CENTRAL BANKS

The ECB unveils an unprecedented package of measures

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- Negative depo + four-year Targeted LTRO + full allotment until Dec16 + suspension SMP sterilising. Is it enough?
- The door remains open for further easing if needed
- Inflation projections have been revised down over the forecast horizon

As widely expected, the ECB Governing Council (GC) decided to cut the main policy rate by 10bp to 0.15%, a historic low, at today's monetary policy meeting. Moreover, it also cut the deposit facility by 10bp to -0.10% and the marginal lending rate by 35bp to 0.40%, thus narrowing and maintaining the asymmetric corridor for interest rates. In an unprecedented decision, the GC decided on a package of measures to provide additional monetary policy accommodation, to support lending to the real economy and to reinforce the forward guidance. The tone remained dovish and the easing bias was retained. Mr Draghi said that today's decision was unanimously agreed, while he stressed that if required they "will act swiftly with further monetary policy easing" to address a prolonged period of low inflation. However, the probability of further rate cuts has almost disappeared as he clarified that "for all practical purposes, we have reached the lower bound today," while in the introductory statement the word "lower" was dropped in the sentence "interest rates remain at present or lower levels for an extended period of time."

At the press conference, the attention was focused on the new measures announced. This package includes: i) further reductions in the key ECB interest rates, ii) targeted longer-term refinancing operations (TLTRO), iii) preparatory work related to outright purchases of asset-backed securities and a prolonging of fixed rate, iv) full allotment tender procedure (FRFA) and v) the suspension of the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme (SMP).

I. As expected, the ECB lowered the main policy rate to 0.15%, the deposit rate to negative territory (-0.10%) and the marginal lending rate to 0.40%, thus narrowing the corridor which would help to reduce the volatility in the Eonia. Together with the exceptional decision to introduce a negative deposit facility rate, the central bank also applied a negative rate "to average reserve holdings in excess of the minimum reserve requirements and other deposits held with the Eurosystem," in order to avoid banks placing their excess liquidity in the current account. (see)

II. With regard to the TLTROs they (i) are conditional on providing new lending to the private sector (corporates and households but excluding residential mortgages) with an initial allowance equal to 7%. This conditionality will prevent banks from investing these funds in alternative assets other than the targeted ones; (ii) have a maturity of four years, providing stability to the banks' funding; (iii) have a very low cost, which is set at the MRO rate at the time of the take-up plus a spread of 10bp, i.e. currently it would be 0.25bp. This low cost is likely to have a positive effect on the cost of new lending; (iv) need to be repaid if a number of conditions regarding the volume of net lending to the real economy are not fulfilled (further technical details will be announced later); (v) have several take-ups, with an initial allowance in September/December 2014 and quarterly take-ups from March 2015 to June 2016 (all TLTROs will mature in September 2018), which gives banks flexibility. Although the TLTROs should help to solve supply constraints, they will not address the weak loan demand that prevails in some countries. Moreover, regarding previous international experience, the final impact of the measure is uncertain. (see)

III. Moreover, as another measure to support lending to the real economy, the ECB said that is intensifying preparatory work “related to outright purchases of asset-backed securities (ABS).” However, Mr Draghi clarified that the scope of this programme was not discussed by the GC at this meeting.

IV. As anticipated, the GC decided to extend the fixed rate "full allotment" liquidity provision to banks until the end of 2016 for the weekly MRO operations and the three-month LTROs. Meanwhile, it decided to discontinue “the Eurosystem’s special-term refinancing operations with a maturity of one maintenance period.” This measure is very powerful in reinforcing the forward guidance, by anchoring monetary policy expectations. In the Q&A, Mr Draghi took the opportunity to explicitly mention it. (see)

V. Finally, the ECB decided to “suspend the weekly fine-tuning operation sterilising the liquidity injected under the SMP.” The current outstanding amount of bonds purchased under the SMP is EUR164.5bn, with an average maturity outstanding of around three years. When Mr Draghi was asked about the change in this tool, he defended the move by arguing that the main reason to commit to the sterilisation was based on the effects that this liquidity might have on inflation, but he stressed that "now we are in a completely different world," citing "low inflation, a weak recovery and weak monetary and credit dynamics".

