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Markit Economics

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Eurozone

Rate cut to support economy in 2009, but ECB staff projections still at risk

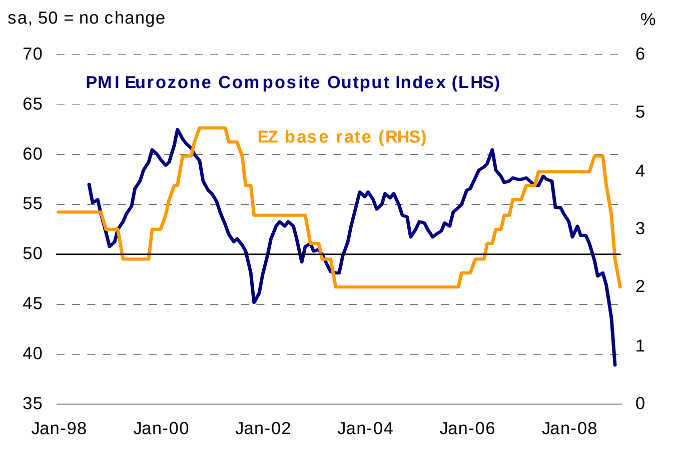
Key findings

- **ECB policy rate reduced by 50bps as severe economic weakness forces governing council's hand...**
- **…but concerns mount that the cost and availability of credit has yet to improve.**
- **Central bank staff projections for 2009 imply a much stronger turnaround in PMIs than that seen after 9/11.**

Today the European Central Bank announced a 50bps drop in its main policy rate from 2.5% to 2.0%, the lowest since November 2005. Moreover, the central rate has never been below this level in the history of the ECB. January's cut puts the policy rate a total of 225bps lower than it was prior to the coordinated central bank action on 8th October last year.

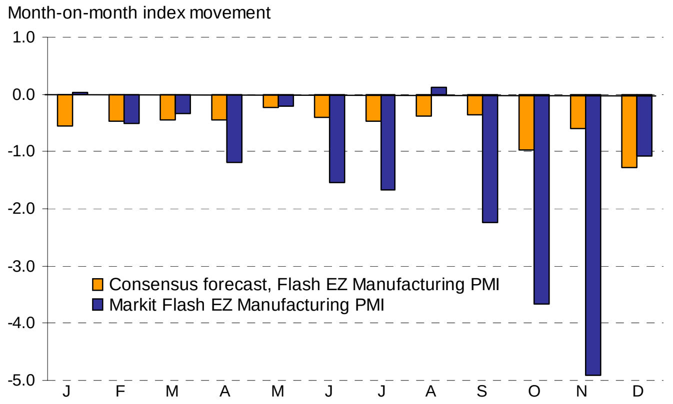
This turnaround has been signalled in advance by Eurozone PMI data, with the chart below illustrating that sharply falling economic output has clearly justified substantial declines in ECB interest rates.

Chart 1: PMI data vs. Eurozone base rate



A rapid downturn in the Eurozone PMI during recent months appears to have caught forecasters by surprise, particularly the extent of the decline in manufacturing. Chart 2 below shows the monthly index movement of the Flash Eurozone Manufacturing PMI against that expected by a Reuters poll of analysts prior to release. The weakness of the manufacturing sector first flagged up by the PMIs has been later borne out by official figures, which showed industrial production falling in November at its fastest rate for at least two decades.

Chart 2: Manufacturing PMI vs. consensus forecast



The unexpected speed of the descent in the Eurozone Manufacturing PMI will have been one of the factors behind the substantial downward revisions to ECB staff projections for GDP. At the December meeting the forecast for euro area GDP growth in 2009 was revised from a range of 0.6% to 1.8% down to -1.0% to 0.0%. Indeed, the future course of ECB policy will be highly dependent on the performance of the economy against this projection, as well as the inflation outlook.

By using a PMI-based GDP indicator (see chart 3) we can estimate the level that the Eurozone Composite PMI Output Index would have to average in 2009, in order for it to imply whole year GDP growth within the range projected by the ECB. In Chart 4, we illustrate the scenario whereby the PMI rises in Q1 and a 'V' shaped recovery is seen throughout 2009, with GDP growth hitting the -1.0% lower bound of the ECB projection.

Chart 3: PMI GDP indicator, 'V' shaped recovery scenario

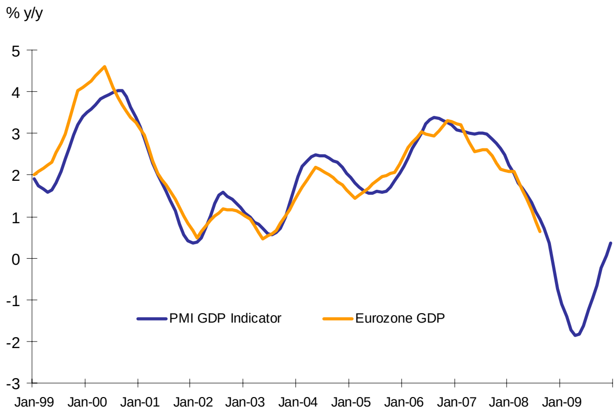
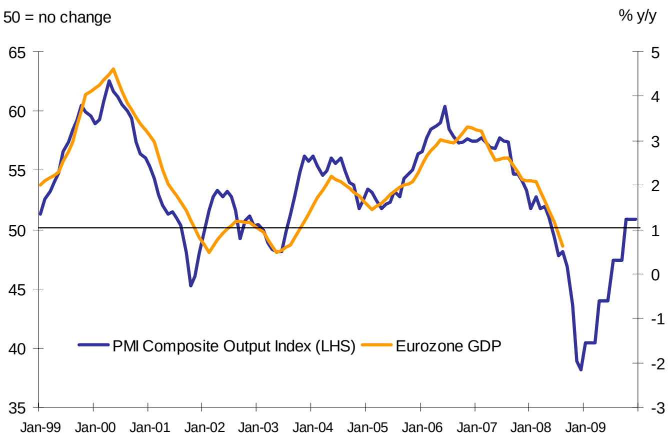


Chart 4: PMI path required to hit ECB projection



As highlighted by the charts above, the GDP indicator suggests a considerable turnaround in the Eurozone Composite PMI would be required for GDP growth to reach even the ECB's most pessimistic projection. The model indicates that an average PMI reading of 45.7 would imply GDP growth of -1.0% in 2009, which is the lower bound of the staff forecast. Even under the best case scenario of a 'V' shaped recovery starting from Q1, the rise in the PMI over the next twelve months would have to be much stronger than the resurgence over the same period seen in 1999 and after 9/11.

The strong relationship between PMI data and Eurozone GDP means that over the course of the year the path of the PMIs will be a key indicator of whether GDP in 2009 is likely to come in below (or above) ECB staff projections. In turn, should the PMIs give an early warning that the Eurozone economy is contracting more rapidly than the lower bound of the ECB forecast, this will likely increase pressure on the governing council to reduce its policy rate to new lows.

Another factor weighing on ECB policymaking is that members recognise that interest rate reductions have not been passed though to the economy. This means alternative and unprecedented measures are being considered in order to improve the functioning of the interbank market.

To provide an insight into the extent to which companies have been affected by money market turmoil, next month Markit Economics will be surveying firms in the euro area about credit conditions.

Meanwhile, the next snapshot of activity in the euro area will be the Flash Eurozone PMI, released on 23rd January 2009.

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