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ECB Watch

Europe

Madrid, 6 March 2014
Economic Analysis

Financial Scenarios

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No action taken (and none foreseen)

- **The ECB left interest rates unchanged and took no non-standard measures.**
- **Inflation forecasts for 2016 well below 2%.**
- **No hints of policy change in the near term.**

At today's monetary policy meeting the ECB left the key policy rate unchanged at 0.25% and took no additional steps on non-standard measures. Mr. Draghi said that there was a broad discussion within the Governing Council (GC) on the possibility of changes in interest rates as well as about other monetary policy instruments. Medium-term inflation risks remain "broadly balanced" and risks to the economic outlook continue to be on the downside. A geopolitical risk has been added. The tone remained dovish and the easing bias was retained.

Mr. Draghi once again used verbal intervention to strengthen his forward guidance (exists a "high degree of unutilised capacity" in the economy and "our accommodative monetary policy stance will remain in place although we see an improvement in the economy"). He was also more explicit than usual on the role of the exchange rate in inflation and, hence, on monetary policy, by recognizing that the euro appreciation since its trough in 2012 had reduced inflation by around 0.4pp.

On the staff projections, the key was the inflation outlook for 2016, which has been published ahead of the usual schedule by request of the Governing Council. The average inflation projection is 1.5% for the whole year; while Mr Draghi clarified that it is 1.7% for 4Q. We would have expected such a forecast to be matched by some policy action, as in our view, these figures are not fully consistent with their target. Nonetheless, Mr. Draghi justified the lack of action by saying that there are global factors that underlie current low inflation rates, such as lower commodity prices, the strength of the euro, but also the ongoing price adjustment in peripheral countries.

Projections for GDP and HICP inflation for 2014 and 2015 remain broadly unchanged. GDP growth has been revised upwards by only 0.1pp to 1.2% in 2014 and remains unchanged at 1.5% for 2015 (BBVA Research: 1.1% and 1.9%), while inflation has been revised slightly downwards to 1% in 2014 and has been kept at 1.3% in 2015 (BBVA Research: 1% and 1.4%). Overall, the forecasts revision was in line with expectations.

During the Q&A, the focus was on why the ECB did not take any action today, as we (and some other analysts) were expecting. Mr Draghi stressed that none of the contingencies that would prompt the central bank to act (an unwarranted tightening in money markets and a worsening of the inflation outlook) had taken place. The economy is recovering slowly, in line with the central bank baseline scenario, and recent macro data over the past month was mostly positive.

Mr Draghi seemed to downplay the potential role of other instruments available for eventual further policy action. In particular, on the revitalization of the ABS market, he made clear that it was not easy as it required regulatory changes. For the first time, he also mentioned that, among the instruments available, a QE programme could be used. He left the door open to ending the sterilization of SMP purchases, though only if money market developments justify it. However, he also seemed to minimize its potential impact. In addition, Mr Draghi stressed that many problems in the eurozone (and, in particular, financial market fragmentation) are of a structural nature and require structural measures to tackle them.

What to expect for coming months? Once it has become clear that the ECB is ready to accept inflation of 1.5% in 2016 without taking further action, the expectation of further measures in the short-term in the absence of sizeable shocks is very low. Mr. Draghi had put a great emphasis that on this meeting there would be more information to decide. Having opted to do nothing in a context of inflation significantly below 2% for a long period of time, he has shaken off any expectation of future action absent any shock. Contrary to what has been the case over the last two months, now monetary policy expectations will be aligned towards no action.

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, Frankfurt am Main, 6 ~~February~~March 2014

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.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. Incoming information confirms that the moderate recovery of the euro area economy is proceeding in line with our previous assessment. At the same time, ~~underlying price pressures in~~ the ~~euro area remain weak and monetary and credit dynamics are subdued. Inflation expectations for~~latest ECB staff macroeconomic projections, now covering the ~~euro area over~~ period up to the ~~medium to long term continue to be firmly anchored in line with our aim~~end of ~~maintaining inflation rates below, but close to, 2%. As stated previously, we are now experiencing~~ 2016, support earlier expectations of a prolonged period of low inflation, ~~which will~~to be followed by a gradual upward movement in HICP inflation rates towards levels closer to 2%. In keeping with this picture, monetary and credit dynamics remain subdued. 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~~% later on.~~ %.

