RESEARCH

ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Slight change in numbers, but no change in mood

- **Rates unchanged, but not by unanimity**
- **No hints of policy change in the near term**
- **Slight downward revision of ECB´s projections, but general outlook barely changes**

As expected, the ECB Governing Council (GC) left the key policy rate unchanged at 0.75%. But today´s decision was reached with a "prevailing consensus", a shift from the previous ECB meeting in which the same decision was taken by unanimity. The GC also discussed a potential deposit rate cut, although they discarded it due to the “serious consequences of a measure like that”; this suggests that it is unlikely that the ECB will recur to this measure in the future. Mr. Draghi said that the outlook for price development continues to be seen as broadly balanced over the medium term, while risks for the economic outlook continue to be on the downside. As for future policy actions, Mr. Draghi stood to the usual line that the GC “would not pre-commit to anything in the future,” and reiterated that monetary policy will remain "accommodative" as long as needed, including full-allotment mode of liquidity provision.

In its quarterly review, the ECB downgraded its growth projections for 2013 and 2014. The 2013 GDP growth figure was revised down by 0.2pp due to a more negative carry-over effect from 4Q12´s lower-than-expected GDP, but the projected path of the recovery has remained broadly unchanged. Regarding their technical assumptions, the main change with respect to December is their new assumption on the Eurodollar (now expected to be at 1.35 in 2013 and 2014); but such forecasts were updated with information until 14 February 2013, and do not consider the fact that the euro is now back to around 1.30 dollars. Their assumption implies an effective exchange rate appreciation of 4.2% in 2013 and of 0.1% in 2014, which contrasts with the 0.9% depreciation previously expected for 2013. This new assumption may be detracting at least 0.1pp of growth from their current projections.

A gradual recovery is expected during the second half of the year. In previous meeting, the ECB was more ambiguous, as they expected a gradual recovery later in the year. In contrast, we already expect slight economic growth in 1Q13 (MICA BBVA around 0.1-0.2% QoQ for the eurozone). Nonetheless, very limited hard data have been published and the ECB will have to follow soft indicators in order to confirm this projection.

All in all, the downward revision of growth projections by the ECB was a small surprise. We expected it to be negatively affected by the carryover from Q4´s worse-than-expected data, but we also thought that the ECB would include recent months’ improvements in confidence indicators, mostly from Germany. Indeed, Mr Draghi already pointed out in December that such soft data provided a positive signal, somewhat contrasting with the sharp negative revision of projections they published at the time. The ECB´s still negative outlook may have been affected by the latest (and less positive) PMI data from services, the uncertainties attached to the Italian political process, and by France´s somewhat disappointing macro results.

Inflation projections, and their underlying drivers, are in line with our forecast. In particular, according to the ECB’s technical assumptions, the expected appreciation of the euro should offset higher oil prices. In the Q&A round, Draghi was asked about deflation risks, responding that he only saw lower prices in some products, in some sectors, in some countries, but not a generalized fall in prices across sectors and countries that would correspond with the definition of deflation.

During the Q&A, Mr. Draghi stressed the importance of reducing fragmentation in credit markets, in order to ensure an adequate transmission of monetary policy to financing conditions in euro-area countries, also noting that there are several signs indicating a reduction of fragmentation. He also added that LTRO repayments are a sign of improved confidence. But he showed no complacency, highlighting that funding to SMEs continues fragile and that fragmentation continues at high levels.

Mr. Draghi made clear that the OMT mechanism was not designed to trigger countries return to markets. He added that countries should be on the markets 'by themselves", issuing "certain quantities"… "along the yield curve" and reaching a "broad category of investors."

Table 1
Macroeconomic Projections

		ECB Staff					
		Dec-12		Mar-13		BBVA Resarch	
		2013	**2014**	**2013**	**2014**	**2013**	**2014**
GDP	Interval estimation	(-0.9 ; 0.3)	(0.2 ; 2.2)	(-0.9 ; -0.1)	(0.0 ; 2.0)		
	Point estimation	-0.3	1.2	-0.5	1.0	0.3	1.3
HICP	Interval estimation	(1.1 ; 2.1)	(0.6 ; 2.2)	(1.2 ; 2.0)	(0.6 ; 2.0)		
	Point estimation	1.6	1.4	1.6	1.3	1.6	1.5

Source: ECB

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, Vítor Constâncio, Vice-President of the ECB, Frankfurt am Main, 7 ~~February~~March 2013

