TD Economics

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Data Release: European Central Bank cuts rates, announces measures, promises more

- At its meeting today, the European Central Bank (ECB) decided to cut both its main refinancing rate (refi) and its deposit rate by 10bps. It also cut the marginal lending rate by 35bps. Markets were expecting cuts of 15bps, 10bps and 15bps, respectively.
- This brings the marginal lending rate and the refi rate down to 0.40bps and 0.15 bps, respectively, and takes its deposit rate into negative territory at -0.10bps.
- The ECB also announced a series of additional monetary measures. It introduced a new Targeted Long-Term Refinancing Operation (TLTRO), which will enable European banks to borrow from the ECB an amount equal to 7% of their loans to the euro area non-financial private sector, excluding mortgage loans, outstanding on April 30th 2014. The combined initial entitlement is of roughly €400bn. This program will be in place for the next four years until September 2018. The goal of this action is to encourage lending.
- In order to reinforce forward guidance, the ECB announced that they will continue fixed rate full allotment refinancing operations at least until the end of 2016, suggesting no rate hikes before then.
- The ECB also announced that they had suspended the weekly sterilization of liquidity injected via their Securities Market Program (SMP), which should boost money supply.
- Finally, the ECB also announced that they had intensified preparatory work for outright purchases of asset-backed securities. The ECB will consider buying "simple and transparent ABS" with claims against the euro area nonfinancial sector.
- In terms of the outlook for the economy, Eurosystem staff projections are for real GDP growth to reach 1% in 2014, 1.7% in 2015 and 1.8% in 2016. This is a downgrade for 2014, but an upgrade for 2015, relative to the March projections for growth of 1.2% in 2014 and 1.5% in 2015. The forecast for 2016 has been left unchanged.
- In terms of the outlook for inflation, projections are for consumer prices to rise by 0.7% in 2014, 1.1% in 2015, and 1.4% in 2016, with inflation reaching 1.5% by the last quarter of 2016. Projections have been downgraded over the entire 2014-16 period, and the forecast for the end of 2016 has been lowered from the 1.7% level it had previously projected in March. This clearly shows that worries about deflationary pressures motivated today's actions and suggests more to come.
- On the topic of interest rates, Draghi stated that they "will remain at present levels for an extended period of time, in view of their current outlook for inflation". In the Q&A afterwards, Mario Draghi, the president of the ECB, stated that for all goods and purposes, the ECB had now reached a floor in rates.

Key Implications

- The European Central Bank just about met market expectations on rate cuts and then delivered on additional measures.
- The rate cuts had already largely been priced into the markets. From 1.395 in early May, the euro had already fallen to 1.360 yesterday (relative to the USD), in anticipation of today's announced stimulus. In the immediate aftermath of the rate cut announcement, the euro weakened marginally further. Ten-year bond yields were relatively unchanged in core economies but fell substantially in the periphery, where some of the targeted measures are expected to have the largest impact.
- Bringing the deposit rate into negative territory takes the ECB into uncharted waters. There are few instances of central banks using negative rates and certainly it has never been done by so prominent a central bank. Time will tell whether cutting the deposit rate will encourage banks to increase lending, will lead to capital outflows, or whether banks will treat this as a cost of operating and simply pass it on to consumers and businesses. Some combination of these three outcomes is probable. The main reason

for the cut is to lower the value of the euro, which will help raise inflation. Given the large amount of economic slack, particularly in the periphery, it remains to be seen whether this will be sufficient to allay fears of deflation.

- The TLTRO is a targeted measure to increase lending to the private sector. It is intended to ensure that that additional funding extended to banks is specifically used to lend to private sector businesses and households, rather than invested in sovereign bonds. On net, this will be positive for economic growth in euro zone periphery economies, which should exert upward pressure on inflation.
- The suspension of the sterilization of the SMP will effectively increase liquidity in the eurozone by over €150 billion, which all else equal, should be positive for inflation.
- As per Draghi's remarks, the ECB has now effectively set a floor on interest rates and therefore no further cuts should be expected. However, extending the full-rate fixed allotment refinancing operations is a powerful signal that rates will remain at or near their current level well into 2016.
- While no more rate cuts should be expected, the ECB has definitely left the door open for further monetary easing down the road. While we do not anticipate the ECB moving to full out quantitative easing via purchases of sovereign bonds as seen in the U.S., Japan or the UK, the possibility of asset-backed purchases is likely coming.
- Today's announcements do not materially change the outlook for the euro zone, but they should constrain the euro and should help anchor inflation expectations, which was the main goal the ECB was looking to achieve.

Andrew Labelle, Economist
416-982-2556