



AIB Group Treasury Economic Services Unit

ECB Finally Delivers

After months of watching and waiting the ECB delivered its second interest rate cut of the year at last Thursday's policy meeting. The move reduced the refi rate to 4.25%. The interest rate on the marginal lending facility was also reduced by 0.25%, to 5.25%. In the press conference which followed the ECB's more downbeat assessment of the eurozone economy suggests that there are further cuts on the way but the ECB was as allusive as ever as to the timing of its next move.

Our central forecast anticipated a 0.25% rate cut in both Q3 and Q4. With the first of these now delivered, and in the light of recent eurozone data and ECB comments, it seems appropriate to review this forecast. With a sole objective of price stability, the ECB's primary focus over the last year has been the eurozone's inflation rate. Although monetary policy is supposed to be forward looking, the ECB seems to adopt a more retrospective approach. The fall in inflation since May and the weakening in economy activity have been evident for all to see for quite some time. However, it has taken until now for it to provoke a policy response from the ECB. This suggests that data released for the remainder of the year should have a considerable impact on ECB policy decisions.

Unlike in previous rate moves, ECB head, Wim Duisenberg, did not indicate that rates were now on hold, saying that he cannot forecast when another move will come, or in what direction it might be. He also added that when new information becomes available the ECB will take a decision on the course of action required. This suggests that if inflation continues to decline and economic activity remains weak, the central bank will move again. The headline inflation (HICP) rate should fall sharply on a positive basis effect in September, opening the door to a further rate cut at the meeting in early October.

Another rate cut could be on the cards by the year-end with the HICP likely to move closer to the ECB's 2.0% price stability target in November. Furthermore, for the first time, the ECB has admitted that its growth forecast for 2001 was not realistic. Changes to official forecasts will not be made until December but the slowdown in the US has had a bigger impact than anticipated. The growth rate in the eurozone could be as low as 1.5% in the second half of the year. If this is the case, we expect rates to finish the year at 3.75%, which is 0.25% lower than our original forecast. There are two main factors mitigating against a fourth 0.25% cut. The first is money supply growth and the second is the euro. To date, the ECB has explained away the sharp rise in M3 by saying that it is due to statistical distortions. However, if M3 growth remains strong, some council members may prefer to take a much more cautious approach. At Thursday's press conference the ECB acknowledged the part that the euro's recovery played in allowing it to cut interest rates. A renewed bout of euro weakness could seriously jeopardise the chances of a move to 3.75%.

With the market heavily discounting a rate cut at last week's meeting there was considerable scope for upset, particularly for the euro. Although much of its recent rally has been based on disappointment in the US economy's failure to respond to aggressive monetary easing, the euro has also been supported by expectations that the ECB is finally ready to cut rates. Expectations of further rate cuts, which should boost eurozone growth over the medium term, should also be supportive.

**Geraldine Concagh,
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