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ECB keeps interest rates unchanged

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By Ralph Atkins in Frankfurt

The European Central Bank has signalled it could cut interest rates next month but held back from immediate fresh steps to combat the eurozone debt crisis, keeping pressure on politicians to embark on a far-reaching overhaul of Europe's monetary union in the weeks ahead.

A warning by Mario Draghi, ECB president, of "increased downside risks" to growth, indicated that the bank's governing council had dropped its opposition to lowering its main interest rates below 1 per cent – already a historic low.

"We are watching closely all developments and stand ready to act," said Mr Draghi, who disclosed a "few" on the bank's 22-strong council had wanted to cut rates already.

The change of tone reflects ECB alarm at heightened financial market tensions, which are threatening to blow a hoped-for recovery off course. The ECB president also announced the ECB would continue until at least the end of the year to meet in full banks' demands for loans lasting up to three months.

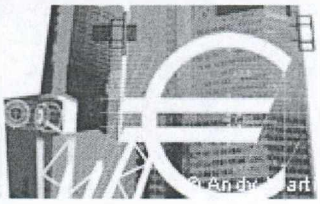
Mr Draghi's message was carefully calibrated, however. It left open the possibility of interest rates remaining at 1 per cent if prospects improve, for instance on a better-than-feared outcome of Greece's June 17 election or an easing of problems in the Spanish banking system.

Moreover, the ECB president gave no indication that he was any closer to unleashing bolder weapons in the central bank's armoury to shore-up investor confidence in the eurozone. That was a setback for those hoping for a repeat of December and February's offers of unlimited three-year loans to the eurozone banking system, which temporarily calmed markets.

In depth

Eurozone in crisis

Mr Draghi's warning that the ECB could not compensate for "other institutions' lack of action" was also a rebuff to eurozone leaders wanting the reactivation of its government bond buying programme to bring Spain's escalating borrowing costs under control.

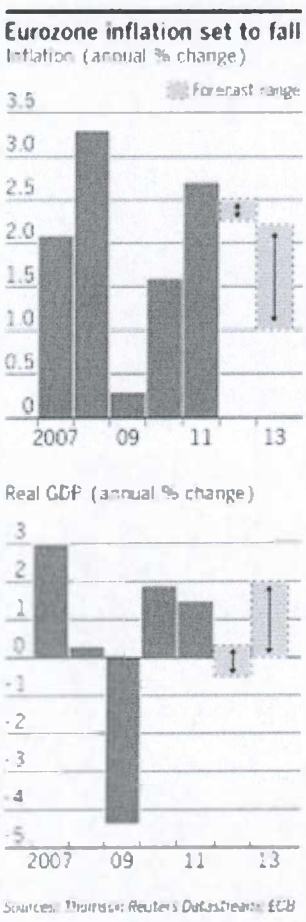


As the debt storm spreads Europe's leaders battle to save the eurozone

"Mr Draghi's message is that the ECB is minding its own business, and he gave several not-so-discreet calls for European leaders to mind theirs," said Julian Callow, European economist at Barclays.

Mr Draghi insisted there would be no "horse-trading" between the ECB and European leaders – who will hold a summit on June 28 – but again called for a "10-year vision" on the eurozone's future, modelled on the 1989 Delors report that paved the way for the euro's launch a decade later. Setting out future goals would help restore confidence in the shorter term, he argued. "The key point is to clarify this process."

Mr Draghi's brinkmanship was "high risk", warned Gerard Lyons, Standard Chartered Bank's chief economist. "It would seem high time to become more pro-active and get ahead of the curve ... One would hope that the politicians would do something at the end of June which will allow the ECB to provide some further help."



Although ECB growth and inflation forecasts for 2012 and 2013 were left broadly unchanged from March's projections, Mr Draghi admitted they were based on optimistic assumptions about financial market tensions abating and buoyant global growth.

He based the ECB's decision to hold interest rates unchanged for now on concerns about the effectiveness of such steps when financial markets were dysfunctional. There were also "conflicting signals" on the eurozone's prospects, with official growth data for the first quarter of 2012 proving better than feared but purchasing managers' indices pointing to a sharp slowdown in the second quarter.

Even in the depths of the 2009 recession, which followed the collapse of Lehman Brothers, the ECB did not cut interest rates below 1 per cent. Mr Draghi said current difficulties were not as severe as then, when the world had seen the collapse of an important bank and still had not got to grips with the financial crisis.

However, a July interest rate cut would help banks in the crisis-hit eurozone "periphery" countries, which are borrowing heavily from the ECB. It would also take the ECB closer to embarking on US or UK-style "quantitative easing" to boost the economy when interest rates can be cut no further.

One issue for the ECB would be whether to also cut the interest rate paid on its "deposit facility," used by banks to park funds overnight, which is currently just 0.25 per cent but provides a floor for market rates.