ECB WATCH 12th April 2007

ECB TO RAISE RATES FURTHER

The European Central Bank left interest rates unchanged at its monthly policy meeting today. The decision to leave rates on hold was widely expected. Rates have been raised from 2% in late 2005 to 3.75% by March 2007 in what has been described as a process of normalising the level of official interest rates in the eurozone.

Based on Mr Trichet's comments at the ECB press conference today, it seems clear that rates have not yet peaked in the eurozone. The ECB still regards monetary policy as on the accommodative side and believes that the level of official rates remains moderate. The economy is continuing to grow at a strong rate. Last month, the ECB revised up its GDP growth forecasts for 2007 to 2.5% and is forecasting 2.4% growth for 2008. These forecasts are above the estimated trend growth rate of the eurozone economy.

The ECB expects inflation to hover around 2% over the medium term but it believes that the risks to this forecast are on the upside. It points to the possibility of further oil price rises and additional increases in administered prices and indirect taxes. More fundamentally, wage dynamics could be stronger than currently expected given the strength of economic activity and recent positive labour market developments.

ECB officials also believe that **the continued strong growth rate of monetary and credit aggregates poses another upside risk to price stability.** Eurozone M3 money supply accelerated to a record rate of 10% year-on-year in February, confirming that there is abundant liquidity in the economy, which the ECB says points to upside risks to inflation over the medium term. Credit growth, although moderating, remains strong, especially loans to the corporate sector.

Eurozone Interest Rate Forecasts

	Refi Rate	3 Mth	1 Year	2 Year	5 Year
Current	3.75	3.93	4.20	4.32	4.33
June 07	4.00	4.15	4.25	4.35	4.35
Sept 07	4.00	4.20	4.30	4.40	4.40
Dec 07	4.25	4.35	4.50	4.50	4.45

Forecasts are end month. Swap rates used beyond 1 year.

Current rates are sourced from Reuters, forecasts from AIB ERU.

The HICP inflation rate edged up to 1.9% in March from 1.8% in the opening two months of 2007. The ECB says that based on current prices for oil, significant base effects should lead to a fall in inflation rates by mid-year. **However, these effects will be temporary and inflation is expected to rise again later in the year. Crucially, the ECB believes that over the medium term, the risks to inflation are on the upside.**

Mr. Trichet indicated that all developments will be monitored very closely. A rate hike next month is most unlikely. Instead, with the ECB again hiking rates in three month intervals, the next rate rise will probably be in June, when the refi rate can be expected to be increased by 0.25% to 4%. Even after such an increase in June, **the 4% level may not represent the peak of eurozone interest rates given the strength of economic activity.**

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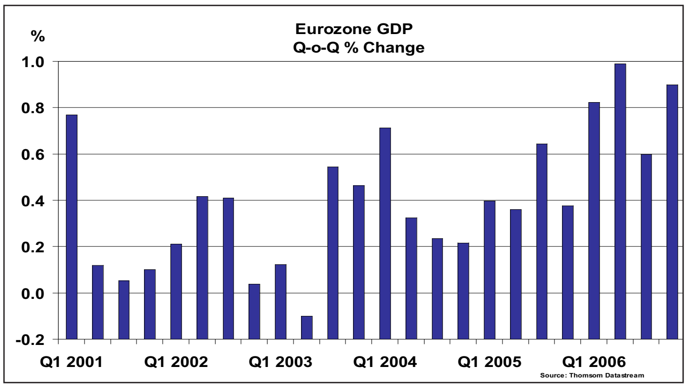
INDICATORS POINT TO CONTINUING STRONG ACTIVITY

Real eurozone GDP grew by 2.7% in 2006. The overall impression from recent eurozone economic indicators is that growth remained strong in the opening months of 2007, despite a significant tightening of fiscal policy in Germany, which has dampened consumer spending. Retail sales fell by 0.8% in the eurozone in January, led by a sharp drop in German sales, before rising by a modest 0.3% in February. Encouragingly, though, consumer confidence in the eurozone continued to improve in the first three months of the year.

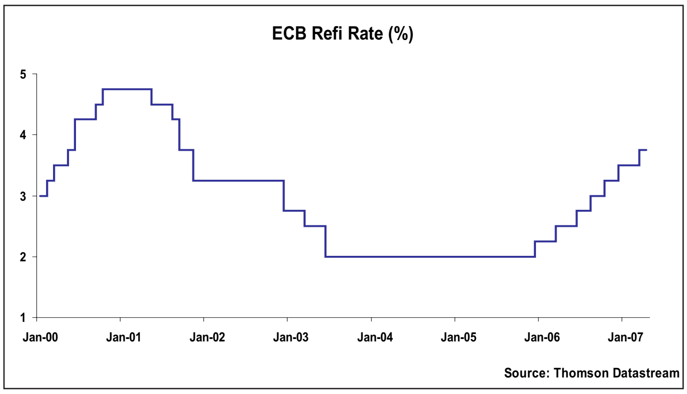


Meanwhile, the EC's economic sentiment indicator reached a new cyclical high in March and is now at levels consistent with very strong economic growth. Furthermore, the EC's industrial confidence indicator has been running at record highs for the last six months. The composite PMI indicator for the manufacturing and services sectors has levelled off, but at a high level consistent with continuing robust economic growth.

At a national level, the EC's sentiment indicators and PMIs also point to continued healthy growth in the main economies in the eurozone. This is also borne out by the continuing strong readings for other national indices, such as the German Ifo, French INSEE and Italian ISAE business surveys. Industrial production has made a very strong start to the year in the eurozone, especially Germany, where it rose by 0.9% in both January and February. Exports, in particular, appear to continuing to perform very strongly.

Thus, despite the sluggishness of consumer spending, the elevated levels of most other indicators points to GDP growth in Q1 remaining reasonably robust at 0.5-0.6%. The strength of leading indicators suggests that growth will remain robust over the balance of the year. Furthermore, the improving labour market conditions should eventually lead to a strengthening of consumer spending. Thus, real GDP could rise by around 2.7% again this year, remaining well above the eurozone's non-inflationary growth potential.

This strong economic growth is impacting on the labour market, with employment rising by 0.4% per quarter over the past year. The unemployment rate fell to 7.3% in February, down from 8.3% at the start of 2006. Again, the fall in unemployment has been most marked in Germany.



The favourable prospects for the economy suggest that the expected rate hike in June is unlikely to be the last in this cycle. A continuation of the strong economic performance is likely to mean that, at some stage, the ECB will deem it appropriate to increase rates beyond 4% to a somewhat restrictive policy stance. This could occur before the end of this year. The market is beginning to contemplate such a move but it has not yet fully discounted rates rising to 4.25%. Yields, though, have risen in recent weeks on increasing bearishness about interest rate prospects. Two and five year swap rates are now above 4.3%, moving closer to our long standing forecast that swap rates could rise to 4.5% later this year.

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