The European Central Bank cut its deposit rate below zero and said it would announce further measures later today as policy makers try to counter the prospect of deflation in the world’s second-largest economy.

ECB President Mario Draghi reduced the deposit rate to minus 0.10 percent from zero, making the institution the world’s first major central bank to use a negative rate. Policy makers also lowered the benchmark rate to 0.15 percent from 0.25 percent. Draghi will hold a press conference at 2:30 p.m. in Frankfurt.

“They have to do something to address weak inflation,” Nick Matthews, senior economist at Nomura International Plc in London, said before the decision. “Investors are expecting them to keep alive the option of more unconventional measures like quantitative easing.”

The euro fell to the lowest in four months after the move. Draghi has said a worsening in the medium-term outlook for prices would justify broad-based asset purchases, and with inflation stuck well below the ECB’s goal for the past eight months and revised staff forecasts due today, that’s a scenario that remains possible. While he’s unlikely to announce a QE program immediately, he may keep the option alive by providing insight into how a plan could overcome the practical challenges it faces in an 18-nation currency union.

**Stimulating Lending**

First though, Draghi will probably signal that his room for maneuver on interest rates isn’t over. He’s likely to reiterate his pledge to keep borrowing costs at “present or lower levels,” two euro-area central bank officials said this week, declining to be identified because policy discussions aren’t public.

The currency was 0.3 percent lower on the day, trading at $1.3562 as of 1:55 p.m. in Frankfurt. That’s the lowest since Feb. 5.

The cut in the deposit rate was forecast by 44 of 50 economists in a Bloomberg News survey.
Today’s briefing may also be the venue for Draghi to announce non-standard measures aimed at stimulating lending to the real economy, which ECB data show has been falling for two years and has only in recent months started to show tentative signs of stabilizing.

A program modeled on the Bank of England’s Funding for Lending Scheme is one option, and banks may be offered funding equivalent to 5 percent of their outstanding loan portfolios, one of the people said.

**Market Reaction**

The Bank of England kept its benchmark rate at a record-low 0.5 percent today, while its bond-purchase plan stayed at 375 billion pounds ($636 billion).

Speculation that the ECB will act has pushed the euro down 1.7 percent against the dollar since the last policy meeting on May 8. Officials have cited a strong currency as one factor curbing inflation by reducing the price of imported goods.

Even so, markets are already braced for all those measures, according to Holger Schmieding, chief economist at Berenberg Bank in London.

“It would probably take a major surprise to get a big and lasting market response beyond any initial knee-jerk reaction,” he said. “Serious quantitative easing could be such a surprise, boosting equities and bonds and weakening the euro by a few cents for a while. We consider such QE highly unlikely.”

**QE Trigger**

The ECB views QE, or large-scale asset purchases with the aim of boosting the money supply and thereby inflation, as a legitimate option. At the same time, it isn’t an easy one, as the euro area lacks a unified government debt market that would be the obvious target for purchases, making the appropriate assets for an effective QE policy hard to select.

Government bond yields are also already at record lows, yet that isn’t feeding into bank lending for small and medium-sized firms. Draghi has been promoting a functioning market for asset-backed securities to improve the flow of credit to SMEs, which account for the bulk of private-sector employment in the euro region. That market has withered since the financial crisis.

Draghi hasn’t yet conceded that the threshold for QE in the euro area has been reached, though he has stepped up his warning that the trigger may be near.

“What we need to be particularly watchful for at the moment is, in my view, the potential for a negative spiral to take hold between low inflation, falling
inflation expectations and credit, in particular in stressed countries,” he said last month at the ECB Forum in Sintra, Portugal.

Inflation in the euro area slowed to 0.5 percent in May, matching the lowest rate in more than four years. Officials will significantly reduce their 2014 inflation outlook from the 1 percent forecast in March when they publish their latest forecasts today, one central-bank official said.

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