Global Financial Turbulence? European Central Bank Cuts Interest Rates and Announces Asset Purchasing Program

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The European Central Bank has again lowered official interest rates and will begin a program of purchasing asset-backed securities in financial markets in the hope that these measures will counter the ever-worsening economic situation in the eurozone.

The new measures came in the wake of figures showing that inflation in the region had fallen to 0.4 percent in the second quarter, compared to the ECB's target of around two percent, while its three major economies, France, Italy and Germany, either remained stagnant or contracted. The growth rate in Germany, the leading economy, accounting for almost 30 percent of eurozone gross domestic product, fell by 0.2 percent.

Announcing the new measures after a meeting in Frankfurt on Thursday, ECB president Mario Draghi painted a gloomy picture. The economic outcome for the second quarter had been "weaker than expected" and survey data available up to August indicated "a loss in cyclical growth momentum."

The recovery, he said, was likely to continue to be dampened by "high unemployment" and "sizeable unused capacity" as well as negative loan growth to the private sector and necessary balance sheet adjustments, that is, the reduction in debt, in both the private and public sectors.

Draghi made several references to the worsening economic situation throughout his prepared speech and in response to questions from journalists at his press conference.

The ECB's governing council, he said, considered the "risks surrounding the economic outlook for the euro area to be on the downside." Inflation was expected to drop again to just 0.3 percent in August, representing a "worsening of the medium-term inflation outlook."

"Add to this," he continued, "I would say most, if not all, the data we got in August, both hard and soft, on GDP and inflation … showed that the recovery was losing momentum. The growth recovery was losing momentum."

He said there were several reasons for this, one of them being the lack of confidence. "There is a lack of confidence in the future, lack of confidence in the prospects, in economic prospects."

The ECB announced that it would further cut its interest rate on refinancing operations for the Eurosystem by 10 basis points to 0.05 percent and its marginal lending facility rate by 10 basis points to 0.3 percent. Banks will be charged for money they hold at the ECB with the rate on the deposit facility lowered by a further 10 basis point to minus 0.2 percent.

Draghi indicated there was no room for further cuts as interest rates were "at the lower bound" and further adjustments "are not going to be possible any longer."

The new initiative was the decision to start purchases of asset-backed securities. During the global financial crisis these securities were dubbed "toxic assets." Draghi insisted that the ECB's purchases would not have derivatives tied up in them.

He did not give a precise figure on the size of the purchases, which will begin when the "modalities" of the operation are decided at the ECB's meeting in October. But he indicated the aim of the operation was to expand the size of the bank's balance sheet to the level it reached at the beginning of 2012. According to various estimates, this means that the asset purchases will total between €700 billion and €1 trillion.

The measures are regarded as something less than full quantitative easing, as has been practised by the US Federal Reserve, because they will not involve purchases of government bonds. Any move in that direction is likely to bring significant opposition from Germany where such purchases are widely regarded as illegal and outside the ECB's mandate.

Divisions within the ECB meant that Draghi had to tread carefully in initiating purchases of asset-backed securities.

Last July German Bundesbank president Jens Weidmann, who sits on the ECB governing council, called purchases of asset-backed securities "problematic" and is reported to have voted against the measures decided at Thursday's meeting.

While not going into details, Draghi indicated that the decision was not unanimous but said there was "a comfortable majority in favour of doing the program."

In a further indication of divisions within the ECB's governing body, where there is opposition to the German position, he said that full-scale quantitative easing was discussed. "Some of our governing council members were in favour of doing more than I have presented, and some were in favour of doing less. So our proposal strikes the middle of the road."

The presentation of the decision as some kind of "golden mean" is an attempt to cover over divisions that are certain to widen if economic trends continue to worsen.

Those divisions emerged clearly following yesterday's announcement. The *Financial Times* reported that German banks dismissed the measures as "largely being useless for achieving its stated aim of reviving economic growth." German savers were also "left fuming" over the likely reduction in their return on deposits and the "collateral damage their accounts suffered from the euro's sharp fall after the ECB decision."

An indication of the German opposition was provided by the managing director of the German Association of Public Banks, Liane Bucholz. She told the *Financial Times* that the rate cut was akin to offering the euro "in a late summer sale." It would not lead to a boost in bank lending to small and medium-sized companies and the ECB had "reached the limit with stimulatory effects of economic policy."

While he did not elaborate, Draghi pointed to the new conditions that are emerging in global financial markets. The decisions of the ECB reflected the "fact that there are significant and increasing differences in the monetary policy cycle between major advanced economies," he said.

In the US, the Fed is winding back quantitative easing and is expected to start lifting official interest rates next year, possibly as early as March. The ECB and the Bank of Japan, however, are moving in the opposite direction, ending the situation which has existed over the past six years where all the major central banks were in accord.

Such divergences could be the source of increased global financial turbulence in the coming months.

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