

ECB STAYS ON THE SIDELINES

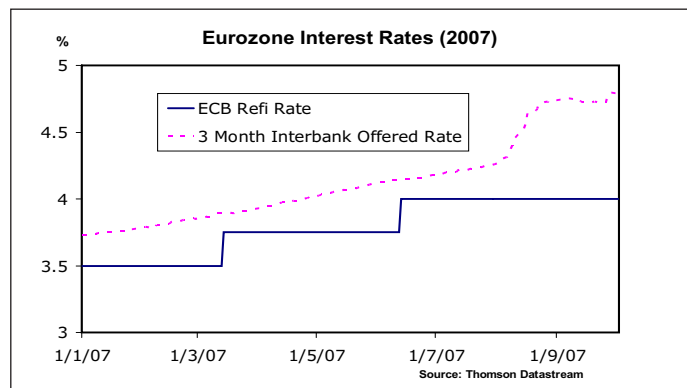
The European Central Bank left interest rates unchanged at its monthly policy meeting today. The decision to leave rates on hold at 4% was expected. The turmoil in financial markets over the past two months has convinced most commentators that the ECB will not hike rates again this year. Indeed, the markets are of the view that rates have peaked at 4%.

The ECB did not repeat, though, that it regards monetary policy as being on the "accommodative side", possibly reflecting the fact that recent market movements have resulted in an effective tightening of policy. However, **Mr Trichet stressed that upside risks to the outlook for price stability remain and that the ECB stands ready to counter these risks.**

Nonetheless, the turmoil in financial markets has led to increased uncertainty, so the ECB seems very much on hold for now. Indeed, the ECB is explicit in saying that it is appropriate to await additional information before drawing further conclusions for monetary policy. No doubt, it also wants to see a return to more normal trading conditions in financial markets, especially in the money markets.

The level of interbank rates remains well above official interest rates, with very wide bid-offer spreads. Credit spreads also remain wide. Meanwhile, debt issuance remains curtailed in many non-government bond markets, with corporate issuers

having to pay much higher interest rates to get deals done. **It is unclear how long these abnormal conditions in financial markets will last.**



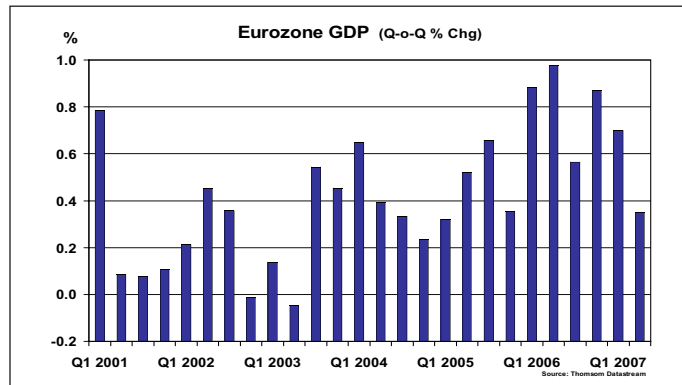
The recent trends in economic data also argue in favour of keeping rates on hold at the present time. Inflationary pressures are increasing, with oil prices soaring to above \$80 a barrel, growth in monetary and credit aggregates is accelerating and labour market conditions have tightened considerably. On the other hand, the turbulence in financial markets has dented confidence, with clear signs of a weakening in sentiment surveys and leading indicators of economic activity. It is unclear if this will prove a temporary phenomenon or have any lasting impact on the growth rate of the economy.

Meanwhile, the rise in market interest rates and marked appreciation of the euro since August represents an effective tightening of monetary conditions. US rates have also been cut recently. **Mr Trichet refused to be drawn in his press conference about the recent appreciation of the euro other than repeating the usual line that excessive movements in exchange rates are counterproductive.** Overall, then, it would seem that despite the warnings about the upside risks to price stability, there is unlikely to be any change in official rates in the near term. **The ECB is very much in a 'wait and see' mode.**

RATE HIKE IN 2008 CANNOT BE RULED OUT

The overall impression from recent eurozone economic indicators is that growth may be losing momentum. Indeed, GDP growth had already slowed to 0.3% in Q2, although this was largely due to a fall in fixed investment and a rundown of inventories, both of which should have reversed in Q3 boosting GDP growth.

More recent indicators are showing signs of weakening activity, suggesting that GDP growth may lose steam again in Q4. The EC's economic sentiment indicator retreated from its cyclical highs over the summer months, before registering a particularly sharp fall in September. Meanwhile, the composite PMI indicator for the manufacturing and services sectors, which was running at a high level, registered a sharp fall in September also, to record its lowest reading in two years. These trends are borne out by leading activity indicators in the main eurozone economies, such as the Ifo, INSEE and ISAE business surveys, as well as national consumer confidence surveys. Nonetheless, all these indicators are still at levels consistent with reasonable GDP growth.



Despite these signs of a softening in activity, the ECB believes that over the medium term, the risks to inflation are on the upside. It points to the marked uptrend in oil prices and possible additional increases in administrative charges, indirect taxes and food prices. More fundamentally, **wage increases could be stronger than currently expected, given the continuing positive trends in the labour market.** The jobless rate has fallen to 6.9% in the eurozone, with a particularly sharp fall in German unemployment.

ECB officials also believe that the continued strong growth rate of monetary and credit aggregates poses another upside risk to price stability. M3 money supply rose at a rate of 11.6% year-on-year in August. Meanwhile, the growth in private sector credit also remained uncomfortably high at 11.8% year-on-year, driven in particular by strong loan growth to the corporate sector.

These conflicting trends suggest that the ECB will keep interest rates unchanged over the balance of the year, especially with the Fed recently cutting rates and the euro on the ascent.

The outlook for interest rates in 2008 is quite uncertain. However, if the monetary easing by the Fed staves off a recession in the US and activity improves there over the course of next year, it could bring rate hikes back onto the agenda in the eurozone. We also expect to see a return to more normal trading conditions in financial markets in 2008, if not in Q4 2007. Indeed, there have been some signs of improvement recently. Such a scenario should see an improvement in the eurozone economic environment next year. With the ECB still worried about upside risks to inflation, it implies that a further rise in ECB rates cannot be ruled out. Overall, **we cannot help feeling that it may be how the US economy evolves next year that could prove the critical factor for the course of eurozone interest rates in 2008.**

| | Refi Rate | 3 Mth | 1 Year | 2 Year | 5 Year |
|---------|-----------|-------|--------|--------|--------|
| Current | 4.00 | 4.58 | 4.55 | 4.51 | 4.49 |
| Dec 07 | 4.00 | 4.40 | 4.45 | 4.40 | 4.40 |
| Mar 08 | 4.00 | 4.20 | 4.35 | 4.40 | 4.40 |
| Jun 08 | 4.25 | 4.35 | 4.40 | 4.40 | 4.40 |

Current rates are mid-point rates sourced from Reuters.

Swap rates used beyond 1 year. Forecasts are from AIB ERU.