

Eurozone

Pressure mounts for early rate hike

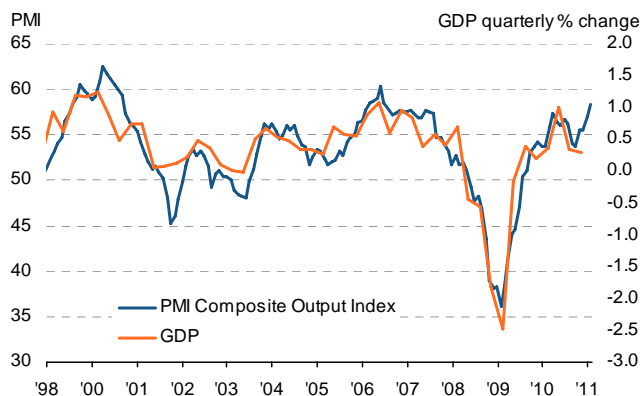
- **ECB sounds hawkish on interest rates.**
- **Economic growth lifts higher and spreads to the periphery.**
- **Price pressures mount.**

The ECB kept its policy rate unchanged at 1.0% today, as expected. However, President Trichet warned that the risk of higher inflation has moved on the upside since the January and February meetings, and that the ECB is prepared to change policy in a "firm and timely manner". An increase in rates as soon as next month was cited as "possible". The case for an early hike in interest has strengthened due to three key factors: strong growth, higher price pressures, and signs of life in the periphery.

Strong growth in Q1

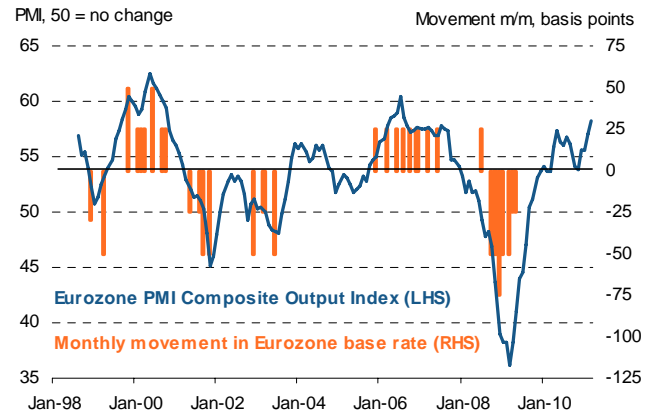
First, Eurozone GDP growth was unchanged in Q4 on the sluggish 0.3% quarterly rate of increase seen in Q3, but we expect a strong uplift in Q1 as northern regions saw business rebound from the harsh weather at the end of last year. Today's final Markit Eurozone PMI data are consistent with 0.8% GDP growth in Q1, assuming the index shows no major change from its current level in March. This puts the PMI further into rate-hike territory, according to historical comparisons of ECB rate decisions and the survey data (see chart). The upward revision to the ECB growth forecast further highlights the expected temporary nature of the slowdown seen late last year.

Eurozone PMI and GDP



Sources: Markit, Eurostat.

Eurozone PMIs and ECB Rate Decisions

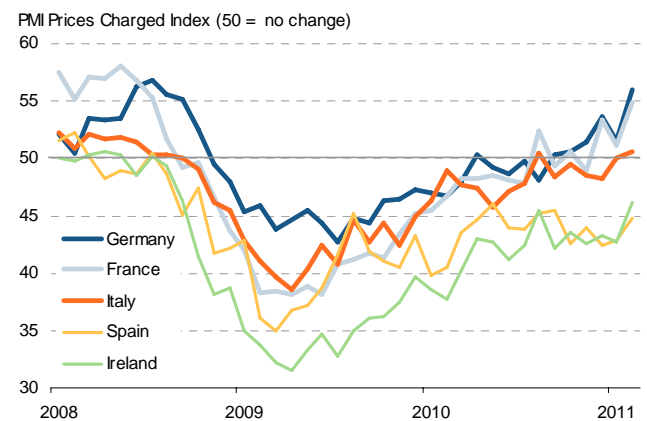


Sources: Markit, ECB.

Growing price pressures

Second, growth has surged higher in Germany and its neighbours to the extent that second-round price pressures are a concern, which is something Trichet has warned that the ECB will be watching with "strong vigilance". To illustrate, German GDP growth looks set to have rebounded strongly in Q1, rising by over 1%, and the country's service providers raised their charges at a near-record rate in February as improved demand from both businesses and households has boosted companies' pricing power.

Services PMI Prices Charged



Source: Markit.

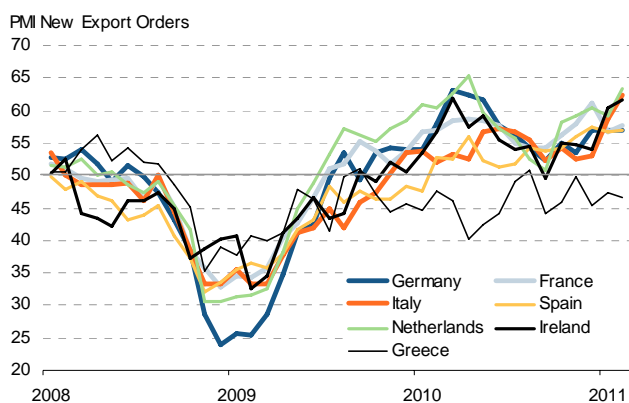
The enhanced ability of firms to pass higher costs on to customers has even more significance now that

unrest in the Middle East is putting further upward pressure on oil prices, meaning a greater risk of both higher and stickier inflation.

Signs of life in the periphery

Third, a factor that has deterred the ECB from hiking in past months has been the fragility of the recoveries in the region's periphery. However, this may well change soon as there are real signs of life now appearing in countries such as Italy, Spain and Ireland both in terms of rising exports and some improvements in service sector growth, according to the PMIs.

Manufacturing PMI New Export Orders



Source: Markit.

Early hike on the cards

It is likely that policymakers will want to wait to see the extent to which the current strength of the business surveys reflects a temporary rebound rather than a firming in the underlying rate of growth. The ECB will also be looking to see if tensions in the Middle East and North Africa hit business confidence to any significant extent via higher oil prices. However, in the absence of any further jump in oil prices or any worsening of the debt crisis in the euro area's periphery, an early hike in rates looks to be on the cards if data such as the PMIs continue hold up well in March and April.

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