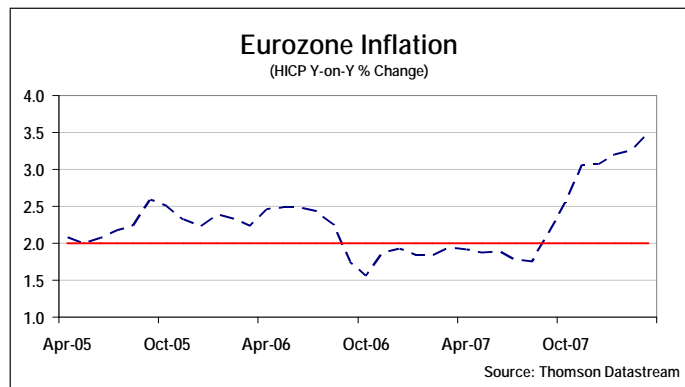


## ECB HOLDS FIRM

The European Central Bank again left interest rates unchanged at its policy meeting today. The decision to leave rates on hold at 4% was expected and means that rates now have been unchanged since June 2007. The continuing difficulties in financial markets, marked appreciation of the euro and slowdown in economic activity have taken policy tightening off the agenda, but high inflation and risks to price stability have ruled out rate cuts. Hence, **the ECB has no policy bias at the present time.**

The primary goal of the ECB, though, is price stability and Mr Trichet again emphasised this point at his press conference today. He **indicated that upside risks to the outlook for price stability remain.** He also stressed that the ECB is strongly committed to preventing second-round effects materialising from the current elevated inflation readings, following the recent upward spike in the HICP rate to 3.5% from below 2% last summer.

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. Some concern has been expressed at recent wage deals agreed in Germany that will see workers get pay rises of around 8% over the two year period 2008-2009. The



ECB's latest inflation forecasts, though, see HICP inflation falling back to average 2.1% next year.

Of course, there has been an effective further tightening of policy since last summer via a rise in interbank rates and the marked appreciation of the euro. **Mr Trichet did say today that he "deplores excessive volatility" in exchange rates. His main message, though, was that ECB rates remain very much on hold at 4%.** 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. Indeed, official interest rates continue to be hiked in a number of countries, including ones where rates are already well above 4%.

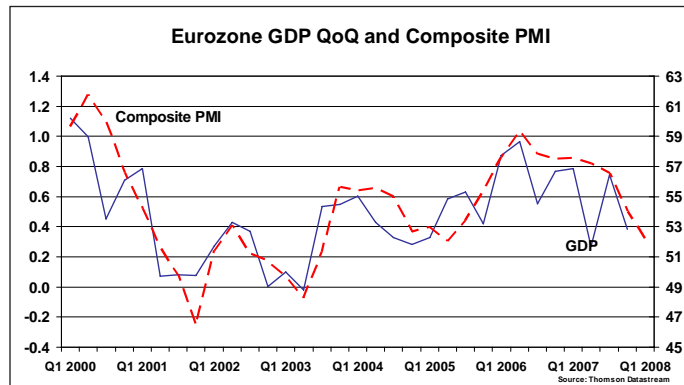
**Given the current high level of inflation, it is understandable that the ECB is not in any mood at present to contemplate policy easing.** Furthermore, while the economy has slowed, activity is holding up reasonably well and GDP growth in Q1 could well match the 0.4% rate achieved in Q4, helped by a solid performance by the German economy in particular.

**Nonetheless, the continuing downtrend in leading activity indicators suggests that growth will move further below trend as the year progresses.** Inflation is also likely to ease later in the year provided that oil and food prices do not continue on an upward trajectory. **Thus, we believe that the ECB will be able to ease policy later this year. However, rate cuts may amount to no more than 50bps given the upside risks to price stability.**

## GDP GROWTH SLOWS BUT INFLATION SPIKES EVEN HIGHER

**Leading eurozone indicators have weakened considerably since mid-2007, a clear sign that the economy has lost momentum.** Both the ESI and PMI surveys have continued their downtrend in recent months, reflecting in particular marked declines in the services sector. The EC's economic sentiment indicator has fallen sharply, hitting 99.6 in March, well down on its peak of 111.6 in May 2007. Meanwhile, the composite PMI for services and manufacturing fell to 51.8 in March, well below its peak of 57.8 last June.

**The weakening trend in leading activity indicators has been borne out by real economy data.** GDP growth slowed to 0.4% in Q4 2007 from 0.7% in Q3. GDP growth decelerated to 2.2% year-on-year in Q4 2007 from 3.2% in Q1 of the year. It is likely that the eurozone economy grew by around 0.4% again in Q1 2008. Consumer spending contracted by 0.1% in Q4 2007 and seems to have remained weak in Q1 2008.



The continuing decline in leading indicators in the opening months of the year suggests that growth will weaken even further during 2008. The composite PMI reading of 51.8 in March is consistent with GDP growth of about 0.3%. We think that eurozone GDP growth could average just above 1.5% 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 uptrend in oil and other commodity prices and possible additional increases in administrative charges and indirect taxes. Wage inflation may also accelerate given the continuing positive trends in the labour market and high capacity utilisation. The eurozone jobless rate has fallen steadily to 7.1%. Hence, the current wage round is being closely watched by the ECB, and recent pay deals in Germany, averaging 4% per annum for 2008 and 2009, may cause it some concerns.

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 stood at 11.4% year-on-year in February on a three month moving average basis. Meanwhile, the growth in private sector credit is running at 12.5 % y-o-y.

**On top of this, the HICP rate continues to accelerate, reaching 3.5% in March, its highest level since the inception of the euro.** Rising oil and food prices are the main causes. Food price inflation has surged from 2.4% to 5.8% year-on-year since September. Energy price inflation, meanwhile, is running at 10.4% y-o-y.

However, the ECB knows that well below trend growth is probably the surest way of squeezing inflationary pressures out of the economy. **We expect that the ECB will be more comfortable about easing policy later this year as data confirm a further slowing in activity and inflation pressures begin to ease. However, rate cuts may amount to no more than 50bps given the upside risks to price stability and expectations that inflation will remain above 2% for quite some time.**

<b>Eurozone Interest Rate Forecasts (end month)</b>					
	Refi Rate	3 Mth	1 Year	2 Year	5 Year
Current	4.00	4.71	4.71	4.26	4.17
June 08	4.00	4.50	4.40	4.10	4.05
Sept 08	3.75	3.95	3.80	3.90	3.90
Dec 08	3.50	3.70	3.70	3.80	3.85

*Current rates are mid-point rates sourced from Reuters.  
Swap rates used beyond 1 year. Forecasts are from AIB ERU.*