Regarding the medium-term outlook for prices and growth, ~~further~~ the information and analysis ~~will become~~ now available ~~in early March. Recent evidence~~ fully ~~confirms~~ confirm our decision to maintain an accommodative ~~stance of~~ monetary policy stance for as long as necessary~~, which~~. This will assist the gradual economic recovery in the euro area. We firmly reiterate our forward guidance. We continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy, the high degree of unutilised capacity and subdued ~~monetary dynamics. With regard to recent~~ money ~~market volatility and its potential impact on our monetary policy stance, we~~and credit creation.

We are monitoring developments on money markets closely and are ready to consider all ~~available~~ instruments available to us. Overall, we remain firmly determined to maintain the high degree of monetary accommodation and to take further decisive action if required.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Following two quarters of positive real GDP growth, developments in recent data and surveys overall suggest that the moderate recovery continued in the last quarter of 2013.~~Real GDP in the euro area rose by 0.3%, quarter on quarter, in the last quarter of 2013, thereby increasing for three consecutive quarters. Developments in survey-based confidence indicators up to February are consistent with continued moderate growth also in the first quarter of this year. Looking ahead, ~~our previous assessment of economic growth has been confirmed. Output in the euro area~~ the ongoing recovery is expected to ~~recover~~proceed, albeit at a slow pace. In particular, some further improvement in domestic demand should materialise, supported by the accommodative monetary policy stance, improving financing conditions and the progress made in fiscal consolidation and structural reform~~s~~. In addition, real incomes are supported by lower energy ~~price inflation.~~prices. Economic activity is also expected to benefit from a gradual strengthening of demand for euro area exports. At the same time, although unemployment in the euro area is stabilising, it remains high, and the necessary balance sheet adjustments in the public and ~~the~~ private ~~sector~~sectors will continue to weigh on the pace of the economic recovery.

~~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, notably in~~ This assessment is also broadly reflected in the March 2014 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 1.2% in 2014, 1.5% in 2015 and 1.8% in 2016. Compared with the December 2013 Eurosystem staff macroeconomic projections, the projection for real GDP growth for 2014 has been revised slightly upwards.

The risks surrounding the economic outlook for the euro area continue to be on the downside. Developments in global financial markets and in emerging market economies, as well as geopolitical risks, may have the potential to ~~negatively~~ affect economic conditions negatively. Other downside risks include weaker than expected domestic demand and export growth and ~~slow or~~ insufficient implementation of structural reforms in euro area countries.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.~~7~~8% in February 2014, unchanged from the (upwardly revised) outcome for January~~ 2014, after 0.8%~~. While energy prices fell more strongly in ~~December. This decline was mainly due to energy price developments. At~~ February than in the ~~same time, the inflation rate~~previous month, increases in industrial goods and services prices were higher than in January~~ 2014 was lower than generally expected .~~. On the basis of current information and prevailing futures prices for energy, annual HICP inflation rates are expected to remain at around current levels in the coming months. ~~Over the medium term, underlying price pressures in the euro area are expected to remain subdued. 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%~~Thereafter, inflation rates should gradually increase and reach levels closer to 2%, in line with inflation expectations for the euro area over the medium to long term.

