ECB IMPOSES NEGATIVE

INTEREST RATE

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The European Central Bank has introduced a raft of measures aimed at stimulating the eurozone economy, including negative interest rates and cheap long-term loans to banks.

It cut its deposit rate for banks from zero to -0.1%, to encourage banks to lend to businesses rather than hold on to money.

The ECB also cut its benchmark interest rate to 0.15% from 0.25%.

The ECB is the first major central bank to introduce negative interest rates.

Howard Archer, chief UK and European economist at IHS Global Insight said: "Despite being widely anticipated and in some quarters criticised for occurring too late, it is still a bold and unusual move by the ECB to take its deposit rate into negative territory."

"There has to be considerable uncertainty as to how effective negative deposit rates will turn out to be," he added.

Analysis

Andrew Walker *BBC World Service Economics correspondent*

The negative interest rate - charging commercial banks to park their surplus funds - is perhaps the most striking element in this package.

Negative rates do happen now and then, but they are rare and often a sign of some sort of financial or economic stress.

That certainly applies in this case, where the eurozone economic recovery is weak and risks being undermined by deflation or falling prices.

One source of weakness is declining bank loans to the private sector. The negative rate might encourage banks to lend more, but it also imposes a cost on them and so might affect their profitability.

In truth the impact is uncertain, so proceeding with this move does underline the ECB's concern.

It has been tried before in smaller economies. Sweden and Denmark, who are both outside the Single Currency, attempted to use negative rates in recent years with mixed results.

Analysts said in Sweden it had little discernible impact; in Denmark it did have the effect of lowering the value of the currency, the Krone, but according to the Danish Banking Association it also hit the banks' bottom line profits.

Unconventional measures

The ECB's president, Mario Draghi, also announced other measures.

Long term loans are to be offered to commercial banks at cheap rates until 2018. These loans would be capped at 7% of the amount that the individual banks in question lend to companies. Thus, the more the banks lend to companies, the more money they can borrow cheaply from the ECB.

It is also doing preliminary work that could lead to buying bundles of loans that are made to small businesses in the form of bonds. This is being seen as a step towards providing companies with credit through the financial markets.

Mr Draghi said the ECB's policymakers unanimously agreed to consider more unconventional measures to boost inflation if it stays too low. The ECB stopped short of instituting a large asset-buying programme like the quantitative easing (QE) undertaken by the US Federal Reserve. However. Mr Draghi insisted that more would be done, if necessary.

"Are we finished? The answer is no. We aren't finished here. If need be, within our mandate, we aren't finished here." he said.

Mr Draghi said that the whole package of measures was aimed at increasing lending to the "real economy".

"Now we are in a completely different world," he said.

Even though some of the measures, like the more to negative rates on deposits, were expected European shares moved higher on the ECB announcement.

The benchmark German Dax 30 index jumped above the 10,000 level for the first time. The Cac 40 in Paris was up 0.8% shortly after the ECB's comments.

Meanwhile, the euro fell to $1.3558, its lowest level in four months.

Deflation fears

Everything for a euro - deflation is a very real threat in the eurozone

Although the danger of deflation in the eurozone is limited, the ECB is concerned that growth is very sluggish and bank lending weak - both of which could potentially derail the fragile economic recovery.

The eurozone economy grew by just 0.2% in the first quarter of the year. Consumer spending, investment and exports are all growing at a slower pace than this time last year.

Inflation in the eurozone fell to 0.5% in May, down from 0.7% in April. This is well below the European Central Bank's target of just below 2%.

Unemployment

If the eurozone slips into deflation, the fear is that consumers might spend even less because they would expect prices to fall in future months. For the same reason investors could stop investing.

Growth would then be hit and demand would be severely constrained. The large debts amassed by the eurozone's countries, companies and banks would take longer and be harder to pay off.

Unemployment, which is already at nearly 12% in the eurozone, and much higher in places like Spain, Portugal and Greece, could get even worse.

Mr Draghi emphasised that recovery in the eurozone was not just in the hands of the ECB, but also in the domain of the banks and the governments. He said the banks needed to play their part by increasing lending and reforms by national governments should be carried through.

"In order to strengthen the economic recovery, banks and policy-makers in the euro area must step up their efforts. Banks should take full advantage of this exercise to improve their capital and solvency position, thereby contributing to overcome any existing credit supply restriction that could hamper the recovery."

"At the same time, policymakers in the euro area should push ahead in the areas of fiscal policies and structural reforms," he added.

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