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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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ECB: strong reaction on liquidity but no new signs on SMP

- **A wide range of measures approved: lower refi rates by 25 bp, liquidity provision up to 3 years, softer collateral and reserve requirements.**
- **Significant downward revision of GDP growth projections for 2012 with "substantial" downward risk.**
- **As expected, there is no news on the increase in bond purchases. The role as lender of last resort continues to be closed.**
- **We cannot discard the ECB going lower than 1% if necessary.**

At today's monetary policy meeting the ECB has announced a wide range of measures to deal with the deterioration of economic activity and with the acute funding problems faced by European banks, in a context of increasingly worrying symptoms of money markets malfunctioning. All the measures are positive considering the ongoing difficulties in funding markets for a very prolonged period of time and taken into account the huge maturities that the European banking system confront over 2012, mainly concentrated in the first quarter of the year. The ECB reaction shows that they are worried about a possible credit crunch in the Eurozone.

As we expected, **the ECB reduced refi rates by 25 basis points to 1%**, following another 25 basis points cut in November. This decision was not taken by unanimity, but Mr. Draghi made clear that the discrepancies were not on the essence, but only on the timing. Also as expected, **the ECB announced the lengthening of unlimited long-term funding operations to up to three years** for the new two LTRO. The first operation will be allotted on 21 December 2011 and will replace the 12-month LTRO announced on 6 October 2011, while the second one will be allotted on February 29th. The new operations will be flexible, in the sense that there will have the option of an early repayment after one year.

As broadly anticipated, following recent declarations of Mr. Draghi, the ECB announced **a more flexible collateral policy** in order to expand the ability of European banks, especially small and medium ones, to access ECB liquidity. Even more, the ECB will allow National Central Banks to accept temporarily as collateral for Eurosystem credit operations additional performing credit claims that satisfy specific eligibility criteria. In addition (and in this case it was unexpected) **the ECB decided to reduce the reserve ratio from 2% to 1%** as of the reserve maintenance period starting on 18 January 2012 (this measure would also increase the available collateral to banks).

Regarding the Securities Markets Programme (SMP), Mr. Draghi remains stick to the official position on the prohibition set by the Treaty on monetary financing, and made references to the spirit of the Treaty. This means that the ECB should not be expected to act as lender of last resort (as other Central Banks are acting now), considering their commitment with the spirit of the Treaty. However Mr. Draghi changed the wording regarding its policy of bond purchases, i.e., instead of using the previous "temporary and limited terms of the SMP", he said "the SMP is neither eternal nor infinite, we don´t want to circumvent Article 123". At present time, the ECB is not ready to increase massively its bond purchases, and in particular it will not declare explicitly that it is ready to defend sovereign bonds in the euro area, which would be an easy way to support the bond markets at a low cost. There seems to be an open door ("legally very complex"…. "the ECB is not a IMF member") for lending money to the IMF, but always under the spirit of the Treaty.

Looking forward, **ECB staff projections revealed a significant downward revision on GDP growth** for 2012, the midpoint projection being reduced from 1.3% to 0.3%, while for 2013 the GDP projection is set at 1.3%. More importantly, the Governing Council's assessment of risks to economic activity is described as "substantial downside risks", that "…notably relate to a further intensification of the tensions in euro area financial markets and their potential spillover to the euro area real economy". According to our projections (updated with incoming data for Q4) the Euro area is expected to grow around 0.5% in 2012 under the baseline scenario, whose probability has been decreasing over the last few months, as financial strains remain high. **Regarding inflation**, ECB´s staff projection point to a decline to 2% on average in 2012 (from 2.7% in 2011) and to 1.5% in 2013. Risks remain broadly balanced, according to the Governing Council. In the Q&A session Mr. Draghi commented on the risk of deflation as follows: "At present time, we do not see any high probability of deflation". In all, considering 1) very low growth projection by the ECB´s staff for 2012, 2) the assessment of risks regarding inflation and, especially, economic outlook, we continue to think that additional rate cuts cannot be discarded if these risks materialize. For the time being, however, the ECB will stay in a wait and see mode..

