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ECB Unexpectedly Lowers Rate to 1.25% as Draghi Signals No Debt Backstops

By Jeff Black and Gabi Thesing - Nov 3, 2011 3:52 PM GMT

The European Central Bank unexpectedly cut interest rates at Mario Draghi's first meeting in charge even as the new president signaled no plans to backstop the region's most vulnerable nations as the escalating debt crisis threatens to splinter the euro region.

What makes you think that becoming the lender of last resort for governments is what you need to keep the euro region together?" Draghi asked reporters in Frankfurt today. "That is not really in the remit of the ECB. The remit of the ECB is maintaining price stability in the medium term."

ECB officials unanimously lowered the benchmark interest rate by 25 basis points to 1.25 percent, confounding 51 of 55 economists in a Bloomberg News survey. Only four predicted a quarter-point move and two expected a half-point reduction. Italian bond yields fell after the rate cut and the euro extended declines, dropping as much as 0.8 percent to $1.3657.

European leaders last night raised the prospect of the 17- member area breaking apart, with France and Germany saying they would treat Greece's surprise referendum on a second bailout as a vote on its euro membership. With the region's economic slowdown deepening and investors growing increasingly concerned, the ECB was under pressure to reverse this year's two rate increases.

'Wall of Money'

The ECB needs to "go into the market and say 'We have a wall of money here and no matter how much speculation there is, we're going to keep buying Italian bonds or any other euro bonds that are threatened'," Irish Finance Minister Michael Noonan told Dublin-based RTE Radio yesterday.

Draghi rebuffed those calls, sticking to the line adopted by his predecessor, Jean-Claude Trichet. The ECB's bond purchase program is "temporary, it's limited in the amount and it’s justified on the basis of restoring the functioning of monetary policy transmission channels,” he said.

The yield on Italy’s 10-year government bond, which fell 5 basis points to 6.13 percent on the rate cut, rose to 6.21 percent as Draghi spoke before dropping again. Earlier, it touched a euro-era record of 6.35 percent. Spain’s 10-year yield fell 1 basis point to 5.41 percent.

The ECB lowered rates partly because “what we’re observing now is slow growth heading toward a mild recession,” Draghi said.

“It’s a bold move by Draghi,” said Howard Archer, chief European economist at IHS Global Insight in London, who predicts another quarter-point cut within months. “He’s not going to be afraid of making bold moves, which is what’s needed in the current environment.”

Downward Revisions

Draghi said recent data suggest the ECB will probably have to revise down growth forecasts in its next round of projections due in December.

Unemployment in Germany, Europe’s largest economy, unexpectedly rose for the first time in more than two years in October and Europe’s manufacturing industry contracted for a third month.

The Organization for Economic Cooperation and Development on Oct. 31 lowered its growth forecast for the U.S. and the euro area. The U.S. economy, the world’s largest, will expand 1.7 percent this year and 1.8 percent next, the Paris-based OECD said. By contrast, the euro area’s will grow 1.6 percent in 2011 and just 0.3 percent in 2012, it said.

While the current inflation rate of 3 percent is well above the ECB’s 2 percent limit, weaker growth and demand may drive down oil prices. The ECB currently forecasts inflation will slow to 1.7 percent in 2012.

“If sustained, sluggish economic growth has the potential to reduce medium-term inflationary pressure in the euro area,” Draghi said.

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