

Eurozone

European Central Bank acts as recession risk intensifies

The European Central Bank gave but also took away at its December press conference. The central bank cut rates and boosted credit availability to the banking system, but dented hopes of the ECB providing financial support to beleaguered governments.

The ECB cut its main policy rate for the second month running in December, reversing what now appear to be two ill-timed rate hikes earlier in the year. The policy rate is now down to 1.00%. The move was widely expected. Despite inflation running stubbornly higher than the 2% target, holding at 3% in October, it is becoming increasingly apparent that the region is sliding back into recession.

The ECB cut its economic forecasts for the next two years in the face of signs that the sovereign debt crisis has hit business and consumer confidence at the same time as austerity measures are dampening demand in many countries. PMI™ survey data suggest that the single currency area is likely to contract by 0.5% in the fourth quarter as a result, with double that rate of decline seen in Italy. Even Germany looks to be stagnating. At the same time, price pressures in industrial supply chains have collapsed as sellers lack pricing power, which augurs well for lower consumer price inflation in coming months.

The data suggest that the ECB is correct to be more worried about stabilising the economy, helping restore confidence and fighting off deflationary forces rather than future inflation. The ECB may even look to cut its main policy rate below the current record low of 1.00% in coming months if the economic situation continues to deteriorate.

Additional banking sector support

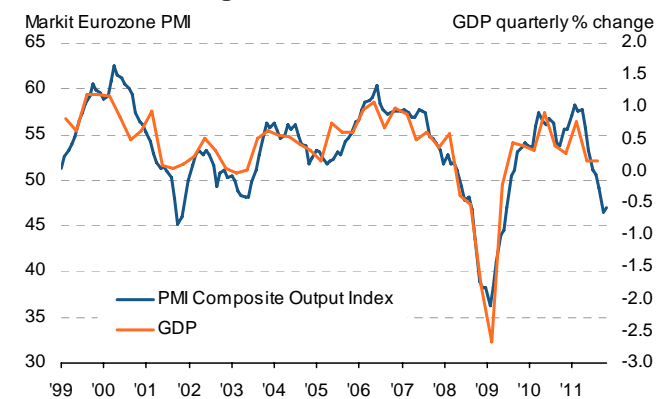
The ECB has also announced additional measures to help support the euro area financial system, especially smaller banks which have had difficulty finding access to credit. These included two new Long-Term Refinancing Operations, each of three years duration, together with a broadening of the collateral base eligible for credit operations and a drop in the reserve requirement from 2% to 1%.

Bond purchase disappointment

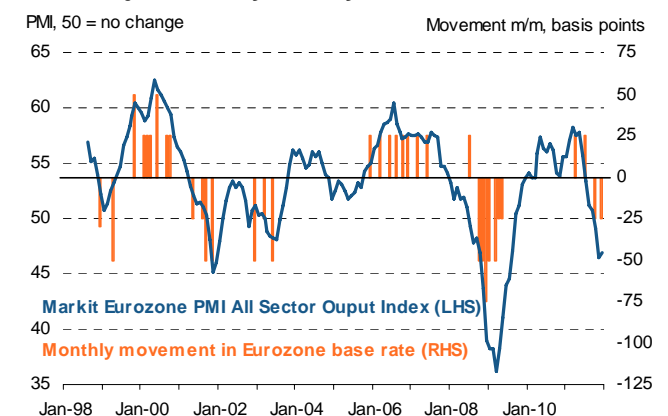
Also as expected, the ECB made no commitment to purchasing distressed government bonds, notably Italian debt. President Draghi hinted, however, that such purchases will not necessarily be forthcoming even if EU leaders agree on suitable rules and policing mechanisms to ensure that national governments tackle their fiscal deficits, which is something that the markets had interpreted recent remarks as suggesting.

Hopes for a resolution to the region's financial crisis were further knocked by Draghi stressing that the provision of ECB funding to national governments through the IMF would be against the spirit of the EU Treaty, seemingly ruling out one of the more promising looking options for helping resolve the sovereign debt crisis that has recently been discussed.

Euro zone sliding back into recession



Rate cut justified by survey data



Sources: Markit, ECB, Ecwin.

To find out how to receive PMI data, please contact
economics@markit.com.

Chris Williamson

Chief Economist

Markit

Tel: +44 20 7260 2329

Email: chris.williamson@markit.com

Twitter: <http://twitter.com/WilliamsonChris>

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