BBVA | RESEARCH

ECB Watch

Europe

Madrid, 4 July 2013
Economic Analysis

Financial Scenarios

Sonsoles Castillo
s.castillo@bbva.com

María Martínez Álvarez
maria.martinez.alvarez@bbva.com

Cristina Varela Donoso
cvarela@bbva.com

Alejandro Neut
robertoalejandro.neut@bbva.com

Forward guidance, the ECB´s new policy strategy?

- **The ECB adopts forward guidance, stating that rates will remain "at present or lower levels for an extended period"**
- **The ECB strikes a more dovish tone, distancing itself from the Fed´s perceived hawkishness. The BoE acts similarly**
- **Its economic outlook remains weak and uncertain due to financial market conditions. Risks to price stability remain broadly balanced**

The GC explicitly said that "key ECB interest rates (are) to remain at present or lower levels for an extended period." This is an unexpected, unprecedented and welcomed step for the ECB, which moves away from its long-standing stance to "never pre-commit" and moves closer to a "forward guidance" strategy. Mr. Draghi clarified that this decision was conditional on expectations of three variables: the "overall subdued outlook for **inflation** into the medium term, given the broad-based weakness in the **real economy** and subdued **monetary dynamics** in the medium term." (including credit)

Despite leaving the key policy rate unchanged at 0.5% (as expected), Mr. Draghi said that there were extensive discussions on the possibility of a rate cut, adding that negative deposit rates remain a feasible option and that 0.50% is not a lower bound. The dovish tone was in line with ECB´s economic outlook, which shows that activity is "still going down but at slower pace." Moreover, Mr. Draghi stressed that the outlook is subject to high uncertainty, as the recent tightening of the markets may have the potential to negatively affect economic conditions. In ECB´s view, risks for the economy remain biased to the downside while risks for price stability "are expected to be still broadly balanced". We thus expect that the ECB will remain on hold, with an increased bias to cut rates which now is dependent on data and global financial market conditions too.

In the press conference, the attention focused on ECB´s forward guidance. Mr Draghi said that the decision on guidance was unanimous within the GC. He highlighted that "what the GC did today was to inject a downward bias in interest rates for the foreseeable future. Our exit is very distant." When Mr Draghi was asked about the new communication strategy, he indicated that the increased market volatility justified it, adding that the ECB "does not react to other central banks´ communication." These remarks were in reference to the Fed´s tapering strategy that was behind the recent market tightening, and also in reference to BoE´s dovish policy statement today. As for ECB´s future policy strategy, Mr. Draghi said that it is too early to speculate on future communication (e.g., thresholds in its monetary policy guidance, such as in the Fed). Moreover, Mr. Draghi declined to define "extended period of time".

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, Frankfurt am Main, ~~6 June~~4 July 2013

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. 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 has confirmed our previous assessment~~ which led to the cut in interest rates in early May. The underlying price pressure~~. Underlying price pressures in the euro area ~~is~~are expected to remain subdued over the medium term. In keeping with this picture, monetary and, in particular, credit dynamics remain subdued. ~~Medium-term inflation~~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. At the same time, recent ~~economic sentiment~~ confidence indicators based on survey data have shown some further 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 an economic recovery later in the year. Against this overall background~~Our monetary policy stance is geared towards maintaining the degree of monetary accommodation warranted by the outlook for price stability and promoting stable money market conditions. It thereby provides support to a recovery in economic activity later in the year and in 2014. Looking ahead, our monetary policy stance will remain accommodative for as long as necessary. The Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics. 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.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP ~~contracted~~declined by 0.~~2~~3% in the first quarter of 2013, following a ~~decline~~contraction of 0.6% in the ~~fourth~~ last quarter of 2012. ~~Output has thus declined for six consecutive quarters, with~~ At the same time, labour market conditions ~~remaining~~ remain weak. Recent developments in ~~economic sentiment~~ cyclical indicators, particularly those based on survey data~~ have shown~~, indicate some further improvement from low levels. Looking ahead to later in the year and to 2014, euro area export growth should benefit from a gradual recovery in global demand, while domestic demand should be supported by the accommodative monetary policy stance ~~of our monetary policy and by~~ as well as the recent gains in real income ~~gains due~~owing to ~~lower oil prices and~~ generally lower inflation. Furthermore, ~~the significant~~notwithstanding recent developments, the overall 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,~~ This being said, 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~~ continue to be on the downside. The recent tightening of global money and financial market conditions and related uncertainties may have the potential to negatively affect economic conditions. Other downside risks include the possibility of weaker than expected domestic and global demand and slow or insufficient implementation of structural reforms in euro area countries.

As stated in previous months, annual inflation rates are expected to be subject to some volatility throughout the year owing particularly to base effects. According to Eurostat's flash estimate, euro area annual HICP inflation was 1.6% in June 2013, up from 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~~ reflected 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~~ upward base effect relating to energy ~~and food~~ price developments twelve months earlier. ~~Looking through this volatility, the~~However, underlying price ~~pressure over the medium term is~~pressures are expected to remain subdued over the medium term, reflecting ~~low capacity utilisation~~the broad-based weakness in aggregate demand and ~~a~~ the modest pace of ~~economic~~the recovery. ~~Over the medium~~ 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 risks to 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~~are expected to be still 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 than expected economic activity.

Turning to the **monetary analysis**, recent data confirm ~~that~~ the ~~underlying pace of~~subdued monetary and, in particular, credit ~~expansion continues to be subdued.~~dynamics. Annual growth in broad money~~, ~~ (M3~~, increased in April to 3.2~~) decreased in May to 2.9%, 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.~~

3.2% in April. Moreover, annual growth in M1 decreased to 8.4% in May, from 8.7% in April. The ~~growth~~annual rate of change of loans to the private sector ~~continued to be weak. The~~remained negative. While the annual growth rate~~s~~ of loans to households (adjusted for loan sales and securitisation) remained at 0.3% in ~~April~~May, broadly unchanged since the turn of the year~~. The annual negative growth~~, the annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) ~~increased~~weakened further to -2.1% in May, from -1.~~3% in March to -1.~~9% in April. ~~This development stemmed, in particular, from~~As in April, strong monthly net redemptions in May were concentrated in short-term loans, ~~which could reflect~~ possibly reflecting 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.

~~In order to ensure adequate transmission of monetary policy to~~Since 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 of 2012 substantial progress has been made in improving the funding situation of banks and, in particular, in strengthening the domestic deposit base in a number of stressed countries~~ and in~~. This has contributed to reducing reliance on ~~the~~ Eurosystem funding, as reflected in the ongoing repayments of the three-year longer-term refinancing operations (LTROs). 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 continues to decline further and that the resilience of banks is strengthened where needed. Further decisive steps for establishing a ~~banking union~~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, 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 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~~ With regard to **other economic policies**, the Governing Council notes the initiatives taken by the European Council of 27-28 June 2013 in the areas of youth unemployment, investment and financing of small and medium-sized enterprises, as well as the European Council's endorsement of the country-specific recommendations of the 2013 European semester. The Governing Council stresses that implementation of these recommendations is essential to contribute to a sustainable recovery in the euro area. Moreover, the new European governance framework for fiscal and economic policies should be applied in a steadfast manner and much more determined efforts should be pursued to carry forward structural reforms to foster growth and employment. In this respect, the Governing Council ~~considers~~deems it ~~very~~particularly important ~~that decisions by the EU 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. Structural reforms should, in particular,~~ target competitiveness and adjustment capacities 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~~. Finally, the Governing Council welcomes the setting-out of a number of steps towards the completion of the Banking Union as moves in the right direction, but also urges that they be implemented swiftly.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.