Economic Research Department

EMU

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ECB Watch

Meeting: July 2nd 2009
Next meeting: August 6th 2009

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Wait and see mode, as expected

- **Policy rates remained unchanged at today's ECB council meeting.**
- **The key projections and messages did not change: current rates are appropriate but the door is open to further cuts if they are deemed necessary.**
- **Mr Trichet welcomed the success of the recent long-term liquidity auction, but did not specify what will happen in future ones.**

Today's meeting lacked any significant news, as expected, perhaps aiming at the good old principle that boring central banks are good central banks. Policy rates were unchanged, as markets and all analysts were expecting.

These are in our view the main points of the statement and the press conference:

- For the ECB council, key policy rates (1% for *refi* operations, 0.25% for the deposit rate and 1.75% for the marginal rate) remain appropriate for the current conditions, which have not changed. However, Mr Trichet made clear in the Q&A (without being asked) that **they maintain their position of not closing the door to further cuts if they are necessary** ("we didn´t decide today that this was the lowest level").

- **The baseline outlook has not changed either**. Growth in the second quarter will be "less negative" than in the first one (which was -2.5% q/q). Here the statement said "much less negative" last month, but the change does not seem justified given that the deterioration of the outlook for Q2 over the last month has been very small and we still forecast activity to fall much less (-0.8% q/q) than in Q1. Positive growth continues to be expected for mid-2010 (our projection is slightly more positive as we forecast a temporary effect in the second half of the year from the fiscal stimulus).

- **The risks to economic activity remain balanced, with an eventual rise in oil prices added to the list of negative risk factors** (which includes also a stronger financial market turmoil, protectionism, more unfavourable labour markets and a disorderly correction of global imbalances). Risks to the inflation outlook are also broadly balanced, and the list of risk factors has not changed. The statement contains a new sentence recalling that the current negative rates of inflation, which are expected to continue for some months, will be “short-lived”, a point Mr Trichet reinforced in the press conference, probably in a effort to ensure that deflation fears are not entrenched in inflation expectations.

- There is also a nuance in the assessment from the monetary analysis, which corroborates “low” inflationary pressures (instead of “moderate” last month). This is probably reflecting the **continued weakness of loans to the private sector**, which have been flat or negative in recent months on a monthly basis. Mr Trichet was asked about this point in Q&A session, and responded that the extraordinary measures implemented recently (i.e. the purchase of covered bonds and in particular the liquidity injection provided last week through the first 12-month full allotment auction) were aimed at addressing this situation. He also said he saw an element of lack of supply behind these developments.

- **Mr Trichet said also he was “very happy” with the results from the auction last week** and with the reduction in Eonia rates closer now to the deposit rate. **He left the door open to changing the conditions of future long-term auctions** (“we’ll see when time comes”).

- On the future reversal of current measures from current measures, a matter of recent debate in public declarations among ECB council members, Mr Trichet said that measures have been designed such as to allow an easy exit strategy.

Markets’ reaction

Markets barely reacted. The euro depreciated against the dollar from 1.407 to 1.401. Interest rates fell very marginally, although this could have also been affected by bad US labour market data released at the same time as Mr Trichet spoke.

Conclusion

Not much has changed in terms of substance from last month, although **perhaps the tone was more dovish**. The ECB remains on hold, in a wait and see mode, especially after the success of the auction last week that has withheld pressure to take further easing measures. Mr Trichet was explicit in leaving a door open to further rates cuts in case the outlook changes, and **we maintain our baseline of one 25 bp cut after the summer and a further one in early 2010, with an upward risk that rates will remain stable at 1%**. In any case, the outlook is for low rates for a protacted period of time.

Box: ECB Statements

	April 2nd	May 7th	June 4th	July 2nd	Concluding remarks*
Monetary policy stance	We **will monitor very closely all developments** over the period ahead	We will monitor very closely all developments. **Rates are appropriate**	We will continue to monitor very closely all developments. **Rates are appropriate**. The GC will **ensure that the measures taken can be quickly unwound and the liquidity provided absorbed**.	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	**Monitor very closely.**
Growth	**Severe downturn in economic activity**. They projected gradual recovery in 2010 reflects the effects of the substantial macroeconomic stimulus under way as well as the extensive policy measures... to restore the functioning of financial markets. **The risks are being broadly balanced.**	**Economic activity in Q109 was significantly weaker than expected**. More recently, there have been some tentative signs in survey data of stabilization, but at very low levels. Gradually recovering in the course of 2010. **The risks remain broadly balanced.**	Fresh confidence data indicate that **economic activity over the remainder of this year is expected to decline at much less negative rates**. After a stabilization phase, **positive quarterly growth rates are expected by mid-2010**. This assessment incorporates adverse lagged effects, such as a **further deterioration in labor markets**.	**Economic activity over the remainder of this year** is expected to remain **weak but should decline less strongly than was the case in Q109**. Looking ahead into next year, after a phase of stabilization, **a gradual recovery with positive quarterly growth rates is expected by mid-2010**.	**Activity in coming quarters is expected to decline at less negative rates. Risks are balanced**
Inflation	**Inflation rates have decreased significantly** and are now **expected to remain well below 2% over 2009 and 2010**... Primarily reflects... commodity prices. However, signs of a more broad-based reduction are also increasingly emerging	Signs of a more broad-based **reduction in inflationary pressure are increasingly emerging**. HICP annual rates will decline further and temporary remaining at negative levels for some months by mid year. Thereafter, they will increase again, **remaining positive but below 2% in 2010**	The further decline in inflation rates was fully anticipated**, projecting further declines to negative rates in coming months, before returning to positive territory by the end of 2009**.	The fall of **annual inflation rates** into negative territory in June is in line with previous expectations and they **are projected to remain temporarily in negative territory over the coming months, before turning positives again**.	**Negative inflation rates by mid-year, remaining well below 2% in 2010. Inflation expectations remain firmly anchored**
Risks	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	**Broadly balanced**
Monetary analysis	**The pace of monetary expansion in the euro area has continued to decelerate markedly** and supports the assessment of **diminishing risk to price stability** in the medium-term.	**Continued deceleration in the pace of underlying monetary expansion**, supporting the assessment of **diminishing inflationary pressures** in the medium term.	**Continued deceleration in the pace of underlying monetary expansion** and thus support **the assessment of moderate inflationary pressures**.	Continue deceleration in monetary dynamics, supporting the assessment of a slower underlying pace of monetary expansion and **low inflationary pressures over the medium term**.	**Continued deceleration in the underlying pace of monetary expansion. Low inflationary pressures**
Movement	-0.25	-0.25	0.00	0.00	
“Refi” rate	1.25	1.00	1.00	1.00	

* BBVA interpretation of the ECB opinion according the statement and the press conference

Relevant events before the next ECB meeting (August 6th)

July, 3	Euro Area retail trade, May
July, 8	Euro Area national Accounts, Q109 second release
July, 14	Euro Area labour industrial production, May
July, 15	Euro Area inflation, June
July, 17	Euro Area trade balance, May
July, 17	Euro Area construction output, May
July, 22	Euro Area industrial new orders, May
July, 28	Euro Area monetary aggregates, June
July, 30	Euro Area business and consumer survey, July
July, 31	Euro Area flash estimate inflation, July
July, 31	Euro Area unemployment, June
August, 4	Euro Area industrial producer prices, June
August, 4	Euro Area PMI, June
August, 5	Euro Area retail trade, June