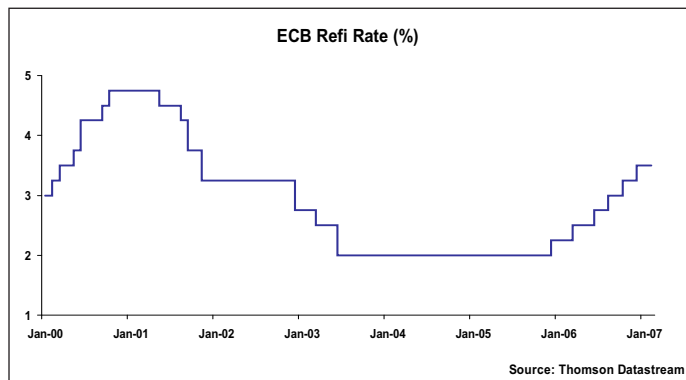


ECB TO HIKE IN MARCH, MORE TO FOLLOW

The European Central Bank, as expected, left official interest rates unchanged at its monthly policy meeting today, but sent a strong signal that rates would be increased in March. The ECB President used the phrase "strong vigilance" at today's press conference in describing the ECB's concerns about inflation. This suggests that rates will be hiked next month.

Rates have been raised in 0.25% steps from 2% in late 2005 to 3.5% by December 2006 in what has been described as a process of normalising the level of official interest rates in the eurozone. **However, the ECB seems to have changed the timing of interest rate decisions back to 3 month intervals from 2 months,** given that rates were last hiked in December.

It has been clear from the comments by numerous ECB officials that rates have not yet peaked in the eurozone and a 0.25% rate hike in March will be no surprise to the markets. **The ECB still regards monetary policy as accommodative,** with speeches by ECB officials consistently highlighting that the level of official rates remains low.



The economy, though, is growing at a strong rate. Although the ECB expects GDP growth to moderate towards its trend rate, it seems increasingly confident that 2007 will prove to be another year of solid growth for the eurozone economy, following the 2.7% rise in GDP in 2006. The German economy, in particular, seems likely to be able to withstand the tightening of fiscal policy there this year.

Meanwhile, the HICP rate has been stable at 1.9% for the past three months. The ECB says that based on current prices for oil, **significant base effects may lead to lower 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.** It notes the risks of a stronger pass-through effect on inflation of previous oil price increases and the possibility of a renewed surge in oil prices.

More fundamentally, wage dynamics could be stronger than currently expected, given the strength of economic activity and recent positive labour market developments. The jobless rate has fallen to 7.5% in the eurozone, with a particularly sharp fall in German unemployment in recent months. Axel Weber, head of the German Bundesbank, has warned that **high wage settlements are now the biggest threat to inflation. Mr Trichet said today that the ECB would monitor the upcoming wage negotiations in the euro area very carefully.**

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 rose at a record rate of 9.7% year-on-year in December, confirming that there is abundant liquidity in the economy, which the ECB says points to upside risks to inflation over the medium term.

ECB RATES OF 4% BY MID YEAR....MAY NOT BE PEAK

Even after a further rate increase in March, it is likely that the ECB will still view policy as accommodative. If, as expected, the economy continues to perform well, the ECB will no doubt at some stage see a need to move to a more neutral policy stance. Certainly, the indicators published to date for January suggest that the economy is continuing to grow at a robust pace. The composite PMI was unchanged in the month at 57.5, consistent with quarterly GDP growth of around 0.7%. The EC Economic Sentiment index did ease back in January but, at a level of 109.2, still points to quite robust growth by the eurozone economy.

While it is true that the ECB has maintained that it does not have a pre-determined path for official rates, **the case for further normalisation is strong and a level of 4% for the ECB's refi rate could well be an initial target level.** This would represent a real rate of about 2%, which is probably close to a neutral stance, and broadly consistent with an economy growing close to potential.



As already indicated, the comments by Mr Trichet at today's ECB press conference signal that a 0.25% hike in rates to 3.75% is on the cards for March. This would leave the door open for the ECB to hike rates to 4% by around mid-year, possibly at its June meeting. Indeed, Mr Trichet has said the ECB will look through any short term volatility in assessing growth and inflation data, leaving scope for further policy tightening.

Thereafter, policy may go on hold, given that inflation could fall to comfortably below 2% in the summer and with a possibility that rate cuts may yet materialise in the US. However, **it is too early to suggest that 4% would represent the peak for official rates in the eurozone.** The growth prospects for the eurozone economy remain favourable, especially as it seems increasingly likely that it will be able to withstand policy tightening this year. Meantime, the continued tightening of labour market conditions could eventually put upward pressure on wages and inflation. The ECB will also be concerned if the recent re-emergence of upward pressure on oil prices persists.

Thus, at some stage, the ECB may deem it appropriate to move policy to a

somewhat restrictive policy stance, especially if growth is above trend. This could occur towards the end of 2007, when inflation may be on the rise again. This is not being contemplated by the markets, which have just about fully discounted official rates getting to 4% by end year. Overall, then, **we see further upward pressure on market interest rates and bond yields. Two year swap rates could well reach 4.5% before end 2007, with the curve possibly inverting.**

Eurozone Interest Rate Forecasts

	Refi Rate	3 Mth	1 Year	2 Year	5 Year
Current	3.50	3.77	4.05	4.18	4.19
Mar 07	3.75	4.00	4.20	4.30	4.30
June 07	4.00	4.15	4.25	4.30	4.30
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.