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ECB Watch

Europe

Madrid, 6 February 2014
Economic Analysis

Financial Scenarios

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Waiting until March

- **Rates were kept unchanged. The GC says it needs more information before taking any action**
- **The ECB does not see any deflationary dynamics in the euro area**
- **Macroeconomic forecasts for 2016 will be released in March**

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 measures. Mr Draghi said that there was "broad discussion" within the Governing Council (GC) but they decided to wait until more information was available. "The reason for today's decision not to act has really to do with the complexity of the situation ... and the need to acquire more information." He announced that they will have more information in March as for first time the macroeconomic projections by the staff will have a first look at 2016 (our projection for that year is 1.8% under the assumption of a swift recovery in the eurozone). He reiterated that they will take a "decisive" action if needed while he also pledged that monetary policy would remain "accommodative" as long as necessary.

At the press conference, the focus was on the risk of deflation. Mr Draghi stressed that they do not see deflationary dynamics, clarifying that they observe relative-price adjustments rather than any deflationary process. However, he recognized the risks of having "low inflation for an extended, protracted period of time," which warrants close attention by the ECB. We think that the low but positive growth numbers expected for the coming months imply that a strong disinflationary process is unlikely to last. We forecast that inflation will fall slightly over 1Q14 and gradually rebound after that.

Mr. Draghi remained cautious on the economic outlook. He stated that the recovery is proceeding, but he warned that it continues "fragile and uneven". The statement included a reference to the recent volatility in emerging markets and its potential effect on activity. Mr Draghi said that "the reasons for this situation are quite complex and are outside the control of the euro area policy authorities," but he stressed that the region has shown "a good deal of resilience."

With regard to the other contingency that would prompt the central bank to act (the unwarranted tightening in money markets), the statement included a reference to the recent volatility in money markets. However, at the Q&A Mr. Draghi played down this development, stating that this volatility manifested in the short-term part of the curve and was not transmitted to the long-term (thanks to the positive effect of the ECB´s forward guidance).

At today's meeting, Mr. Draghi reiterated that the central bank is ready to consider all available instruments allowed by the Treaty. In particular, when he was asked about the possibility to buy ABS (asset backed securities) he highlighted that this could be an important instrument "for revitalizing credit flows and for our own monetary policy." In our view, the probability that the ECB will take further measures in March is high, given the pressure from the weak inflation outlook, although it is not a foregone conclusion. Regarding the measures within its toolkit, we consider that given the low level of the refi rate, a rate cut would be a very gradualist measure and on its own would probably not be enough. If the ECB reacts, it should be through a combination of different measures in order to be effective.

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, ~~9 January~~6 February 2014

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~Let me wish you all a Happy New Year. I would also like to take this opportunity to welcome Latvia as the eighteenth country to adopt the euro as its currency. Accordingly, Mr Rimšēvičs, the Governor of Latvijas Banka, became a member of the Governing Council on 1 January 2014.~~ 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 ~~and analysis have continued to confirm our~~ confirms that the moderate recovery of the euro area economy is proceeding in line with our previous assessment. ~~Underlying~~At the same time, underlying price pressures in the euro area ~~are expected to~~ remain weak and monetary and credit dynamics are subdued ~~over the medium term. In keeping with this picture, monetary and credit dynamics remain subdued. At the same time, inflation~~ . 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%. As stated previously, we are ~~firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%. Such a constellation continues to suggest that we may experience~~now experiencing a prolonged period of low inflation, ~~to~~ which will be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on. ~~Against this background, the Governing Council strongly emphasises that it will~~ Regarding the medium-term outlook for prices and growth, further information and analysis will become available in early March. Recent evidence fully confirms our decision to maintain an accommodative stance of monetary policy for as long as necessary, which will assist the gradual economic recovery in the euro area. ~~Accordingly, we~~We firmly reiterate our forward guidance ~~that we~~. We continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time. ~~As previously stated, this~~ This expectation is 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. With regard to recent money market ~~conditions and their~~ volatility and its potential impact on our monetary policy stance, we are monitoring developments closely and are ready to consider all available instruments. 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**. ~~Real GDP in the euro area rose by 0.1%, quarter on quarter, in the third quarter of 2013, following an increase of 0.3% in the second quarter. While developments in industrial production data for October point to a weak start to the fourth quarter, survey-based confidence indicators up to December have improved further from low levels, overall indicating a continuation of the gradual recovery in economic activity. Looking at 2014 and 2015, output~~ 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. Looking ahead, our previous assessment of economic growth has been confirmed. Output in the euro area is expected to recover at a slow pace~~, in~~. In particular~~ owing to~~, some improvement in domestic demand should materialise, supported by the accommodative monetary policy stance~~. Euro area economic activity should, in addition,~~, improving financing conditions and the progress made in fiscal consolidation and structural reforms. In addition, real incomes are supported by lower energy price inflation. Economic activity is also expected to benefit from a gradual strengthening of demand for euro area exports. ~~Furthermore, the overall improvements in financial markets seen since the summer of 2012 appear to be working their way through to the real economy, as should the progress made in fiscal consolidation. In addition, real incomes have benefited recently from lower energy price inflation.~~ 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 will continue to weigh on the pace of the economic ~~activity~~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 emerging market economies, 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 was 0.7% in January 2014, after 0.8% in December~~ 2013, compared with 0.9% in November. This outcome was broadly as expected and reflected lower services price inflation.~~. This decline was mainly due to energy price developments. At the same time, the inflation rate 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. ~~At the same time, inflation~~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%.

~~The~~Both upside and downside risks to the outlook for price developments remain limited, and they continue to be ~~seen as~~ broadly balanced over the medium term~~, with upside risks relating to higher commodity prices and 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 ~~November support~~December 2013 confirm the assessment of ~~continued~~ subdued underlying growth in broad money (M3) and credit. Annual growth in M3 ~~was broadly unchanged at~~ moderated to 1.0% in December, from 1.5% in November~~, after 1.4% in October, following two consecutive declines in September and August. Annual growth in M1 remained strong at 6.5%, reflecting a preference for liquidity, although it was below the peak of 8.7% observed in April 2013.~~. 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. 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 ~~remained weak.~~continued to contract. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.3% in ~~November~~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 -~~3.1~~2.9% in ~~November, following -3.0~~December, after -3.1% in ~~October.~~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 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.

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 forthcoming comprehensive assessment by the ECB 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~~This is the objective of ~~necessary corrective actions. A~~ the ECB's comprehensive assessment, while the timely implementation of ~~further~~ additional steps to establish a banking union will further help to restore confidence in the financial system.

To sum up, the economic analysis ~~indicates that we may experience~~ confirms our expectation of 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~~the picture of subdued underlying price pressures in the euro area over the medium term.

As regards **fiscal policies**, ~~it is important~~ euro area countries should not ~~to~~ unravel past consolidation efforts ~~but to sustain fiscal consolidation~~ and should put high government debt on a downward trajectory over the medium term. Fiscal strategies should be in line with the ~~fiscal compact~~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 the decisive implementation of **structural reforms**, ~~this~~these strategies will further support the ~~gradual~~still fragile economic recovery~~ in~~. Governments must therefore continue with product and labour market reforms. These reforms will help to enhance the euro ~~area and have a positive impact on public finances. Reforms in product and labour markets and a rigorous enactment of Single Market policies warrant particular focus to improve the outlook for economic~~area's growth ~~and to foster job creation in an environment of~~ potential and reduce the high unemployment rates in many countries.

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