Regarding the ECB Staff projections, after an economic outcome somewhat weaker than expected during the last three months, especially for inflation figures, the projections have been revised down over the forecast horizon. The annual inflation for 2014 is now projected at 0.7% (-0.3pp from the March forecast), 1.1% (-0.2pp) in 2015 and 1.4% (-0.1pp) in 2016, remaining at 1.5% YoY in 4Q16 (-0.2pp). These projections are consistent with stable annual inflation at current low rates in coming months, inching up by the year-end to around 1% YoY and very gradually over the next two years, in line with our assessment. This “underpins the case for today’s decision” due the risks of low inflation over a protracted period. The potential effects of the package announced today are not taken into account in the updated forecasts, but are consistent with the strong determination of the GC to safeguard the anchoring of inflation expectations in the medium-term. Mr. Draghi highlighted that the GC does not see a deflation process, while risks to the outlook for inflation are limited and balanced. Regarding economic activity, the projection for GDP growth was revised down by 0.2pp to 1% in 2014 because of a weaker outcome than projected in 1Q14, but consistent with a gradual recovery supported by a greater role of domestic demand. In contrast, the ECB Staff revised economic growth upwards to 1.7% (+0.2pp) in 2015, in line with our scenario. Risks to this outlook continue to be on the downside.

At today's meeting, Mr. Draghi reiterated the central bank’s willingness to using “unconventional instruments within its mandate should it become necessary to further address risks of too prolonged a period of low inflation“. Today’s decision (the extensive package announced), together with this commitment signal that the door remains open to further easing, although the majority of the measures within the ECB toolbox have been announced today. A "pure" QE remains an option if the outlook for inflation worsens, but this is not our baseline scenario. The most likely scenario is for the ECB to remain on hold, awaiting (for some quarters as Draghi has already mentioned) for the impact of these measures.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in red and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE)

Mario Draghi, President of the ECB,
~~Brussels, 8 May~~Frankfurt am Main, 5 June 2014

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~I would like to thank Governor Coene for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council.~~ We will now report on the outcome of today's meeting of the Governing Council, which was also attended by the Commission Vice-President ~~of the Eurogroup, Finance Minister Dijsselbloem~~, Mr Rehn.

~~Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. Incoming information continues to indicate that the moderate recovery of the euro area economy is proceeding in line with our previous assessment. At the same time, recent information remains consistent with our expectation of a prolonged period of low inflation followed by only a gradual upward movement in HICP inflation rates. The signals from the monetary analysis confirm the picture of subdued underlying price pressures in the euro area over the medium term.~~In pursuing our price stability mandate, today we decided on a combination of measures to provide additional monetary policy accommodation and to support lending to the real economy. This package includes further reductions in the key ECB interest rates, targeted longer-term refinancing operations, preparatory work related to outright purchases of asset-backed securities and a prolongation of fixed rate, full allotment tender procedures. In addition, we have decided to suspend the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme.

The decisions are based on our economic analysis, taking into account the latest macroeconomic projections by Eurosystem staff, and the signals coming from the monetary analysis. Together, the measures will contribute to a return of inflation rates to levels closer to 2%. Inflation expectations for the euro area over the medium to long term ~~remain~~continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%.

