ECB Mulls Bolder Moves to Guard Against Low Inflation

Officials Indicate They Will Consider Negative Interest Rates, Asset Purchases

By Brian Blackstone

Updated March 25, 2014 5:23 p.m. ET

European Central Bank officials sent strong signals Tuesday that they are willing to consider dramatic steps to guard against dangerously low inflation, suggesting the bank is prepared to shed some of its traditionally cautious approach.

The possible tools, cited by some top policy makers from different parts of the euro zone, include effective negative interest rates—meaning rates so low that commercial banks would essentially pay the ECB to park their extra cash overnight. They also include purchases of government or private-sector debt to hold down long-term rates and spur lending.

The officials' remarks come ahead of the central bank's next policy meeting on April 3, and after financial markets registered disappointment that the ECB took no action at its last meeting early this month that would ramp up the fight against a weak economy and strong currency.

Ever since, officials have stressed their willingness to do more, along the lines that other central banks have tried. They were joined Tuesday by central bankers from Finland and Germany—typically thought by analysts to represent the more conservative camp within the ECB.

"We haven't exhausted our maneuvering room" on interest rates, Bank of Finland Governor Erkki Liikanen, told The Wall Street Journal in an interview in Helsinki. Mr. Liikanen is on the ECB's 24-member governing council.
Asked what tools the ECB has remaining, Mr. Liikanen cited a negative deposit rate as well as additional loans to banks and asset purchases. His comments and others' suggest some support for ECB President Mario Draghi if he presses for bold measures to prevent crippling consumer-price declines, known as deflation, from taking hold in Europe.

Bundesbank President Jens Weidmann, in an interview with news agency MNI, didn't rule out large-scale asset purchases, known as quantitative easing, as a possibility. He also raised the option of negative deposit rates, though he said he wasn't talking about any imminent decision.

Jozef Makuch, Slovakia’s central bank governor and also a member of the ECB’s governing council, said on Tuesday that quantitative easing was one option and added that "several [ECB] policy makers are ready to adopt nonstandard measures to prevent slipping into a deflationary environment."

Mr. Draghi was less specific Tuesday on what the central bank might do. But in a speech in Paris, he sought to underscore the bank’s resolve in fighting excessively low inflation, which weakens consumer spending, business profits and investment. "We will do what is needed to maintain price stability," he said, adding that the ECB is paying close attention to the euro’s exchange rate.

Erkki Liikanen is one of the ECB’s longest serving members. European Pressphoto Agency

The comment was reminiscent of his July 2012 pledge to do "whatever it takes" to keep the euro together. That remark triggered a lasting rally in government bond markets in southern Europe. The ECB didn't even have to purchase any government bonds—Mr. Draghi's words were enough.

The market moves on Tuesday were small despite the ECB officials' rhetoric. Some analysts warned that unless the bank follows through on such words with action soon, doubts could creep in about its resolve in fighting ultralow inflation.

Though Denmark has experimented with negative rates on bank deposits, the ECB would be the largest central bank to go this route since the global financial crisis erupted more than five years ago.

Many U.S. economists have criticized the ECB for being too slow to act in the face of mounting evidence of falling inflation and near-record unemployment. A more aggressive approach by the European authorities could spark hope that the continent would at least cease to be a drag on global growth, and perhaps even help to become an engine of expansion.

"It would be desirable from a global perspective to see a stronger euro-area economy," said Donald Kohn, former Federal Reserve vice chairman and a senior fellow at the Brookings Institution in Washington. "So seeing the central bank take some action to make sure inflation does not fall further and begins to rise again towards its target would be helpful to Europe, and it would be helpful to the global economy."

Like the ECB, the Fed has been concerned about inflation running persistently below the desired level. However, Fed officials are generally comfortable inflation will gradually rise toward their 2% target because of firm U.S. inflation expectations and a more solid U.S. growth outlook. In Europe, the bleak economic backdrop in many countries makes such confidence harder to muster.

The ECB’s main lending rate to banks is currently 0.25%, a record low. A separate deposit rate set by the ECB for overnight funds parked at the central bank has been at zero for nearly two years. The central bank
held its key interest rates unchanged when it met earlier this month, disappointing some economists who thought the bank would cut interest rates to boost annual inflation, which at 0.7% is well below the ECB's target of a little below 2%.

The euro slipped lower against major currencies Tuesday. The common currency closed 0.1% lower against the dollar, to $1.3826. Setting negative rates and an asset-purchase program in Europe "would push the euro to $1.35," said Michael Woolfolk, senior currency strategist at BNY Mellon. "But it would take the threat of an imminent interest-rate hike in the U.S. for it to fall below $1.30."

"There has been little effect from the verbal jousting," Marc Chandler, head of currency strategy at Brown Brothers Harriman, said in a research note. "Investors need to see real action to be convinced."

Q&A With Liikanen

The Bank of Finland governor sat down with The Wall Street Journal's Brian Blackstone to discuss the possibility of interest rate cuts and other stimulus measures.

Faced with a negative, or penalty, rate for parking funds at the ECB, commercial banks might instead lend their excess funds to other financial institutions, lowering short-term borrowing costs. It could also make euro-denominated assets less attractive to global investors, taking some of the froth off the value of the euro, and thereby boosting exports and inflation.

One potential downside is that banks might pass along the added costs to customers by raising the interest rates they charge for loans. But Mr. Liikanen signaled he doesn't think a negative deposit rate would generate unwanted side effects. "The question of negative deposit rates, in my mind, isn't any longer a controversial issue," he said.

"The perception has been that [ECB officials] talk about it but won't do it. I think they're closer [to making the deposit rate negative] than has been perceived," said Ken Wattret, economist at BNP Paribas.

Mr. Liikanen said that while the euro's exchange rate isn't a policy objective, it does factor into the ECB's assessment on inflation. The euro has approached $1.40 against the U.S. dollar in recent weeks, well above its long-term average. That makes prices of imported goods cheaper, weakening consumer-price growth when it is already well below the ECB's target.

The central bank expects consumer price growth to slowly pick up through 2016. But Mr. Liikanen stressed officials are aware of the risks of too-low inflation, which make it difficult for governments and households to reduce debts, already a difficult task for southern European members of the currency area.

"If inflation is low for very long it creates a challenge because deleveraging will be harder. We must be aware of that risk," he said.

Mr. Liikanen signaled that he is ready for central banks to step back from their dominant role in recent years as guardians of the global economy.

"Let's hope that we see the economic recovery so we can withdraw monetary stimulus and get back to the normal world," he said.

"For central bankers it is always easier to raise interest rates than to cut. It is in our DNA."

—James Ramage and Pedro Nicolaci da Costa contributed to this article.

Write to Brian Blackstone at brian.blackstone@wsj.com