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# ECB Rate Cut

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The European Central Bank (ECB) announced on 5th June a combination of measures for additional monetary policy accommodation and support of lending to the real economy. The EURO interest rate has been lowered by 10 basis points to 0.15%. Even more strikingly, the rate on the deposit facility, i.e. the interest rate for surplus funds of commercial banks' deposits at the ECB, will be lowered to -0.1% from 0%. In addition, € 400 billion will be provided to the private sectors in the form of cheap loans through a series of targeted longer-term refinancing operations (TLTROs).

These firm and unconventional measures of the ECB show the bank's strong determination in dealing with the Eurozone economic and financial risks. According to Eurostat estimates, the annual inflation in the euro area was 0.5% in May this year, after 0.7% in April. This worrying trend of low inflation increases the likelihood of being trapped in a deflationary cycle. The economic recovery in the Euro area is also lacking strength, as the projection for real GDP growth for 2014 had to be revised downwards to 1.0%.

No major central bank in the world has ever cut its interest rate for the deposits of commercial banks to below zero percent. The effectiveness of such a move is still unknown if not questionable, according to some commentators. But as the commercial banks in the Eurozone are likely to lend more, this will provide more liquidity for European enterprises. Nevertheless, a potential side-effect is that banks' profit would be affected since the negative rate will induce extra costs for the banks' surplus money. When Denmark introduced the negative deposits rate in 2012, the krone, which is tied to the euro, showed some sign of stabilization. However, in Sweden, a similar policy appeared to have little discernible impact.

Overall, the ECB's action will likely reverse the rising trend of the Euro since last year and help European exporters to compete. A weaker Euro would also render imports more expensive, which would address the potential risk of entering a deflationary cycle. The increased availability of liquidity for European companies would also help consolidate the recovery of the EU economy. Following the ECB announcement, the market so far has responded quite positively, with major European stock indexes rising. The benchmark 10 years bond yields of Spain, Ireland and Italy also fell to a record low level.

European Central Bank, ECB
Courtesy of AlphaTangoBravo

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