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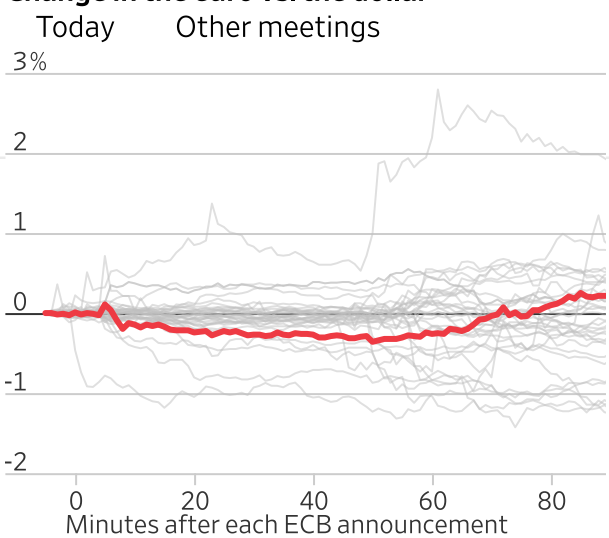
EUROPE ECONOMY

ECB Signals Rate Cut, Possible Stimulus Relaunch

Central bank is examining a return to asset purchases, a major policy shift

Change in the euro vs. the dollar



Note: Meetings since 2015 Sources: Tullet Prebon, FactSet
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By Tom Fairless

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FRANKFURT—The European Central Bank signaled it is preparing to cut short-term interest rates for the first time since early 2016 and possibly restart its giant bond-buying program, a major policy shift aimed at insulating the eurozone's wobbling economy against international headwinds.

By refraining from taking fresh action Thursday, the ECB has given the Federal Reserve the opportunity to be first among the world's biggest central banks to reduce policy rates in this cycle. The Fed is widely expected to lower interest rates for the first time in over a decade when it meets at the end of July.

The ECB said in a statement Thursday that it expects to keep its key interest rate at its current level of minus 0.4% or lower through the first half of 2020, a clear signal that it is planning a rate cut.

The economic outlook "is getting worse and worse," especially in manufacturing, ECB President Mario Draghi said at a press conference. "Basically we don't like what we see on the inflation front."

Crucially, the central bank also said its staff would examine “potential new net asset purchases” in an effort to push up persistently low inflation. The ECB aims to keep inflation just below 2% but has fallen short of that target for years.

“It now increasingly looks as if the September meeting will not only bring a single measure but rather a package of several measures,” said analysts at ING Bank.

The euro fell around half a cent against the dollar after the ECB announcement, to $1.1112. Yields on eurozone government debt slid as investors anticipated fresh bond purchases by the region’s largest buyer.

European Central Bank President Mario Draghi is presiding over one of his last meetings as head of the bank on Thursday.
PHOTO: RONALD WITTEK/SHUTTERSTOCK

The decision to signal a rate cut is the minimum that investors had expected from the ECB. Some investors had expected the central bank to cut rates this week in a move that would pre-empt the Fed.

But the ECB’s decision to bring into play its bond-buying program, which was phased out in December, signals a deeply serious intent.

The ECB said its staff committees would examine the “size and composition of potential” new bond purchases, language that the bank has previously used to signal action at its next policy meeting.

It also said they would examine a tiered system for the deposit rate. With that rate negative, commercial banks have to pay the ECB to park reserves at the central bank. Eurozone banks have paid about €7 billion ($7.8 billion) annually because of the negative deposit rate.

Under a tiered system, a certain amount of reserves could be exempted or hit with a lower rate, in order to cushion of the effect on banks. The Swiss central bank exempts some bank deposits from its minus 0.75% policy rate.

Major central banks have signaled a return to ultralow interest rates in recent months amid mounting threats in the global economy, which range from trade tensions to Brexit. Central bankers are eager to act early to safeguard the long economic expansion because they appear to have limited policy space to counteract any recession.

In the eurozone, economic data have started to flash red as the region emerged as a prime victim of the trade tensions between the U.S. and China. The eurozone exports goods and services worth 28% of its economic output each year, compared with 12% for the U.S.

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Germany's economy, Europe's largest, has stagnated for much of the past year amid a downturn in its key manufacturing sector. In Italy, the No. 3 eurozone economy, the political situation remains volatile.

The eurozone economy is still expanding and inflation is above 1%, not far from the ECB's target of just below 2%. That is a marked change from the ECB's last major round of stimulus in early 2016, when the currency union was flirting with deflation, or a cycle of falling prices.

But ECB officials had signaled in recent weeks that they were concerned about a downturn in the key manufacturing sector, and were preparing to act.

The central bank's decision on Thursday sends a signal to financial markets that the ECB still has firepower left, even though its key interest rate is already below zero and its balance sheet has swollen to around 40% of eurozone economic output, double that of the Federal Reserve.

Investors are likely to question the effectiveness of additional stimulus, however, given that borrowing costs and government bond yields across the eurozone are already extremely low.

—Brian Blackstone contributed to this article.

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