Mr. Draghi elaborated on **the concept of a "fiscal compact"** he mentioned on the European Parliament as a requirement for enhanced ECB action. This includes three elements as:

1) commitment at national level with the fiscal consolidation and with policies to improve competitiveness;
2) commitment at European level on a redesign of fiscal rules, including ex-ante control and automatic rules; and
3) 3) making operative the stabilisation mechanism ("my preference on this is that it goes to the EFSF first and the ESM later", which could be understood as a rejection of the idea of combining resources the EFSF and ESM at the same time by bringing forward the operation of the later, as has been rumoured recently).

These three points are fairly obvious, and in any case Mr Draghi continues to put pressure on EZ countries ahead of the summit to deliver on their reform plans. He points out two critical points for the Summit: to deliver a credible legal process regarding fiscal rules, and to act rapidly (the speed of implementation is important, presumably because the ECB want to intervene only until the EFSF is fully operating.

Table 1
Eurozone GDP Growth and Inflation Forecasts

	ECB Staff Sep 11		ECB Staff Dec 11		BBVA Research Sep 11		BBVA Research Incoming data	
	GDP	HICP	GDP	HICP	GDP	HICP	GDP	HICP
2011	(1,4-1,8) **(1,6)**	(2,5-2,7) **(2,6)**	(1,5-1,7) **(1,6)**	(2,6-2,8) **(2,7)**	1.7	2.6	1.6	2.7
2012	(0,4-2,2) **(1,3)**	(1,5-2,2) **(1,7)**	(-0,4-1,0) **(0,3)**	(1,5-2,5) **(2,0)**	1.0	1.6	0.6	1.7
2013			(0,3-2.3) **(1,3)**	(0,8-2,2) **(1,5)**				

Source: ECB and BBVA Research

Annex 1: Introductory statement, tracking the changes

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~3 November~~8 December 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~Today is the first time that I have had the privilege and pleasure of chairing the~~ We will report on the outcome of today's meeting of the Governing Council ~~of the ECB. I am delighted to proceed now with our well-established practice of real-time communication and to report on the outcome of our meeting, together with the Vice-President~~.

Based on its regular economic and monetary analyses, the Governing Council decided to ~~reduce~~ lower the key ECB interest rates by 25 basis points. ~~While inflation has remained elevated and~~ , following the 25 basis point decrease on 3 November 2011. Inflation is likely to stay above 2% for ~~some~~several months to come, ~~inflation rates are expected to decline further in the course of 2012~~before declining to below 2%. The intensified financial market tensions are continuing to dampen economic activity in the euro area and the outlook remains subject to high uncertainty and substantial downside risks. In such an environment, cost, wage and price pressures in the euro area should remain modest over the policy-relevant horizon. At the same time, the underlying pace of monetary expansion ~~continues to be~~remains moderate. ~~After today's decision, inflation should remain in line with price stability over the policy-relevant horizon. Owing to their unfavourable effects on financing conditions and confidence, the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond. The economic outlook continues to be subject to particularly high uncertainty and intensified downside risks. Some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely. In such an environment, price, cost and wage pressures in the euro area should also moderate; today's decision takes this into account.~~ Overall, it ~~remains~~ is essential for monetary policy to maintain price stability over the medium term, thereby ensuring a firm anchoring of inflation expectations in the euro area in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Such anchoring is a prerequisite for monetary policy to make its contribution towards supporting economic growth and job creation in the euro area.

~~The provision of liquidity and the allotment modes for refinancing operations will continue to ensure that euro area banks are not constrained on the liquidity side. All the non-standard monetary policy measures taken during the period of acute financial market tensions are, by construction, temporary in nature.~~

~~Let me now explain our assessment in greater detail, starting with the economic analysis. Real GDP growth in the euro area, which slowed in the second quarter of 2011 to 0.2% quarter on quarter, is expected to be very moderate in the second half of this year. There are signs that previously identified downside risks have been materialising, as reflected in unfavourable evidence from survey data. Looking forward, a number of factors seem to be dampening the underlying growth momentum in the euro area, including a moderation in the pace of global demand and unfavourable effects on overall financing conditions and on confidence resulting from ongoing tensions in a number of euro area sovereign debt markets. At the same time, we continue to expect euro area economic activity to benefit from continued positive economic growth in the emerging market economies, as well as from the low short-term interest rates and the various measures taken to support the functioning of the financial sector.~~

