



ECB SITTING TIGHT ON RATES

At its policy meeting today, the European Central Bank again left its refi rate unchanged at 1%, where it has been pitched since May 2009. The ECB 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 set 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 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.**

ECB's staff quarterly economic forecasts published last month show that they expect the **eurozone economy to expand 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

Although leading activity indicators such as PMIs and EU Commission sentiment surveys have picked up strongly, most real economic data have been less impressive. The 0.4% growth in GDP in Q3 2009 was more than accounted for by a rise in inventories, while GDP did not grow at all in Q4. GDP growth in Q1 2010 is likely to have been negatively impacted by poor weather. Consumer spending remains weak, with growth still mainly confined to industry and exports. Meanwhile, the jobless rate has reached 10% and the annual inflation rate excluding energy has fallen to just 0.6%.

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. With price pressures expected to remain moderate, weak monetary growth, high and rising unemployment and doubts about the strength and durability of the upswing in activity, it all points to a prolonged period of low interest rates. **Thus, it may well be 2011 before the ECB starts to contemplate refi rate hikes.**

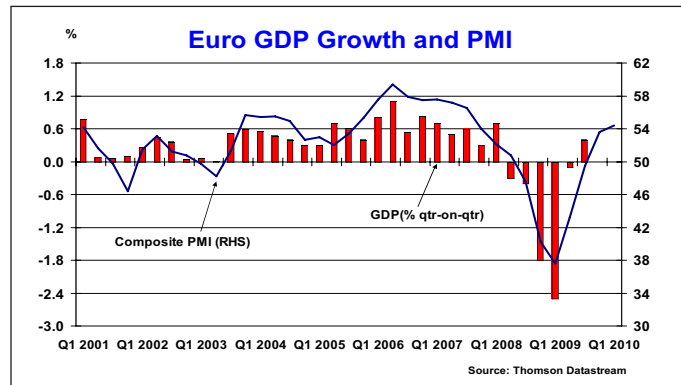
Meanwhile, the ECB's is continuing the **gradual withdrawal of its non-standard liquidity support measures for the banking system.** The December 2009 twelve month LTRO (long term refi operation) was the last of that duration, while the six month LTRO conducted at the end of March was the last in that maturity. As a further step in phasing out the special liquidity measures, the three month refinancing operation is reverting to a variable rate tender from this month.

The ECB has indicated, though, that it will continue to provide enhanced credit support to the banking system. In particular, it has committed to continue providing unlimited one-week and one-month funding for banks until at least mid-October, thereby leaving the system with excess liquidity. As a result, money market rates continued to hit new lows in recent weeks.

Moderate Recovery in Eurozone Economy, Driven By Exports

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. **This pointed to a fragile recovery in activity, a view borne out by recent GDP data which showed no growth at all in Q4 2009. Domestic spending continued to contract in Q4** as a result of a further fall in fixed investment, with consumer spending showing no growth in the quarter. **Exports rose strongly in H2 2009 but this has not yet translated into a pick up in domestic spending.**

However, **survey data** published for Q4 2009 and Q1 2010 **suggest that the recovery is picking up speed.** 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 reached 55.9 in March, having averaged 53.6 in Q4 2009 and 49.5 in Q3 2009, well above its low of 36.2 hit in February 2009. It is now at levels consistent with a strongly growing economy, as our chart shows.

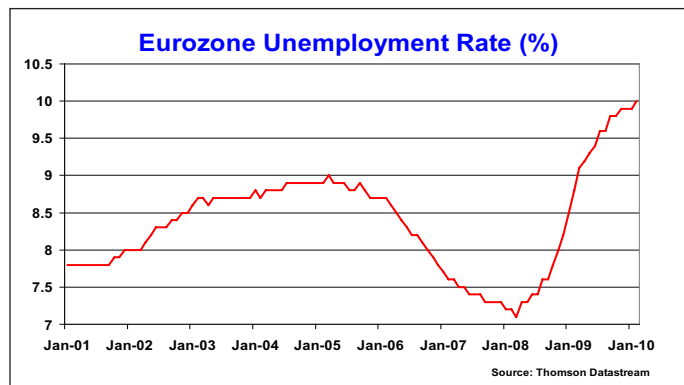


The EC's economic sentiment index, another good leading indicator of economic growth, has also risen strongly since mid-2009, reaching 97.7 in March, compared to the low of 70.6 hit a year earlier. There has also been a marked rise in key national business confidence surveys, notably the Ifo index in Germany and the closely followed Belgium business confidence index, all pointing to strong growth. Industrial production has extended its H2 2009 recovery into January, with output rising by a very pronounced 1.7% in the month.

Other data, though, have remained weak, suggesting that the recovery remains largely industry and exports driven. Retail sales fell in both January and February, indicating that consumer spending remains depressed - French consumer spending was particularly weak in early 2010. The **eurozone economy also continues to face significant headwinds.** In particular, the provision of credit remains constrained, which will continue to dampen the upturn in activity - both annual private sector loan growth and the annual growth rate of M3 fell by 0.4% in February. Low capacity utilisation is depressing investment. Inventory rebuilding may not extend into 2010 either. Bad weather may also have depressed GDP somewhat in the first quarter of 2010.

Most forecasters expect a weak and uneven recovery in activity. Following a decline of 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%. These forecasts may prove somewhat pessimistic. **Stronger exports should see the economic recovery pick up pace** this year. Thus, we expect **GDP growth to average 1% or above in 2010.**

However, this would **still constitute quite a moderate recovery and do little to make inroads into high unemployment.** The jobless rate has risen sharply, picking up to 10% by February compared to 8.2% at the end of 2008 and 7.2% in early 2008. Employment has been contracting since mid-2008 and fell by 2% during 2009. Little job growth is likely in 2010.



It all suggests that inflation will remain subdued. The flash estimate for March shows the headline CPI rate picked up to 1.5% on higher oil prices. However, excluding energy, inflation fell to just 0.6% year-on-year in February, its lowest level in a decade. **Core inflation is likely to remain very subdued this year.**

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