ECB Watch

Meeting: August 6th 2009
Next meeting: September 3rd 2009

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Still a wait and see mode

- **Both policy rates and messages remained unchanged at today's ECB council meeting.**
- **The ECB's view: current rates are appropriate and the ECB can implement the exit strategy in a timely manner. Our view, in contrast, is that weak economic conditions and risks of a deflationary episode justify the ECB lowering rates below the 1% level.**
- **Once more, Mr Trichet welcomed the success of the recent longer-term (one-year) liquidity auction, but did not specify if conditions for these auctions will be modified for the next one in September.**

Today's meeting was held in Frankfurt, and although it was followed by a press conference instead of the usual August written communiqué, it did not bring any surprise: **Policy rates remained unchanged at 1%, as expected by markets and all analysts.**

In our view the main points of the statement and the press conference are the following:

- 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.

- **President Trichet declined to make any specific comment regarding the Euro zone economy's medium-term outlook before the new ECB projections are released in September.** Yet as for the performance of the Eurozone's economy in Q2, Trichet commented that the pace of contraction will slow down. As for the medium-term, he was particularly vague and only commented that growth rates will return to the positive territory without and explicit mention of when this will happen. This contrasts to July's statement where it was explicitly acknowledged that recovery will take place by mid-2010.

- **The risks to economic activity remain balanced, with an eventual rise in oil prices and other commodities being added to the list of negative risk factors**, which already includes 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: a weak economy's outlook in the downside, and both commodity prices and fiscal consolidation in the upside.

- **The weakness of loans to the private sector and declining pace of monetary expansion remain.** However, the latest Banking Lending Survey gives some positive signs that credit will start to flow soon.

- With respect the negative inflation rates registered in June and July, Trichet reaffirmed the message that long-run inflation expectations are firmly anchored. However, we have some concerns that a protracted period of low inflation, such as our projections indicate it will happen over the next two years, might "unanchor" such expectations and therefore a deflationary spiral could realize.

- With respect the Bank of England unexpected decision of increasing its Asset Purchase Programme to additional 50 bn GBP (when the discussion in the last weeks has been about when they will stop the programme) one of the issues in the Q&A session was again the "exit strategy". Mr Trichet has reassured that "measures have been designed such as to allow an easy exit strategy".

Markets' reaction

As the decision was expected, there was not any significant market reaction.

Conclusion

We have modified baseline scenario and **official rates will remain stable at 1% for the next months until the ECB cuts rates by 50 bps in December.** Therefore, we have postponed the one 25 bp cut expected after the summer and advanced the further one expected for early 2010.

In the next September meeting, the ECB will release its new projections for the Eurozone's economy, and Trichet has advanced that these new forecasts will be "prudent and cautious".

Box: ECB Statements

	May 7th	June 4th	July 2nd	August 6th	Concluding remarks*
Monetary policy stance	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**.	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**.	We will continue to ensure a firm anchoring of medium term inflation expectations. **Rates are appropriate**. The GC will **ensure that the measures taken can be quickly unwound and the liquidity provided absorbed**.	**Monitor very closely.**
Growth	**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**.	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 but at slower pace. Risks are balanced**
Inflation	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**.	The fall of **annual inflation rates** into negative territory in July is in line with expectations and they **are projected to remain temporarily in negative territory over the coming months, before turning positive again**. later this year	**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	**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**.	Continued 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 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	0.00	0.00	0.00	
“Refi” rate	1.00	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 (September 3rd)

August, 12	Euro Area industrial production, June
August, 14	Euro Area inflation, July
August, 17	Euro Area trade balance, June
August, 19	Euro Area construction output, June
August, 24	Euro Area industrial new orders, June
August, 27	Euro Area monetary aggregates, July
August, 28	Euro Area business and consumer survey, August
August, 31	Euro Area flash estimate inflation, August
September, 1	Euro Area unemployment, July
September, 2	Euro Area industrial producer prices, July
September, 3	Euro Area PMI, July
September, 3	Euro Area retail trade, July