



ECB Holds Rates At 1%

As expected, at its policy meeting today, the ECB kept its key refi rate unchanged at 1%.

The ECB had cuts rates by 0.25% at each of its two previous monthly policy meetings, fully reversing the two 0.25% rate hikes implemented in April and July of last year. After these two rate cuts, no change was expected today, as the ECB takes time to assess their impact and the effect of the range of other measures it has adopted to counteract the weakening economy and malfunctioning markets.

The recent rate cuts were triggered by the sharp slowdown in economic activity over the course of 2011. Indeed, it **now seems likely that the economy contracted in the final quarter of last year.** Unemployment has also been rising since mid-2011, with the jobless rate reaching 10.3% in recent months. Inflation was stuck at 3% over the autumn, but eased to 2.8% in December. The expectation is that the sharp economic slowdown will exert further downward pressure on inflation, helped also by oil prices movements. This should see the HICP rate fall sharply over the course of 2012 to comfortably below 2%.

The ECB staff quarterly economic projections published last month reflect the changing landscape. They contained further significant downward revisions to growth forecasts. GDP growth for 2012 is now seen at 0.3%, down from the forecasts of 1.3% and 1.9% made in September and June 2011, respectively. GDP growth for 2013 is forecast at 1.3%.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2010	2011	2012	2013
HICP	1.6	2.7	2.0	1.5
Real GDP	1.7	1.6	0.3	1.3

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$111.5 in 2011, \$109.4 in 2012 and \$104.0 in 2013. Source: ECB December 2011

The weakening economy is one of a number of serious issues confronting the ECB. It is being forced to inject massive amounts of liquidity into the money markets and provide medium term funding for banks. In December, it eased collateral requirements for repo operations and extended the maximum repo term to 3 years. It also cut the reserve ratio from 2% to 1%, freeing up more collateral.

At his ECB press conference today, the ECB President, Mr Draghi, indicated that these measures are having an impact. He noted that the non-standard measures are making a substantial contribution to improving the funding situation of banks, which face significant redemptions in early 2012. The strong demand at today's Spanish and Italian debt auctions would also suggest that some of these funds are finding their way into the short end of government debt markets and putting downward pressure on yields. While the ECB has been adamant that it cannot act as a buyer of last resort of government debt, it would seem that its **moves to loosen up access to cheap funding is encouraging investors to buy sovereign paper, especially at the short end of the curve.**

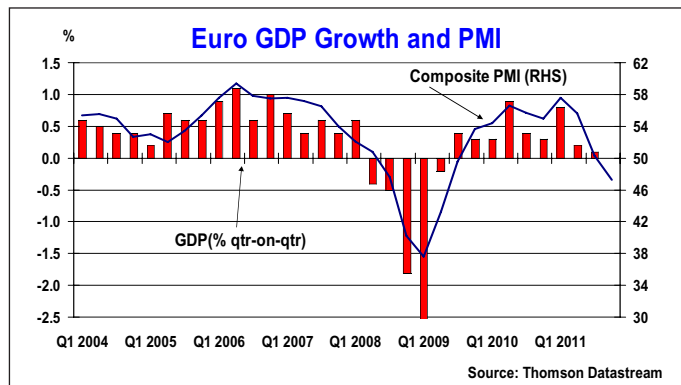
Meanwhile, Mr Draghi gave no indication today about future moves on interest rates. The refi rate is now back at its historic low of 1% but **the market is pricing in at least one further 0.25% cut by the spring, which would take the refi down to 0.75%, and possibly another cut to 0.5% later in the year.** Today's decision to keep rates on hold was unanimous. Mr Draghi indicated that in the current very uncertain environment, the ECB will look at all factors and monitor all developments when making its rate decisions. Thus, another rate cut is neither guaranteed nor ruled out, but further weak GDP data could well see the ECB reduce rates by another 0.25%.

Eurozone May Be Back in Recession

The last eurozone recession ended in mid-2009 but the subsequent recovery in activity looks to have been not only moderate but also short lived. **Growth in GDP has averaged less than 0.5% per quarter over the past two years** and exceeded 0.4% in only two quarters. The economy did grow strongly in Q1 2011, with GDP rising by 0.8%, but it lost momentum again in Q2 and Q3, with GDP growing by just 0.2% and 0.1%, respectively. **The economy continued to lose momentum in the closing months of last year. Initial estimates suggest that German GDP fell by 0.25% in Q4. Thus, it seems likely that GDP contracted in the eurozone as a whole in Q4 2011 and may well decline again in Q1 2012.**

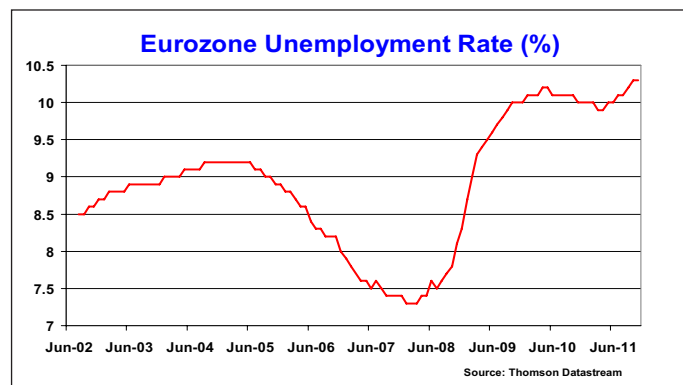
The recovery in activity since mid-2009 has been very dependent on export growth as domestic spending has remained very weak. This continued to be the case in Q2 and Q3 2011, as domestic demand contracted in both quarters, with the modest rise in GDP all attributable to net exports. Indeed, both consumer and government spending were flat in the year to Q3 2011, while there was just a small rise in fixed investment.

Given the reliance on exports, **the marked slowdown in the pace of activity in the global economy in 2011 was always going to be a serious threat to the recovery in the eurozone economy. An additional negative factor has been the worsening eurozone sovereign debt crisis.** This has damaged confidence, generated fresh concerns about the stability of the banking system and added greatly to the tightening of both credit conditions and fiscal policy in the euro area.



All the major world economies lost momentum last year in the face of high oil prices and thus higher inflation, the interruptions to production caused by the Japanese earthquake, and the tightening of fiscal and monetary policies in many countries. Furthermore, high unemployment, weak income growth, household deleveraging and tight credit conditions all continued to weigh on economic growth. **The UK and Japanese economies, though, managed to pick up strength in Q3, while the US economy regained considerable momentum in the second half of 2011.**

By contrast, the eurozone continued to weaken, no doubt reflecting the impact of the deepening sovereign debt crisis. The **eurozone's composite PMI**, a good leading indicator of economic activity, fell to 50.3 in Q3 and then **47.3 in Q4**, from 57.6 and 55.6 in Q1 and Q2 2011, respectively. The PMIs, though, for the US, UK and global economy all remained above 50 in Q4. Meanwhile, the **EC's economic sentiment index**, another good leading indicator of growth, has also been on a declining trend since it peaked at 108 in February. By December, it had fallen to 93.3.



Furthermore, **unemployment is on a rising trend again.** The jobless rate had edged down below 10% by last spring but it has climbed back up again, hitting 10.3% by the autumn. Some recent data from the real economy have been poor also, notably industrial production and retail sales. **These trends have seen growth forecasts slashed for this year. The EC cut its 2012 GDP forecast for the eurozone to just 0.5%, while the OECD is even lower at 0.2%. The ECB is forecasting growth of 0.3%. Thus, the eurozone is expected to be the weakest of the major economies this year, experiencing a mild recession.**

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