk to price stability.** Eurozone M3 money supply growth accelerated to 10.9% year-on-year in June, confirming that there is abundant liquidity in the economy, which the ECB says points to upside risks to inflation over the medium term. Growth in private sector credit remains strong, reaccelerating to 11.5% yoy in June, buoyed in particular by strong growth in loans to the corporate sector, which is running at 13.3% yoy.



All these factors suggest that ECB rates are likely to be hiked to 4.5% by early next year. Turning to 2008, the latest ECB forecast is for GDP growth to slow next year, averaging 2.3%, which would be in line with the trend growth rate of the economy. In these circumstances, interest rates may be put on hold at 4.5%. There is a risk, though, especially if consumer spending picks up momentum, that eurozone GDP growth will exceed expectations again next year, with the economy continuing to grow above trend. Given the ECB's belief that the risks to inflation are on the upside and its references to diminishing spare capacity, above trend growth next year would most likely result in official rates being hiked to above 4.5%. At this stage, then, **it is too early to conclude, as the markets have, that 4.5% would represent the peak for ECB rates.**

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