



ECB RATES TO REMAIN VERY LOW

At its policy meeting today, the European Central Bank again left its refi rate unchanged at 1% for the tenth month running. It also continued to give the strong impression that rates will not be increased anytime soon. This is an historically low level for the refi rate, which troughed at 2% in the previous cycle in 2003-05. The 1% level, though, is expected to be the trough in this cycle, now that the economy has emerged from recession.

While the recession has proved very deep, **the ECB expects the recovery in activity to be moderate and uneven**, leaving the economy with a large amount of spare capacity for a prolonged period. Thus, price pressures are expected to remain very subdued. The weak growth of monetary indicators also points to continuing low inflation rates. It is for this reason that **the ECB is not in any hurry to raise interest rates.**

The latest ECB's staff quarterly economic forecasts were published today also. These see the **eurozone economy expanding by just 0.8% in 2010 and 1.5% in 2011**, following a sharp decline of 4.0% in GDP in 2009. The staff forecasts see **inflation averaging 1.2% in 2010 and 1.5% in 2011**, well below the key 2% level.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2008	2009	2010	2011
HICP	3.3	0.3	1.2	1.5
Real GDP	0.6	-4.0	0.8	1.5

Forecasts are mid-point of a range and based on assumption that oil prices will average \$75.1 in 2010 and \$79.8 in 2011. Source: ECB March 2010

Recent data support the ECB's cautious view. While leading activity indicators such as PMIs and EU Commission sentiment surveys have picked up strongly, real economic data have been less impressive. The 0.4% growth in GDP in Q3 was more than accounted for by a rise in inventories. GDP growth slowed to just 0.1% in Q4. Retail sales, in particular, were weak in the final quarter of last year. Meanwhile, the unemployment rate reached 9.9%, while inflation is running at 0.9%.

Mr Trichet repeated again today that the refi rate is at an appropriate level, suggesting that the ECB is not considering changing rates any time soon. The subdued outlook for inflation, weakness of monetary indicators, high and rising unemployment and doubts about the strength and durability of the upswing in activity all point to a prolonged period of low interest rates. **Thus, it may well be 2011 before the ECB starts to contemplate refi rate hikes.**

Mr Trichet also gave information today about the further steps that will be taken in Q2 2010 in the ECB's **gradual withdrawal of its non-standard liquidity support measures for the banking system.** The December 2009 twelve month LTRO (long term refi operation) was the last of that duration, while the ECB had already indicated that the six month LTRO to be conducted at the end of this month will also be the last in this maturity.

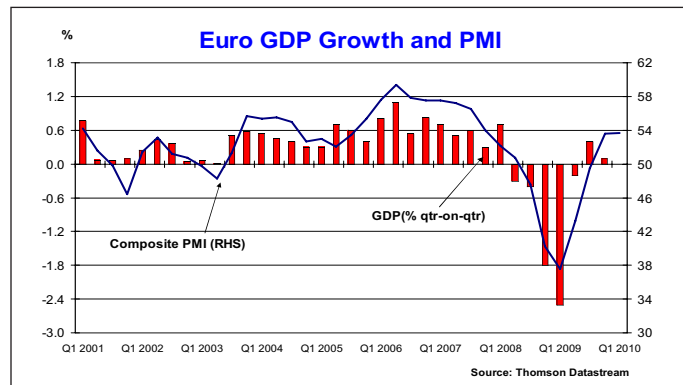
As a further step in phasing out these extraordinary liquidity measures, the ECB indicated today that, while it will continue to provide enhanced credit support to the banking system, the three month refinancing operations will revert to a variable rate tender from April.

Very Weak Recovery in Eurozone Economy

The eurozone economy came out of recession in Q3 2009 after five consecutive quarters of declining output. GDP expanded by 0.4% in Q3 but this was all driven by a rise in inventories, which added 0.5% to GDP in the quarter. On an output basis, the Q3 GDP rise was narrowly based, with industrial production accounting for all the growth in the economy. This suggests a fragile recovery in activity, a view borne out when GDP growth slipped to a meagre 0.1% in Q4 2009.

Consumer spending and investment continued to contract in Q4 2009, indicating that final domestic spending remains very weak. **Exports are recovering but this is not translating into a pick up in domestic demand** as in previous cycles.

Survey data published for Q4 2009 and early 2010 point to a stronger paced recovery in activity than shown in GDP numbers. The clearest evidence of this is provided by PMIs, a good leading indicator of economic activity. The composite PMI has risen sharply since early last summer. It averaged 53.6 in Q4 2009 compared to 49.5 in Q3. The composite PMI stood at 53.7 in January/February, which is well into positive GDP growth territory.

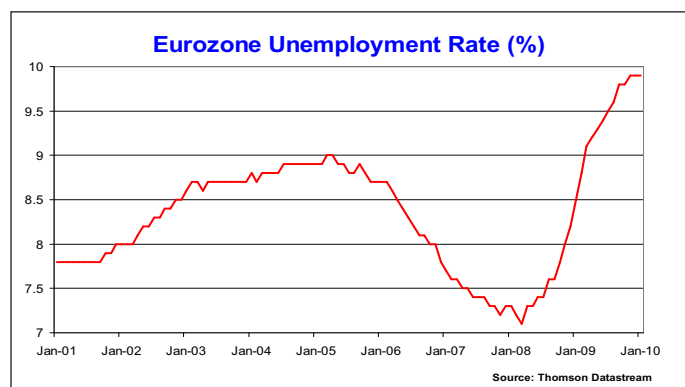


The EC's economic sentiment index, another good leading indicator of economic growth, has also risen strongly since mid-2009, standing at 96 in January and February, compared to an average level of 80 in Q3 2009. There has also been a marked rise in some key national business confidence surveys, notably the Ifo index in Germany and the closely followed Belgium business confidence index.

However, the jump in these leading indicators has not been backed up by trends in real economic data. Eurozone retail sales have remained very weak suggesting that consumer spending continues to contract. The pick up in industrial activity has also lost some strength in recent months. Indeed, the leading indicators have also shown signs of levelling off recently, supporting expectations that **the pick-up in activity will remain very anaemic throughout 2010.**

In particular, the provision of credit remains constrained, which will continue to dampen the upturn in activity - annual private sector loan growth fell by 0.6% in January, while the annual growth rate of M3 stood at just 0.1%. Inventory rebuilding in H2 2009 may not extend into 2010 either. Thus, **most forecasters expect a slow-paced, uneven recovery in activity.** Following a decline of around 4% in 2009, the EU Commission is forecasting that eurozone GDP will rise by just 0.7% this year, while the ECB is anticipating a similarly subdued growth rate of 0.8%.

A weak recovery points to a further rise in unemployment. The jobless rate has risen sharply, picking up to 9.9% in recent months from 8.2% at the end of 2008 and 7.2% in early 2008. Employment has been contracting since mid-2008. The EU Commission is forecasting that the unemployment rate will rise to close on 11% this year with employment falling by an average 1.3% in 2010, after a 2.3% decline in 2009.



It all suggests that inflation will remain very subdued. The flash estimate for February shows the headline CPI rate at 0.9%, while excluding energy, inflation was just 0.7% year-on-year in January. Core inflation is now running at its lowest level in a decade.

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