~~Looking ahead, we will monitor economic developments and money markets very closely. We~~ Looking ahead, the Governing Council is strongly determined to safeguard this anchoring. Concerning our forward guidance, the key ECB interest rates will ~~maintain a high degree of monetary accommodation and act swiftly, if required, with further monetary policy easing. We firmly reiterate that we continue to expect the key ECB interest rates to~~ remain at present ~~or lower~~ levels for an extended period of time~~. This expectation is based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy, the high degree of unutilised capacity, and subdued money and credit creation.~~ in view of the current outlook for inflation. This expectation is further underpinned by our decisions today. Moreover, if required, we will act swiftly with further monetary policy easing. The Governing Council is unanimous in its commitment to using also unconventional instruments within its mandate ~~in order to cope effectively with~~should it become necessary to further address risks of ~~a~~ too prolonged a period of low inflation~~. Further information and analysis concerning the outlook for inflation and the availability of bank loans to the private sector will be available in early June~~.

Let me now briefly describe the individual measures decided today. Further details will be published at 3.30 p.m. on the ECB's website.

First, we decided to lower the **interest rate** on the main refinancing operations of the Eurosystem by 10 basis points to 0.15% and the rate on the marginal lending facility by 35 basis points to 0.40%. The rate on the deposit facility was lowered by 10 basis points to -0.10%. These changes will come into effect on 11 June 2014. The negative rate will also apply to reserve holdings in excess of the minimum reserve requirements and certain other deposits held with the Eurosystem.

Second, in order to support bank lending to households and non-financial corporations, excluding loans to households for house purchase, we will be conducting a series of **targeted longer-term refinancing operations** (TLTROs). All TLTROs will mature in September 2018, i.e. in around 4 years. Counterparties will be entitled to borrow, initially, 7% of the total amount of their loans to the euro area non-financial private sector, excluding loans to households for house purchase, outstanding on 30 April 2014. Lending to the public sector will not be considered in this calculation. The combined initial entitlement amounts to some €400 billion. To that effect, two successive TLTROs will be conducted in September and December 2014. In addition, from March 2015 to June 2016, all counterparties will be able to borrow, quarterly, up to three times the amount of their net lending to the euro area non-financial private sector, excluding loans to households for house purchase, over a specific period in excess of a specified benchmark. Net lending will be measured in terms of new loans minus redemptions. Loan sales, securitisations and write-downs do not affect the net lending measure. The interest rate on the TLTROs will be fixed over the life of each operation, at the rate on the Eurosystem's main refinancing operations (MROs) prevailing at the time of take-up, plus a fixed spread of 10 basis points. Starting 24 months after each TLTRO, counterparties will have the option to make repayments. A number of provisions will aim to ensure that the funds support the real economy. Those counterparties that have not fulfilled certain conditions regarding the volume of their net lending to the real economy will be required to pay back borrowings in September 2016.

In addition, the Governing Council decided to extend the existing eligibility of additional assets as collateral, notably under the additional credit claims framework, at least until September 2018.

Third, the Governing Council decided to intensify preparatory work related to outright purchases in the **ABS market** to enhance the functioning of the monetary policy transmission mechanism. Under this initiative, the Eurosystem will consider purchasing simple and transparent asset-backed securities with underlying assets consisting of claims against the euro area non-financial private sector, taking into account the desirable changes in the regulatory environment, and will work with other relevant institutions to that effect.

Fourth, in line with our forward guidance and our determination to maintain a high degree of monetary accommodation, as well as to contain volatility in money markets, we decided to continue conducting the MROs as **fixed rate tender procedures with full allotment** for as long as necessary, and at least until the end of the reserve maintenance period ending in December 2016. Furthermore, we decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted before the end of the reserve maintenance period ending in December 2016 as fixed rate tender procedures with full allotment. The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO. In addition, we decided to suspend the weekly fine-tuning operation sterilising the liquidity injected under the Securities Markets Programme.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP in the euro area rose by 0.2%, quarter on quarter, in the ~~last quarter of 2013, thereby increasing for three consecutive quarters. Recent data and survey indicators confirm that the ongoing moderate recovery continued in the~~ first quarter of ~~2014 and at the beginning of the second quarter.~~this year. This confirmed the ongoing gradual recovery, while the outcome was somewhat weaker than expected. Most recent survey results signal moderate growth also in the second quarter of 2014. Looking ahead, domestic demand should continue to be supported by a number of factors, including the accommodative monetary policy stance, ongoing improvements in financing conditions working their way through to the real economy, the progress made in fiscal consolidation and structural reforms, and ~~developments~~gains in real disposable income resulting from falls in energy prices. At the same time, although labour markets have ~~stabilised and~~ shown ~~the first~~some further signs of improvement, unemployment remains high in the euro area and, overall, unutilised capacity continues to be sizeable. Moreover, the annual rate of change of MFI loans to the private sector remained negative in ~~March~~April and the necessary balance sheet adjustments in the public and private sectors are likely to continue to weigh on the pace of the economic recovery.

