



**Bank
Financial
Group**

TD Economics

Commentary

July 2, 2009

ECB – STEADY AS SHE GOES

- **ECB leaves policy rate unchanged at 1.00%**
- **ECB pleased with results of last week's auction of EUR442bn in liquidity to banks**

As expected, the ECB left interest rates unchanged in July at 1.00% and provided very few changes to their outlook for inflation and the Eurozone economy. The only notable change in language was the downgrading of inflationary pressures from “moderate” to “low.” (Our dissection of the ECB’s statement can be found here: http://www.td.com/economics/comment/ecb_jul09.pdf.) Outside of this, the ECB continues to see the risks to both inflation and economic growth broadly balanced around their base case forecast for positive quarterly GDP growth to return by mid-2010 and inflation to remain dampened over the medium term.

We believe the ECB is likely to remain in this holding pattern on their outlook until at least the last quarter of this year. At that point, we will have a better sense of the strength of any short-term rebounds and medium-term recovery, and how long the ECB will be comfortable leaving the policy rate at its current low level. In our opinion, it would take another negative shock to push the ECB to cut again and see a greater risk of the ECB hiking modestly in mid-2010. This would not likely be the beginning of a longer hiking cycle, but what could be called a normalization of accommodation. Many ECB Governing Council members

have expressed unease in the past with such low interest rates, and several have noted on occasion that interest rate hikes can be a valid tool for addressing asset bubbles.

We do see a risk of a stronger than expected rebound in Eurozone GDP at the end of this year, as well as the risk that the Eurozone credit crunch will be smaller than previously feared (see *Could the Eurozone Economy See the ‘Mother of All Rebounds?’* http://www.td.com/economics/special/rk0609_eurozone.pdf). Given the ECB’s past proclivities, this is likely to drive an active internal debate as to whether exit strategies should include some preemptive increases in interest rates. However, even though our own economic forecasts are more optimistic than the ECB’s staff forecasts, we would argue interest rates should remain at 1.00% longer than this. We think that inflationary pressures will still remain low even into 2011, given a muted recovery in 2010, but think the ECB will be more prone to hike.

It is early days in this recovery, though, so this outlook remains very dependent on a still hazy crystal ball. Once we are through summer and into the end of the year, we will have a better sense of whether the ECB’s new liquidity injections are moving from precautionary deposits to actual loans in the economy, and whether nascent signs of an early economic rebound are supported.

Richard Kelly, Senior Economist
416-982-2559

This report is provided by TD Economics for customers of TD Bank Financial Group. It is for information purposes only and may not be appropriate for other purposes. The report does not provide material information about the business and affairs of TD Bank Financial Group and the members of TD Economics are not spokespersons for TD Bank Financial Group with respect to its business and affairs. The information contained in this report has been drawn from sources believed to be reliable, but is not guaranteed to be accurate or complete. The report contains economic analysis and views, including about future economic and financial markets performance. These are based on certain assumptions and other factors, and are subject to inherent risks and uncertainties. The actual outcome may be materially different. The Toronto-Dominion Bank and its affiliates and related entities that comprise TD Bank Financial Group are not liable for any errors or omissions in the information, analysis or views contained in this report, or for any loss or damage suffered.