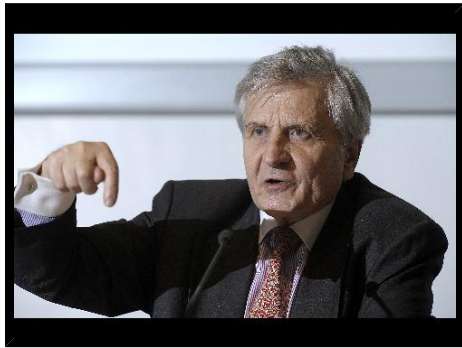


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ECB Cuts Key Rate as Recession Forces Trichet's Hand (Update1)

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By Simone Meier



Jan. 15 (Bloomberg) -- The **European Central Bank** cut its benchmark interest rate by half a percentage point to 2 percent, matching a record low, as the deepening recession pressed policy makers into action.

The reduction, the fourth in as many months, was in line with the median forecast of 60 economists in a Bloomberg News survey. The **rate** was last at this level between 2003 and 2005. The Frankfurt-based central bank, which took charge of monetary policy in 1999, will reduce the benchmark to 1.5 percent in March, another survey of economists shows.

President **Jean-Claude Trichet** said last month there's a limit to how far the ECB can cut rates and refused to give any signal for January, suggesting he favored a pause. At the same time, the economy of the 16 euro nations is deteriorating more rapidly than the ECB anticipated as the global financial crisis hurts exports, damps spending and threatens credit ratings in the region.

"The ECB really had little option but to act again given the clear, widespread evidence that the euro-zone recession is deepening," said **Howard Archer**, chief European economist at IHS Global Insight in London. "We suspect that the ECB will trim interest rates further in February and bring them down to 1 percent by mid-2009."

The euro dropped almost a cent to \$1.3087 after the decision. Trichet holds a press conference at 2:30 p.m.

Lagging The Fed

The ECB still has the highest rates among the Group of Seven industrialized nations. The U.S. Federal Reserve, the Bank of England and the **Swiss central bank** have cut borrowing costs more aggressively as the world's largest economies slide simultaneously into recession for the first time since World War II.

The **Bank of England** on Jan. 8 reduced its main lending rate to 1.5 percent, the lowest since it was founded in 1694. The **Fed** last month lowered its key rate to a target range of zero to 0.25 percent. Japanese and Swiss rates are also close to zero. Canada's rate is at 1.5 percent.

The ECB has reduced its benchmark by 225 basis points since early October. Last month it lowered the rate by 75 points, its biggest step ever.

Trichet told journalists on Dec. 15 the bank was focused on making sure its easing to date flowed through to the economy. It wanted to avoid being "trapped" with rates that are "too low," he said. Executive Board member **Juergen Stark** said on Dec. 10 the scope for further moves was "very limited."

Credit Rating Cut

The faltering economy is hurting budgets in some euro-region countries. Standard & Poor's yesterday lowered Greece's sovereign credit rating one notch to A-, saying the financial crisis has "exacerbated an underlying loss of competitiveness." The ratings of Ireland, Portugal and Spain are also under threat.

European confidence has plunged to the lowest on record, industrial production posted its biggest annual drop in 18 years in November and **unemployment** rose to 7.8 percent in November, a two-year high.

The German economy, Europe's largest, may have contracted as much as 2 percent in the **fourth quarter**, the country's statistics office said yesterday. That would be the biggest slump in more than two decades.

"Economic data has been catastrophic," said **Karsten Junius**, senior economist at Dekabank in Frankfurt and co-author of a book on the ECB. If policy makers had cut interest rates by 25 basis points or left them unchanged, "they would have made fools of themselves."

Slower Inflation

Some council members had signaled a willingness to lower borrowing costs further. ECB Vice President **Lucas Papademos** and Portugal's **Vitor Constancio** both said this month that lower rates may be warranted if the inflation rate drops too far below 2 percent, the bank's definition of price stability.

The rate declined to 1.6 percent in December.

The ECB last month forecast **inflation** would average 1.4 percent this year and 1.8 percent in 2010. It predicted the economy would contract 0.5 percent in 2009 before rebounding to expand 1 percent in 2010.

"Risks to the economic forecasts are not only to the downside, they're also increasing," said **Nick Kounis**, chief European economist at Fortis in Amsterdam. Trichet "needs to recognize that in the press conference."

The shadow ECB council, a group of economists that monitors the central bank, said on Jan. 13 that a half-point reduction in rates may not be enough and called for a full percentage point cut. A worsening recession increases the risk of "excessive disinflation," and this should be as much a concern to the ECB as inflation above its target, the economists said.

Investors expect the ECB to lower the benchmark rate to as low as 1.25 percent by June, Eonia forward contracts showed before today's decision.

"The ECB cannot prevent the collapse in activity under way," said **Kenneth Wattret**, senior economist at BNP Paribas SA in London. "But it can certainly do more to try and generate conditions more favorable to a recovery in late 2009 and 2010."

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