AIB Global Treasury
Economic Research

ECB WATCH 4th February 2010

ECB RATES TO REMAIN VERY LOW

At its policy meeting today, the European Central Bank again left its refi rate unchanged at 1% for the ninth month running. It 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 expected 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 very 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 tighten monetary policy.**

The ECB's staff quarterly economic forecasts published in December, see the **eurozone economy expanding by just 0.8% in 2010 and 1.2% in 2011,** 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 2%.

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: ECB Dec 2009

Recent data support the ECB's cautious view. While leading activity indicators such as PMIs and EU Commission sentiment surveys continue to pick up, real economic data have been less impressive. The 0.4% growth in GDP in Q3 was more than accounted for by a rise in inventories. The expectation is that GDP growth is unlikely to have exceeded this level in Q4. Retail sales, in particular, were weak in the final quarter of last year. Meanwhile, the unemployment rate reached 10% in December, while inflation is running at 1%.

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. 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 late this year at the earliest before the ECB starts to contemplate rate hikes.**

Mr Trichet did not give any new information today about further steps in the ECB's plan for 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 ECB had already indicated that there will be only one further six month LTRO, to be conducted at end March. The ECB repeated today that it will continue to provide enhanced credit support to the banking system. It also indicated that, **at its next meeting in March, it will make decisions regarding the next steps to be taken in the gradual phasing-out of extraordinary liquidity measures** that are no longer needed to the same extent as in the past. The decisions taken in this regard would be implemented during Q2 2010.

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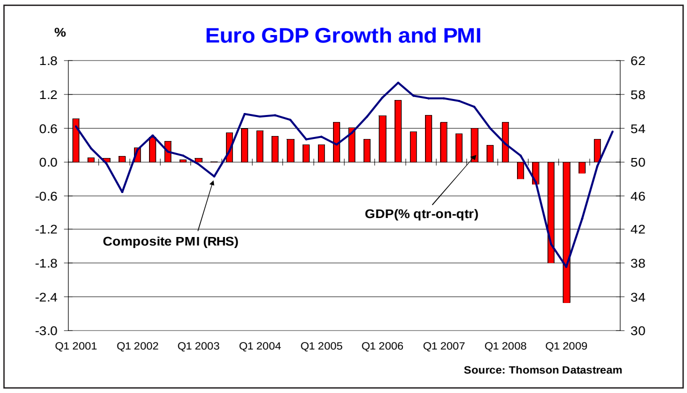
Sluggish Recovery in Eurozone Economy

The eurozone economy came out of recession in Q3 2009 after five consecutive quarters of declining output. GDP expanded by 0.4% in Q3 but this was all driven by a rise in inventories, which added 0.5% to GDP in the quarter. Exports were up strongly, rising by 3.1% in Q3, but this was almost entirely offset by an equally strong rise of 3.0% in imports. **Private final domestic demand remained weak**, with household consumption falling by 0.1% as car scrappage schemes started to end. Fixed investment contracted by 0.8%.

On an output basis, **the Q3 GDP rise was narrowly based,** with industrial production accounting for all the growth in the economy. Overall, then, while the recession ended in Q3, the GDP data were not figures to get overly-excited about, with the recovery proving narrow, anaemic and fragile.

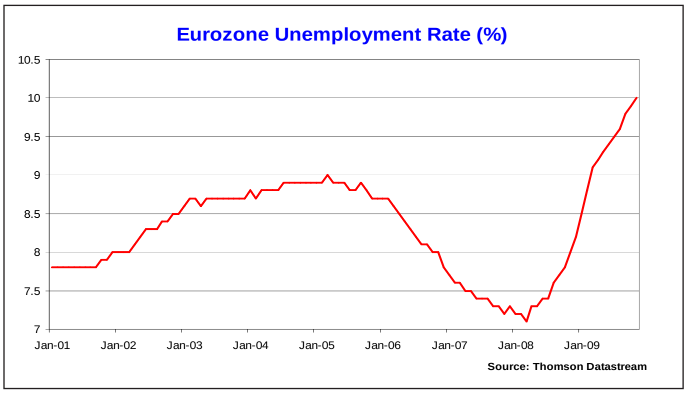


Nevertheless, **survey data published for Q4 2009 and early 2010 point to a continuation of the recovery in activity.** The clearest evidence of this is provided by PMIs, a very good leading indicator of economic activity. The composite PMI has risen a lot since early last summer, reaching 54.2 by December, well above the key 50.0 level. It averaged 53.6 in Q4 2009 compared to an average reading of 49.5 in Q3. The composite PMI did fall to 53.7 in January, but this is still well into GDP growth territory.

The EC's economic sentiment index, another good leading indicator of economic growth, has also risen strongly since mid-2009, jumping to 94.1 in December and 95.7 in January, compared to an average level of 80 in Q3. There has also been a continued improvement in some key national business confidence surveys in recent months, notably the Ifo index in Germany and the closely followed Belgium business confidence index.

These leading indicators suggest that growth has picked up further momentum since Q3 2009, but this has not been backed up by trends in real economic data. Weak Eurozone retail sales suggest that consumer spending probably contracted again in Q4. The pick up in industrial activity has also lost some strength. Thus, GDP data for Q4, which are due next week, are expected to show a rise of 0.4%, as in Q3.

There are some concerns about whether the pick-up in activity can be sustained even at this modest pace in 2010. Consumer spending was boosted by temporary factors in 2009, such as government car scrappage schemes. Household spending could decline in 2010 in the face of a continued rise in unemployment. The jobless rate has risen sharply, picking up to 10% by December from 8.2% at the end of 2008 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% this year with employment falling 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 - annual private sector loan growth was flat in December, while the annual growth rate of M3 stood at -0.2%. Inventory rebuilding in H2 2009 may not extend into 2010 either. Thus, **most forecasters expect a slow-paced, uneven 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% this year, while the ECB is anticipating a similarly subdued growth rate of 0.8%. This would be a very weak recovery in activity, indeed.

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