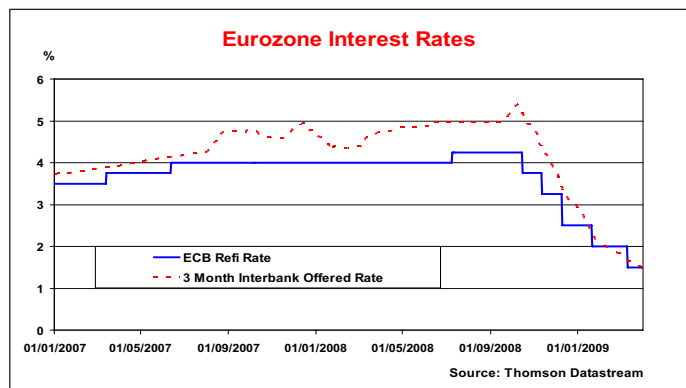


ECB REFI RATE HITS 1.25%

The European Central Bank cut its refi rate by 0.25% to 1.25% today, bringing the total reduction in official rates in the eurozone to 3.0% since last October. This represents an historic low for ECB rates, which troughed at 2% in the previous cycle in 2003-2005.

The extent of the rate move was less than market expectations, which had centred on a rate cut of 0.5% at today's meeting. One of the reasons put forward by Trichet for the decision to cut rates by just 0.25% was a reluctance to narrow the corridor between the refi rate and the overnight deposit rate. This rate, which acts as a floor for money market rates, was also cut by 0.25% at today's meeting,



bringing it down to just 0.25%. The last time that the corridor was narrowed banks took the opportunity to deposit excess funds with the ECB rather than pass them on. Trichet indicated that the ECB sees the current 0.25% level as the floor for the overnight deposit rate.

However, he didn't rule out a further cut in the key refi rate saying that it is not necessarily at its lowest limit. Indeed, **we would expect a further 0.25% cut in the refi rate in the coming months, bringing it to 1.0%**. This, then, may well prove the trough for ECB rates in this cycle with many on the ECB's Governing Council reluctant to cut the refi rate below 1%.

The focus at the press conference was also very much on indications of when and to what extent the ECB might engage in quantitative easing measures, similar to those already being pursued in the US and UK, to boost money supply to counter the deep recession and increasing deflationary pressures. ECB Vice-President, Lucas Papademos, raised the prospect of such a move last week, saying that the ECB was considering the purchase of corporate bonds.

It seems increasingly likely that the ECB will adopt quantitative easing measures. Indeed, Trichet indicated that the central bank will take a decision at next month's meeting on whether such measures will be pursued and if so what form they will take. A rate cut next month, in addition to an announcement on quantitative easing, now seems less likely and the ECB may well now wait until June to cut rates to 1%, which would also coincide with the release of its latest economic projections.

These are likely to substantiate the case for further easing with readings from key leading activity indicators, in particular the PMI surveys and EC's economic sentiment index, continuing to point to a very deep recession. While there has been some indication that these lead indicators may be beginning to stabilise, they are at very low levels and a fall of up to 4% in eurozone GDP could 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 in the eurozone will remain very low over the next couple of years. This all suggests that **eurozone interest rates are going to remain very low for a prolonged period of time, certainly well into 2010.**