ECB Cuts Main Rate to Record Low, Deposit Rate to Zero

By Jeff Black - Jul 5, 2012

The European Central Bank cut interest rates to a record low and said it won’t pay anything on overnight deposits as the sovereign debt crisis threatens to drive the euro region into recession.

Policy makers meeting in Frankfurt today lowered the ECB’s main refinancing rate to 0.75 percent from 1 percent, as predicted by 49 of 64 economists in a Bloomberg News survey. The ECB also cut its deposit rate to zero from 0.25 percent and its marginal lending rate to 1.5 percent from 1.75 percent. President Mario Draghi holds a press conference at 2:30 p.m. in Frankfurt to explain the decision.

With Europe’s debt crisis curbing growth across the continent and damping the global outlook, the ECB was under pressure to ease monetary conditions, even though Draghi last month voiced misgivings about the effectiveness of a rate reduction. While today’s moves may not stimulate demand, they will lower borrowing costs for struggling banks and could build on the confidence boost euro-area governments delivered last week when they took steps toward a deeper economic union.

“The benchmark rate doesn’t really matter at the moment, but cutting the deposit rate all the way to zero takes the ECB into new territory,” said James Nixon, chief European economist at Societe Generale SA in London. “If you can kick-start the money market you go a long way to addressing some of the funding problems that banks face. That may free banks to lend to the economy.”

Global Easing

The euro fell more than half a cent after the ECB decision to $1.2445 at 1:57 p.m. in Frankfurt.

Central banks around the globe are easing policy in response to Europe’s debt crisis, which has pushed at least seven euro nations into recession and forced five of them to seek bailouts.

The Bank of England, which has been drawn into the scandal over Barclays Plc’s rigging of Libor rates, today raised its target for bond purchases by 50 billion pounds ($78 billion) to 375 billion pounds. The U.S. and Australian central banks eased monetary policy last month and China cut rates today.

In Europe, bond and equity markets rallied last week after euro-area leaders opened the way to recapitalizing banks directly with bailout funds once a single banking supervisor is established. They also dropped the requirement that taxpayers get preferred creditor status on aid to Spain’s crippled lenders.

Deposit Rate

Yields on Spanish 10-year bonds fell to 6.25 percent yesterday from 6.94 percent on June 28. They rose to 6.53 percent this morning.

A deposit rate of zero may encourage banks to lend to other institutions, companies or households instead of parking excess cash in the ECB’s overnight deposit facility. About 800 billion euros ($1 trillion) is currently...
being deposited with the ECB each day.

The deposit rate has steered market borrowing costs since the ECB started to provide banks with unlimited liquidity after the collapse of Lehman Brothers Holdings Inc. in 2008. That policy removed the need for banks to lend to each other to meet their reserve requirements, pushing down interest rates. Today’s move may therefore lower the euro overnight index average, or Eonia, which stood at 0.33 percent yesterday.

“Cutting the deposit rate reduces bank lending rates, and indirectly it helps the economy,” said Martin Van Vliet, senior euro-area economist at ING Bank in Amsterdam. “It’s not a silver bullet, but everything helps.”

**Benchmark Rate**

Cutting the benchmark rate will lower the cost of ECB loans. The ECB has lent banks more than 1 trillion euros for three years in its so-called Longer Term Refinancing Operations, with the interest determined by the average of the benchmark rate over the period of the loans.

Draghi last month questioned the effectiveness of cutting rates, arguing that “price signals” have a “relatively limited immediate effect” amid financial-market tensions. Euro-area economic data have deteriorated since then.

Unemployment rose to a record 11.1 percent in May, economic confidence slumped to the lowest in more than two and a half years in June, and data yesterday confirmed that services and manufacturing output contracted for a fifth month. The euro economy will shrink 0.3 percent this year, according to the European Commission.

“It does look like it is going to be a somewhat rocky 2012 for the euro-area economy,” said Richard Barwell, senior European economist at Royal Bank of Scotland Group Plc in London. “At the same time, I don’t think the ECB are convinced that conventional policy has that much of an impact.”

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