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. HICP inflation rates have declined further, as anticipated, and ~~are expected to fall~~ fell below 2% in ~~the coming months.~~February. Over the policy-relevant horizon, inflationary pressures should remain contained. The underlying pace of monetary expansion continues to be subdued. ~~Medium to longer-term inflation~~Inflation expectations for the euro area remain firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2~~%.~~% over the medium term. Overall, this ~~allows~~will allow our monetary policy stance to remain accommodative. ~~The~~ Available data continue to signal that economic weakness in the euro area ~~is expected to prevail in the early part of 2013. In particular,~~ has extended into the beginning of the year, while broadly confirming signs of stabilisation in a number of indicators, albeit at low levels. At the same time, necessary balance sheet adjustments in the public and private sectors will continue to weigh on economic activity. Later in 2013 economic activity should gradually recover, supported by a strengthening of global demand and our accommodative monetary policy stance~~, the improvement in financial market confidence and reduced fragmentation, as well as a strengthening of global demand~~. In order to ~~sustain~~support confidence, it is essential for governments to ~~reduce~~continue implementing structural reforms, to build further ~~both~~ on the progress made in fiscal ~~and structural imbalances~~consolidation, and to proceed with financial sector restructuring.

With regard to the liquidity situation of banks, counterparties have so far repaid €~~140.6~~ 224.8 billion of the €~~489.2~~ 1,018.7 billion obtained in the ~~first of the~~ two three-year longer-term refinancing operations (LTROs) settled in ~~December~~ December 2011 and ~~March~~ March 2012. ~~This reflects the improvement in financial market confidence. Repayments are provided for in the modalities of the three-year LTROs and are at the discretion of the counterparties, who must appropriately assess their funding situation, their ability to provide new loans to the economy and their resilience to shocks.~~In net terms, this implies that, of the increase in the outstanding volume of bank refinancing through the ECB's monetary policy operations of around €500 billion between mid-December 2011 and early March 2012, about €200 billion have now been repaid. These repayments reflect improvements in financial market confidence over the last few months and receding financial market fragmentation. We ~~will~~ are closely ~~monitor~~monitoring conditions in the money market and their potential impact on the stance of monetary policy~~, which~~ and the functioning of the transmission of our monetary policy to the economy. Our monetary policy stance will remain accommodative with the full allotment mode of liquidity provision.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Euro area real GDP declined by 0.1%, quarter on quarter, in the third quarter of 2012, following a contraction of 0.2% in the second quarter. Available data continue to signal further weakness in activity in the fourth quarter and at the beginning of 2013. This weakness reflects the adverse impact of low consumer and investor sentiment on domestic expenditure, as well as subdued foreign demand. However, financial market sentiment has improved and the latest survey indicators confirm earlier evidence of a stabilisation in business and consumer confidence, albeit at low levels. Later in 2013 a gradual recovery should start, with domestic demand being supported by our accommodative monetary policy stance, the improvement in financial market confidence and reduced fragmentation, and export growth benefiting from a strengthening of global demand~~The GDP outcome for the fourth quarter of 2012 was weak, with Eurostat's second estimate indicating a contraction of 0.6% quarter on quarter. The decline was largely due to a fall in domestic demand but also reflected weak exports. As regards 2013, recent data and indicators suggest that economic activity should start stabilising in the first part of the year. A gradual recovery should commence in the second part, with export growth benefiting from a strengthening of global demand and domestic demand being supported by our accommodative monetary policy stance. Furthermore, the improvements in financial markets since July last year and the continued implementation of structural reforms should work their way through to the economy. At the same time, necessary balance sheet adjustments in the public and private sectors, and the associated tight credit conditions, will continue to weigh on economic activity.

~~The risks surrounding the economic outlook for the euro area continue to be on the downside. They relate to the possibility of weaker than expected domestic demand and exports, slow implementation of structural reforms in the euro area, as well as geopolitical issues and imbalances in major industrialised countries which could both have an impact on developments in global commodities and financial markets.~~This assessment is also reflected in the March 2013 ECB staff macroeconomic projections for the euro area, which foresee average annual real GDP growth in a range between -0.9% and -0.1% in 2013 and between 0.0% and 2.0% in 2014. Compared with the December 2012 Eurosystem staff macroeconomic projections, the ranges have been revised slightly downwards. The revision for 2013 mainly reflects a more negative carry-over effect from the outcome for real GDP in the fourth quarter of 2012, while the projected path of the recovery has remained broadly unchanged.

The Governing Council continues to see downside risks surrounding the economic outlook for the euro area. The risks relate to the possibility of weaker than expected domestic demand and exports and to slow or insufficient implementation of structural reforms in the euro area. These factors have the potential to dampen the ~~ongoing~~ improvement in confidence and thereby delay the recovery.

According to Eurostat's flash estimate, euro area annual HICP inflation was ~~2.0% in January~~1.8% in February 2013, down from 2.~~2~~0% in ~~November and December and from 2.5% in October. On the basis of current futures prices for oil,~~January. The on-going decline in annual inflation rates mainly reflects the energy and food components of the price index. Looking ahead, while the monthly pattern of headline inflation rates ~~are expected to decline further to below 2% in the coming months. Over the policy-relevant horizon, in an~~ may be somewhat volatile, underlying price pressures should remain contained given the environment of weak economic activity in the euro area ~~and well-anchored long-term inflation expectations, underlying price pressures should remain contained~~. Inflation expectations are well-anchored and in line with price stability over the medium term.

