ECB WATCH 5th Febuary 2009

# ECB SET TO REDUCE RATES FURTHER

**The European Central Bank left rates unchanged at 2% today, having reduced rates in each of the past four months**. The ECB refi rate stands at 2%, matching its low in the previous cycle in 2003-05. **The expectation is that given the worsening economic conditions and fall in inflation to very low levels, the ECB will cut rates again next month by 0.5%.**

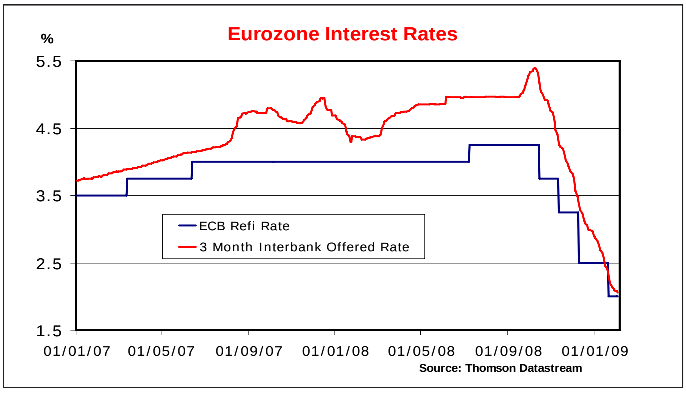
The ECB President, Mr Trichet, at today's press conference gave strong hints of a rate cut in March, which would coincide with the publication of the next set of ECB quarterly economic forecasts. These are likely to contain significant downward revisions to the projections made in December in regard to the outlook for both growth and inflation.

**The recent readings from key leading activity indicators, in particular the PMI surveys and EC's economic sentiment index, as well as industrial production data, have been truly awful and point to a very deep and prolonged recession.** GDP could have contracted by over 1% in Q4. Output is likely to continue declining in the first two or three quarters of this year - Mr Trichet talked today about persistent weakness in activity in the coming quarters. **A fall of 2.0% in eurozone GDP is now on the cards for 2009,** with just a modest recovery in 2010.

Meanwhile, the fall in oil prices and weakening demand and labour market conditions suggest that **inflation may turn negative in the summer.** At current oil prices, the CPI rate is likely to average around 0.5% in 2009, well below the ECB's target.

In the last cycle, ECB rates were eventually cut to a low of 2%. On that occasion, though, the economy managed to avoid recession. With the economy now in deep recession, inflation falling sharply and interbank and credit markets still malfunctioning, **there is a strong case for cutting ECB rates to well below 2% in 2009**. We expect that rates will be cut to 1.5% in March.

There is likely to be some resistance on the ECB council to pushing rates much lower than this. Nonetheless, we think that rates could be reduced to 1% by the summer given the bleak outlook for the economy. Indeed, zero rates cannot be ruled out, with Mr Trichet saying today that such a policy is not appropriate at present - begging the question if it could happen at a future date.




**A positive development has been the steep fall in interbank rates and the elimination of their spread over official ECB interest rates,** which still pertains in the UK and US. Three month rates have fallen to around 2%, the level of the refi rate, from 5.25% last autumn. As well as the large rate cuts, the decision by the ECB to provide funding out to six months at its benchmark rate has helped produce this big fall in wholesale rates. However, liquidity in the interbank market remains poor and borrowing costs remain high for many corporates, pointing to the need for low interest rates.

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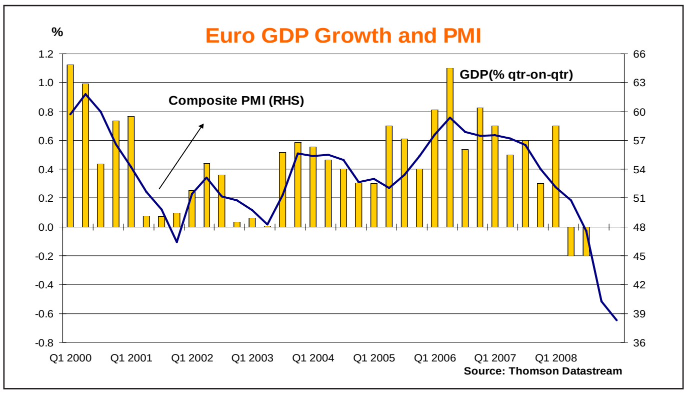
# Deep Recession In Eurozone Economy