~~Both upside and downside risks to the outlook for price developments remain limited, and they continue to be broadly balanced over the medium term.~~

~~Turning to the **monetary analysis**, data for December 2013 confirm the assessment of subdued underlying growth in broad money (M3) and credit. Annual growth in M3 moderated to 1.0% in December, from 1.5% in November. Deposit outflows in December mirrored the strong sales of government and private sector securities by euro area MFIs, which, in part, could be related to adjustments by banks in anticipation of the ECB's comprehensive assessment of banks' balance sheets. These developments also affected annual growth in M1, which moderated to 5.8% in December but remained strong.~~This assessment is also broadly reflected in the March 2014 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.0% in 2014, 1.3% in 2015 and 1.5% in 2016. In the last quarter of 2016, annual HICP inflation is projected to be 1.7%. In comparison with the December 2013 Eurosystem staff macroeconomic projections, the projection for inflation for 2014 has been revised slightly downwards. In view of the first publication of a three-year projection horizon in the March 2014 ECB staff macroeconomic projections, it should be stressed that the projections are conditional on a number of technical assumptions, including unchanged exchange rates and declining oil prices, and that the uncertainty surrounding the projections increases with the length of the projection horizon.

Regarding the Governing Council's risk assessment, both upside and downside risks to the outlook for price developments are seen as limited and are considered to be broadly balanced over the medium term.

Turning to the **monetary analysis**, data for January 2014 confirm the assessment of subdued underlying growth in broad money (M3) and credit. Annual growth in M3 increased to 1.2% in January, from 1.0% in December. The monthly inflow to M3 in January was substantial, compensating for the strong outflow in December. The increase in M3 growth reflected a stronger annual growth rate of M1, which rose to 6.2% from 5.7% in December. As in previous months, the main factor supporting annual M3 growth was an increase in the MFI net external asset position, which continued to reflect the increased interest of international investors in euro area assets. The annual rate of change of loans to the private sector continued to contract. ~~The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.3% in December, broadly unchanged since the beginning of 2013.~~ The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was -2.9% in ~~December, after -3.1% in November. The January 2014 bank lending~~

~~survey provides indications of some further stabilisation in credit conditions for firms and households and a smaller net decline in loan demand by enterprises. Overall, weak~~January, unchanged from December. Weak loan dynamics for non-financial corporations continue to reflect their lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.2% in January 2014, broadly unchanged since the beginning of 2013.

Since the summer of 2012 substantial progress has been made in improving the funding situation of banks. 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. This is the objective of the ~~ECB's~~ongoing comprehensive assessment by the ECB, while ~~the~~ a timely implementation of additional steps to establish a banking union will further help to restore confidence in the financial system.

To sum up, the economic analysis confirms our expectation of a prolonged period of low inflation, to be followed by a gradual upward movement towards levels of inflation ~~rates below, but close~~closer to~~,~~ 2~~% later on.~~%. A **cross-check** with the signals from the monetary analysis confirms the picture of subdued underlying price pressures in the euro area over the medium term.

As regards **fiscal policies**, the ECB staff macroeconomic projections indicate continued progress in reducing fiscal imbalances in the euro area. The aggregate euro area general government deficit is expected to have declined to 3.2% of GDP in 2013 and is projected to be reduced further to 2.7% of GDP this year. General government debt is projected to peak at 93.5% of GDP in 2014, before declining slightly in 2015. Looking ahead, euro area countries should not unravel past consolidation efforts and should put high government debt ratios on a downward trajectory over the medium term. Fiscal strategies should be in line with the Stability and Growth Pact and should ensure a growth-friendly composition of consolidation which combines improving the quality and efficiency of public services with minimising distortionary effects of taxation. ~~When accompanied by~~National authorities should also continue with the decisive implementation of **structural reforms**~~, these strategies will further support the still fragile economic recovery. Governments must therefore continue with product and labour market reforms. These reforms will help to enhance the~~ in all euro area~~'s growth potential and reduce the high unemployment rates in many~~ countries. These reforms should aim, in particular, to make it easier to do business and to boost employment, thus enhancing the euro area's growth potential and reducing unemployment in the euro area countries. To this end, the Governing Council welcomes the European Commission's communication of yesterday on the prevention and correction of macroeconomic imbalances and on the Excessive Deficit Procedure. Looking ahead, it is key that the macroeconomic surveillance framework in the euro area, which was significantly strengthened in the wake of the sovereign debt crisis, is implemented fully and in a consistent manner.

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