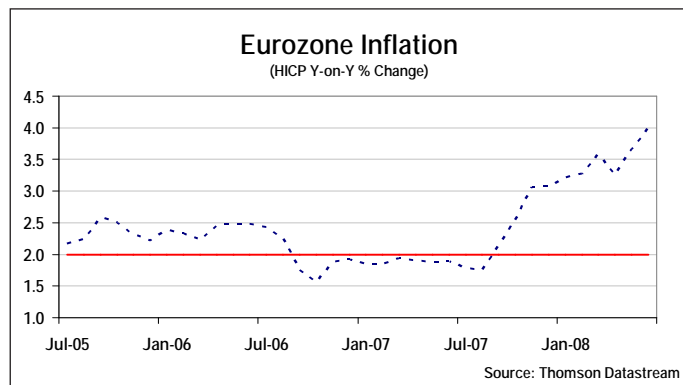


## ECB HIKES RATES BY 0.25%

The European Central Bank increased interest rates by 0.25% to 4.25% at its policy meeting today. The decision had been well signalled by the ECB over the past month and thus came as no surprise to the markets. It was the first change in official interest rates since the 0.25% rate hike in June of last year. **The rate increase was in response to what the ECB sees as the growing upside risks to price stability**, with the inflation rate in the eurozone hitting a record high of 4% last month and expected to remain at an elevated level for a considerable period.

The primary goal of the ECB is price stability as Mr Trichet again pointed out at today's press conference. He stressed that the ECB is strongly committed to preventing second-round effects materialising from the current elevated inflation readings and also to firmly anchoring inflationary expectations in line with price stability.

There were real concerns in the market that the ECB would follow up this rate increase with a further rate hike. **However, Mr Trichet gave no indication that further tightening is in the pipeline.** Indeed, he noted that after today's decision, the monetary policy stance will contribute to achieving the objective of price stability. Thus, market interest rates eased following Mr Trichet's comments.



However, futures contracts are pricing in three month money rates of 5.2% by end year, suggesting that **the market still believes there is a risk that the ECB could hike rates again.**

It should be noted, though, that there has been quite a marked tightening of monetary conditions since last summer. Interbank rates have seen a pronounced rise, with three month EURIBOR rising by 0.75% to 5% and twelve month EURIBOR up by 1% to 5.5%. Furthermore, there has been a sharp appreciation of the euro over the past year. There are clear signs that this monetary tightening is impacting on economic growth. All the leading indicators of activity are pointing to a very sharp slowdown in the economy.

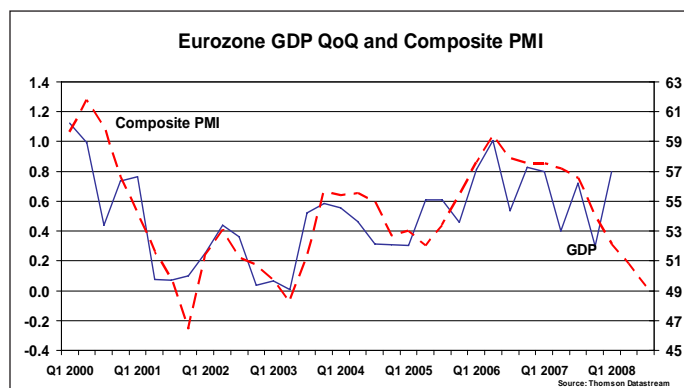
The ECB published forecasts last month that saw it cut its GDP growth forecast for 2009 to 1.5% from 1.8% previously, and the projected rate of 1.8% in 2008. This compares with GDP growth of 2.6% in 2007 and would represent below trend growth for both this year and next. Even these forecasts could prove too optimistic. **The latest PMI readings for both the manufacturing and services sectors point to GDP growth more or less stagnating this summer.**

**The ECB, then, is facing what could be described as something close to stagflation in the eurozone economy.** This will make it difficult for it to hike rates any further. Indeed, the HICP rate is likely to fall back next year as the upward pressure eases on food and energy prices. **With the economy likely to have weakened considerably over the course of 2008, we could well see the ECB cut interest rates in 2009, provided inflationary pressures abate.**

## OMINOUS SIGNS FOR THE ECONOMY

The leading eurozone indicators have been in decline since mid-2007, a clear sign that the economy is losing momentum. **Although GDP growth was strong in Q1 at 0.8%, the year-on-year growth rate stood at 2.2%, down from 3.2% a year earlier. Data published since then point to a much more severe deceleration in the pace of activity over the balance of this year and into 2009.**

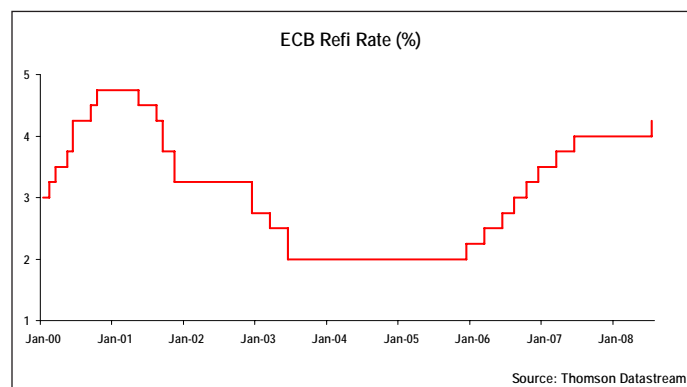
**The EC's economic sentiment indicator fell sharply in June** to 94.9 from 97.6 in May, well down on its May 2007 peak of 111.6. Meanwhile, the manufacturing PMI fell to a three year low of 49.2 in June from 50.6 in May, well below its peak of 57.8 last June. The services PMI declined to 49.1 in June from 50.6 in May, a four year low and well down on the peak of 58.3 a year ago. The composite PMI stood at 49.3 in June, down from 51.1 in May and its peak of 57.8 a year earlier.



The continuing sharp decline in leading indicators in recent months suggests that growth will weaken much further during the course of 2008. **The PMI readings for June are consistent with an economy that is now close to stagnation.** If the PMI readings remain below the 50.0 level, it suggests that the economy could grow by less than 1% next year. Indeed, if the PMIs continue their marked downtrend, the eurozone economy could well hit recession.

**Inflation, though, has picked up sharply on the back of soaring food and energy prices, hitting 4% in June. Further, despite the signs of a marked weakening in activity and subdued core inflation, the ECB believes that, over the medium term, the risks to price stability 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 has also accelerated. ECB officials also believe that the continuing strong growth rates of monetary and credit aggregates pose another upside risk to price stability.

The ECB's sole mandate is preserving price stability so today it has responded to the surge in inflation by hiking interest rates. The indications, though, are that this will be a once-off rate increase. In our view, a further rate hike seems unlikely over the balance of the year with the economy close to stalling.



**The ECB's task may not prove as difficult next year.** Inflation should benefit from a positive basis effect on energy and food prices and as weak growth dampens underlying price pressures in 2009. Thus, the HICP rate should fall sharply next year and could even decline below 2% by the end 2009. **Hence, with the economy likely to be very weak, a cut in ECB rates cannot be ruled out for next year, but it would require a marked fall in inflation, down towards 2%.** The crucial factor in this regard will be the evolution of energy and food prices which, ironically, are beyond the control of the ECB and its monetary policy. The tightening of monetary conditions over the past year, though, may also play a role. It has helped drive the economy close to recession, which should in time lead to downward pressure on the core inflation rate.

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