TD Economics

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Data Release: ECB cuts rates (again), announces new measures (again), leaves door open for more

- The ECB cut both its deposit rate and its main refinancing rate by 10bps each today, bringing them to -20bps and 5bps respectively.
- The ECB also announced a new asset-backed securities program, involving the purchase of "simple and transparent" ABS with claims against the euro area non-financial private sector. In the press conference afterwards, Mario Draghi, president of the European Central Bank, stated that ABS purchases would include residential mortgage-backed securities.
- The ECB also announced a new covered bond purchase program, involving the purchase of covered bonds issued by euro zone financial institutions.
- Details on the covered bond and ABS programs will be unveiled at the ECB's next meeting on October 2nd, with purchases set to begin in October 2014.
- The ECB stated that the motivation for today's decisions was to underpin the firm anchoring of medium to long-term inflation expectations.
- The ECB downwardly revised its economic forecasts for 2014 and 2015, while increasing its forecast for 2016. Real GDP growth is now expected to be 0.9% in 2014 (prior 1%), 1.6% in 2015 (prior 1.7%), and 1.9% in 2016 (prior 1.8%). The inflation forecast for 2014 was also revised downwards to 0.6% Y/Y (prior 0.7%), while 2015 and 2016 were left unchanged at 1.1% and 1.4%, respectively.
- The ECB stated that the Governing Council was "unanimous in its commitment to using additional unconventional instruments within its mandate" should it be necessary to further address risks of too prolonged a period of low inflation.

Key Implications

- Both rate cuts were unexpected as Draghi had previously hinted in June that rates had hit their lower bound. On their own, rate cuts won't have much economic impact given how low short-term interest rates already are. Draghi also stated that policy rates had now effectively reached their lower bound and therefore no further cuts should be anticipated.
- The panoply of measures can be viewed as QE-lite, although in some ways ABS purchases are superior to purchases of government bonds, as they create additional incentives for banks to lend to the real economy. In the Q&A afterwards, Draghi mentioned that the ECB aims to return its balance sheet to the size it was in 2012. This would imply additional liquidity of roughly €1 trillion ($1.3 tr.). Although of a different nature, on a comparative basis, the size of QE3 by the Federal Reserve was roughly $1.8 trillion, split between Treasuries and MBS.
- Just about the only tool yet to be unsheathed by the ECB is full-blown quantitative easing, involving the outright purchase of government bonds. Although Draghi stated that the ECB was unanimous in its commitment to using additional unconventional instruments, the fact that the ECB has resorted to just about every other type of stimulus program points to its ultimate reluctance. A significant deterioration in the outlook would likely be necessary for the ECB to shed this reluctance.
- Market reaction was for generally lower yields across the euro zone. However, in Germany and France, longer maturity yields rose as the additional measures raised medium-term inflation expectations and perhaps reflect some disappointment that full QE was not put on the table. The

euro fell relative to the USD, as the increasing divergence in central bank policy with respect to the Federal Reserve becomes more entrenched.

- Overall, the measures are unlikely to have a large immediate economic impact. However, in 2015 and beyond, once the liquidity starts filtering through and banks start lending again, they should help kickstart an economy that has clearly stagnated. At the margin, they are likely to raise business confidence, assuming geopolitical tensions do not increase further. Furthermore, the steady fall in the euro over the past several months, which is expected to continue, should allow for a modicum of support for both inflation and economic growth, particularly for export-oriented economies.
- As a final point, monetary policy alone cannot solve the challenges faced by the euro zone as a whole, as Draghi has been eluding to in speeches. Ultimately, there will need to be more movement on structural economic reforms to provide a firmer foundation under the region's growth prospects, and this is not in the hands of the ECB.

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