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ECB Watch

Europe

Madrid, 5 December 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

Europe

Miguel Jiménez
mjimenezg@bbva.com

Agustín García
agustin.garcia@bbva.com

Wait and see stance

- **Rates were kept unchanged while inflation projections were slightly modified, as expected**
- **The ECB is fully aware of the downward bias, retaining its dovish stance**
- **No specific measures were discussed, but Mr Draghi mentioned discussions on negative deposit rates, a new LTRO and the non-sterilisation of SMP**

As expected, 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 liquidity measures. No rate cut was proposed at today's meeting. Mr. Draghi reiterated that the monetary stance will continue to be accommodative for as long as necessary, maintaining intact the forward guidance provided in July while staying ready to use any available instrument. On the Committee´s economic outlook, inflation was revised as expected while medium-term inflation risks were kept as "broadly balanced" and risks to the economic outlook was kept on the downside.

The Staff´s updated forecasts gathered attention, as they shed more light on the ECB's inflation expectations for 2015 and on whether the negative surprises registered in September and October had increased the ECB's perception of deflation risks (which seem to have determined the interest rate cut a month ago). In general, the forecasts came in line with expectations: annual HICP inflation was revised down for 2013 and 2014 (to 1.4% and 1.1%, respectively), and was kept constant for 2015 (1.3%) with the 95% lower limit of the forecast interval clearly above zero in the forecast horizon. The ECB continues to see balanced risks to this base scenario (upside risks stemming from commodity and administered prices and downward risks from a weaker-than-projected domestic demand), while medium-term inflation expectations remain firmly anchored (Draghi stressed that this is one of the main differences with the Japanese deflationary episode). Growth forecasts were kept virtually unchanged: -0.4% for this year, 1.1% for 2014 (+0.1pp higher than September´s forecast) and 1.5% for 2015. These forecasts, both for growth and inflation, are very much in line with our own projections.

Mr. Draghi took the opportunity to make a strong defence of November´s rate cut. He emphasized that the action was "fully justified" and that it had clarified their reaction function. He added that this assessment is now shared by some Governing Council (GC) members that voted not to cut rates last month ("dissenters"). The ECB president stressed that some positive developments have occurred after last month's rate cut, i.e bank-bond issuance has picked up even in stressed countries and yields of many non-core government bonds have gone down (together with the yields of senior unsecured bank bonds). This is correct, although some of these market developments were already taking place before last month´s rate cut. Mr Draghi did not mention last month´s appreciation of the exchange rate.

In the press conference, attention was also put on the instruments available. Mr. Draghi reiterated that the GC is “ready and able to act within the forward guidance framework” but insisted that the GC had not considered any “specific instrument" at today's meeting. When he was asked about the possibility of a negative deposit rate, he said that it was discussed only “briefly”. On the possibility of a new LTRO, Mr. Draghi stressed the difference between financial markets now and back when the ECB launched its 3-year LTRO in 2011: "We view the LTRO as a very successful monetary policy measure… but the funding situation was severely stressed at the time. Today, fortunately, the situation is substantially different." Moreover, he stressed that if the ECB launches a new liquidity injection, it would monitor very carefully that the funds reach the real economy, something that did not happen with most of the liquidity provided through its 3-year LTROs. In particular, he said that "if we do a similar operation, we want to make sure this is being used for the economy; to make sure this is not going to be used for subsidising capital formation in the banking system." As a result, we do not see any immediate action on non-standard measures, with any new LTRO being probably submitted to some kind of conditionality. Finally, Mr Draghi mentioned that the GC also discussed the possibility of not sterilising SMP.

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, ~~7 November~~ 5 December 2013

Ladies and gentlemen, I am very pleased to welcome you to our press conference. I will now report on the outcome of today's meeting of the Governing Council, ~~during~~ which ~~we took a number of decisions on key ECB interest rates, forward guidance and liquidity provision~~was also attended by the Commission Vice-President, Mr Rehn.

~~First, based~~Based on our regular economic and monetary analyses, we decided to ~~lower~~keep the **key ECB 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~~**rates** unchanged. Incoming information and analysis have confirmed our assessment and monetary policy decisions of last month. Underlying price pressures in the euro area are expected to remain subdued 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. 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%. 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~~Our monetary policy stance will remain accommodative for as long as necessary~~. It~~, and will thereby ~~also~~ continue to assist the gradual economic recovery ~~as reflected in confidence indicators up to October.~~

~~Second, following today's rate cut,~~ in the euro area. In this context, the Governing Council ~~reviewed the~~confirmed its forward guidance ~~provided in July and confirmed~~ that it 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 overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy and subdued monetary dynamics.

