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ECB Watch

Europe

Madrid, 6 June 2013
Economic Analysis

Financial Scenarios

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ECB on hold and continues ready to act if needed

- **The ECB keeps rates. The prevailing consensus was that changes to the outlook were not enough to grant any immediate action**
- **The ECB revises, slightly, its projections**
- **Not action to boost lending to SMEs in the short-term**

As expected, the ECB Governing Council left the key policy rate unchanged at 0.5%. According to Draghi, today´s decision was reached after "a very rich discussion", which led to a prevailing consensus that there "wasn't any directional change that would justify taking action at this time.” As in other meetings, he also emphasized that monetary policy would remain "accommodative" for “as long as necessary”, while the ECB does not "pre-commit" to future rate cuts, they are “ready to act and will continue to monitor closely all incoming data.” In our view, the ECB is expected to maintain interest rates, while the bias continued to be on the downside, i.e. a further worsening of the economic outlook could trigger an additional rate cut.

The ECB updated its forecast for GDP to the downside in 2013 (from -0.5% to -0.6%), mainly due to the observed fall in 1Q13. Our current forecast which assumes a positive growth as soon as 2Q13 and further progress in the second half of the year, is also biased to the downside when considering 1Q13 data. The difference between the ECB´s forecasts and ours is probably due to the ECB expecting null growth in 2Q13. As for 2014, the ECB revised slightly upwards its growth forecast from 1% to 1.1% (BBVA: 1%). On inflation, the forecast was revised down for 2013 (from 1.6% to 1.4%) due to lower oil prices but it remained unchanged for 2014 (1.3%). The latest data have also biased down our forecasts for inflation (1.6% in 2013 and 1.4% in 2014), yet in our view this change would be accompanied by a slight moderation in core inflation. Overall, the prospects for a mild recovery in the second half of the year remain in place.

Regarding non-standard measures, while we were not expecting any announcement, the remarks at the press conference have contributed to dampen expectations. Mr. Draghi said that there is an ample discussion about the various measures that could be used to repair the transmission monetary policy: ABS, LTROs, collateral, credit claims and the possibility of a negative deposit rate. Yet, on actions to spur lending to SMEs and to revitalize the market of ABS (that were put forward last month by the ECB) he said that the central bank is still working on this. Moreover, Draghi highlighted that any action was "not for the short-term".

On banking union, Draghi stressed that, before the ECB conducts its planned asset quality reviews (AQR) on banks, all governments need to have explicit backstops in place: “We don't want to repeat the mistake that we made in 2011, when we had the EBA running stress tests without the countries having agreed on having a backstop." “We want to make sure there is an explicit commitment by the government, the ESM, the Eurogroup so that in case of a capital shortfall there would be a backstop." "It is psychologically so important" for markets to know that banks have a backstop in place in case they are unable to cover any capital shortfalls themselves, Draghi explained just three weeks ahead at the end-June EU council meeting..

Annex 1. Introductory statement, tracking the changes:

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.

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB~~.~~
~~Bratislava, 2 May~~,
Frankfurt am Main, 6 June 2013

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~I would like to thank Governor Makúch 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~~, during~~ of the Governing Council, which ~~we took a number of decisions on key ECB interest rates, liquidity provision and possible ways forward to enhance the provision of credit. The meeting~~ was also attended by the ~~Commission Vice-~~President~~, Mr Rehn~~ of the Eurogroup, Finance Minister Dijsselbloem.

~~First, based~~Based on our regular economic and monetary analyses, we decided to ~~lower~~keep the key ECB interest ~~rate on the main refinancing operations of the Eurosystem by 25 basis points to 0.50% and the rate on the marginal lending facility by 50 basis points to 1.00%. The rate on the deposit facility will remain~~ rates unchanged ~~at 0.00%. These decisions are consistent with low~~ . Incoming information has confirmed our assessment which led to the cut in interest rates in early May. The underlying price pressure in the euro area is expected to remain subdued over the medium term. ~~Inflation~~ In keeping with this picture, monetary and, in particular, credit dynamics remain subdued. Medium-term inflation expectations for the euro area continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2~~% over the medium term. In keeping with this picture, monetary and loan dynamics remain subdued.~~%. At the same time, ~~weak~~ recent economic sentiment ~~has extended into spring of this year. The cut in interest rates~~ survey data have shown some improvement from low levels. The accommodative stance of our monetary policy, together with the significant improvements in financial markets since mid-2012, should contribute to support prospects for ~~a~~ an economic recovery later in the year. Against this overall background, our monetary policy stance will remain accommodative for as long as ~~needed.~~necessary. In the period ahead, we will monitor very closely all incoming information on economic and monetary developments and assess any impact on the outlook for price stability.

