RESEARCH

ECB Watch

Europe

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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

ECB is “ready to consider all available instruments”

- **Rates were kept unchanged, yet a rate cut was discussed**
- **ECB stance remains dovish as it continues to observe a very fragile economic recovery**
- **The ECB is ready to use all available instruments and “excludes no option”**

As expected, at today’s monetary policy meeting the ECB left the key policy rate unchanged at 0.5%, maintained intact its forward guidance and took no additional steps on non-standard liquidity measures. Mr. Draghi said there was discussion within the Governing Council on the possibility of a rate cut, as in the last meeting in September. In particular, he said that “some governors observed that improvements in the economy would not justify this discussion but other governors believed that the discussion was warranted.”

As expected, Mr. Draghi remained cautious on the economic outlook, emphasizing that the recovery in the eurozone remains "weak, fragile, uneven." In response to the questions about the low levels of inflation, Mr Draghi said that the inflation path “is developing as expected,” clarifying that the current low level is a “combination of energy prices, indirect tax increases, food prices and also the appreciation of the exchange rate and the general economic conditions." Moreover inflation remains in line with the ECB outlook, yet on the “very low” side of their target band. He stressed that they need to “look through the medium term to decide on action either with an interest rate cut or another instrument.” He reiterated that medium-term inflation risks still remain “broadly balanced” and that risks for the economic outlook continue to be on the downside.

Mr. Draghi reiterated, that the ECB will remain “particularly attentive” to developments in money markets. As during his recent hearing in the European Parliament, he emphasised that the ECB “is ready to use all available instruments to make sure the short-term money market rates are in line with our medium-term target for price stability.” After a question about a new LTRO, he took the opportunity to reiterate that the bank has a vast array of instruments, and he stressed that the bank will “exclude no option, in order to address the needs as is most appropriate.” He stood strongly in favor of supporting liquidity: “I would say that nobody wants to have a liquidity accident standing between now and the recovery.”

On the Banking Union, Mr. Draghi was confident on the approval of the Single Resolution Mechanism (SRM), by both the EU Council and the plenary of the EU parliament, before the EU parliament closes in April 2014. After several EU officials have stated that using the ESM to fund any backstop would require a change in the ESM Treaty, Mr Draghi suggested that there are other measures that can be seen as backstops. He pointed to the exclusion of public injections to banks from official government accountings (e.g., under the definition of the excessive deficit procedure). Mr. Draghi added that details about the upcoming Asset Quality Review (AQR) will be unveiled during the second half of October, but he signaled that homologation of some definitions (such as that of non-performing loans) are needed. He also said that the governing council has never discussed the treatment of sovereign bonds in the balance sheet assessment.

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, ~~Frankfurt am Main, 5 September~~ Vítor Constâncio, Vice-President of the ECB, Paris, 2 October 2013

Ladies and gentlemen, the Vice-President and I ~~am~~ are very pleased to welcome you to our press conference. I would like to thank Governor Noyer 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, Mr Rehn.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. Incoming information and analysis have further underpinned 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, real GDP growth in the second quarter was positive, after six quarters of negative output growth, and confidence indicators up to ~~August~~ September confirm the expected gradual improvement in economic activity from low levels. Our monetary policy stance 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. Looking ahead, our monetary policy stance will remain accommodative for as long as necessary, in line with the forward guidance provided in July. 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 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. In the period ahead, we will monitor all incoming information on economic and monetary developments and assess any impact on the medium-term outlook for price stability. With regard to money market conditions, ~~these have also been influenced by a gradual reduction in excess liquidity. Repayments of funds taken up in the context of the three-year longer-term refinancing operations reflect improvements in financial market confidence, some reduction in financial market fragmentation and the ongoing deleveraging by euro area banks. We~~we will remain particularly attentive to ~~the implications that these~~ developments which may have implications for the stance of monetary policy and are ready to consider all available instruments.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Following six quarters of negative output growth, euro area real GDP rose, quarter on quarter, by 0.3% in the second quarter of 2013~~. This increase is partly explained by transitory effects~~, also supported by temporary factors related to unusually adverse weather conditions in ~~the first half of~~ some euro area countries earlier this year. ~~Since then,~~ Developments in industrial production data point to somewhat weaker growth at the beginning of the third quarter, while survey-based confidence indicators up to ~~August~~ September have improved further from low levels, overall confirming our previous expectations of a gradual recovery in economic activity. Looking ahead ~~to the remainder of the year and to 2014, in line with our baseline scenario~~, output is expected to recover at a slow pace, in particular owing to a gradual improvement in domestic demand supported by the accommodative monetary policy stance. Euro area economic activity should, in addition, benefit from a gradual strengthening of external demand for exports. Furthermore, the overall improvements in financial markets seen since last summer appear to be gradually working their way through to the real economy, as should the progress made in fiscal consolidation. In addition, real incomes have benefited recently from generally lower inflation. This being said, unemployment in the euro area remains high, and the necessary balance sheet adjustments in the public and private sectors will continue to weigh on economic activity.

