Outlook for Eurozone Interest Rates

- ***"And this current monetary policy stance remains appropriate.....for some time to come".*** The ECB's decision to leave interest rates on hold was a disastrous one for the euro, which now faces the prospect that rates will not be cut until after the central bank's summer recess. There are grave concerns that the central banks insistence on keeping rates at 4.50% will jeopardise eurozone growth going forward. In contrast, the pro-active approach of the Federal Reserve in the US continues to inspire confidence in a US economic rebound.

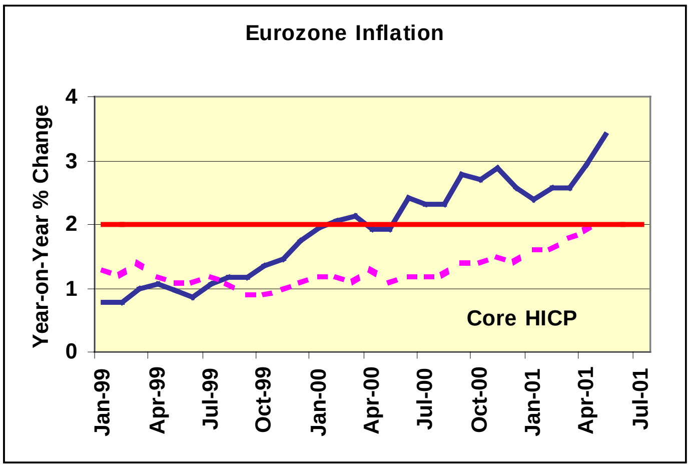
- The slowdown in the eurozone has gained momentum over recent months. According to preliminary data, eurozone GDP rose by 0.5% in the first quarter of 2001. On a year-on-year basis, Q1 GDP was up 2.5%. Growth has been on a steady decline since the second quarter of last year when GDP growth peaked at 3.7%. The breakdown in Q1's GDP data was worrying, as it showed that growth was only helped by a positive net trade balance. Domestic demand growth, seen last year as the most likely motor for the European economy in 2001, was flat. Growth in the German economy was particularly weak in the first quarter with both domestic demand and exports falling. The pronounced weakness in domestic demand seems to have been caused by two factors. First, rising inflation and slowing employment growth have eroded real disposable income. Secondly, higher real interest rates and sluggish real income growth have pushed the construction sector deep into recession.

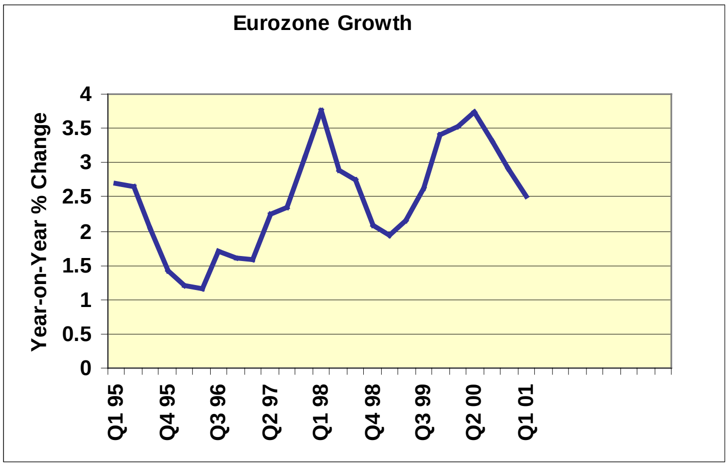
- Leading indicators such as PMI, INSEE, Ifo and OECD survey data all point to a continuation of the deceleration in activity. The weak performance of Germany remains a major restrain on overall growth. However, other major eurozone economies are also slowing down. Most notable here is France, where strong employment growth had helped keep consumer confidence at record high levels. As business confidence and industrial activity fall consumer sentiment has been eroded. After hitting an all-time high in January, confidence has now fallen to its lowest level since July 1999. Confidence and activity levels are also falling in Italy and Spain. On the basis of current conditions, eurozone growth is likely to be sub 2.0% this year

- Although growth is slowing the ECB is face with an inflation problem, leaving it difficult to reduce rates at this juncture. It had been expected that eurozone inflation would fall back towards the ECB's 2.0% over the course of this year. However, higher food and energy prices and a weak euro have made this impossible. Assuming no further shocks, inflation is now not expected to fall back to below 2.0% until well into next year. The move back from May's peak of 3.4% is unlikely to be a smooth one.

- So where does this leave the ECB? Interest rate markets were pricing in a refi rate of 4.0% by year-end. Last week's development mean that this has now been revised to one 0.25% cut in September. This is in line with our consensus view. A further reduction may be possible by year-end but this will very much depend on the inflation outturn.

Geraldine Concagh
06-July 2001





AIB Group Treasury
Economic Services Unit