ECB WATCH 4th June 2009

ECB RATES ON HOLD AT 1%

As expected, the European Central Bank left its refi rate unchanged at 1% today, having already reduced this key official interest rate by a total of 3.25% between October and May. This is a historically low level for the refi rate, which troughed at 2% in the previous cycle in 2003-2005. As was also expected, the ECB left its overnight deposit rate - which acts as floor for very short term money market rates - unchanged at 0.25%. Overnight money market rates have been trading at around 0.5% in recent weeks.

At the post meeting press conference, **Mr Trichet again indicated, as he had done after the May meeting, that the ECB had not decided that rates could not go any lower. However, a further cut in interest rates seems unlikely,** certainly in the near term. In our view, with leading economic indicators picking up in the eurozone and elsewhere, and oil prices rising sharply in recent months, the 1% level may well represent the trough for the refi rate in this cycle.

The market focus today was also on other measures that the ECB could use to further expand monetary policy. **In this regard, the ECB announced the details of its plan to purchase €60 billion of euro denominated covered bonds** (these are bonds supported by a pool of assets, either mortgage or public sector loans, and are generally viewed as high quality). The bonds must have at least one rating of AA or higher and issues must be at least €500 million in size to qualify. Purchases will begin next month and last until June 2010.

The ECB's latest staff quarterly economic forecasts were also published today. The ECB now sees the economy contracting by 4.6% in 2009, a marked downward revision from the 2.7% decline in its March forecasts. It is forecasting a GDP decline of 0.3% for 2010. GDP contracted by a very sharp 2.5% in Q1 2009, triggering the downward revision to the ECB's 2009 growth forecast. The ECB does not see a return to positive growth until mid-2010.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2007	2008	2009	2010
HICP	2.1	3.3	0.3	1.0
Real GDP	2.6	0.6	-4.6	-0.3

Forecasts are mid-point of a range and based on assumption that oil prices will average $54.5 per barrel in 2009 and $65.5 per barrel in 2010. Source: European Central Bank

The ECB has made only slight changes to its inflation forecasts. It is now predicting that the HICP rate will average 0.3% in 2009, which compares to its March forecast of 0.4%. It sees inflation remaining low in 2010, averaging 1%. These forecasts are based on oil averaging $54.5 a barrel in 2009 and $65.5 a barrel in 2010, which might prove a bit optimistic with prices now above $65.

The latest readings from key leading activity indicators, in particular the PMI surveys, suggest that the pace of contraction in the eurozone economy is easing. These lead indicators have risen for a number of months now, albeit from very low levels. Furthermore, they have a good distance to rise yet to reach levels that would be consistent with a return to economic growth. Meanwhile, the very weak demand and labour market conditions suggest that inflation should remain subdued in the eurozone over the next couple of years. However, the recent marked rise in oil prices suggests that upward pressure may emerge on the headline inflation rate later in the year, but the ECB does not see this as a threat to price stability.

John Beggs
Chief Economist
john.f.beggs@aib.ie

Oliver Mangan
Chief Bond Economist
oliver.n.mangan@aib.ie

Geraldine Concagh
Senior Economist
geraldine.t.concagh@aib.ie

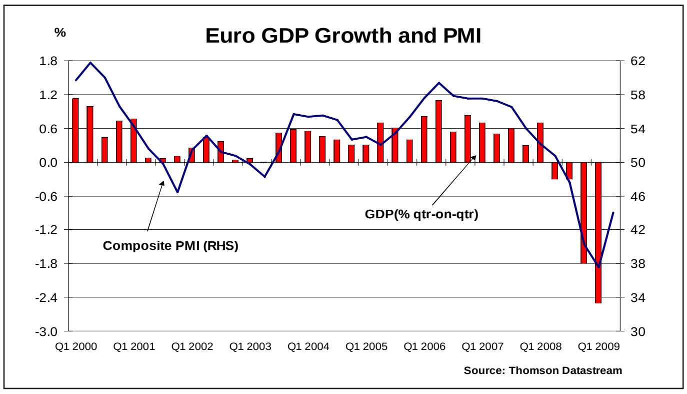
Jenny Pollock
Senior Economist
jenny.c.pollock@aib.ie