~~Second, we are closely monitoring money market conditions and their potential impact on our monetary policy stance and its transmission to the economy. In this context, we decided today to continue conducting the main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the 6th maintenance period of 2014 on 8 July 2014. This procedure will also remain in use for the Eurosystem's special-term refinancing operations with a maturity of one maintenance period, which will continue to be conducted for as long as needed, and at least until the end of the second quarter of 2014. The fixed rate in these special-term refinancing operations will be the same as the MRO rate prevailing at the time. Furthermore, we decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted until the end of the second quarter of 2014 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.~~

~~Third, the Governing Council decided to start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities collateralised by loans to non-financial corporations.~~

~~In the meantime, it is essential for governments to intensify the implementation of structural reforms at national level, building on progress made in fiscal consolidation and proceeding with bank recapitalisation where needed. Furthermore, they should maintain the momentum towards a genuine Economic and Monetary Union, including the swift implementation of the banking union.~~

~~Let me now explain our assessment in greater detail, starting with the economic analysis. Real GDP contracted by 0.6% in the fourth quarter of 2012, following a decline of 0.1% in the third quarter. Output has thus declined for five consecutive quarters. Overall, labour market conditions remain weak. Recent developments in short-term indicators, notably survey data, indicate that weak economic sentiment has extended into spring of this year. Looking ahead, euro area export growth should benefit from a recovery in global demand and our monetary policy stance should contribute to support domestic demand. Furthermore, the improvements in financial markets seen since last summer should work their way through to the real economy. At the same time, necessary balance sheet adjustments in the public and private sectors will continue to weigh on economic activity. Overall, euro area economic activity should stabilise and recover gradually in the second half of the year.~~

~~The risks surrounding the economic outlook for the euro area continue to be on the downside. They include the possibility of even weaker than expected domestic and global demand and slow or insufficient implementation of structural reforms in the euro area. These factors have the potential to dampen confidence and thereby delay the recovery.~~

~~According to Eurostat's flash estimate, euro area annual HICP inflation was 1.2% in April 2013, down from 1.7% in March. This decline in the annual inflation rate reflects a significant fall in energy prices, but is also due to a sizeable transitory effect coming from the annual rate of change in services prices on account of the timing of Easter. Inflation rates could remain subject to some volatility throughout the year. Looking further ahead, underlying price trends should persist and, over the medium term, inflation expectations remain firmly anchored in line with price stability.~~

~~Taking into account today's decisions, risks to the outlook for price developments are broadly balanced over the medium term, with upside risks relating to stronger than expected increases in administered prices and indirect taxes, as well as higher commodity prices, and downside risks stemming from weaker economic activity.~~

~~Turning to the monetary analysis, recent data confirm that the underlying pace of monetary expansion continues to be subdued. Annual growth in broad money moderated in March, standing at 2.6%, after 3.1% in February. The annual growth rate of the narrow monetary aggregate, M1, increased slightly further to 7.1% in March, reflecting the continued preference for the most liquid instruments in M3. Deposits with the domestic money-holding sector continued to grow further in most stressed countries in March.~~

~~The annual growth rates of loans (adjusted for loan sales and securitisation) to non-financial corporations and households have now remained broadly unchanged since the turn of the year, standing in March at -1.3% and 0.4% respectively. To a large extent~~Let me now explain our assessment in greater detail, starting with the economic analysis. Real GDP contracted by 0.2% in the first quarter of 2013, following a decline of 0.6% in the fourth quarter of 2012. Output has thus declined for six consecutive quarters, with labour market conditions remaining weak. Recent developments in economic sentiment survey data have shown some improvement from low levels. Looking ahead to later in the year and to 2014, euro area export growth should benefit from a recovery in global demand, while domestic demand should be supported by the accommodative stance of our monetary policy and by the recent real income gains due to lower oil prices and generally lower inflation. Furthermore, the significant improvements in financial markets seen since last summer should work their way through to the real economy, as should the progress made in fiscal consolidation. At the same time, the remaining necessary balance sheet adjustments in the public and private sectors will continue to weigh on economic activity. Overall, euro area economic activity should stabilise and recover in the course of the year, albeit at a subdued pace.

This assessment is also reflected in the June 2013 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP declining by 0.6% in 2013 and increasing by 1.1% in 2014. Compared with the March 2013 ECB staff macroeconomic projections, the projection for 2013 has been revised marginally downwards, largely reflecting the incorporation of the latest GDP data releases. For 2014 there has been a marginal upward revision.

