BBVA RESEARCH

ECB Watch

Europe

Madrid, 7 November 2013
Economic Analysis

Jorge Sicilia
Group Chief Economist

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

Europe

Miguel Jiménez
mjimenezg@bbva.com

Agustín García
agustin.garcia@bbva.com

A deliberate surprise

- **Refi rate to a record-low of 0.25% aims at fighting prolonged low inflation while the door remains open for further easing**
- **The rate cut also aims to strengthen the credibility of the ECB's forward guidance**
- **There will be occasions to test whether this is enough to strengthen its forward guidance**

In an unexpected move, the ECB Governing Council (GC) decided to cut the main policy rate by 0.25% to 0.25%, a historic low, at today´s monetary policy meeting. Moreover, the ECB did not leave a symmetric corridor for interest rates, as they cut the marginal lending rate by 25 basis points to 0.75%, while leaving the deposit facility unchanged at 0%. Regarding non standard measures, the GC decided to extend the fixed-rate full allotment liquidity provision until 2015. The tone remained dovish and the easing bias was retained. Mr Draghi said that the decision to maintain the downward bias on the key ECB rates was agreed by unanimity, he stressed that rates "haven't reached the zero bound" and emphasized that these rates could "go lower".

Why did the ECB cut rates?

In order to explain the rate cut, the ECB's statement and Mr Draghi's words placed a strong emphasis on the surprise in October's inflation, which fell from 1.1% to 0.7% (BBVA Research: 0.9%, Consensus: 1.1%). The ECB pointed out that the fall in inflation was due not only to volatile components (energy, unprocessed food) but also to services.

Mr. Draghi explained in detail the changes in inflation over the last month: i) it has been fairly "broad based across a variety of components such as services, energy, processed food, non energy industrial goods in general", and ii) annualized quarterly figures have been decreasing in September and October.

Going forward, the ECB foresees a "prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below but close to 2% later on".

The exchange rate was not mentioned at all beyond the usual mention to its role as another piece of information in the Q&A.

Why did they decide to cut today?

Questioned about the decision, Mr. Draghi pointed out that the Governing Council was "wholly in agreement about the need to act," but with differences among members about the timing to act. In particular, "a considerable majority of the GC members remarked that enough evidence of a broad-based and protracted period of low inflation was sufficient," while others said the ECB should wait for "certain information" expected in data releases over the next month.

In our view, it would not have surprised anyone had they decided to wait until December´s meeting, where more complete and detailed information on inflation would be available (final figures for October´s data by component and an updated forecast from the ECB´s staff and the Survey of Professional Forecasters).

The easing of monetary policy will keep ECB observers busy trying to second guess the decision as the ECB´s diagnosis on inflation does not appear at first glance to be much different from what was expected before the inflation surprise. The low rates of inflation reflect also very low or negative rates in part of the periphery, of temporary nature, which could be reflecting base effects from past indirect increases and salutary adjustment of relative prices within the eurozone.

We do not see a risk of deflation any different than how it was a few months ago. We expect inflation to move up to about 1% at the end of the year, and remain in the 1%-1.5% throughout 2014, broadly as we did before with interest rates at 0.5%.

We in any case welcome the decision as with inflation under control and a very subdued economic recovery, any help from monetary policy increases the likelihood of the expected pick up in economic activity. Unfortunately, we continue to place a greater emphasis on the need to solve the high fragmentation in the euro area which impedes the transmission of monetary policy. A concern shared by Mr. Draghi which pointed out that over the last three months, the improvement in many components of fragmentation has halted.

Perhaps a more satisfactory explanation of the decision lies in his assessment that this decision perhaps strengthens the forward guidance. As such, today's action could be interpreted as a deliberate signal of the ECB's commitment with its (somewhat light) forward guidance provided in July. The ECB has thus taken the window opportunity, open by recent inflation data and with the tailwind of euro depreciation, to strengthen it.

What's next?

We consider that the ECB has used one of the key measures within its toolkit, putting the main refinancing rate at a record low. We do not expect further rate cuts in the coming months but we find it prudent that they have remained the door open. Whether this has strengthened the forward guidance will be tested when the Fed starts its tapering process, i.e. in case interest rates increase as they did during last summer. In case the ECB's commitment with this forward guidance is not priced in by the market, the ECB might need to consider the use of its remaining "artillery": lower refi rates (rate cuts of less than 25bps?), negative deposit facility, and a new LTRO (which surprisingly they "didn't discuss this with any significance" at today´s meeting).

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 IS ON POURPOSE)

Mario Draghi, President of the ECB,
~~Vítor Constâncio, Vice-President of the ECB,~~
~~Paris, 2 October~~Frankfurt am Main, 7 November 2013

Ladies and gentlemen, ~~the Vice-President and~~ I ~~are~~ am 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, during which ~~was also attended by the Commission Vice-President, Mr Rehn.~~

~~Based~~we took a number of decisions 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.~~ , forward guidance and liquidity provision.