~~Risks~~ The March 2013 ECB staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 1.2% and 2.0% in 2013 and between 0.6% and 2.0% in 2014. In comparison with the December 2012 Eurosystem staff macroeconomic projections, the ranges are broadly unchanged.

In the Governing Council's assessment, risks to the outlook for price developments continue to be seen as broadly balanced over the medium term, with upside risks relating to ~~higher~~ stronger than expected increases in administered prices and indirect taxes, as well as higher oil prices, and downside risks stemming from weaker economic activity ~~and, more recently, the appreciation of the euro exchange rate~~.

Turning to the **monetary analysis**, monetary figures for January 2013 support our assessment that the underlying pace of monetary expansion continues to be subdued. The annual growth rate of M3 ~~decreased to~~remained broadly unchanged at 3.5% in January, after 3.4% in December 2012~~.~~. The annual rate of growth of the narrow monetary aggregate, M1, increased to 6.7% from 6.3~~.8% in November. Shifts from overnight deposits to short-term time deposits led to a decrease in the annual rate of growth of M1, which declined to 6.2~~% in December~~, from 6.7% in November, and outflows from marketable instruments dampened overall M3 growth. A further strengthening in the~~ 2012. The deposit base of MFIs in a number of stressed countries ~~took place in December,~~ strengthened further in ~~combination with further capital inflows into the euro area, both of which continued to reduce fragmentation~~January.

The annual growth rate of loans ~~to the private sector~~ (adjusted for loan sales and securitisation) ~~remained negative in December. This mainly reflected ongoing negative annual growth of loans~~ to non-financial corporations~~, which was~~ stood at -1.5% in January, after -1.3% in December ~~after -1.5% in November. However,~~2012. The annual growth in MFI loans to households ~~remained broadly unchanged at~~ moderated slightly to 0.5%, from 0.7% in December. To a large extent, subdued loan dynamics reflect the current stage of the business cycle, heightened credit risk and the ongoing adjustment ~~in the balance sheets~~ of ~~the~~ financial and non-financial ~~sectors. In line with these developments, the bank lending survey for the fourth quarter of 2012 confirms the weakness in credit demand and the continued effect of credit~~

~~risk considerations on the tightening of credit standards. At the same time, the survey confirms the positive impact of Eurosystem measures on banks' overall funding and liquidity situation. In particular, banks reported improvements across all funding categories in the fourth quarter~~sector balance sheets. At the same time, available information on the access to financing of non-financial corporates indicates tight credit conditions for small and medium-sized enterprises.

In order to ensure adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential to continue reducing fragmentation of euro area credit markets and strengthening the resilience of banks where needed. Decisive steps for establishing an integrated financial framework will help to accomplish this objective. The future ~~single supervisory mechanism~~Single Supervisory Mechanism (SSM) is one of the main building blocks~~. It is~~, together with a Single Resolution Mechanism (SRM). Both are crucial ~~move~~elements for moving towards re-integrating the banking system.

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.

~~As regards other policy areas, **structural reforms** and **fiscal adjustment** can complement each other, thereby improving the outlook for job creation, economic growth and debt sustainability. Past policy action is bearing fruit, in terms of both the unwinding of existing fiscal imbalances and the reduction of current account deficits. In particular, in several countries with particular adjustment needs, contained growth in unit labour costs signals greater price competitiveness and exports are performing better. Governments should build on the progress achieved in fiscal consolidation, strengthen competition in product markets and continue with labour market reforms. This would boost the euro area's growth potential, reduce high structural unemployment and improve the adjustment capacities of the euro area countries.~~

While the accommodative monetary policy stance will continue to support the recovery in the euro area, it is essential that **fiscal and structural policies** strengthen the prospects for economic growth over the medium term. As regards fiscal policies, the European Commission's 2013 winter forecast reflects progress in reducing fiscal imbalances in the euro area. The euro area-wide general government deficit is expected to have declined from 4.2% of GDP in 2011 to 3.5% of GDP in 2012 and is projected to be reduced further to 2.8% of GDP this year. Governments should build on this progress with a view to further restoring confidence in the sustainability of public finances. At the same time, fiscal consolidation must be part of a comprehensive structural reform agenda to improve the outlook for job creation, economic growth and debt sustainability. In the view of the Governing Council, it is of particular importance at this juncture to address the current high long-term and youth unemployment. To this end, further product and labour market reforms are needed to create new job opportunities by supporting a dynamic, flexible and competitive economic environment.

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