

ECB REFI RATE HEADING FOR 1%

The European Central Bank cut rates by 0.5% to 1.5% today, bringing the total reduction in official rates in the eurozone to 2.75% since last October. This represents a historic low for ECB rates, which troughed at 2% in the previous cycle in 2003-2005. A further 0.5% reduction in ECB rates seems likely by the summer, taking them down to 1%. Indeed, overnight rates have already fallen to 1%, with the ECB providing one week money to the market at 1.21% at yesterday's tender.

Some senior ECB Council members have already hinted that the refi rate could be cut to as low as 1%, while also indicating that they do not want the rate to fall to as low as 0%. Bundesbank President, Axel Weber, said that a refi rate of 1% would be "the lowest limit" for him. However, this would not rule out short term money market rates dropping below 1%. **Neither can other policy measures be ruled out,** such as the purchase of short-term commercial paper by the ECB.

The reason for such actions is apparent in the latest quarterly economic forecasts published today by the ECB. Last September, before it started to

ease policy, the ECB forecast that the euro economy would grow by 1.2% in 2009. Now, it sees the economy contracting by 2.7% in 2009, with zero growth forecast for 2010.

The ECB has also made further significant reductions to its inflation forecasts. It is now predicting that the HICP rate will average 0.4% in 2009, which compares to forecasts of 1.4% and 2.6% made last December and September, respectively. It sees inflation remaining low in 2010, averaging 1.0%.

The latest readings from key leading activity indicators, in particular the PMI surveys and EC's economic sentiment index, are truly awful and point to a very deep recession. GDP contracted by 1.5% in Q4 2008 and is likely to decline sharply in the first two or three quarters of this year also. Thus, a fall of 2.7% in eurozone GDP looks to be on the cards for 2009.

Meanwhile, the sharp fall in oil prices as well as weakening demand and labour market conditions suggest that inflation will remain very low in the eurozone over the next couple of years. It all suggests that eurozone interest rates are going to remain very low for a prolonged period of time, certainly well into 2010.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2007	2008	2009	2010
HICP	2.1	3.3	0.4	1.0
Real GDP	2.6	0.7	-2.7	0.0

Forecasts are mid-point of a range and based on assumption that oil prices will average \$49.3 per barrel in 2009 and \$57.4 per barrel in 2010. Source: European Central Bank