First, based on our regular economic and monetary analyses, we decided to lower the **interest rate** on the main refinancing operations of the Eurosystem by 25 basis points to 0.25% and the rate on the marginal lending facility by 25 basis points to 0.75%. The rate on the deposit facility will remain unchanged at 0.00%. These decisions are in line with our forward guidance of July 2013, given the latest indications of further diminishing underlying price pressures in the euro area over the medium term, starting from currently low annual inflation rates of below 1%. In keeping with this picture, monetary and, in particular, credit dynamics remain subdued. ~~Inflation~~ At the same time, inflation expectations for the euro area over the medium to long term 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 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~~ %. Such a constellation suggests that we may experience a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on. Accordingly, our monetary policy stance will remain accommodative for as long as necessary. It will thereby also continue to assist the gradual economic recovery as reflected in confidence indicators up to October.

Second, following today's rate cut, 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~~Governing Council reviewed the forward guidance provided in July~~. The Governing Council confirms~~ and confirmed that it ~~expects~~continues to expect 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~~ of 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, we will remain particularly attentive to 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, also supported by temporary factors related to unusually adverse weather conditions in some euro area countries earlier this year. Developments in industrial production data point to somewhat weaker growth at the beginning of the third quarter, while survey-based confidence indicators up to September have improved further from low levels, overall confirming our previous expectations of a gradual recovery in~~

~~economic activity.~~Third, we continue to monitor closely money market conditions and their potential impact on our monetary policy stance. We are ready to consider all available instruments and, 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 2015 on 7 July 2015. 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 2015. 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 2015 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.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP in the euro area rose by 0.3%, quarter on quarter, in the second quarter of 2013, following six quarters of falling output. Developments in survey-based confidence indicators up to October are consistent with continued, albeit modest, growth in the second half of the year. Looking ahead, output is expected to continue 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~~year 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 energy price 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.

The risks surrounding the economic outlook for the euro area continue to be on the downside. 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~~ domestic demand and export growth, and slow or insufficient implementation of structural reforms in euro area countries.

According to Eurostat's flash estimate, ~~and broadly in line with expectations,~~ euro area annual HICP inflation decreased in October 2013 to 0.7%, from 1.1% in September~~ 2013 to 1.1%, from 1.3% in August.~~. This decline was stronger than expected and reflected, in particular, lower food price inflation, a larger fall in energy prices and some weakening in services price inflation. On the basis of current futures prices for energy, annual inflation rates are expected to remain at ~~such~~ low levels in the coming months. ~~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~~Underlying price pressures in the euro area are expected to remain subdued over the medium term. At the same time, inflation expectations 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%. Such a constellation suggests that we may experience a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below but close to 2% later on.

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

Turning to the **monetary analysis**, data for ~~August indicate that the~~September confirm the subdued underlying growth of broad money (M3) and, in particular, credit~~ remained subdued~~. Annual growth in M3 ~~continued~~moderated to ~~be broadly stable at~~2.1% in September, from 2.3% in August~~, compared with 2.2% in July~~. Annual growth in M1 remained strong ~~but decreased to~~ at 6.6%, reflecting a preference for liquidity, although it was below the peak of 8~~% in August, from 7.1% in July.~~.7% observed in April. Net capital inflows into the euro area continued to be the main factor supporting annual M3 growth, while the annual rate of change of loans to the private sector remained weak. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.~~4~~3% in ~~August~~September, 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.~~9% in August, compared with -2.8~~7% in ~~July. Weak~~September, compared with -2.9% in August. Overall, weak loan dynamics for non-financial corporations continue to reflect primarily their lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. At the same time, the October 2013 bank lending survey tentatively signals a stabilisation in credit conditions for firms and households, in the context of still weak loan demand.

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~~The ECB's comprehensive assessment before it adopts its supervisory role under the single supervisory mechanism will further support this confidence-building process. It will enhance the quality of information available on the condition of banks and result in the identification and implementation of necessary corrective actions. Further decisive steps to establish a banking union will help to restore confidence in the financial system.

~~To sum up, the economic analysis indicates that price developments should remain in line with price stability over the medium term.~~To sum up, taking into account today's decisions, the economic analysis indicates that we may experience a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on. A **cross-check** with the signals from the monetary analysis confirms this picture.

~~As regards **fiscal policies**, euro area countries should not unravel their efforts to reduce deficits and put high government debt ratios on a downward path. 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.~~As regards **fiscal policies**, the euro area budget deficit is projected to decline further from 3.1% of GDP in 2013 to 2.5% in 2014, according to the European Commission's autumn 2013 economic forecast. At the same time, the euro area government debt ratio is expected to rise from 95.5% of GDP in 2013 to 95.9% in 2014. In order to put high public debt ratios on a downward path, governments should not unravel their efforts to reduce deficits and sustain fiscal adjustment over the medium term. 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. 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~~Progress has been made in reducing current account deficits and unit labour cost differentials, but substantial efforts still need to be undertaken with a view to further improving competitiveness ~~and to rebalance~~, supporting rebalancing within the euro area~~, but also to create~~ and creating more flexible and dynamic economies that in turn generate sustainable economic growth and employment.

DISCLAIMER