~~In the Governing Council's assessment, the downside risks to the economic outlook for the euro area are confirmed in an environment of particularly high uncertainty. Downside risks notably relate to a further intensification of the tensions in some segments of the financial markets in the euro area and at the global level, as well as to the potential for these pressures to further spill over into the euro area real economy. They also relate to the impact of the still high energy prices, protectionist pressures and the possibility of a disorderly correction of global imbalances.~~

~~With regard to price developments, euro area annual HICP inflation was 3.0% in October according to Eurostat's flash estimate, unchanged from September. Inflation rates have been at elevated levels since the end of last year, mainly driven by higher energy and other commodity prices. Looking ahead, they are likely to stay above 2% for some months to come, before falling below 2% in the course of 2012. Inflation rates are expected to remain in line with price stability over the policy-relevant horizon. This pattern reflects the expectation that, in an environment of weaker euro area and global growth, price, cost and wage pressures in the euro area should also moderate.~~

~~The Governing Council continues to view the risks to the medium-term outlook for price developments as broadly balanced, taking also into account today's decision. On the upside, the main risks relate to the possibility of increases in indirect taxes and administered prices, owing to the need for fiscal consolidation in the coming years. In the current environment, however, inflationary pressure should abate. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally. In fact, if sustained, sluggish economic growth has the potential to reduce medium-term inflationary pressure in the euro area.~~

~~Turning to the~~ monetary analysis~~, the annual growth rate of M3 increased to 3.1% in September 2011, up from 2.7% in August. The annual growth rate of loans to the private sector, adjusted for loan sales and securitisation, was 2.7% in September, unchanged from August. As in August, inflows into M3 also reflect the heightened tensions in some financial markets. In particular, inflows into money market fund shares/units, as well as into repurchase agreements conducted through central counterparties, appear to have significantly affected monetary developments in September. The annual growth rate of M1 increased to 2.0% in September, from 1.7% in August.~~

~~On the counterpart side, the annual growth rate of loans to non-financial corporations and to households in September, adjusted for loan sales and securitisation, remained broadly unchanged compared with August, at 2.2% and 2.6% respectively. These~~ In its continued efforts to support the liquidity situation of euro area banks, and following the coordinated central bank action on 30 November 2011 to provide liquidity to the global financial system, the Governing Council today also decided to adopt further non-standard measures. These measures should ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market. They are expected to support the provision of credit to households and non-financial corporations. In this context, the Governing Council decided:

First, to conduct two longer-term refinancing operations (LTROs) with a maturity of 36 months and the option of early repayment after one year. The operations will be conducted as fixed rate tender procedures with full allotment. The rate in these operations will be fixed at the average rate of the main refinancing operations over the life of the respective operation. Interest will be paid when the respective operation matures. The first operation will be allotted on 21 December 2011 and will replace the 12-month LTRO announced on 6 October 2011.

Second, to increase collateral availability by reducing the rating threshold for certain asset-backed securities (ABS). In addition to the ABS that are already eligible for Eurosystem operations, ABS having a second best rating of at least "single A" in the Eurosystem harmonised credit scale at issuance, and at all times subsequently, and the underlying assets of which comprise residential mortgages and loans to small and medium-sized enterprises, will be eligible for use as collateral in Eurosystem credit operations. Moreover, national central banks will be allowed, as a temporary solution, to accept as collateral additional performing credit claims (namely bank loans) that satisfy specific eligibility criteria. The responsibility entailed in the acceptance of such credit claims will be borne by the national central bank authorising their use. These measures will take effect as soon as the relevant legal acts have been published.

Third, to reduce the reserve ratio, which is currently 2%, to 1%. This will free up collateral and support money market activity. As a consequence of the full allotment policy applied in the ECB's main refinancing operations and the way banks are using this option, the system of reserve requirements is not needed to the same extent as under normal circumstances to steer money market conditions. This measure will take effect as of the maintenance period starting on 18 January 2012.

Fourth, to discontinue for the time being, as of the maintenance period starting on 14 December 2011, the fine-tuning operations carried out on the last day of each maintenance period. This is a technical measure to support money market activity.

