



AIB Corporate & Commercial Treasury

Market Comment

2 April 2001

Focus on ECB

EURO UNDER PRESSURE AS MARKETS REJECT ECB'S 'WAIT AND SEE' STANCE

The euro has come under renewed pressure with the decision by the European Central Bank to leave official interest rates unchanged. Most economists had expected that the ECB would leave rates unchanged last Thursday. However, earlier last week the foreign exchange market appeared to trade on the basis that the ECB would cut on Thursday. As the week progressed, the markets fell into line with economists' views that rates would be left unchanged and the euro started to weaken. The downtrend in the euro has continued this week with the currency reaching its lowest level this year against the US dollar. Why is the euro under renewed pressure? A major factor must be the ECB's ongoing credibility deficit with the financial markets.

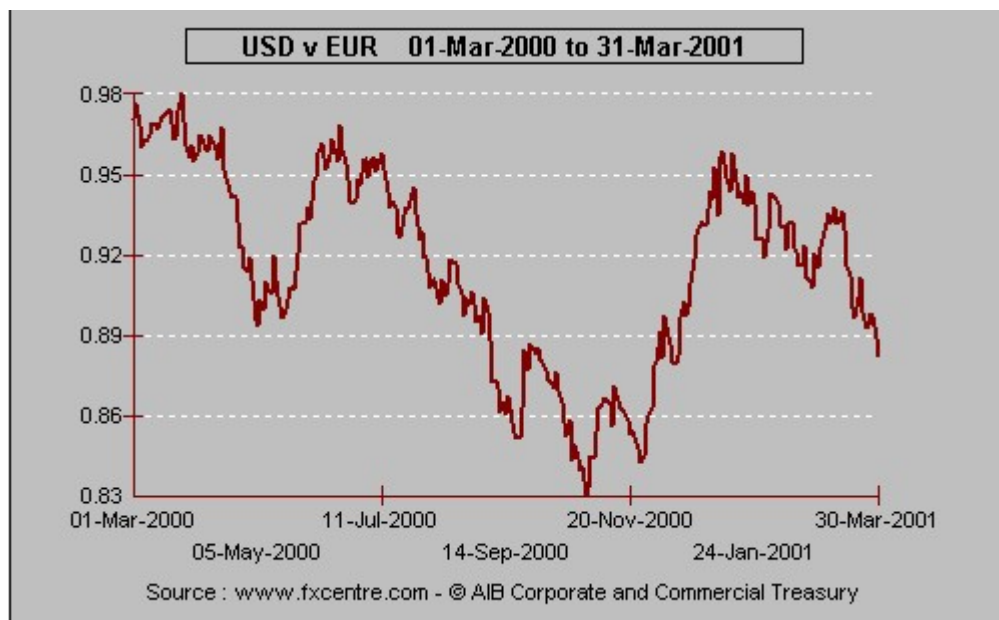
In an unusual move, the ECB issued a statement on Friday confirming its position of 'wait and see' with regard to its monetary policy stance. The ECB regards itself as being in neutral mode with the minimum refinancing rate at 4.75%. The statement said that the Governing Council was carefully assessing whether and to what extent upward risks to price stability will continue to decline.

In a world in which the US Federal Reserve has cut US interest rates by 1.5 percentage points and poised to do more, where the UK's Monetary Policy Committee may cut again this week and where, in Japan, interest rate policy has been set at zero, the ECB's 'wait and see' policy is regarded as a threat to eurozone economic growth. The markets believe that by leaving official interest rates unchanged, euro economic growth will fall well short of the ECB's projected rate of around 3% for 2001 and may even fall below the euro area's non-inflationary speed limit potential of 2.25-2.5%.

Herein lies the nub of the problem. The financial markets see the near certainty that eurozone economic growth will fall back from last year's 3.4% to 2.5% or lower this year as a negative factor for the euro currency. However, as Otmar Issing, the ECB's Chief Economist pointed out last weekend "There should be no misunderstanding: such a return to sustainable rates of growth is a positive

message". He saw a return to growth rates of 2.5% or lower as indicating a lack of imbalances in the euro economy and he believed " it signals that the euro-area economy is robust, supported by sound conditions on the demand side". In summary, therefore, if the rate of economic growth in the eurozone falls to 2.25-2.5%, the ECB will not necessarily cut interest rates.

There does not appear to be any end in sight of the conflict between the financial markets and the ECB. The markets are of the view that other central banks will avert recessionary conditions in their respective economies by cutting interest rates. They do not regard the ECB's position as tenable. The next ECB governing Council meeting is due on 11 April. At this point, it would appear that the ECB will disappoint the market. If it does, the euro will fall further and intervention will be required to prevent a decline back towards last October's lows.



John Beggs
Chief Economist
AIB Group Treasury
www.johnbeggs.com