Surprise interest rate cut by European Central Bank

Nick Beams
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The surprise decision by the European Central Bank (ECB) to cut interest rates, after resisting all calls for a reduction over the past month, has come in the wake of reports that the economic slowdown in Europe could be worse than originally anticipated.

But the gloomy growth outlook was not among the reasons given by ECB president Wim Duisenberg when he announced the 0.25 percentage point cut on Thursday. Sticking to his position that the ECB is concerned only with keeping inflation below a target level of 2 percent, Duisenberg said that "refinement of its statistical apparatus" had reduced its estimate of the growth of money supply, thereby lessening inflation dangers and enabling it to order a rate cut.

The decision came after the ECB had defied calls by US administration, the International Monetary Fund, the Organisation for Economic Co-operation and Development, euro zone finance ministers as well as most of the financial press for action to stimulate economic growth in the face of the sharp slowdown in the US economy. In response to these calls Duisenberg had declared: "I hear but I do not listen."

While the reduction has been generally welcomed, Duisenberg's reliance on technical changes in the calculation of the money supply to explain the decision seemed to heighten uncertainties in financial markets about the direction of ECB policy with the result that the euro fell to a three-week low in currency trading.

Duisenberg maintained his position that the economic slowdown in the US would have only a limited impact on the euro zone, which was on course to grow at or above its long-term average of 2.5 percent.

But other observers are not nearly as confident.

As the *Economist* noted: "In recent weeks, the outlook for Europe has become gloomier, especially so in Germany, by far the largest of the euro zone economies. Figures released on May 9th showed that industrial output fell by 3.7 percent in March, compared with February, a much bigger drop than many people had been expected: construction, mining and manufacturing activity all declined sharply."

It pointed out that the main measure of business confidence, the Ifo index, had fallen for nine of the past 10 months and economists had been cutting back their forecasts. The government has cut its forecast of growth from 2.75 percent to 2 percent, while the IMF is predicting only 1.9 percent growth. Two days ago Chancellor Schroeder felt it necessary to dismiss recession fears—on the same day that a member of the Bundesbank council had warned that a recession was possible this year.

A comment on the German economy published by the London-based *Lombard Street Research* earlier this month noted that while there had been no "technical recession" (defined as two consecutive quarters of negative growth) since 1993, the "growth outlook for 2001 is dismal." Construction was in the "doldrums" while inventories were "piling up in manufacturing."

"Germany may escape a recession in 2001. But this is by no means certain. Current growth forecasts, both public and private (which also tend to cluster around 2 per cent) are still much too optimistic," it said.

The Bank of England has also cut interest rates by 0.25 percent. But unlike the ECB's move its decision was widely expected. And it made clear that the slowing British and world economy was the main reason.

In its statement, the bank warned that "the world economic prospect has on balance continued to weaken" and that "the extent and duration of the slowdown remain uncertain."

Figures from the Office of National Statistics released on Thursday show that manufacturing output in Britain fell by 0.7 percent in the first quarter of this year—the largest three-month decline in more than two years.

And according to estimates by the UK National Institute of Economic and Social Research, the British economy expanded by only 0.2 percent. This means that the Treasury forecast of 2.5 percent growth this year is not likely to be reached.

The worsening outlook in Europe means that the three key sectors of the world economy—the United States, Europe and Japan—now face either severely reduced growth, if not outright recession, in 2001. This is in marked contrast to the situation that has prevailed for most of the past decade.

In the first half of the 1990s, slower growth in Europe and the US was balanced by rapid expansion in East Asia. And in the latter part of the decade, growth rates of between 4 and 5 percent in the US economy provided a stimulus to the world economy as a whole.

But today all the major industrial centres are experiencing a reduction in growth rates. As Anirvan Banerji, direction of research at the Economic Cycle Research Institute in New York, told Reuters: "The global cyclical outlook has not been this bleak for over 20 years."