



LIQUIDITY SUPPORT TO BE SCALED DOWN

At its policy meeting today, the European Central Bank again left its refi rate unchanged at 1% for the seventh month running. This is a historically low level for the refi rate, which troughed at 2% in the previous cycle in 2003-2005. The ECB also left its overnight deposit rate unchanged at 0.25%. **The 1% level is expected to be the trough for the refi rate** in this cycle, now that the economy has emerged from recession.

However, the ECB is not in any hurry to tighten monetary policy. While the recession has proved very deep, **the ECB expects the recovery in activity to be at a moderate pace as a number of the supporting factors are of a temporary nature,** 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.

The ECB's latest staff quarterly economic forecasts, which were published today, provide useful insights in this regard. **In light of recent improvements in economic activity, these now see the economy expanding by 0.8% in 2010,** following a sharp decline of 4.0% in GDP in 2009. **The staff forecasts see inflation averaging 1.3% in 2010** and 1.4% in 2011, thus remaining low and well below the 2% level.

ECB Macroeconomic Forecasts for the Euro Area				
(%)	2008	2009	2010	2011
HICP	3.3	0.3	1.3	1.4
Real GDP	0.6	-4.0	0.8	1.2

Forecasts are mid-point of a range and based on assumption that oil prices will average \$62.2 per barrel in 2009, \$81.4 in 2010 and \$85.9 in 2011. Source: European Central Bank

Mr Trichet repeated 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 is still our view that it will be well into next year before the ECB starts to contemplate rate hikes.**

However, given improved conditions on financial markets, **the ECB is starting the gradual process of withdrawing its non-standard liquidity support measures for the banking system.** As a first step, Mr Trichet confirmed that the ECB would not be extending its twelve month LTRO (long term refi operation) past December. Furthermore, Trichet announced that the December LTRO would move from the current 1% fixed rate to a variable rate tender. While this move surprised the market, arousing some speculation that it could be a signal that the ECB is preparing the ground for a rate hike some time in 2010, Trichet was at pains to point out that this was not a policy signal. Meanwhile, the six month refi operation is not to be extended past March next year.

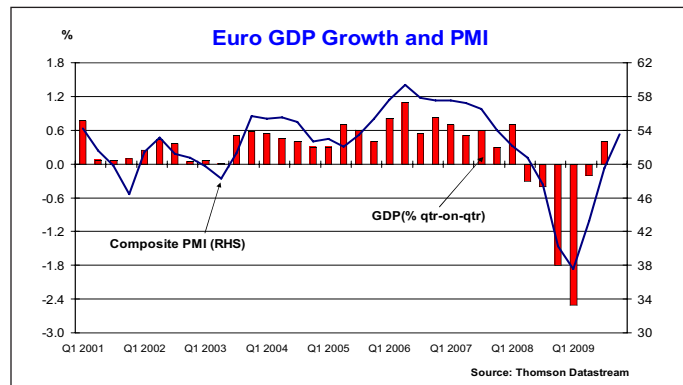
The ECB will be anxious to minimise the impact on money markets and banks of its exit programme. It is likely to continue to provide considerable liquidity support to the system for some time. Indeed, Trichet indicated that full allotment at the main refinancing operations will be kept in place for as long as needed, and until at least mid April 2010. Thus, there is likely to be a slow, gradual withdrawal of these unconventional liquidity support measures.

Gradual 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, helped by a strong contribution from inventories. Exports were also up strongly, rising by 2.9% over the quarter, though this was largely offset by an equally strong rise of 2.6% in imports. Private domestic demand remained weak, though, with household consumption falling 0.2% as car scrappage schemes started to end. Fixed investment, meanwhile, contracted by 0.4%.

The data published to date for Q4 2009 point to a strengthening of activity. The clearest evidence of this is provided by PMIs, a very good leading indicator of economic activity. The composite PMI has risen steadily since early summer, reaching 53.0 in October, and 53.7 in November, well above the key 50.0 level. It compares to an average reading of 49.5 in Q3.

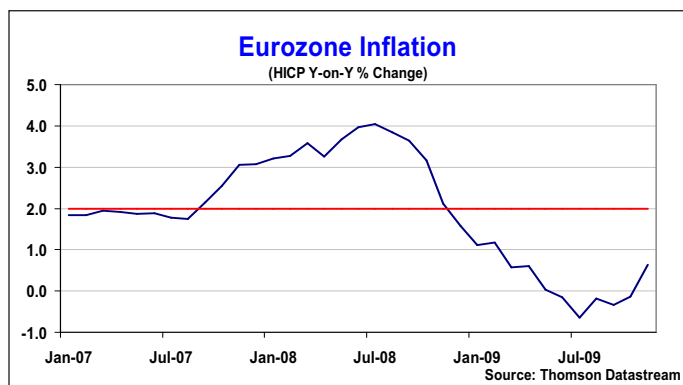
The EC's economic sentiment index, another good leading indicator of economic growth, has also risen strongly in recent months, jumping to 86.1 in October and 88.8 in November compared to an average level of 80 in Q3. There has also been a big improvement in national surveys of business and consumer confidence in the past few months, including the key Ifo index in Germany and the closely followed Belgium business confidence index. Eurozone industrial orders rose for a fifth straight month in September, in a further sign of a pick up growth.



There are doubts, though, about whether or not the pick-up in activity will be sustained. Consumer spending has been boosted by temporary factors, such as government car scrappage schemes. Household spending could falter in 2010 in the face of a continued rise in unemployment. The jobless rate has risen sharply, picking up to 9.8% by October from 8.2% at the end of last year 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% next year and that employment will fall by an average 1.3% in 2010, after a 2.3% decline in 2009.

The provision of credit also remains constrained, which will dampen the upturn in activity - private sector loan growth has turned negative, falling by 0.8% year-on-year in October. The annual growth rate of M3 has slowed to just 0.3% in October. Inventory rebuilding in H2 2009 may not extend into 2010 either. **Thus, most forecasters expect a slow-paced 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% next year, while the ECB is anticipating a similarly subdued growth rate of 0.8%.

On the inflation front, the CPI rate turned positive in November at 0.6%, having been negative over the previous five months. The headline CPI has been impacted by the volatility in oil prices over the past year. Other commodity prices have fallen also, which has seen food price inflation turn sharply negative over the summer months. The recession and rising unemployment have put downward pressure on core inflation. The annual core CPI rate has declined to 1.0% from 2.6% in mid-2008. Core inflation should remain very subdued and may ease even further. Overall, **CPI inflation is expected to remain very low next year**, averaging around 1%, well below the key 2% level - the EU Commission is forecasting that the HICP rate will average 1.1% in 2010, while the ECB is forecasting an average rate of 1.3%.



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