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Markit Economic Research

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Eurozone

European central bank holds rates but discusses looser policy

- **Main policy rate held at 0.75%**
- **Some policymakers saw need for rate cut**
- **Business survey data support view of economy stabilising, so holds key to future policy**

The European Central Bank left interest rates unchanged at its March policy meeting, disappointing the minority of analysts that had been expected a cut in its current policy rate of 0.75% to a new all-time low of 0.5%. No other measures were announced.

The policy council was split, however, on the need to cut rates, meaning any further weakening of the business surveys could increase the chance of a rate cut in coming months.

Forecasts revised down

The ECB still sees the region's economy to be on course to stabilise in the first half of 2013, and then enjoy a modest recovery thereafter. Its new staff forecasts were revised down slightly, but this reflected a carry-over from greater than expected weakness at the end of last year rather than any material change to its outlook.

The recovery path is therefore largely unchanged, remaining one of a rather underwhelming economic performance. GDP is expected to fall by between 0.9% and 0.1% this year, while 2014 likely to see anything between a flat picture and 2.0% growth.

The inflation outlook is unchanged, with price stability expected over the medium-term. The risks to that outlook were seen to have been broadly balanced.

Data dichotomy

The split in the council's views on the need to cut rates possibly in part reflects the dichotomy between disappointing official data and more positive business surveys that ECB head Mario Draghi referred to in the press conference. This is a 180-degree turnaround from much of last year, when the gloomy business surveys contrasted with surprisingly resilient official data, and we believe merely represents a lag in the official compared to the surveys, which are now correctly indicating that the Eurozone economy is moving towards stabilisation, albeit somewhat hesitantly.

Two examples of the lag between official data and PMI surveys were provided by official releases today.

First, **German industrial orders** fell 1.9% in January, taking orders 2.1% below levels of a year ago; the steepest annual rate of decline for four months. The German manufacturing PMI had been indicating falling orders up to December, but has shown a marked improvement in performance so far this year, with new orders growing at the fastest rate for almost two years in February.

Second, **French goods exports** fell 1.9% in the three months to January, the steepest rate of decline since May 2009. The PMI data had signalled an acceleration in the rate of decline of exports to the highest since mid-2009 in December, but has since shown an easing trend, with the February decline in exports the weakest seen for six months.

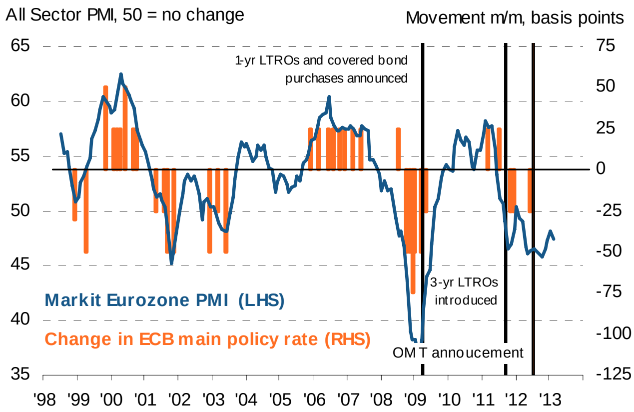
Rate cut possible if stabilisation not assured in first half of 2013

The survey data therefore support the majority ECB view that the economy is showing signs of repair (the survey is so far consistent with GDP falling again in the first quarter, albeit by a mere 0.3% compared to the 0.6% decline seen in the final quarter of last year), but whether stabilisation will be achieved by the second quarter remains more uncertain. Having risen in the three months to January, the Eurozone PMI fell back in February.

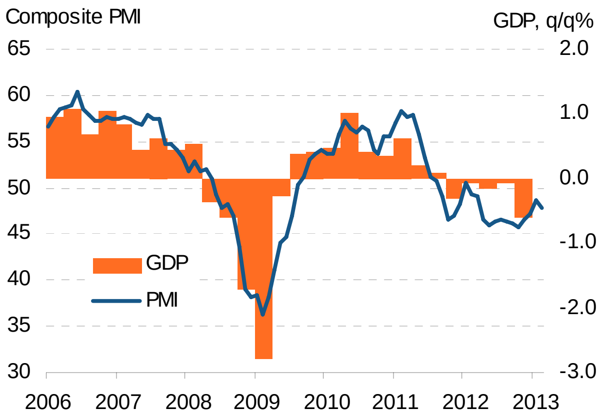
With business uncertainty heightened due to the political stalemate in Italy, a renewed upward trend in the PMI is by no means certain, and a further downturn in March would push any chances of euro zone stabilisation into the second half of the year. If such a renewed weakening were to occur, the number of policy council members voting for a lowering of interest rates could soon move into the majority. However, another argument to cutting rates is that some on the

ECB's council are concerned about the impact of a negative deposit rate (i.e. charging banks to hold deposits at the central bank). The hurdle to a rate cut therefore probably remains high.

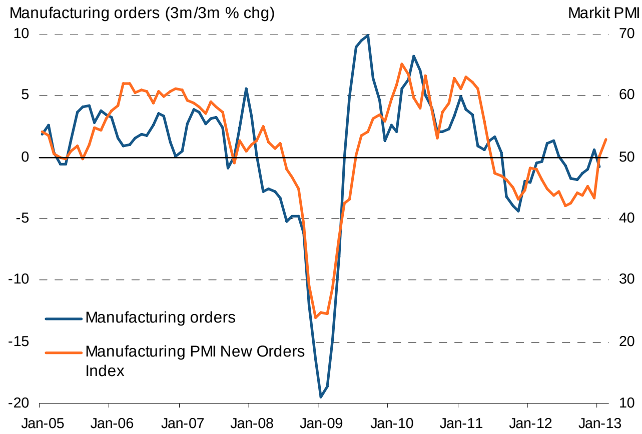
PMI surveys and ECB policy



Eurozone GDP

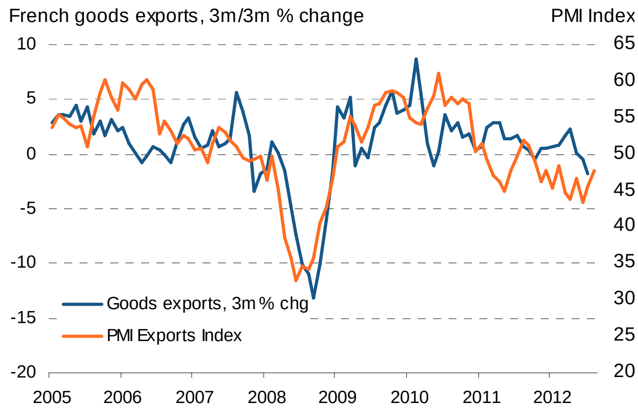


German industrial orders



Sources: Markit, FSO via Ecowin.

French exports



Sources: Markit, INSEE (via Ecowin).

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