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INTERNATIONAL ECONOMIC REPORT

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ECB CUTS BENCHMARK RATE AS DOWNSIDE RISKS TO THE OUTLOOK RISE

SUMMARY

- The ECB cut its benchmark main refinancing rate 25 basis points to 0.50 percent in today's monetary policy decision. The marginal lending facility rate was also cut 25 bps to 1.00 percent, while the ECB deposit facility rate, already 0 percent before today's decision, will remain unchanged.
- The ECB will continue providing funding to Eurozone commercial banks at least through the second quarter of 2014 and reiterated that related programs will continue "as long as is necessary."
- The ECB's narrow policy mandate and the structure of the Eurozone financial system prevent the central bank from using the unconventional monetary tools that are supporting a return to growth in the U.S., U.K., and Japan.

The European Central Bank lowered two of its three benchmark interest rates by 25 basis points today, reducing the main refinancing rate to 0.50 percent and the marginal lending rate to 1.0 percent. The deposit facility rate remains unchanged at 0 percent. This rate, a benchmark for interbank borrowing, is the central bank's most important tool to influence monetary conditions at present. The ECB noted that reducing this rate to a negative level would have "unintended consequences," but that the ECB holds an "open mind" about possibly taking this step. The ECB reiterated its commitment to provide European commercial banks with as much liquidity as they request for "as long as is necessary," and to do so *at least* until the second quarter of 2014. This extends the ECB's previous *"at least"* commitment, which had promised to keep the ECB's MRO and LTRO funding programs active through the second quarter of 2013.

The ECB's assessment of the real economy held few surprises. President Draghi noted that "weak economic sentiment had extended into spring of this year" and that risks to growth are to the downside. Draghi did not see risks of CPI inflation significantly undershooting the ECB's "below, but close to, 2 percent" target over the medium term, and attributed the dip in April, when year-ago CPI inflation was only 1.2 percent, to energy price fluctuations and the Easter holiday. More positively, the ECB expects the lessened fragmentation in Eurozone capital markets and improvement of financial conditions relative to mid-2011 to eventually translate into better conditions in the real economy.

Today's announcement highlights the paucity of tools left in the ECB's toolkit as it cuts rates to near zero. Draghi mentioned several times in the press conference the obstacles to the ECB's use of the type of unconventional policy measures central banks are using to support growth in the U.S., U.K., and Japan: the ECB's narrow mandate only targets medium term price stability, not full employment; E.U. law prohibits the central bank from financing government borrowing, precluding Fed- or Bank of England-style quantitative easing; and banks (not capital markets) provide most financing to households and businesses in the Eurozone, making ECB purchases of non-financial assets (like the Fed's purchases of agency securities which are supporting the U.S. housing market recovery) very technically difficult. Draghi mentioned that the ECB is discussing ways to collaborate with the European Investment Bank, a state-owned development agency, to expand support for bank lending, but that their "thinking is very much in the preliminary stage." As is customary, Draghi also urged Eurozone governments to follow through with fiscal and structural reforms, and suggested that spending cuts would crimp growth less than tax increases. European governments will probably ignore his advice. Draghi also urged governments to quickly implement the Eurozone banking union.

In short, today's rate cut is a mostly symbolic measure that does not materially affect the Eurozone economy's weak outlook for 2013. While a return to modest growth is likely in the second half of this year, downside risks have increased since January. The euro-dollar exchange rate is mostly unchanged following the ECB's decision at around $1.31.

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