~~Third, we continue to monitor closely~~ With regard to money market conditions and their potential impact on our monetary policy stance~~. We~~, we are monitoring developments closely and 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.~~Following a rise of 0.3% in the second quarter of 2013, real GDP in the euro area increased by 0.1%, quarter on quarter, in the third quarter. Developments in survey-based confidence indicators up to ~~October~~November are consistent with ~~continued, albeit modest,~~a positive growth rate also in the ~~second half~~fourth quarter of the year. Looking ahead to 2014 and 2015, output is expected to ~~continue to~~ recover at a slow pace, in particular owing to ~~a gradual~~some improvement in domestic demand supported by the accommodative monetary policy stance. Euro area economic activity should, in addition, benefit from a gradual strengthening of demand for exports. Furthermore, the overall improvements in financial markets seen since last 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~~At the same time, unemployment in the euro area remains high, and the necessary balance sheet adjustments in the public and the private sector~~s~~ will continue to weigh on economic activity.

This assessment is also reflected in the December 2013 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP declining by 0.4% in 2013 before increasing by 1.1% in 2014 and 1.5% in 2015. Compared with the September 2013 ECB staff macroeconomic projections, the projection for real GDP growth for 2013 has remained unchanged and it has been revised upwards by 0.1 percentage point for 2014.

The risks surrounding the economic outlook for the euro area ~~continue~~are assessed 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, 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 ~~decreased in October~~increased in November 2013 to 0.~~7~~9%, from ~~1.1~~0.7% in ~~September. This decline was stronger than~~ October. The increase was broadly as expected and reflected, in particular, ~~lower food price inflation, a larger fall~~an upward base effect in energy prices and ~~some weakening in~~ higher services price inflation. On the basis of ~~current~~ prevailing futures prices for energy, annual inflation rates are expected to remain at ~~low~~ around current levels in the coming months. ~~Underlying~~Over the medium term, 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 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~~.

~~Taking into account today's decisions, the~~ Broadly in line with this assessment, the December 2013 Eurosystem staff macroeconomic projections for the euro area foresee annual HICP inflation at 1.4% in 2013, at 1.1% in 2014 and at 1.3% in 2015. In comparison with the September 2013 ECB staff macroeconomic projections, the projection for inflation for 2013 has been revised downwards by 0.1 percentage point and for 2014 it has been revised downwards by 0.2 percentage point.

The risks to the outlook for price developments are seen to be broadly balanced over the medium term. Upside risks relate ~~in particular~~ to higher commodity prices ~~as well as~~ and stronger than expected increases in administered prices and indirect taxes, ~~and~~ while downside risks stem from weaker than expected economic activity.

Concerning the staff macroeconomic projections, let me inform you that the Governing Council has decided to publish more details as of December 2013. You will receive this material today after the press conference.

Turning to the **monetary analysis**, data for ~~September~~ October confirm the assessment of subdued underlying growth ~~of~~ in broad money (M3) and~~, in particular,~~ credit. Annual growth in M3 moderated to 1.4% in October, from 2.~~1~~0% in September~~, from 2.3% in August.~~. This moderation was partly related to a base effect. Annual growth in M1 remained strong at 6.6%, reflecting a preference for liquidity, although it was below the peak of 8.7% 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 0.3% in ~~September~~October, broadly unchanged since the ~~turn~~beginning of the year. The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was -2.~~7~~9% in October, following -2.8% in September~~, compared with~~ and -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. 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. 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, ~~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**, 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.~~As regards **fiscal policies**, the Governing Council welcomes the European Commission's assessment of the 2014 draft budgetary plans which were submitted in October for the first time under the "two-pack" regulations. This new surveillance exercise needs to be fully effective. 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~~In particular, consolidation measures should be ~~geared towards~~ growth-friendly ~~measures which~~ and have a medium-term perspective~~ and combine improving the quality~~ , so as both to improve public services and ~~efficiency of public services with minimising~~ minimise the distortionary effects of taxation. ~~Governments must also decisively strengthen efforts to implement the needed **structural reforms** in product and labour markets. 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, supporting rebalancing within the euro area and creating more flexible and dynamic economies that in turn generate sustainable economic growth and employment~~At the same time, there is a need to push ahead with **product and labour market reforms**, in order to improve competitiveness, raise potential growth, generate employment opportunities and foster the adaptability of our economies.

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