ECB Watch
Europe

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Economic Analysis

Financial Scenarios

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ECB maintains dovish stance

- **Monetary policy will remain accommodative for an extended period of time**
- **There are tentative signs of stabilization in economic activity**
- **The Council is discussing to publish minutes of its meetings**

As expected, at today´s monetary policy meeting the ECB left the key policy rate unchanged at 0.5% and took no additional steps on non-standard liquidity measures. On the economic outlook, activity seems to have stabilized, as recent surveys show further improvement. Mr. Draghi said that there may be a "gradual recovery in economic activity in the remaining part of the year and in 2014," yet he kept a cautious tone and stressed that "the signs we are seeing now confirm the baseline projections of the ECB staff projections for the second part of the year." Overall, the tone remained dovish and the easing bias was retained. In particular, Mr. Draghi said that the key ECB rates "haven't reached the zero bound" and stressed that these rates will "stay where they are or go lower." Mr Draghi reiterated that the monetary stance continues to be accommodative, that medium-term inflation risks remain "broadly balanced." and that risks for the economic outlook continue to be on the downside.

The ECB has consolidated last month´s forward-guidance strategy, repeating that the Governing Council unanimously "expects the key ECB interest rates to remain at present or lower levels for an extended period of time." Moreover, the communique added that their expectation continues to be based on "an unchanged overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the economy and subdued monetary dynamics." During the press conference, Mr. Draghi added that the Council had discussed the need to repeat the above message at every communique or to leave it out and only communicate a change in policy: on the one hand, repetition avoids that markets misinterpret silence as a change of heart; on the other, restating the message every month could lead markets to equate "extended period of time" with only "one month". For now, the Council has opted for repetition. Mr. Draghi also added that the Council had not discussed the use of explicit thresholds or targets. Yet he said that the current wording is quite stronger than the mere communication of the outlook: the views on inflation, activity and financial markets were not the ones of the ECB, but directly those of the members in the Council. Moreover, Mr. Draghi said that there are a variety of ways to signal in advance the end of current policy, a job that, as of now, was being undertaken only by the Fed.

Regarding the possibility of publishing the minutes of ECB meetings, as other central banks do, Mr. Draghi said this discussion is in its early stages, and that the board will be presenting a proposal in the fall. Mr. Draghi added that "it is a highly complex discussion and it is one of those decisions that has to be truly consensual." He highlighted that any change in communication must respect the ECB set-up without putting into question Council members´ independence.

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, ~~4 July~~1 August 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, 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. Underlying price pressures in the euro area are expected to remain subdued over the medium term. In keeping with this picture, monetary and, in particular, credit dynamics remain subdued. 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 confidence indicators based on survey data have shown some further improvement from low levels and tentatively confirm the expectation of a stabilisation in economic activity. Our monetary policy stance ~~is~~ continues to be 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 gradual recovery in economic activity ~~later~~ in the remaining part of the year and in 2014. Looking ahead, our monetary policy stance will remain accommodative for as long as necessary. The Governing Council confirms that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation ~~is~~ continues to be based on ~~the~~an unchanged 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 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 declined by 0.3% in the first quarter of 2013, following a contraction of 0.6% in the last quarter of 2012.~~Following a six-quarter economic contraction in the euro area, recent confidence indicators based on survey data have shown some further improvement from low levels and tentatively confirm the expectation of a stabilisation in economic activity at low levels. At the same time, labour market conditions remain weak. ~~Recent developments in cyclical indicators, particularly those based on survey data, indicate some further improvement from low levels.~~ Looking ahead to ~~later in~~ the remainder of 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 as well as the recent gains in real income owing to generally lower inflation. Furthermore, ~~notwithstanding recent developments,~~ the overall improvements in financial markets seen since last summer ~~should work~~appear to be gradually working their way through to the real economy, as should the progress made in fiscal consolidation. 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~~ slow pace.

The risks surrounding the economic outlook for the euro area continue to be on the downside. ~~The recent tightening of~~ Recent developments in 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 July 2013, unchanged from June~~ 2013, up from 1.4% in May. This increase reflected an upward base effect~~. Annual inflation rates are currently expected to temporarily fall over the coming months, owing particularly to base effects relating to energy price developments twelve months earlier. ~~However~~Taking the appropriate medium-term perspective, underlying price pressures are expected to remain subdued~~ over the medium term~~, reflecting the broad-based weakness in aggregate demand and the modest pace of the recovery. Medium to long-term inflation expectations ~~remain~~continue to be firmly anchored in line with price stability.

The risks to the outlook for price developments 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 the subdued monetary~~ underlying money and, in particular, credit ~~dynamics.~~growth remained subdued in June. Annual growth in broad money (M3) decreased in ~~May~~June to 2.~~9~~3%, from ~~3.~~2.9% in ~~April.~~May. Moreover, annual growth in M1 decreased to ~~8.4% in May, from 8.~~7.5% in ~~April.~~June, from 8.4% in May. The annual rate of change of loans to the private sector ~~remained negative.~~weakened further. While the annual growth rate of loans to households (adjusted for loan sales and securitisation) remained at 0.3% in ~~May~~June, broadly unchanged since the turn of the year, the annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) ~~weakened further to~~was -2.3% in June, after -2.1% in May~~, from -1.9% in April. As in April, strong monthly net redemptions in May were concentrated in short-term loans, possibly reflecting reduced demand for working capital against the background of weak order books in early spring. More generally, weak~~. 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 bank lending survey for the second quarter of 2013 confirms that borrowers' risk and macroeconomic uncertainty remained the main factors restraining banks' lending policies. At the same time, the degree of net tightening of credit standards for loans to non-financial corporations remained unchanged in the second quarter of 2013, compared with the first quarter, and declined for loans to households.

Since the 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. ~~This has contributed to reducing reliance on 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~~declines further and that the resilience of banks is strengthened where needed. Further decisive steps for establishing a Banking Union will help to accomplish this objective. ~~In particular, 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~~check** with the signals from the monetary analysis confirms this picture.

~~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 deems it particularly important to target competitiveness and adjustment capacities in labour and product markets. 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.~~

As regards **fiscal policies**, in order to bring debt ratios back on a downward path, euro area countries should not unravel their efforts to reduce government budget deficits. The emphasis should be on growth-friendly fiscal strategies which have a medium-term perspective and combine improving the quality and efficiency of public services with minimising distortionary effects of taxation. To reinforce the overall impact of such a strategy, Member States must step up the implementation of the necessary **structural reforms** so as to foster competitiveness, growth and job creation. Removing rigidities in the labour market, lowering the administrative burden and strengthening competition in product markets will particularly support small and medium-sized enterprises. These structural reform measures are essential to bring down the currently high level of unemployment, in particular among the younger citizens of the euro area.

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