Eurozone GDP contracted by 0.2% in Q2 and again in Q3, confirming that the economy entered recession last spring. **The data published to date for Q4 show that the economy is likely to have contracted very sharply in the quarter, with estimates that GDP may have declined by over 1.0%,** pointing to a marked deepening of the recession.

**Industrial production has been very weak in particular,** declining by more than 1.5% for three consecutive months to November. It could fall by over 3.5% in Q4. This alone would reduce GDP by some 0.7%. Allowing for declines in construction output and service activity would bring the fall in GDP to 1% or more for the quarter.

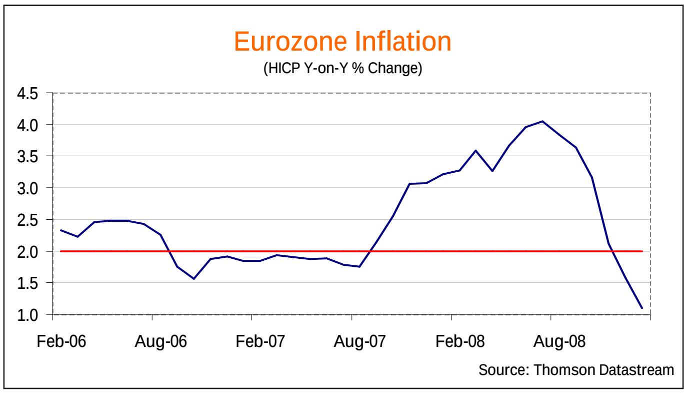



**Recent trends in leading indicators of activity leave no doubt that the recession is deepening. The EC's economic sentiment index, a good leading indicator of economic growth, has collapsed in recent months,** falling to 68.9 in January compared to 87.5 in September. This leaves the index at a record low, and well down on its 2007 peak of 111.6. Meanwhile, **the composite eurozone PMI has also nose dived, falling to a record low of 38.2 by December and 38.3 in January** from 46.9 in September, well below its peak of 57.8 in June 2007.

A marked fall is also evident in national surveys of business and consumer confidence, notably the Ifo index in Germany, INSEE surveys in France and ISAE index in Italy. All the recent indicators point to a sizeable fall in eurozone GDP in Q4 2008 and Q1 2009. They suggest that this will be a prolonged, deep recession as it will take some time for the indices to rise back up to levels consistent with economic growth. **Eurozone GDP could contract by 2.0% in 2009**.

**The eurozone labour market has also weakened a lot. The unemployment rate has been rising steadily since the summer, picking up to 8% by December compared to 7.4% in July and 7.2% earlier last year.** Employment fell by 0.1% in Q3 2008, with the rise in the year-on-year rate decelerating to 0.8% from 1.8% in Q4 2007. Survey data point to a continued weakening of the labour market in 2009.

Meanwhile, **inflation has fallen sharply since last summer, when it hit 4%, declining to 1.1% by January.** The fall in the CPI rate reflects the collapse in oil prices since the summer and declines in agricultural commodity prices, which has seen a marked easing in food price inflation. The CPI rate is set to continue on its downward path given the marked fall in oil prices. The recession and rising unemployment will also put downward pressure on core inflation. **The CPI rate is likely to turn negative in the summer** if the fall in oil prices in recent months proves sustained. We see the CPI rate averaging 0.5% in 2009, well below the ECB target.




**The growth in monetary aggregates is also decelerating.** M3 grew by 7.3% yr-on-yr in December, down from 12% at end 2007. Growth in private sector credit has slowed sharply in recent months, falling to 6.8% yr-on-yr in December from 10.1% in September and close to 13% at end 2007. Loan growth to households had slowed to just 1.8% yr-on-yr by end 2008, another sign of a very weak economy.



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