A detailed press release will be published at 3.30 p.m. today on the ECB's website. As stated on previous occasions, all the non-standard monetary policy measures are, by construction, temporary in nature.

Let me now explain our assessment in greater detail, starting with the economic analysis. Real GDP in the euro area grew by 0.2% quarter on quarter in the third quarter of 2011, unchanged from the previous quarter. Evidence from survey data points to weaker economic activity in the fourth quarter of this year. A number of factors seem to be dampening the underlying growth momentum in the euro area. They include a moderation in the pace of global demand growth and unfavourable effects on overall financing conditions and on confidence resulting from ongoing tensions in euro area sovereign debt markets, as well as the process of balance sheet adjustment in the financial and non-financial sectors. At the same time, we expect euro area economic activity to recover, albeit very gradually, in the course of next year, supported by resilient global demand, very low short-term interest rates and all the measures taken to support the functioning of the financial sector.

This assessment is also reflected in the December 2011 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between 1.5% and 1.7% in 2011, between -0.4% and 1.0% in 2012 and between 0.3% and 2.3% in 2013. Compared with the September 2011 ECB staff macroeconomic projections, there is a narrowing of the range of the real GDP growth projection for 2011 and a significant downward revision of the range for 2012. These revisions mainly reflect the impact on domestic demand of weaker confidence and worsening financing conditions, stemming from the heightened uncertainty related to the sovereign debt crisis, as well as downward revisions of foreign demand.

In the Governing Council's assessment, substantial downside risks to the economic outlook for the euro area exist in an environment of high uncertainty. Downside risks notably relate to a further intensification of the tensions in euro area financial markets and their potential spillover to the euro area real economy. Downside risks also relate to the global economy, which may be weaker than expected, as well as to protectionist pressures and the possibility of a disorderly correction of global imbalances.

With regard to price developments, euro area annual HICP inflation was 3.0% in November, according to Eurostat's flash estimate, unchanged from the two previous months. Inflation rates have been at elevated levels since the end of last year, mainly driven by higher energy and other commodity prices. Looking ahead, they are likely to stay above 2% for several months to come, before declining to below 2%. This pattern reflects the expectation that, in an environment of weaker growth in the euro area and globally, underlying cost, wage and price pressures in the euro area should also remain modest.

This assessment is also reflected in the December 2011 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation in a range between 2.6% and 2.8% for 2011, between 1.5% and 2.5% for 2012 and between 0.8% and 2.2% for 2013. Compared with the September 2011 ECB staff macroeconomic projections, the projection ranges for 2011 and 2012 have been revised slightly upwards. This results from the upward impact of higher oil prices in euro terms, as well as a higher contribution from indirect taxes. The upward impact of these factors is expected to more than compensate the downward adjustments to profit margins and wage growth that are related to the downward revision of activity.

The Governing Council continues to view the risks to the medium-term outlook for price developments as broadly balanced. On the upside, the main risks relate to further increases in indirect taxes and administered prices, owing to the need for fiscal consolidation in the coming years. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally.

Turning to the **monetary analysis**, the annual growth rate of M3 decreased to 2.6% in October 2011, after 3.0% in September. The annual growth rate of loans to the private sector, adjusted for loan sales and securitisation, increased to 3.0% in October, compared with 2.7% in September. As in the previous two months, the monetary data for October reflect the heightened uncertainty in financial markets.

On the counterpart side, the annual growth rates of loans to non-financial corporations and loans to households, adjusted for loan sales and securitisation, remained broadly unchanged in October, at 2.3% and 2.5% respectively. The unadjusted growth rates were lower, owing to substantial securitisation activities in October. Overall, the figures on lending do not ~~signal~~suggest that the heightened financial market tensions have significantly affected the supply of credit ~~up to September.~~in the period to October. However, ~~as such~~ given that credit supply effects can manifest themselves with lags, close scrutiny of credit developments is warranted in the period ahead.

Taking the appropriate medium-term perspective and looking through short-term volatility, ~~underlying broad money and loan growth have stabilised over recent months. Overall~~overall, the underlying pace of monetary expansion ~~thus~~ remains moderate.

