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Eurozone

ECB takes further action to boost economy

- **ECB cuts interest rates to record low**
- **ABS and covered bond purchase programme to commence in October**
- **Economic forecasts revised down slightly amid weakened dataflow and geopolitical worries**

The European Central Bank took further steps to bolster the faltering eurozone economic recovery at its September meeting. New action included cutting interest rates to a record low and buying asset backed securities and bonds, though not government debt, to boost the supply of credit in the economy.

The ECB cut its main policy rate from 0.10% to a new low of 0.05% and its deposit rate to -0.2% from -0.1%.

The Bank also announced the commencement of a programme to buy asset backed securities and covered bonds (which are safer than ABSs) in October, the plans for which had been outlined back in June. The ECB will buy a wide range of assets designed to boost credit to the private sector including residential mortgage backed securities and other securities backed by loans to the real economy.

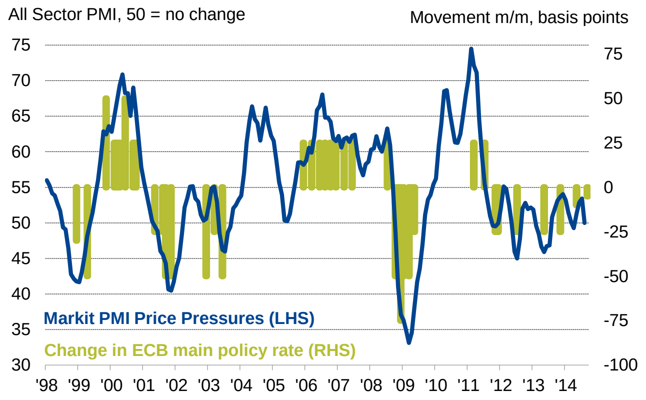
Surprise, surprise

The markets were taken by surprise, in particular by the rate cut announcement. Previous guidance by the ECB had indicated that it would wait until it had assessed the impact of previous policy measures, which include the introduction of new discounted loans targeted at households and businesses through the banking system, due to be implemented in September and December.

The rate cuts were especially unexpected after Draghi himself had indicated after the June cuts that “for all practical purposes, we have reached the lower bound” on interest rates, though he had noted some “technical adjustments” were possible.

At the press conference, ECB President Mario Draghi reported that the decision was not unanimous among the Governing Council, but had been reached by a “comfortable majority”.

PMI Prices Pressures and ECB Policy



Sources: Markit, ECB.

Faltering economy

The new stimulus had been made in response to concerns that inflation expectations in the euro area were turning down and that the economy was showing surprising weakness this year. GDP had been flat in the second quarter and recent PMI survey data had disappointed. Geopolitical concerns, notable the crisis in the Ukraine, also represent a major downside risk to the outlook.

The ECB trimmed its growth forecasts for 2014 and 2015, down from 1.0% to 0.9% and from 1.7% to 1.6% respectively. The inflation outlook for 2014 was also revised down, dropping to 0.6%, though further forecasts were left unchanged, albeit remaining below the target of below but close to 2.0%, with the rate edging up to 1.1% and 1.6% for 2015 and 2016 respectively.

Assessing the impact

There are big questions over the effectiveness of the further reduction in interest rates and, while the asset purchases may have a more significant impact, little is known about just how many assets the ECB will be able to buy and what impact this will have on the economy.

Perhaps the main immediate benefit of the additional policy action is a weakening of the exchange rate (the euro dropped around 1% on the news and is down 5%

since the start of July). The lower exchange rate will undoubtedly provide a boost to exporters' competitiveness.

The action should also help improve business and consumer confidence. The more determined and aggressive approach from the ECB should hopefully encourage more investment and spending.

There are suspicions that the increasingly aggressive stance from the ECB could reduce the likelihood of the central bank buying sovereign debt, a policy which is politically controversial but widely considered as becoming increasingly essential in reviving the economy. Draghi, however, noted that the Governing Council was unanimous using other "unconventional instruments" if necessary, assumed to include government debt purchases along the lines seen in the US, UK and Japan.

However, an additional benefit may be that the action from the ECB may help to encourage governments to step up the pace of economic reforms which, it is widely agreed, are essential accompaniments to looser monetary policy.

Draghi also built on comments made in his Jackson Hole speech, that supportive fiscal policy will also need to work alongside monetary policy and structural reforms, emulating the three-arrowed approach of "Abenomics" undertaken in Japan.

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