



This Issue

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gives his view.

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ECB eyes fiscal tightening ahead of rates action

It came as no great surprise that the European Central Bank left official interest rates unchanged at 1% following last week's Governing Council meeting. The ECB President, Jean-Claude Trichet, described the current level of interest rates as appropriate. This view was based on the ECB's assessment of a range of economic and financial data which led it to believe that there was no threat to the ECB's medium term target of keeping the annual inflation rate at or slightly below the 2% level. With the economic outlook pointing to only modest and uneven growth of well under 1% this year and 1.5% in 2011, eurozone inflation is forecast to average about 1.2% in 2010 and 1.5% in 2011.

Based on these forecasts, our best guess is that the ECB will hold to its current official rate of 1% until the start of 2011. It could possibly signal its intention in December to move early in 2011. Before that, however, it is likely to unwind its

other monetary support to the market as conditions improve. This unwinding, though appropriate in the ECB's opinion, may cause occasional bouts on nervousness in markets, particularly if the latter have a different view of economic prospects.

It has to be expected that as the ECB and other central banks move away from the extraordinary level of non-conventional monetary support and extremely low interest rates markets will worry about the speed of upward adjustment and the risks to economic recovery. However, to date, central bankers have acted very cautiously and seem well aware of the dangers of moving too soon in restoring interest rates to higher levels. Given the risks and uncertainties surrounding the economic outlook, there is no current case for raising official interest rates.

The euro economy is on a slow recovery path, heavily dependent on export led growth. Domestic demand is very weak and unlikely to contribute much to the forecast expansion in 2010. Weather

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related factors may affect the outturn for the first quarter but with rising unemployment and serious fiscal problems in many member states, the speed of recovery will be slow. At the end of 2009, real GDP was down 2.1% on the same period of 2008. On an annual average basis, real GDP fell by 4.1% last year. The ECB's forecast is that real GDP growth will average 0.8% in 2010. It is possible that the annual rate moved back into positive territory in the first quarter of 2010 with growth of around 0.5%. However, at end 2010, the annual rate could still be under 1%.

Looking into 2011, our quarterly profile would still leave the euro economy expanding by less than 2% on an annual basis. While this is getting close to the eurozone's potential growth rate, the economy is faced with a significant amount of spare capacity. On this basis, any potential inflationary dangers are unlikely to emerge before 2012. It's easy to see on the basis of this growth and inflation profile why the ECB can afford to refrain from raising official interest rates until 2011.

The ECB will also be conscious of the need to provide scope for a tightening of fiscal policy ahead of monetary policy within the eurozone as a whole. With limited inflation risks, the ECB can afford to take a back seat while governments bring fiscal deficits closer to levels consistent with longer term stability. In the absence of more determined action to reduce fiscal deficits, the euro area will remain in the spotlight, risking more sovereign rating problems and a threat to the euro currency. The ECB would wish to avoid such market speculation even though a weaker currency could help to promote faster export growth and quicker overall economic recovery. However, this is not the way in which the ECB wishes to see the eurozone emerge from its deep recession. Currency stability is also an important intermediate objective so the preference is clearly on governments making meaningful inroads into unsustainably high deficits.

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