The Governing Council continues to see downside risks surrounding the economic outlook for the euro area. They include the possibility of weaker than expected domestic and global demand and slow or insufficient implementation of structural reforms in euro area countries.

According to Eurostat's flash estimate, euro area annual HICP inflation was 1.4% in May 2013, up from 1.2% in April. This increase was, in particular, accounted for by a rebound in services prices related to the unwinding of the Easter effect and an increase in food prices. More generally, as stated last month, annual inflation rates are expected to be subject to some volatility throughout the year due particularly to base effects relating to energy and food price developments twelve months earlier. Looking through this volatility, the underlying price pressure over the medium term is expected to remain subdued, reflecting low capacity utilisation and a modest pace of economic recovery. Over the medium term, inflation expectations remain firmly anchored in line with price stability.

This assessment is also reflected in the June 2013 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.4 % and 1.3 % in 2013 and 2014, respectively. In comparison with the March 2013 ECB staff macroeconomic projections, the projection for inflation for 2013 has been revised downwards, mainly reflecting the fall in oil prices, while the projection for 2014 remains unchanged.

In the Governing Council's assessment, risks to the outlook for price developments are broadly balanced over the medium term, with upside risks relating to stronger than expected increases in administered prices and indirect taxes, as well as higher commodity prices, and downside risks stemming from weaker economic activity.

Turning to the monetary analysis, recent data confirm that the underlying pace of monetary and, in particular, credit expansion continues to be subdued. Annual growth in broad money, M3, increased in April to 3.2%, from 2.6% in March, mainly due to a base effect and special factors. The same factors have impacted on the annual growth rate of the narrow monetary aggregate, M1, which increased from 7.1% in March to 8.7% in April.

The growth of loans to the private sector continued to be weak. The annual growth rates of loans to households (adjusted for loan sales and securitisation) remained at 0.3% in April, broadly unchanged since the turn of the year. The annual negative growth of loans to non-financial corporations (adjusted for loan sales and securitisation) increased from -1.3% in March to -1.9% in April. This development stemmed, in particular, from net redemptions in short-term loans, which could reflect reduced demand for working capital against the background of weak order books in early spring. More generally, weak loan dynamics continue to reflect primarily the current stage of the business cycle, heightened credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. ~~The recent Bank Lending Survey (BLS) confirmed weak demand for loans in the euro area. While some signs of stabilisation are emerging, the Survey on the access to finance of small and medium-sized enterprises (SMEs) in the euro area indicates continued tight credit conditions, particularly for SMEs in several euro area countries. Moreover, the available information indicates high risk perception on the part of banks.~~

In order to ensure adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets continues to decline further and that the resilience of banks is strengthened where needed. Progress has been made since last summer in improving the funding situation of banks, in strengthening the domestic deposit base in stressed countries and in reducing reliance on the Eurosystem as reflected in repayments of the three-year LTROs. Further decisive steps for establishing a banking union will help to accomplish this objective. In particular, the Governing Council emphasises that the future Single Supervisory Mechanism and a Single Resolution Mechanism are crucial elements for moving towards re-integrating the banking system and therefore require swift implementation.

To sum up, ~~taking into account today's decisions,~~ the economic analysis indicates that price developments should remain in line with price stability over the medium term. A cross-check with the signals from the monetary analysis confirms this picture.

~~With regard to fiscal policies, the spring 2013 deficit and debt data notifications by euro area countries indicate that the average government deficit declined from 4.2% of GDP in 2011 to 3.7% in 2012. Over the same period, the average government debt rose from 87.3% to 90.6% of GDP. In order to bring debt ratios back on a downward path, euro area countries should~~ With regard to fiscal consolidation and structural reforms, the Governing Council welcomes the progress made and encourages governments to continue with determined efforts. It is essential that euro area countries do not unravel their efforts to reduce government budget deficits. The new European governance framework for fiscal and economic policies should be applied in a steadfast manner. In this respect, the Governing Council considers it very important that decisions by the European Council to extend the time frame for the correction of excessive fiscal deficits should remain reserved for exceptional circumstances. At the same time, it is necessary to continue, where needed, to take legislative action or otherwise promptly implement ~~structural reforms, in such a way as to mutually reinforce fiscal sustainability and economic growth potential. Such~~ structural reforms. Structural reforms should, in particular, target ~~improvements in~~ competitiveness and adjustment capacities~~, as well as aim to increase sustainable growth~~ in labour and product markets, thereby helping to generate employment opportunities in an environment of unacceptably high unemployment levels, especially among young workers, prevailing in several countries. Combined action on the fiscal and structural front should mutually reinforce fiscal sustainability and economic growth potential and thereby foster sustainable job creation.

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