

Eurozone interest rates

PMI data underlined the need for October's emergency rate cut

Key findings

- **October rate cut was justified by economic data.**
- **PMI data indicate price pressures have peaked, building case for further ECB rate cuts.**

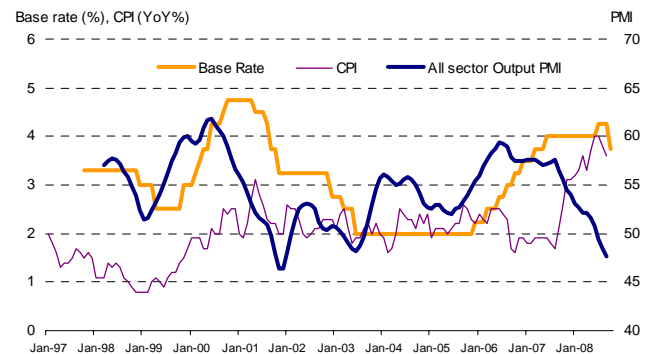
The European Central Bank (ECB) announced a half-point cut in its central rate to 3.75% on 8th October. This decision contrasted with the hawkish stance the ECB had adopted when hiking rates by 25 basis points in July.

While the decision to cut rates may have been seen as a volte-face by many, driven by the need to co-ordinate action with other central banks across the world, PMI data suggest that the underlying economic conditions changed rapidly in the euro area between July and October to justify the change in monetary policy.

The ECB's governing council have consistently inferred that monetary loosening would not be considered until evidence emerged that the inflationary outlook had subsided, and financial market turmoil had started to have a significant effect on the real economy. Markit's Purchasing Managers' Index (PMI) data for the Eurozone clearly signalled that these requirements had been met by the end of Q3 2008, with input price inflation past its summer peak and business activity the weakest since the aftermath of 9/11.

A useful guide to past ECB policy decisions has been the Eurozone PMI's Output Index (see chart 1). However, the relationship broke down over the past year as inflation gathered pace despite the sharp slowdown in economic growth. With the ECB following a single objective of maintaining consumer price inflation at "close to but below 2%", the rise in CPI arguably warranted higher base rates back in July.

Chart 1: Economic growth, inflation and base rates



Price pressures have peaked

Since the summer, clear signs have emerged to suggest that inflation has peaked. PMI data in charts 2 and 3 show that euro area and worldwide inflationary pressures in September were significantly below their mid-2008 peak, following relief from falling commodity prices (particularly oil, which has almost halved in price since this year's peak).

Chart 2: Eurozone inflation

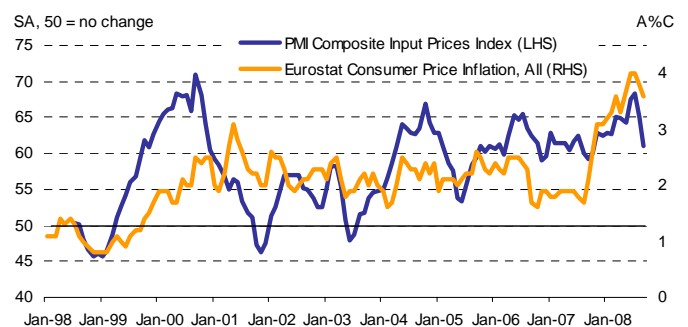
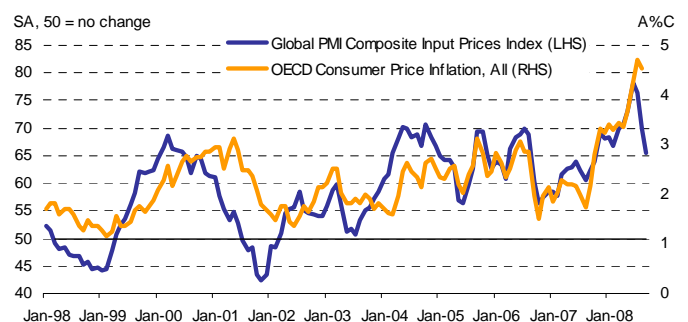


Chart 3: Global inflation



A version of chart 3 appeared in the October 2008 ECB *Monthly Bulletin*, which commented on “a noticeable easing in cost inflation” shown by the PMI.

Second-round inflation effects limited by weak growth

Concerns over second-round inflation effects have also encouraged a hawkish approach to rates at the ECB, with particular worries over rising wage pressures. However, the labour market has cooled at a rapid pace in recent months, alongside the downturn in economic growth (see charts 4 and 5).

Chart 4: Eurozone economic growth

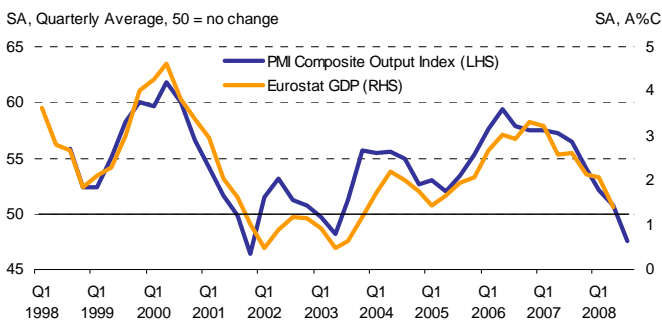
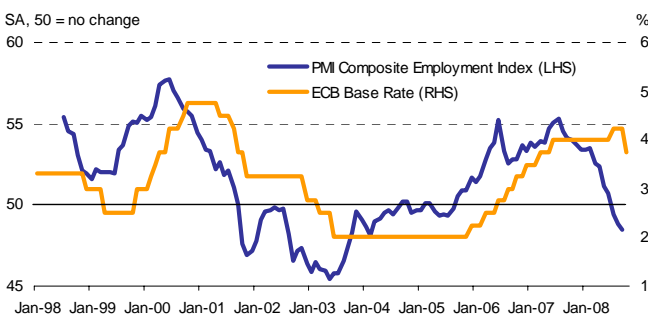


Chart 5: Eurozone employment and ECB policy rate



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For Q3 2008 as a whole, the Eurozone PMI Composite Output Index fell to its lowest for almost seven years. Moreover, the PMI Employment Index signalled the steepest rate of job losses since mid-2003, when the ECB opted to cut the central rate by 50 basis points.

Not only does the Q3 2008 PMI output and employment data confirm that global financial turmoil has deepened the recent downturn in the real economy, but also the figures will have a significant impact upon the inflation outlook. The real risk of a technical recession in the third quarter, together with deteriorating labour market conditions and falling oil prices, suggest that the probability of second-round inflationary effects have diminished significantly.

PMI data consistent with more rate cuts to come

Plotting the PMI output and employment data against base rates, as shown in charts 1 and 5 respectively, indicates that the survey data are consistent with further reductions in ECB base rates, assuming consumer price inflation continues to moderate. In this respect, detailed analysis of consumer sector trends from the PMI survey database in fact suggests that price pressures are now falling markedly for both consumer-oriented goods and services, as weak demand reduces firms’ pricing power, which should lead to further substantial falls in headline inflation in coming months (**see our note on consumer prices in the Eurozone from 10 October 2008**).

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