

Eurozone

PMIs signal need for 50bp cut in Eurozone rates in March

Key findings

- Interest rates held at 2% despite continued signs of weakness
- Cut remains likely during Q1 2009

After cutting rates by between 50-to-75 basis points at each of their previous four meetings, the European Central Bank (ECB) maintained interest rates at 2% in February. This contrasted with the 50 basis point cut announced earlier today by the Bank of England, and a move to a near zero rate target in the US in mid-December. Despite the catch up in rate policy represented by the recent cuts implemented by the ECB, has the latest decision again left it behind the curve of global monetary policy?

Although the ECB may have been wary of stoking pipeline inflation by undershooting the appropriate medium-term rate level before the effects of prior cuts and recent national stimulus packages have time to filter through, Markit PMI data suggest four vital reasons why there is little possibility of this occurring.

Firstly, composite PMI data covering manufacturing and services released in late 2008 and January 2009 suggest that the ECB's cut in January was insufficiently deep and the latest hold will do nothing to rectify this support deficit (see chart 1).

Secondly, while the January reading for the PMI Composite Output Index held close to the record low posted in December, breaking a four-month sequence of falling index numbers, the final reading for January was lower than its earliest flash estimate. The PMI data therefore indicate that conditions actually took a slight turn for the worse towards the end of the month.

Thirdly, PMI data tracking trends in output changes and input costs provided no evidence that pipeline inflationary pressures are building. Rates of decrease for

Chart 1

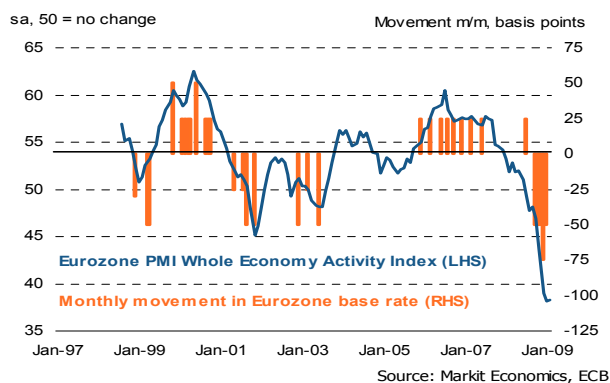
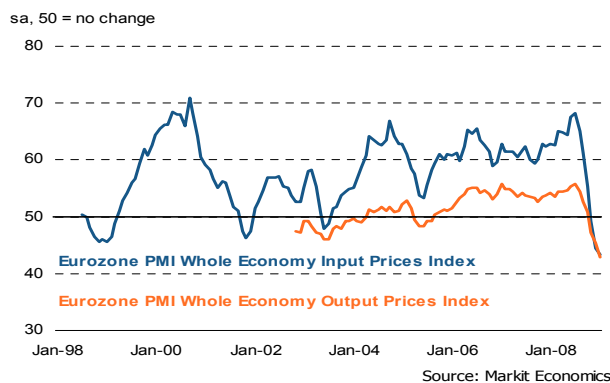


Chart 2



both accelerated to series records in January (see chart 2). This is not consistent with an immediate increase in inflationary pressure on headline consumer prices.

Finally, employment across the manufacturing and service sectors fell at a PMI series record pace in January. Substantial job losses will weigh on consumer confidence making the need for supportive policy even greater.

This suggests that the ECB is definitely behind the monetary policy curve and makes the likelihood of a cut in March a major possibility.

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