

Eurozone: ECB Stays Pat at 1.00%

The European Central Bank kept interest rates on hold at 1.00%. The marginal lending rate and the deposit rate were also left unchanged at 1.75% and 0.25% respectively.

At the press conference following the decision, European Central Bank President Jean-Claude Trichet said that “the latest information continues to signal an improvement in economic activity in the second half of this year, and expects the euro area economy in 2010 to recover at a gradual pace”. He also highlighted that “current rates remain appropriate” and that “the outlook remains subject to high uncertainty”.

But adding to the overall positive tone were his comments that “not all our liquidity measures will be needed to the same extent as in the past”, and that “extraordinary liquidity measures will be phased out in a timely and gradual fashion to counter effectively any threat to price stability over the medium to longer term”. Presumably, the ECB is expected to remove one of its flagship policies this year – the exceptional one-year loan of unlimited central bank funds, known as a long-term refinancing operation (LTRO) when it ends in December. Hitting a peak in June with loans of 442 billion euros, the policy has helped bring down inter-bank lending rates.

Not only have latest surveys suggest that lending to households and businesses has either begun to pick up or is set to do so in the coming months; earlier this week, the European Union’s executive arm forecast that the Eurozone economy would expand by 0.7% in 2010 and 1.5% in 2011. It expects that the Eurozone economy will contract by 4.0% this year, roughly in line with our forecast of -4.1%. This is a strong upward revision from the last forecast made on May 4, when it projected the Eurozone economy to contract by 0.1% in 2010. We are looking for a full-year growth of 1.8% in 2010.

Nevertheless, a strong Euro and weak labour market conditions would continue to be headwind-factors against the recovery process. September unemployment rate for the Eurozone was at a high of 9.70% and we see that number rising further to above the 10% level next year. Annual Harmonized Index of Consumer Prices (HICP) inflation came in at -0.1% in October, slightly higher than the -0.3% in September. However, Trichet said that “medium to longer-term inflation expectations remain firmly anchored in line with the aim of keeping inflation rates below, but close to, 2.0% over the medium term.

	End 4Q09	End 1Q10	End 2Q10
ECB Refinancing Rate	1.00	1.00	1.00
EUR/USD	1.500	1.525	1.530
Source: UOB			

These factors would imply that policymakers will be in favour for rates to stay at current levels for the time-being. We are looking at rates to move up only in the second half of 2010. Meanwhile, the ECB decision yesterday pushed the EUR/USD to highs of 1.4918 in the London-NY session. Currently, the pair is seen trading just below the 1.4900-levels. Dollar weakness has been permeating in the backdrop on the back of the turnaround in markets and the revival in risk-taking since March this year. EUR/USD, as such, has been enjoying a rally to highs of 1.5063 on October 26. We expect to see further weakness in the US dollar for the near term, though the pace of decline will be less aggressive going forward. And as the recovery theme becomes clearer for the Eurozone, we expect that a gradual hawkish approach by the ECB would be supportive of the EUR/USD. Our projection is for the pair to trade comfortably at 1.530 by the middle of next year.

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