

## SLOWING ECONOMY POINTS TO RATE CUTS

The European Central Bank again left interest rates unchanged at its policy meeting today for the eighth consecutive month. The decision to leave rates on hold at 4% was expected. The continuing uncertainty in financial markets, marked appreciation of the euro and slowdown in economic activity are ruling out policy tightening, but high inflation and risks to price stability rule out rate cuts at the present time.

The primary goal of the ECB is price stability and Mr Trichet again pointed this out at his press conference today. He stressed that upside risks to the outlook for price stability remain and that the ECB remains committed to preventing second-round effects materialising. However, **he struck a less hawkish tone than in previous press conferences, putting considerable emphasis on the downside risks to growth also. He was not prepared either to characterise policy as on the accommodative side as before, or to say that the ECB would act pre-emptively to counteract risks to price stability.** Notably, the ECB did not consider the option of a rate hike today, unlike at previous meetings.

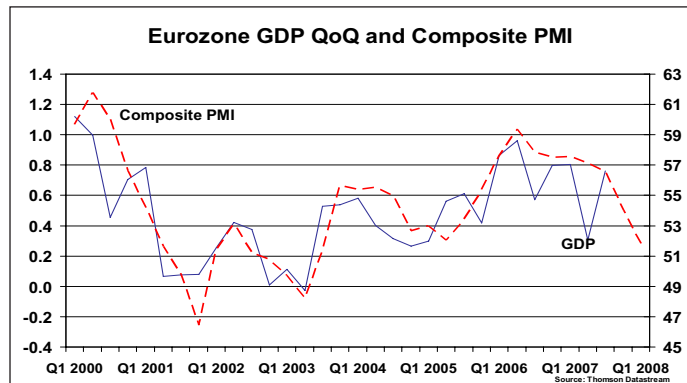
**Thus, despite much hawkish talk from the ECB in recent months, it seems most unlikely that there will be a hike in interest rates at this stage.**

The ECB expects that the current rise in inflation will prove temporary. However, Trichet has warned that, for this to be the case, it is essential that price and wage setting behaviour remains unaffected by the present high rate of inflation.

Indeed, there has been an effective further tightening of policy since last summer via a rise in interbank rates and the appreciation of the euro. **The eurozone economy is also now clearly slowing down. Oil prices are also off their peak. Combined, these should act to dampen inflationary pressures in the economy.** In particular, it should help prevent excessive wage increases that could endanger price stability.

It should be borne in mind that 4% is not an exceptionally high level for ECB rates, especially when compared to the level that official rates reached in most Anglo-Saxon economies last year. Thus, it is understandable that, with inflation hitting its highest level since the inception of the euro and the economy enjoying another year of robust growth in 2007, the ECB has not been in any mood up to now to contemplate policy easing.

**Nonetheless, the marked downtrend in leading indicators of activity suggests that growth will move well below trend this year.** Inflation is also likely to ease back over the course of this year provided that oil prices do not move back onto an upward trajectory. **Thus, we believe that the ECB will ease policy, probably by mid-year. The market is of the same view and is now discounting rate cuts of 0.75% by end 2008.**

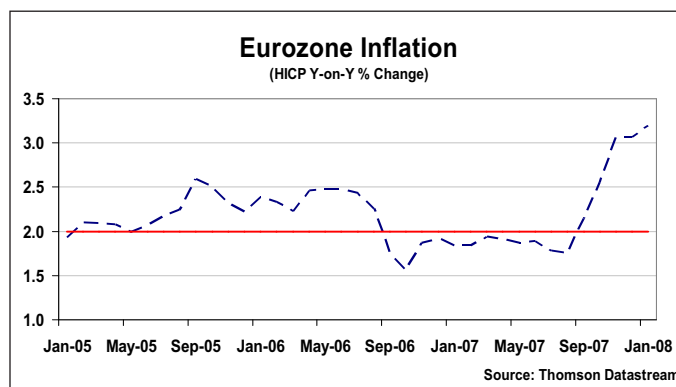


## ECONOMY LOSING MOMENTUM BUT INFLATION RISING

**Leading eurozone indicators are now showing clear signs of a marked weakening of economic activity, suggesting that GDP growth will slow sharply in 2008.** The EC's economic sentiment indicator has been in decline since mid-2007, and has fallen sharply in recent months, hitting 101.7 in January, well down on its peak of 111.6 in May 2007. Meanwhile, the composite PMI for services and manufacturing fell to 51.8 in January, again well below its peak of 57.8 last June, with services slowing in particular. 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, which have all declined since mid-2007.

The January reading for the composite PMI of 51.8 is consistent with GDP growth of around 0.3% per quarter, which is well below trend. Indeed, growth in Q4 2007 may have already dropped close to this level. **What is also striking is the steady downtrend in these leading indicators.** If this continues, it will be consistent with very weak growth by the eurozone economy this year.

**However, despite the signs of a marked weakening in activity, the ECB believes that over the medium term, the risks to inflation are on the upside.** It points to the marked rise in oil and other commodity prices and possible additional increases in administrative charges and indirect taxes. More fundamentally, wage inflation may accelerate given the continuing positive trends in the labour market. The eurozone jobless rate has fallen steadily to 7.2%.



ECB officials also believe that the continued strong growth rates of monetary and credit aggregates pose another upside risk to price stability. The growth in M3 money supply surged to a record high of 12.1% year-on-year in December on a three month moving average basis. Meanwhile, the growth in private sector credit has also surged, running at 12.7 % y-o-y at end 2007.

**On top of this, the HICP rate has accelerated sharply to 3.2% in January, its highest level since the inception of the euro.** High oil prices are a factor but **the core rate has also picked up, reaching 2.3% at end 2007**, up from 1.6% at end 2006. Food price inflation doubled from 2.4% to 4.8% year-on-year between September and December 2007. Thus, it is not that surprising that the ECB has focused on containing inflation and ruled out cutting rates up to now.

However, the ECB knows that well below trend growth is probably the surest way of squeezing inflationary pressures out of the economy. Leading indicators are pointing to very weak growth in 2008. The ECB will publish revised economic forecasts next month, which should show lower growth projections. **We expect that the ECB will be more comfortable about easing policy by mid-year when real data confirm a marked slowdown in activity and inflation pressures begin to ease. We see rate cuts of at least 0.5% in 2008.**

### Eurozone Interest Rate Forecasts (end month)

	Refi Rate	3 Mth	1 Year	2 Year	5 Year
Current	4.00	4.32	4.29	3.81	3.91
Mar 08	4.00	4.15	4.00	3.75	3.85
Jun 08	3.75	3.85	3.65	3.70	3.80
Sept 08	3.50	3.50	3.40	3.60	3.75

*Current rates are mid-point rates sourced from Reuters.*

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