Recessionary Pressures Easing in the Eurozone

Eurozone GDP contracted by 2.5% in Q1 2009 following a decline of 1.8% in Q4 2008. It marked the fourth consecutive quarter of declining GDP and left output in Q1 down 4.8% on year earlier levels, pointing to a very deep recession in the eurozone. The GDP data for Q1 show a fall of 0.5% in consumer spending in the quarter and big declines in fixed investment and exports of 4.2% and 8.1%, respectively. On a more positive note, there was a sharp rundown of inventories in Q1 2009 after they rose markedly in H2 2008. This drawdown of inventories accounted for 1% of the 2.5% fall in GDP in Q1.

Meanwhile, industrial output continued its sharp contraction in Q1, declining by 8.8%, which follows a fall of 5.7% in Q4 2008. This is being largely driven by the sharp downturn in world trade. Indeed, **the big decline in industrial output and associated falls in transport and trade account for the vast bulk of the contraction in eurozone GDP since Q1 2008.**

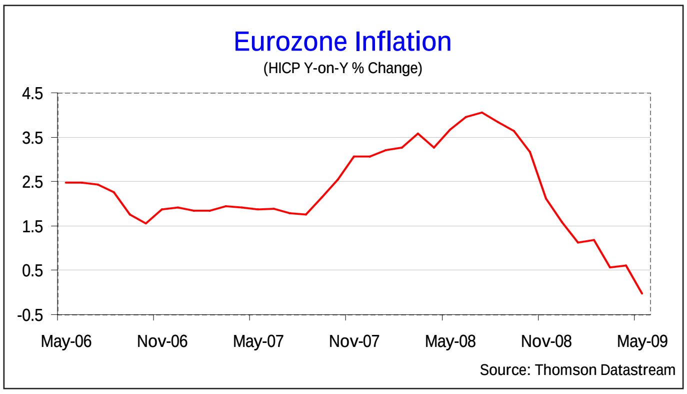
There is good news, though, in that the data published to date for Q2 2009 point to an easing of recessionary pressures, with the pace of contraction slowing considerably. The clearest evidence in this regard is provided by PMIs, a very good lead indicator of economic activity. The composite PMI rose to 44.0 in May, up from 41.1 in April, 38.3 in March and its cyclical low of 36.2 reached in February. There has been a good rebound in both the services and manufacturing components of the PMI, with the latter's rise suggesting that the pace of decline in industrial activity is easing.



The EC's economic sentiment index, another good leading indicator of economic growth, has also started to edge up in the past two months, albeit from very depressed levels. Meanwhile, there has also been an improvement in national surveys of business and consumer confidence in the past couple of months.

It must be stressed, though, that all these indices are still at recessionary levels and it will take some time for the indices to rise back up to levels consistent with economic growth. **The ECB does not expect a return to positive growth until mid-2010, with GDP still declining on average next year.**

The eurozone labour market also continues to weaken. The unemployment rate has risen sharply in recent months, picking up to 9.2% in April from 8.2% at end 2008 and 7.3% a year earlier. Employment contracted in H2 2008 and survey data point to a marked fall in employment in 2009 - the EU Commission is forecasting that employment will decline by 2.6% this year and a further 1.5% in 2010.



There is good news on the inflation front. The CPI rate has fallen sharply since last summer, when it peaked at 4%, declining to 0% by May. The fall in the CPI rate reflects the collapse in oil prices since last summer. Other commodity prices have fallen also, which has seen food price inflation ease sharply in particular. The recession and rising unemployment are also putting downward pressure on core inflation. Inflation is expected to turn negative over the summer but will start to rise again later in the year, especially if the recent marked rise in oil prices proves sustained. Core inflation, though, should remain very subdued in 2010.

AIB International Centre, IFSC, Dublin 1 Tel: 353-1-8740222 Fax: 353-1-6799590