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Eurozone unemployment hits record high

By James Wilson in Frankfurt

People queue at a government employment benefit office in Madrid on Friday

The European Central Bank is widely expected to make an interest rate cut this week to try to invigorate the eurozone's ailing economy after unemployment in the region climbed to a record high and a key survey of manufacturing showed the sector to be at its weakest in three years.

Attention is back on the ECB's role in helping the eurozone emerge from its debt crisis, after last week's EU summit agreed that the central bank should play a role in common bank supervision. Leaders also backed the view of Mario Draghi, ECB president, that eurozone bailout funds should be offered directly to recapitalise struggling banks.

Few analysts expect the ECB to offer politicians a quid pro quo this week by giving further direct support to banks or governments such as more cheap loans or bond buying. But markets are pricing in the likelihood that the ECB will respond to worsening economic data by cutting its main policy rate to below 1 per cent for the first time – a step that should help peripheral eurozone banks that rely on central bank borrowing.

"A rate cut by 25bp almost looks like a done deal," said Carsten Brzeski, senior economist at ING in Brussels, in research published on Monday.

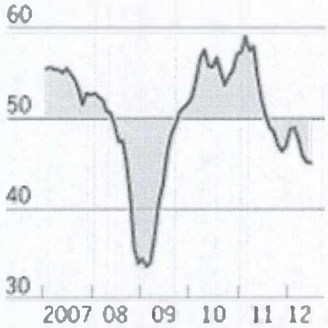
Mr Draghi has voiced alarm at increased risks to the economic outlook and some economists think the central bank could consider a more aggressive rate cut of 50 basis points.

"Circumstances are sufficiently negative to move to 0.5 per cent," said Julian Callow, European economist at Barclays. "It is clear that the economy does need significantly more stimulus."

Joblessness in the eurozone reached 11.1 per cent in May, the highest in the history of the single currency, the EU's statistics office said on Monday. The rate climbed in Spain, where almost one in four people is out of a job, and edged higher in France, where President François Hollande's government is this week to set out key parts of its policies to boost growth and cut the budget deficit.

Eurozone purchasing managers' index

Manufacturing index (above 50 = expansion)



Source: Markit

Across the eurozone the number of unemployed rose by more than 1.8m in the past year. Unemployment among those aged under 25 is more than 52 per cent in Spain and Greece.

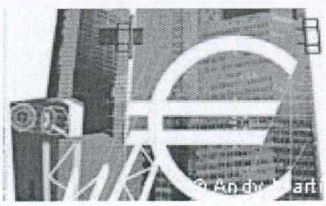
ING's Mr Brzeski said economic confidence was "far below historical averages in all eurozone countries" except for Germany, where unemployment remains low. But confidence is also declining in Germany, with the country's manufacturing sector shrinking at its fastest rate in three years in June according to data from Markit's manufacturing purchasing managers' index.

The index showed that the downturn in eurozone manufacturing extended to an 11th straight month.

"It will not be long before the eurozone is officially in a recession," said Mr Brzeski.

In depth

Eurozone in crisis



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Some economists believe the ECB will yet stay its hand, leaving the main policy rate unchanged. But aside from discussing its main policy rate, the ECB's governing council is also likely to consider what it should do with its deposit facility rate – what banks earn for depositing money overnight at the central bank.

The deposit rate is important because it in effect sets a floor for market interest rates: banks have little incentive to lend to each other at below the deposit rate.

For the past three years the deposit rate has been 75 basis points below the main policy rate. But few economists think the ECB will cut the deposit rate to zero, even if the main refinancing rate falls to 0.75 per cent. "We suspect the ECB would prefer a non-zero rate," said economists at Deutsche Bank.

The ECB held its main policy rate at 1 per cent for much of 2009 and 2010, before tightening last year in a premature attempt at a crisis "exit strategy". The rate was cut again to 1 per cent in December, when the ECB also announced unprecedented three-year loans in a sign of its alarm at a potential borrowing crunch for banks.

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