This assessment of a moderate recovery is also reflected in the June 2014 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 1.0% in 2014, 1.7% in 2015 and 1.8% in 2016. Compared with the March 2014 ECB staff macroeconomic projections, the projection for real GDP growth for 2014 has been revised downwards and the projection for 2015 has been revised upwards.

The risks surrounding the economic outlook for the euro area continue to be on the downside. Geopolitical risks, as well as developments in ~~global financial markets and~~ emerging market economies and global financial markets, may have the potential to affect economic conditions negatively. Other downside risks include weaker than expected domestic demand and insufficient implementation of structural reforms in euro area countries, as well as weaker export growth.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.~~7% in April 2014, up from 0.~~5% in ~~March. As~~May 2014, after 0.7% in April. This outcome was lower than expected~~, given~~. On the ~~timing~~basis of ~~Easter,~~ the ~~increase was mainly due~~ information available to ~~a rise in services prices. On the basis of current information~~us at today's meeting, annual HICP inflation is expected to remain ~~around present~~at low levels over the coming months, before increasing only gradually ~~increasing~~ during 2015 ~~to reach levels closer to 2% towards the end of~~and 2016~~. New macroeconomic projections by Eurosystem staff will become available in early June. Medium to long-term~~, thereby underpinning the case for today's decisions. Meanwhile, inflation expectations ~~remain~~for the euro area over the medium to long term continue to be firmly anchored in line with ~~price stability~~our aim of maintaining inflation rates below, but close to, 2%. Looking ahead, the Governing Council is strongly determined to safeguard this anchoring.

~~The Governing Council sees both upside and downside risks to the outlook for price developments as limited and broadly balanced over the medium term. In this context, the possible repercussions of both geopolitical risks and exchange rate developments will be monitored closely.~~

~~Turning to the **monetary analysis**, data for March 2014~~ Our assessment has been supported by the June 2014 Eurosystem staff macroeconomic projections for the euro area. They foresee annual HICP inflation at 0.7% in 2014, 1.1% in 2015 and 1.4% in 2016. In the last quarter of 2016, annual HICP inflation is projected to be 1.5%. In comparison with the March 2014 ECB staff macroeconomic projections, the projections for inflation for 2014, 2015 and 2016 have been revised downwards. It should be stressed that the projections are conditional on a number of technical assumptions, including exchange rates and oil prices, and that the uncertainty surrounding each projection increases with the length of the projection horizon.

The Governing Council sees both upside and downside risks to the outlook for price developments as limited and broadly balanced over the medium term. In this context, we will closely monitor the possible repercussions of geopolitical risks and exchange rate developments.

Turning to the **monetary analysis**, data for April 2014 continue to point to subdued underlying growth in broad money (M3). Annual growth in M3 moderated further to ~~1.1~~0.8% in ~~March~~April, from 1.~~3~~0% in ~~February.~~March. The growth of the narrow monetary aggregate M1 ~~remained robust but decreased to~~

moderated to 5.2 % in April, after 5.6~~-~~% in March~~, after 6.2% in February. The~~. In the recent past, the increase in the MFI net external asset position, reflecting in part the continued interest of international investors in euro area assets, ~~remains~~has been the main factor supporting annual M3 growth.

