Markit Economic Research
05/06/2014

Eurozone

ECB takes out a policy 'shotgun' to kill deflation

- **ECB cuts interest rates, including negative deposit rate**
- **Package of other measures includes new LTROs and plans for QE**
- **Euro falls on the announcement and equities rise**

While the Bank of England pulled no surprises at its monthly policy meeting, the European Central Bank went further than expected in terms of policy action. The ECB's Governing Council unanimously agreed to announce what ECB President Mario Draghi described as a "significant" package of five measures to help lift growth in the single currency area and ward off the threat of deflation.

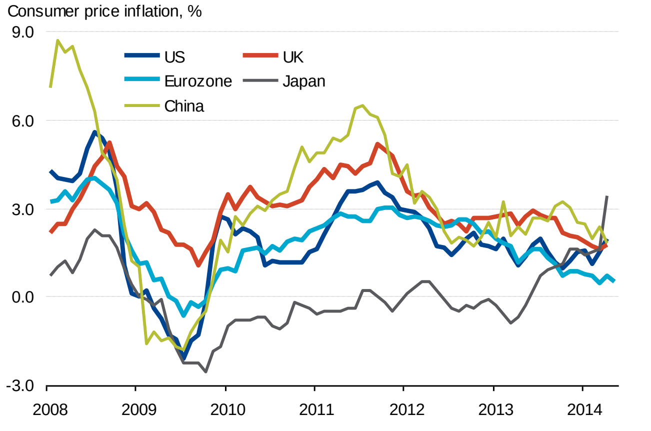
Speculation had intensified in recent months that the ECB would act, and had even been flagged up for June at the prior ECB meeting. Action then became more or less a certainty after inflation fell to just 0.5% in May and the region's PMI signalled a waning recovery.

The only question that really remained is: how bold will policymakers be? As it turns out, the ECB has done pretty much everything that it was thought likely it might do in a 'shotgun' approach to policy.

New staff forecasts showing inflation rising less than previously expected, to reach just 1.5% by the end of 2016, were a key factor driving the decision for renewed and aggressive stimulus. The ECB also cut its 2014 economic growth forecast to 1.0%.

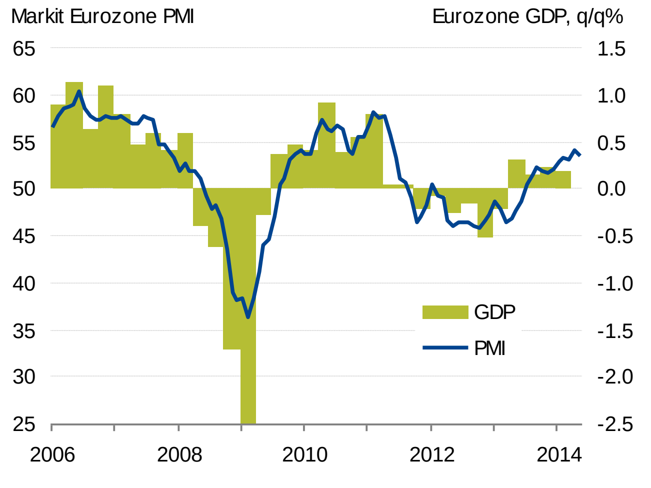
As was widely expected, the package includes a further cut to interest rates, and introduces – for the first time at any major central bank – a negative deposit rate. The latter means it will now charge banks for holding money at the ECB, in the hope that lenders will instead be encouraged to loan out funds to households and businesses. Its main refinancing rate was cut from 0.25% to a new all-time low of 0.15%, while the deposit rate is down from zero to -0.1%.

Inflation rates



Source: Ecowin.

Eurozone PMI and GDP



Sources: Markit, Ecowin.

"Targeted" cheap loans (longer-term refinancing operations), aimed at non-financial companies were also revealed. These are designed to help boost lending to the private sector, with the notable exception of loans for house purchases.

Further stimulus measures were meanwhile being prepared in the form of plans to purchase asset backed securities, which can be considered as a form of quantitative easing.

Other measures included the extension of the ECB's fixed rate, full-allotment tender procedures, and operations designed to sterilise liquidity injected via its

Securities Markets Programme (and appease those worried about the inflationary impact of this policy) were also suspended.

The effectiveness of a negative deposit rate is uncertain, while the TLTRO may also have only a limited impact on actual lending. More importantly, it is probably the lift to business and consumer confidence that will result from the decisiveness of the policy action that will do the most to help the economic recovery find its legs.

Chris Williamson
Chief Economist
Markit
Tel: +44 207 260 2329
Email: chris.williamson@markit.com

Click here for more PMI and economic commentary.
For further information, please visit www.markit.com