The European economy may be winning some respite from its sovereign debt crisis.

With the euro area teetering on the brink of a second recession in three years, data this week showed rebounds in German exports and French business confidence, suggesting the slowdown may be limited. The euro’s 10 percent drop against the dollar since late October and an easing of financial conditions may also provide support as leaders fight to restore investor faith in their region’s bond markets.

The signs of resilience hand European Central Bank President Mario Draghi room to keep the benchmark interest rate at 1 percent today after cutting it twice in the past two months and flooding the banking system with a record amount of cash. The pause may be brief if looming budget cuts and a credit shortage prove too powerful for the economy to withstand.

“The sense that the economy is in freefall is abating but it’s too early to talk of a turning point,” said Juergen Michels, chief euro-area economist at Citigroup Inc. in London. “The picture in the core countries has improved a bit and a weaker euro will help, but further austerity measures in the periphery countries will drag on growth, and the specter of a credit crunch has not been banished.”

**Rate Decision**

Only six of 53 economists in a Bloomberg News survey expect the ECB’s 23-strong Governing Council to cut its key rate today to what would be a new record low. Officials meeting in Frankfurt will announce their decision at 1:45 p.m. and Draghi will explain it to reporters 45 minutes later.

“We’ve had a couple of indications that things may not be as bad in 2012 as people expected them to be,” said Tobias Blattner, an economist at Daiwa Capital Markets who previously worked at the ECB. “The ECB has factored in this downturn that we’re seeing, which reflects the view that the recession won’t be a very deep one.”

German exports rose 2.5 percent in November from October and business confidence in Europe’s largest economy unexpectedly rose for a second month in December. A report last week also showed that euro-area services and manufacturing output contracted less than initially estimated last month, led by Germany.

In France, the second-largest economy in the 17-nation euro region, business sentiment climbed from a two-year low in December and industrial output increased in November.

German Recession?

The economy is far from out of the woods.

German gross domestic product probably dropped 0.25 percent in the fourth quarter of last year from the third, the Federal Statistics Office said yesterday. Some economists predict another contraction this quarter, putting Germany into a technical recession.
Italian unemployment rose to 8.6 percent in November and consumer confidence fell to a 16-year low in December, while Spanish joblessness rose to a record 22.9 percent in November and industrial production recorded its biggest drop in two years. Greece is entering a fifth year of recession.

“The data we’re getting at the moment is mixed,” said Jens Sondergaard, an economist at Nomura International Plc in London. “The ECB wants some time to assess what it has done and what the effects are.”

The central bank last month cut its 2012 growth forecast for the euro region to 0.3 percent from 1.3 percent.

While the median forecast in a survey of 21 economists is for the ECB to keep its key rate at 1 percent through mid 2013, Citigroup, JPMorgan Chase & Co. and Morgan Stanley all expect the benchmark to be cut to 0.5 percent by the middle of this year as recession bites.

‘Big Year’

“Beyond this week’s meeting, it will be a big year for the ECB,” said Greg Fuzesi, an economist at JPMorgan in London.

Concerned its ability to deliver price stability is under threat, the ECB has cut its key rate twice since Draghi took office on Nov. 1. It has also bolstered efforts to grease markets by lending banks an unprecedented 489 billion euros ($620 billion) for three years and making it easier for them to borrow. It continues to buy the bonds of stressed sovereigns such as Italy.

The provision of liquidity may be helping, handing governments breathing space to restore fiscal order and complete an overhaul of budget rules. The Bloomberg Euro-Area Financial Conditions Index has risen to minus 4 percent from a low of minus 5.4 percent in September.

Borrowing Costs

Borrowing costs have also eased. Italian two-year bond yields have dropped back below 10-year rates, while Belgium’s yield curve has steepened in a sign of increased investor confidence. Italy sold 9 billion euros of bills on Dec. 28 at about half the rate of the previous sale in November and Belgium raised more money than planned at a Jan. 3 debt sale.

The economy may also receive a fillip from a weaker euro.

The single currency has fallen almost 5 percent against nine developed-nation currencies in the past three months, according to Bloomberg Correlation-Weighted Currency Indices. ECB research shows a decline in trade-weighted terms of 10 percent adds 0.7 percent to growth in the first year and 1.2 percent in the second.

“The ECB will be happy to acquiesce in an orderly and contained depreciation of the euro,” said Huw Pill, chief European economist at Goldman Sachs Group Inc. who used to work at the ECB.

Car Exports

Stuttgart-based Daimler AG’s (DAI) Mercedes-Benz is targeting higher car deliveries in 2012 after selling a record number of vehicles last year, Chief Executive Officer Dieter Zetsche said Jan. 5. Rival Porsche SE anticipates U.S. sales to rise to more than 30,000 cars next year on demand for the revamped 911 sports car.

Risks remain as governments impose a fiscal squeeze that JPMorgan estimates could reach 2 percent of GDP. Greece has yet to seal a deal with bondholders over a proposed debt write-off on which fresh aid is contingent,
and politicians are still wrangling over a revamp of budget limits.

Meanwhile, the ECB’s injections of cash are not finding their way to companies and households. Banks are instead hoarding the money and parking it back at the ECB. Overnight deposits at the central bank jumped to a record 486 billion euros this week.

The ECB should step up its government bond purchases to combat the debt turmoil, David Riley, head of the sovereign-debt unit at Fitch Ratings, said yesterday. The ratings company said Jan. 10 that it’s likely to make a decision on credit grades for euro-area nations that are under review by the end of this month.

“Europe is still in dangerous territory,” said Elga Bartsch, chief European economist at Morgan Stanley, who expects the ECB to eventually engage in more aggressive asset purchases known as quantitative easing. “But 2012 should also be the year in which the economy turns around.”

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