The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was ~~-3.1% in March, unchanged from February.~~-2.7% in April 2014, compared with -3.1% in March. Weak loan dynamics for non-financial corporations continue to reflect their lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. The annual growth rate of loans to households (adjusted for loan sales and securitisation) ~~stood at~~was 0.4% in ~~March~~April 2014, broadly unchanged since the beginning of 2013.

~~The April 2014 bank lending survey confirmed the stabilisation of credit conditions for loans to enterprises and households. Credit standards over the previous three months remained broadly unchanged for loans to enterprises but were eased in net terms for households. Broadly in line with these results, in the survey on the access to finance of small and medium-sized enterprises (SMEs) for the period October 2013-March 2014, SMEs reported that bank loan availability had become less negative and had actually improved in some euro area countries. According to both surveys, the general economic outlook contributed less negatively or even positively to these developments. At the same time, banks still reported tight levels of credit standards when seen in a historical perspective.~~

~~Since the summer of 2012, substantial progress has been made in improving the funding situation of banks. In order to ensure an adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed. In this context, the~~ To sum up, a **cross-check** of the outcome of the economic analysis with the signals coming from the monetary analysis led the Governing Council to decide on a combination of measures to provide further monetary policy accommodation and to support lending to the real economy.

In order to strengthen the economic recovery, banks and policy-makers in the euro area must step up their efforts. Against the background of weak credit growth, the ongoing comprehensive assessment of banks' balance sheets is of key importance. 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, policy-makers in the euro area should push ahead in the areas of fiscal policies and structural reforms.

~~To sum up, the economic analysis confirms our expectation of a prolonged period of low inflation followed by only a gradual upward movement in HICP inflation rates towards levels closer to 2%. A **cross-check** with the signals from the monetary analysis confirms the picture of subdued underlying price pressures in the euro area over the medium term.~~

~~Regarding **fiscal policies**, according to the European Commission's spring forecast, the~~ As regards **fiscal policies**, the Eurosystem staff macroeconomic projections indicate continued progress in restoring sound public finances in the euro area. The aggregate euro area general government deficit ~~in the euro area~~ is ~~expected~~projected to decline ~~further,~~gradually from 3.0% of GDP in 2013 to 2.5% ~~this year and to 2.3% in 2015. The government debt-to-GDP ratio is expected to stabilise at 96.0% in 2014 and to decline to 95.4% in 2015. In view of still rather high debt ratios and to improve fiscal sustainability, euro area countries should not unravel progress made with fiscal consolidation and should comply with their commitments under the Stability and Growth Pact. At the same time, comprehensive and ambitious **structural reforms** in product and labour markets are warranted to lift the euro area's growth potential, improve its adjustment capacity and reduce the high unemployment facing many euro area countries today. To this end, the Governing Council concurs with Tuesday's ECOFIN Council communication that decisive policy action is needed in countries~~

~~where macroeconomic imbalances hinder the smooth functioning of Economic and Monetary Union.~~of GDP in 2014. For 2015 and 2016, a further decline to 2.3% and 1.9 **%**, respectively, is projected. General government debt is projected to peak at 93.4% of GDP this year. Thereafter, it is projected to decline, reaching around 91% in 2016. As regards **structural reforms**, important steps have been taken to increase the competitiveness and the adjustment capacity of countries' labour and product markets, although progress has been uneven and is far from complete. In this context, the Governing Council takes note of the European Commission's recommendations on fiscal and structural policies, published on 2 June 2014, to continue the path of reducing budgetary and macroeconomic imbalances. The recommendation to the Council to abrogate the excessive deficit procedures for four euro area countries indicates continued progress in restoring sound public finances. However, euro area countries should not unravel progress made with fiscal consolidation. A full and consistent implementation of the euro area's macroeconomic surveillance framework, together with the necessary policy actions by euro area countries, will help to raise potential growth, increase the euro area's resilience to shocks and facilitate job creation.

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