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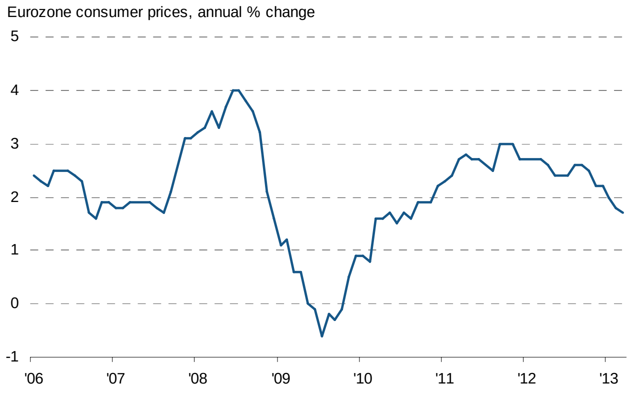
Eurozone

Fall in inflation opens door for ECB action

- **Inflation drops to lowest since August 2010, below ECB target for second month**
- **High inflation no longer barrier to ECB rate cut, but lower rates not assured**

Inflation



Source: Eurostat via Ecowin.

Inflation has eased in the Eurozone to its lowest since August 2010, giving the ECB more leeway to cut interest rates and revive a region that is falling deeper into recession.

Consumer price inflation fell from 1.8% in February to 1.7% in March. With the ECB's target of an inflation rate running at below but close to 2%, the downturn in price pressures opens the door for more stimulus from the central bank. In the preceding 26 months, inflation had exceeded 2%, which was undoubtedly a factor limiting policymakers' appetite for more aggressive stimulus.

With inflation now below target at the same time that the single currency area's economy is widely expected to contract in 2013, and with business surveys showing signs of a renewed deepening of the downturn, expectations have grown that the ECB will cut rates at its next meeting.

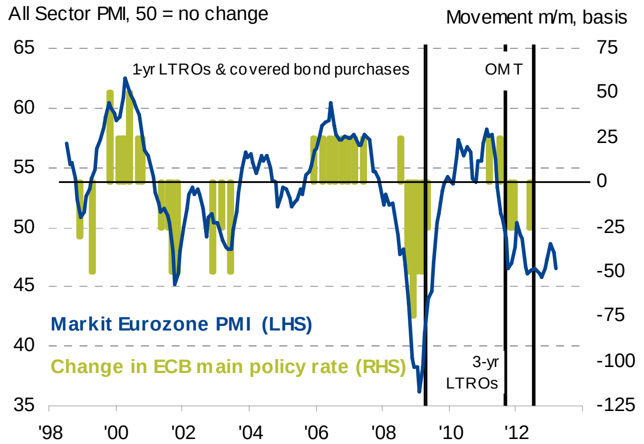
ECB 'ready to act'

ECB president Mario Draghi noted that the bank stands "ready to act" if the economic indicators deteriorate further. The PMI - one of the indicators watched closely by the ECB - fell for a second month running in March and is at a low level that has historically been consistent with policy stimulus.

Rate cut no sure thing

A cut is by no means assured, however, as the ECB has been reluctant to trim rates after cutting its main policy rate to 0.75% in July 2012 not just because inflation has been high, but also because of worries about the distortions such low rates will create in the banking system, notably in deterring bank-to-bank lending. Euribor is currently running at around just 0.2%, and any further fall would limit a bank's incentive to participate in the market. On the other hand, the pressure is clearly building for the ECB to be seen to be doing something to help boost the economy.

ECB policy and the PMI



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