



## ECB IN NO MOOD TO CUT RATES AT PRESENT

Top European Central Bank officials have been going out of their way in the past fortnight to quash rate cut speculation and instead have been warning that they remain very concerned about the upside risks to inflation. It is clear that the ECB is firmly on hold at present and has no appetite for rate cuts despite the sharp slowdown in economic activity. Thus, it came as no surprise that the ECB left rates unchanged at its monthly policy meeting today.

Furthermore, the tone of Mr Trichet's press conference suggested that there is little chance of the ECB easing policy anytime soon. He again highlighted that the primary goal of the ECB is price stability, stressing that the ECB remains strongly committed to preventing second-round effects materialising from the current elevated inflation readings, especially in regard to wages. The ECB also wants to firmly anchor inflationary expectations in line with price stability.

The ECB published its latest quarterly economic forecasts today. It revised up its forecast for HICP inflation in 2008 from 3.4% to 3.5% and from 2.4% to 2.6% in 2009, well above its sub 2% target. It will be difficult to muster much support on the ECB Council for a rate cut anytime soon given these inflation forecasts and with the HICP rate running close to 4%. Indeed, only last week, the head of the German Bundesbank, Mr Weber, suggested that the ECB might have to hike rates further next year if the economic outlook brightens.

The ECB also published new growth forecasts today. It cut its GDP growth forecast for 2008 and 2009 to 1.4% and 1.2% respectively, from 1.8% and 1.5% previously. This compares with GDP growth of 2.6% in 2007 and would represent well below trend growth for both years. Even these forecasts could prove too optimistic. The latest PMI readings for the manufacturing

and services sectors together with the recent readings from EU Commission sentiment surveys point to an economy that has more or less stagnated. Indeed, given the downtrend in these lead indicators, a eurozone recession is now a distinct possibility.

Nonetheless, with inflation still very high, the clear signals from ECB officials are that rates will not be changed anytime soon. Looking to next year, though, the ECB may well have room to cut rates. Oil prices have fallen very sharply since mid-July and this is already beginning to impact on headline inflation. The HICP rate fell to 3.8% in August from 4% in July. Other commodity prices are falling in sympathy with oil, which should see the upward pressure on food prices starting to abate also.

If oil prices were to stabilise at around \$100 a barrel, HICP inflation could be back down to around 2% by next spring. The ECB forecasts, though, are based on an average oil price of \$121 a barrel next year and it does not see inflation falling to 2% until 2010. With the economy weakening sharply, a fall in the HICP rate to 2% by next spring could see the ECB start to cut interest rates by end Q1 2009, which is not being priced in by markets.

ECB Macroeconomic Forecasts for the Euro Area

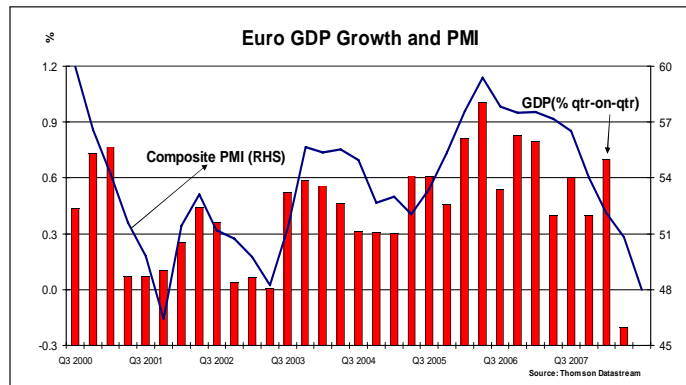
(%)	2006	2007	2008	2009
HICP	2.2	2.1	3.5	2.6
Real GDP	2.7	2.6	1.4	1.2

Forecasts are based on the assumption that oil prices will average \$115.1 per barrel in 2008 and \$120.8 per barrel in 2009.  
Source: European Central Bank

## Eurozone Economy Close To Recession

Leading eurozone indicators have been in decline since mid-2007 and this is being reflected in real economy data in 2008. **GDP growth slowed to just 1% annualised in the first half of 2008 and actually contracted in Q2. Data published since mid-year point to a further deceleration in the pace of activity with a real risk that the economy could enter recession.**

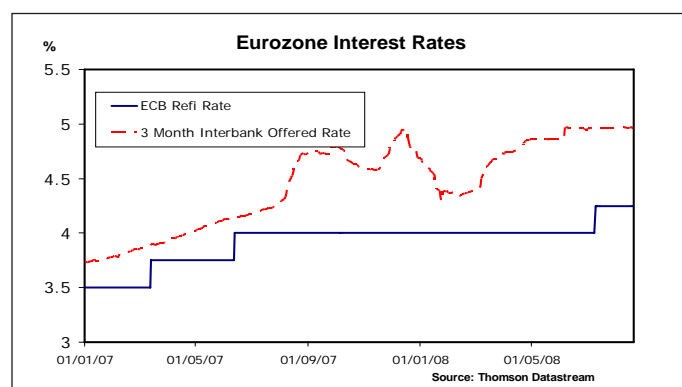
**The EC's economic sentiment indicator has continued to fall sharply in the last two months**, hitting 88.8 in August, down from 94.8 in June, and well below its May 2007 peak of 111.6. Meanwhile, the manufacturing PMI fell to a three year low of 47.5 in July/August from 49.2 in June, well below its peak of 57.8 in June 2007. The services PMI eased to an average 48.4 in July/August from 49.1 in June, a four year low and well down on the peak of 58.3 a year ago. **The composite PMI averaged 48.0 in July/August, down from 49.3 in June** and well off its peak of 57.8 a year earlier.



The continuing sharp decline in leading indicators in recent months suggests that GDP growth will weaken further in the second half of 2008. **Indeed, the EC sentiment and PMI readings for July and August are consistent with an economy that is now virtually stagnant.** If these indicators continue their marked downtrend, then the eurozone economy is likely to hit recession.

**Inflation, though, has picked up sharply this year on the back of soaring food and energy prices, hitting a historic high of 4% in July. Despite the 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 knock-on effects on other prices from the sharp rise in oil and other commodity prices and the risk of a renewed rise in commodity prices, as well as possible additional increases in administrative charges and indirect taxes or an acceleration in wage inflation. ECB officials also believe that the continuing strong growth rates of monetary and credit aggregates pose another upside risk to price stability.

**Inflation, though, has started to fall in response to a collapse in commodity prices, especially oil, since mid-July.** The HICP rate edged down to 3.8% in August and looks set to fall sharply over the balance of the year. Indeed, by our calculations, the HICP rate will be back down to around 2% by the spring if oil prices stabilise at around \$100 a barrel, although the ECB does not see inflation returning to this level until 2010.



With the growth in monetary aggregates also starting to decelerate, **it is going to be very difficult for the ECB not to cut rates next year to boost the ailing economy if inflation falls to 2%.** Indeed, it should be remembered that interbank rates remain very high in the eurozone relative to the 4.25% official refi rate, with 3-month Euribor rates at 5% representing a further effective tightening of policy. This is unwarranted by the current economic situation as was the July hike in official rates. **We expect the ECB to start easing policy next spring and to cut rates by 0.75% during 2009. This is not being discounted by the markets.** Eonia rates imply that the ECB will not start to ease policy until next June, with futures contracts suggesting that rates will be cut by 0.5% by end 2009.

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