~~This assessment is also reflected in the September 2013 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP declining by 0.4% in 2013 and increasing by 1.0% in 2014. Compared with the June 2013 Eurosystem staff macroeconomic projections, the projection for 2013 has been revised upwards by 0.2 percentage point, largely reflecting incoming data. For 2014 there has been a downward revision of 0.1 percentage point.~~

The risks surrounding the economic outlook for the euro area continue to be on the downside. ~~Recent developments~~Developments in global money and financial market conditions and related uncertainties may have the potential to negatively affect economic conditions. Other downside risks include higher commodity prices in the context of renewed geopolitical tensions, weaker than expected global demand and slow or insufficient implementation of structural reforms in euro area countries.

According to Eurostat's flash estimate, ~~as expected~~and broadly in line with expectations, euro area annual HICP inflation ~~was~~decreased in September 2013 to 1.1%, from 1.3% in August ~~2013, down from 1.6% in June and July~~. On the basis of current ~~assumptions~~futures prices for energy ~~and exchange rate developments~~, annual inflation rates are expected to remain at such low levels in the coming months~~, owing in particular to energy price developments~~. Taking the appropriate medium-term perspective, underlying price pressures are expected to remain subdued, reflecting the broad-based weakness in aggregate demand and the modest pace of the recovery. Medium to long-term inflation expectations continue to be firmly anchored in line with price stability.

~~This assessment is also reflected in the September 2013 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.5% in 2013 and 1.3% in 2014. In comparison with the June 2013 Eurosystem staff macroeconomic projections, the projection for inflation for 2013 has been revised upwards by 0.1 percentage point, while the projection for 2014 remains unchanged.~~

The risks to the outlook for price developments are expected to be still broadly balanced over the medium term, with upside risks relating in particular to higher commodity prices as well as stronger than expected increases in administered prices and indirect taxes, and downside risks stemming from weaker than expected economic activity.

Turning to the **monetary analysis**, data for ~~July confirm~~August indicate that the underlying growth of broad money (M3) and, in particular, credit ~~growth~~ remained subdued. Annual growth in M3 ~~decreased further in July~~continued to be broadly stable at 2.3% in August, compared with 2~~%, from~~ .2~~.4~~% in ~~June.~~July. Annual growth in M1 remained strong but decreased to 6.8% in August, from 7.1% in July~~, from 7.5% in June. M3 growth~~. Net capital inflows into the euro area continued to be ~~mainly supported by net capital inflows into the euro area~~the main factor supporting annual M3 growth, while the annual rate of change of loans to the private sector ~~weakened further.~~remained weak. The annual growth rate of loans to households (adjusted for loan sales and securitisation) ~~remained~~ stood at 0.~~3~~4% in ~~July~~August, 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) was -2.~~8~~9% in ~~July~~August, compared with -2.~~3~~8% in ~~June.~~July. Weak loan dynamics for non-financial corporations continue to reflect primarily ~~the current stage of~~their lagged relationship with the business cycle, ~~heightened~~ credit risk and the ongoing adjustment of financial and non-financial sector balance sheets.

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. 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. Further decisive steps to establish a banking union will help to accomplish this objective.

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.

~~In order to further reduce imbalances and to foster competitiveness, growth and job creation,~~ As regards **fiscal policies**, euro area countries ~~need to continue with their reform agenda. As regards **fiscal policies**, governments~~ should not unravel their efforts to reduce deficits and put high government debt ratios on a downward path. ~~The composition of fiscal consolidation should be geared towards growth-friendly measures which have a medium-term perspective and combine improving the quality and efficiency of public services with minimising distortionary effects of taxation. In terms of **economic policies**, product market reforms to increase competitiveness will facilitate the creation of new businesses, support the tradable goods sector and foster job creation, while high unemployment rates require decisive structural reforms to reduce rigidities in labour markets and to increase labour demand~~. The draft budgetary plans that countries will now deliver for the first time under the “two-pack” regulations need to provide for sufficiently far-reaching measures to achieve the fiscal targets for 2014. Governments must also decisively strengthen efforts to implement the needed **structural reforms** in product and labour markets. These reforms are required not only to help countries to regain competitiveness and to rebalance within the euro area, but also to create more flexible and dynamic economies that generate sustainable economic growth and employment.

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