

# European interest rates and growth

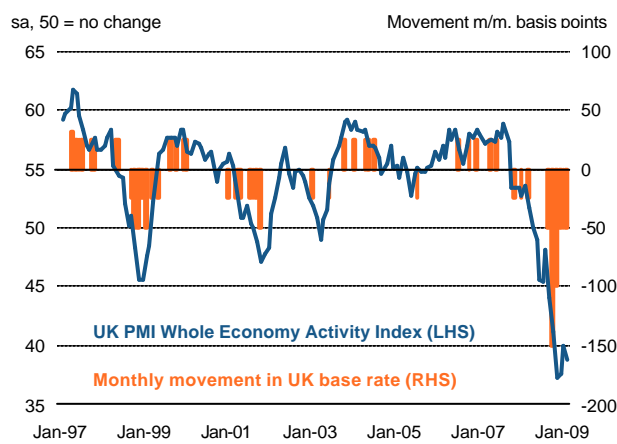
## Eurozone may see sharper contraction than the UK in 2009

### BoE moves into uncharted waters

As widely expected, in the March meeting the Bank of England cut its main policy rate by 50 basis points to a new low of just 0.5 percent as it seeks to redress a severe downturn in the UK economy. It was the sixth successive meeting in which rates have been cut and takes the cumulative reduction since October to 450 basis points. The Bank also confirmed a move to quantitative easing through the extension of its Asset Purchase Facility to include a programme of up to £75 billion in purchases of gilts financed through issuance of central bank reserves.

The decision to cut interest rates sharply since the start of Q4 2008 has been clearly justified by data from the CIPS/Markit UK PMIs, which have shown a steep downturn in private sector output well in advance of official GDP figures.

**Chart 1: UK PMI Output Index vs. BoE base rate**



As highlighted in chart 1, the recent substantial reductions in the Bank of England base rate have followed a rapid downturn in the UK economy signalled by the PMI data. With the base rate now touching its zero bound and the Composite PMI close to a series record low in early 2009, the economic data underline the need to consider unconventional measures to stimulate the economy.

### ECB cuts rates as downturn shows no sign of bottoming out

Also as expected, the European Central Bank cut its benchmark rate by 50 basis points to a new low of 1.5% in March's meeting. This followed a brief pause in February and brought the cumulative decline in the benchmark rate to 275 basis points since October. The chart below shows how the ECB's conventional monetary easing over this period compares to the downturn in euro area economic output, as signalled by the Markit Eurozone Composite PMI.

**Chart 2: EZ PMI Output Index vs. ECB base rate**

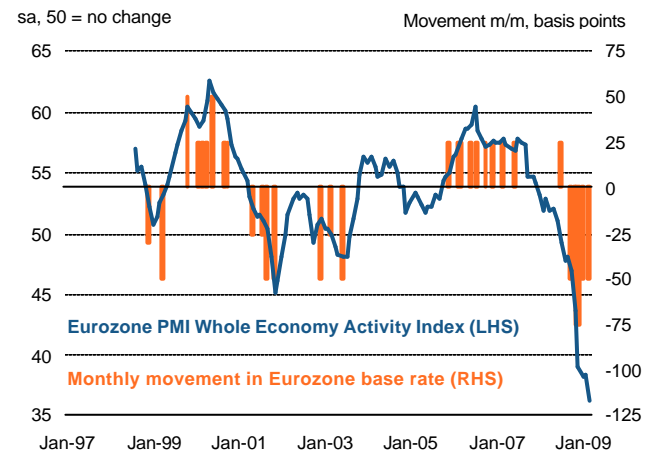


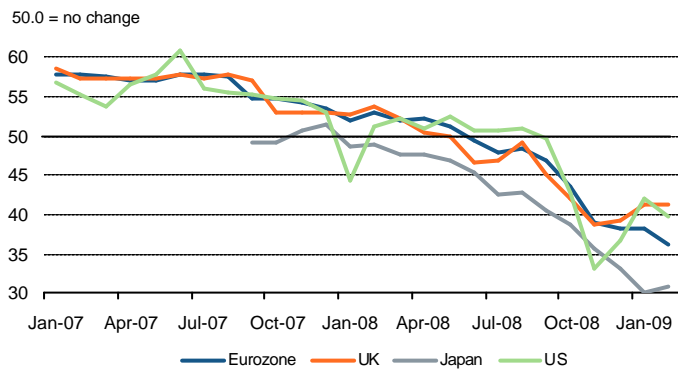
Chart 2 also illustrates that the substantial reductions of the ECB benchmark rate have been clearly justified by the economic data, with the PMI showing the fastest downturn in economic output for over a decade. Furthermore, the failure of the Eurozone PMI to show any signs of an easing in the rate of decline in early-2009 contrasts with the situation in both the US and UK, where composite PMIs (measuring the output of both manufacturing and services) provide tentative evidence to suggest that Q4 represented a low point (see table overleaf) – though in all cases rates of contraction remain steep.

**PMI Composite Output Index, Quarterly Averages**

	US	Eurozone	Japan	UK
Q3 2008	50.3	47.6	41.9	47.0
Q4 2008	37.4	40.2	35.9	40.0
Q1 2009	40.8	37.3	30.4	41.2

Note: Q1 2009 includes only January and February data

**Chart 3: PMI Composite Output Index, EZ, Japan, US and UK**



Source: Markit Economics, ISM

According to the latest Reuters poll of economists, conducted prior to the February PMI numbers, the consensus is for GDP to fall 2% in the Eurozone and 2.9% in the UK in 2009. Given the upturn in the February PMI numbers for the UK and further falls in the Eurozone PMI, as well as the aggressiveness of the monetary easing in the UK relative to that seen in the euro area, it looks like the market might have these numbers the wrong way round. Interestingly, the dire survey data at the start of this year, and the fact that a turning point is still not in sight, has led the ECB to revise down the mid-range of its staff forecast for 2009 Eurozone GDP to -2.7%.

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