



AIB Group Treasury Economic Services Unit

ECB Sounds Note of Caution on Eurozone

"There is, therefore, increased uncertainty surrounding economic growth in the euro area in the second half of 2001, especially in light of possible further effects of the deteriorating growth performance in several other regions of the world and the potential impact of changes in confidence on domestic demand."

With inflation decreasing and economic growth falling, an ECB rate cut of 0.25%, possibly as early as its meeting on 30 August, looks increasingly likely. In its August monthly bulletin, the ECB reiterated that current interest rates are appropriate for the time being but in a move not seen before, voiced some concern about the outlook for growth in the eurozone. It also added that while rates were appropriate for now, there was a need to closely monitor developments that may affect this assessment. Until now, ECB officials have maintained that while 2001 eurozone growth is likely to be slower than the 3.4% posted in 2000, it would still generally be in line with its trend potential rate, which is believed to be somewhere in the region of 2% - 2.25%. However, real GDP in the first half of 2001 is now expected to be below the levels projected earlier in the year. This has implications for growth estimates for the rest of the year. The slowdown not only reflects the global downturn but weaker than expected consumption growth in the eurozone itself.

Given the central bank's narrow price stability objective its view on inflation is crucial to the trend in rates. Inflation in the eurozone clearly peaked in May at 3.4%. It fell to 3% in June with a further fall likely to around 2.8% in July. Lower oil prices have been a significant factor in the decline and could push inflation lower in August while a positive basis effect is likely to see a further significant fall in the annual inflation rate in September, possibly to 2.5% or below. While the ECB sees the level of inflation as still being very high these developments do confirm that the past increase in the HICP was, to a significant extent, due to the direct impact of temporary factors which should gradually unwind. The indirect effect of the past increases in import prices is also expected to gradually decline. Furthermore, with economic activity weakening, wage moderation has continued. In the absence of any other further unfavourable shocks, the decline in inflation is expected to continue.

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