

Eurozone Interest Rates

ECB takes step in the right direction but further rate cuts to be expected

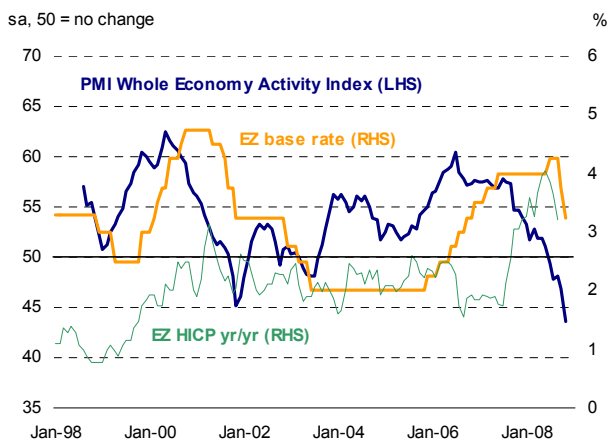
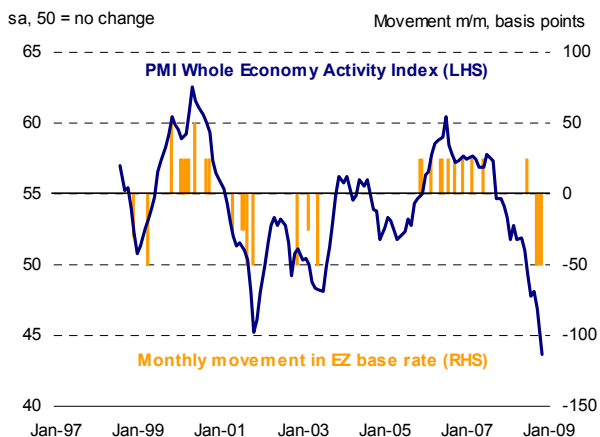
The decision by the ECB to follow up October's coordinated rate cut with a further 50 basis point reduction in November represents another move in the right direction.

However, although the recent actions taken by the ECB have been broadly consistent with the deteriorating economic environment, PMI data from Markit Economics suggest that there is still some way to go before rates reach a level consistent with that prescribed by the extent of the recent downturn in economic growth.

Markit PMIs – which cover construction, manufacturing and services – have been pointing to reductions in interest rates throughout much of 2008 (and even in July, when strong cost inflationary pressure led the ECB to raise the cost of borrowing). The economic situation has deteriorated significantly since then, and PMI survey data on prices have shown a noticeable retreat in the inflation outlook.

The top chart on the right suggests that prior to the coordinated cut in rates on October 8th, the ECB had fallen behind the rate cutting cycle implied by the survey data. To complete the catch-up, the ECB would have needed a deeper cut in rates of around 125 basis points this month, bringing borrowing rates down to 2.5%. The lower chart reinforces the notion that this would be a more appropriate rate based on the current level of business activity data.

Barring an unlikely economic recovery, PMI surveys suggest that the ECB will need to cut rates further in the coming months.



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