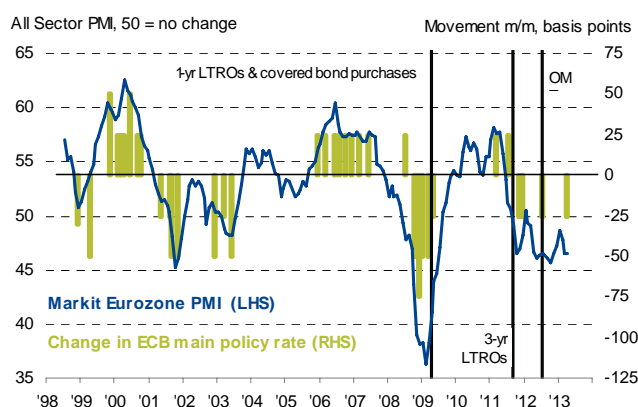


Eurozone

ECB cuts rate to all-time low as recession deepens

- **ECB cuts main policy rate to all-time low as inflation tumbles and growth outlook darkens**
- **No 'non-standard' measures announced, as onus lies with governments to implement structural reforms**

ECB policy decisions and the PMI



At last, the fastest contracting region in the world no longer has the highest central bank policy rate of all major developed economies. A combination of ongoing steep economic decline and falling inflation has prompted in the European Central Bank into renewed action to stimulate growth in the euro currency area.

The ECB cut its main policy rate to an all-time low of 0.50% at its May governing council meeting, its first cut in the ECB's refinancing rate, which has been held at 0.75%, since July of last year. The interest rate on the ECB's little-used marginal lending facility was also cut, down from 1.5% to 1.0%.

However, there was little stock market reaction to the cut, which is seen largely as a symbolic gesture to reassure struggling eurozone countries that it is actively seeking to revive growth. There is little evidence to suggest the rate cut it will feed through to lower interest rates in the troubled peripheral countries, which have remained stubbornly high compared to rates in core countries such as Germany, where lending is seen as a safer bet by banks.

Many have therefore been hoping to see the ECB accompany a cut in rates with at least a discussion of different options by which lending to smaller and medium sized companies in particular can be boosted in countries such as Italy, Spain, Portugal and Greece. However, ECB head Mario Draghi instead reiterated that the onus lies on national governments to implement structural reforms designed to raise competitiveness and improve long-term economic growth potentials, and stressed the need for swift progress towards banking union.

Draghi also stated that the ECB will continue to monitor closely the economic data and remains "ready to act" if further action is required, therefore not ruling out a further cut in its policy rate.

A development to watch is the ECB's discussion of how to build up packages of loans into asset backed securities, which can be more transparently priced and traded, therefore helping to increase non-bank lending.

Falling inflation and ongoing recession

At the April meeting, Draghi had previously reassured markets that the central bank stood "ready to act" if economic data suggested further action was appropriate. Inflation has now fallen for four consecutive months, down from 2.2% at the end of last year to just 1.2% in April, its lowest since February 2010 and sharply below the ECB's target of below but close to 2.0%.

The easing in inflation has been welcomed as it has opened the door for manoeuvre by the ECB, removing the constraint of above target inflation that persisted between December 2010 and the start of this year. However, although Draghi considers inflation expectations to remain "well anchored", the darker side to the downturn in price pressures is that it reflects weak demand and raises the spectre of deflation.

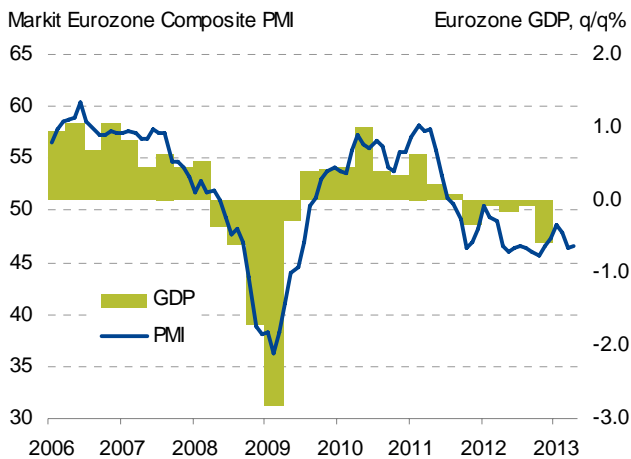
The drop in inflation has been accompanied by a renewed deepening of the economic downturn in the Eurozone. [Markit's flash PMI](#) indicated that business activity is likely to have contracted at an increased rate

in the second quarter, reversing an easing trend that had been evident at the start of the year. Worryingly, the data point to the start of another downturn in Germany alongside still steep rates of contraction in France, Italy and Spain.

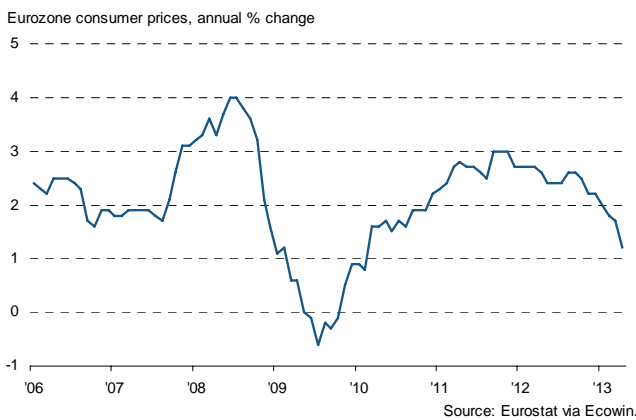
The April PMI survey also showed companies' selling prices fell at the fastest rate since early-2010, as increasing numbers of firms cut prices to stimulate sales, adding to the deflationary picture.

Official data meanwhile showed unemployment in the region hitting a new record high of 12.1%. All-time high levels of joblessness in peripheral countries have added to the political pressure on monetary policymakers to be seen to be doing something to boost growth and counteract austerity-related fiscal policies.

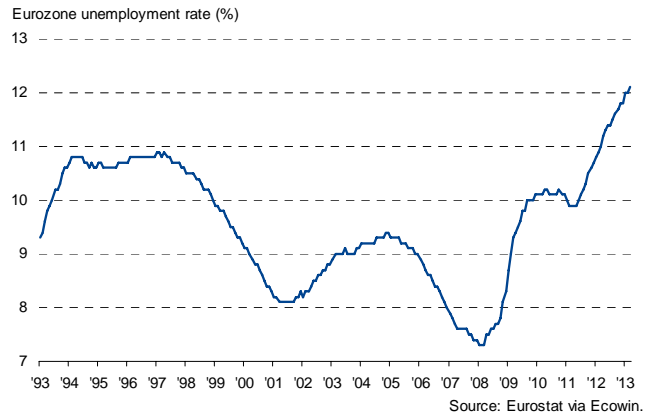
Eurozone economic growth and the all-sector PMI



Eurozone inflation



Eurozone unemployment



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