~~The overall size of monetary financial institutions' balance sheets remained broadly unchanged over the past few months.~~ The soundness of bank balance sheets will be a key factor in reducing potential negative feedback loop effects related to tensions in financial markets, thereby facilitating an appropriate provision of credit to the economy over time. ~~We therefore welcome the~~ The agreement of the European Council of 26 October to proceed with the increase in the capital position of banks to 9% of core Tier 1 by the end of June 2012~~. We also fully support the call to~~ should improve the euro area banking sector's resilience over the medium term. In this respect, it is essential that national supervisors ~~to~~ ensure that ~~banks'~~the implementation of banks' recapitalisation plans ~~do~~does not ~~lead to excessive deleveraging~~result in developments that are detrimental to the financing of economic activity in the euro area.

To sum up, ~~based on its regular economic and monetary analyses, the Governing Council decided to reduce the key ECB interest rates by 25 basis points. While~~ inflation ~~has remained elevated and~~ is likely to stay above 2% for ~~some~~several months to come, ~~inflation rates are expected to decline further in the course of 2012~~ before declining to below 2%. Intensified financial market tensions are continuing to dampen economic activity in the euro area and the outlook remains subject to high uncertainty and substantial downside risks. In such an environment, price, cost and wage pressures in the euro area should remain modest over the policy-relevant horizon. A cross-check with the ~~information~~signals from ~~our~~the monetary analysis confirms ~~that~~ this picture, with the underlying pace of monetary expansion ~~continues to be~~remaining moderate. ~~After today's decision, inflation should remain in line with price stability over the policy-relevant horizon. Owing to their unfavourable effects on financing conditions and confidence, the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond. The economic outlook continues to be subject to particularly high uncertainty and intensified downside risks. Some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely. In such an environment, price, cost and wage pressures in the euro area should also moderate; today's decision takes this into account. Overall, it remains essential for monetary policy to maintain price stability over the medium term, thereby ensuring a firm anchoring of inflation expectations in the euro area in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Such anchoring is a prerequisite for monetary policy to make its contribution towards supporting economic growth and job creation in the euro area~~.

Turning to **fiscal policies**, all euro area governments urgently need to ~~show~~do their ~~inflexible determination~~utmost to ~~fully honour their own individual sovereign signature as a key element in ensuring financial stability~~support fiscal sustainability in the euro area as a whole. ~~The Governing Council takes note of the fiscal commitments expressed in the Euro Summit statement of 26 October 2011 and urges all governments to implement fully and as quickly as possible the measures necessary to achieve fiscal consolidation and sustainable pension systems, as well as to improve governance. The governments of countries under joint EU-IMF~~

~~adjustment programmes and those of countries that are particularly vulnerable should stand ready to take any additional measures that become necessary~~A new fiscal compact, comprising a fundamental restatement of the fiscal rules together with the fiscal commitments that euro area governments have made, is the most important precondition for restoring the normal functioning of financial markets. Policy-makers need to correct excessive deficits and move to balanced budgets in the coming years by specifying and implementing the necessary adjustment measures. This will support public confidence in the soundness of policy actions and thus strengthen overall economic sentiment.

~~It is crucial that~~To accompany fiscal consolidation, the Governing Council has repeatedly called for bold ~~and~~and ambitious structural reforms ~~go~~. Going hand in hand ~~to~~, fiscal consolidation and structural reforms would strengthen confidence, growth prospects and job creation. ~~The Governing Council therefore calls upon all euro area governments to accelerate, urgently, the implementation of substantial and comprehensive structural reforms. This will~~ Key reforms should be immediately carried out to help the euro area countries to ~~strengthen~~improve competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. ~~In this respect, labour~~Labour market reforms ~~are essential and~~ should focus on ~~measures to remove~~removing rigidities and ~~to enhance~~enhancing wage flexibility~~, so that wages and working conditions can be tailored to the specific needs of firms. More generally, in these demanding times, moderation is of the essence in terms of both profit margins and wages. These measures should be accompanied by structural reforms that increase competition in product markets, particularly in services – including the liberalisation of closed professions – and, where appropriate, the privatisation of services currently provided by the public sector. At the same time, the Governing Council stresses that it is absolutely imperative that euro area national authorities rapidly adopt and implement the measures announced and recommended in the Euro Summit statement of 26 October 2011.~~

~~We are now at your disposal for questions.~~

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