



## ECB CONTINUES TO SIT 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 any time 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, despite the fact that inflation may edge upwards by more than anticipated near term due to commodity effects, price pressures are expected to remain subdued over the medium term. 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 in March 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 exports. Meanwhile, the jobless rate has reached 10% and the annual inflation rate excluding energy stands at just 0.8%.

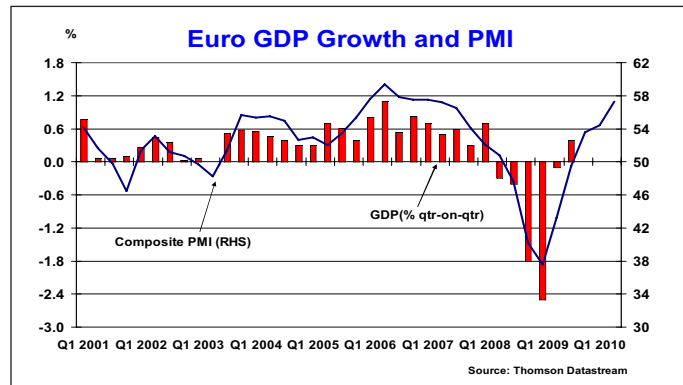
**Mr Trichet repeated again today that the refi rate is at an appropriate level, suggesting that the ECB is not considering changing rates any time soon.** With price pressures expected to remain moderate, weak monetary growth, high and rising unemployment and doubts about the strength and durability 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.**

**There was little to offer markets in terms of the current sovereign debt crisis**, apart from Trichet stressing once again at the post meeting press conference that the ECB firmly believes Greece will not default. Contrary to speculation ahead of the meeting, the monetary council did not discuss buying government bonds as a means of supporting the market but such a discussion in the future could not be ruled out. **In relation to the euro**, Mr. Trichet said that he would not comment directly on the currency but did say that "the euro is a good store of value", suggesting that, despite its recent sharp sell off, the central bank still believes it to be at satisfactory levels.

## 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 the opening months of 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 57.3 in March, having averaged 53.6 in Q4 2009 and 49.5 in Q3 2009, and is 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 opposite shows.

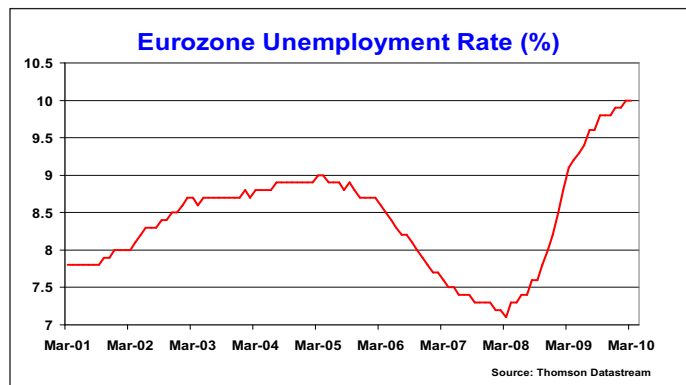


The EC's economic sentiment index, another good leading indicator of economic growth, has also risen strongly since mid-2009, reaching 100.6 in April, compared to a low of 70.6 just over a year ago. There has also been a marked rise in key national business confidence surveys, notably the German Ifo index and the closely followed Belgium business confidence index, all pointing to strong growth. Industrial production has extended its H2 2009 recovery into January and February, with output rising by a very pronounced 2.2% over the two months.

**Other data, though, have remained weak, suggesting that the recovery remains largely industry and exports driven.** Retail sales fell in both January and February and were flat in March, indicating that consumer spending remains depressed. 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 0.1% in March. 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.

As the global economy recovers, the eurozone should benefit from a stronger external environment, though weak domestic demand looks set to restrain the pace of recovery. Indeed, most forecasters, including ourselves, expect a weak and uneven upturn in activity. Following a decline of 4% in 2009, the EU Commission is forecasting that eurozone GDP will rise by just 0.9% this year, while the ECB is anticipating an even more subdued growth rate of 0.8%.

**This moderate pace of recovery will 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 April shows the headline CPI rate edging up to 1.5% from 1.4% in March on higher energy prices. However, excluding energy, inflation stood at just 0.8% year-on-year in March. **Core inflation is likely to remain very subdued this year.**

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