Economic Research Department

BBVA

EMU

ECB Watch

Meeting: December 5th 2009
Next meeting: January 14th 2010

Miguel Jiménez
mjimenezg@grupobbva.com

Agustín García Serrador
agustin.garcia@grupobbva.com

"Exit" to be revisited in March

- **The ECB started the withdrawal of liquidity by announcing that the next 12 and 6 months auctions will be phased out.**
- **Full allotment tenders will be maintained at least until March (only), in what we see a concession to the hawks.**
- **The projections on growth have been revised up and those on inflation maintained. Both were expected.**

At today's meeting there were several important decisions to be taken by the ECB governing council (GC). In general terms, the GC did not surprise neither on the messages sent on rates (which are appropriate now and will likely remain low for the rest of the year) nor on the quarterly projections (revised up for growth and barely unchanged for inflation), but was somewhat more hawkish on the withdrawal of liquidity than one would have expected, despite the language of "gradual" adjustment constantly repeated by Mr Trichet.

Official rates remain unchanged, with the *refi* at 1%. Mr Trichet made clear that the current level is appropriate and that decisions on liquidity are not being used to send signals on future rates. This decision was unanimous.

Decisions on the exit strategy for liquidity:

- The 12 month auctions will be eliminated, as broadly expected. This was also unanimous (other measures were taken "by consensus").
- The last 12 month auction in December will be subject to a variable rate, which will be the average minimum bid rate of the MRO's during the life of the operation (until the end of 2010). This has been done for the sake of neutrality, in Mr Trichet's words: "It was the right way to be neutral not to give a signal on interest rates either in the direction of loosening our policies or hardening the policy". It also aims at avoiding speculation over possible increases or rates during 2010, which could foster demand in the December auction. It also sends a signal that the GC does not discard higher rates at the end of 2010.

- The next 6-month auction in March will also be the last one, and will be carried out using a full allotment fixed rate tender procedure. It was unclear before the meeting what would the ECB decide on these auctions and we were expecting a postponement of the decision on them.
- The full allotment nature of auctions for weekly MROs and for special one-month operations is maintained “for as long as is needed” and at least until March. This is also somewhat stricter than what we would have expected. The open clause goes in line with the commitment by the GC not to surprise markets and approach the exit with caution, but the commitment of three months is a bit short and no doubt a concession to the hawks in the GC. Mr Trichet tried to sweeten this by saying that they are happy with current rates (“it is not our intention to increase Eonia”; “we did not want to change in any respect the yield curve we have in front of us”) we think that a longer period of ensured full allotment auctions (say June, the date when markets see Eonia at 1%) would have been more in line with the ECB declarations (“we have to be gradual and timely”).

This difference in tone between what the Statement says and Mr Trichet’s clarifications was also reflected in the markets reaction, as the euro and OIS rates rose during the reading of the first, while they fell back again during Mr Trichet’s declarations.

The economic outlook remains broadly unchanged with respect to what was advanced in recent months: there has been growth in Q3 and the situation is better than before, but the tone of caution continues to be prevalent. The Staff’s projections have been increased as we expected (from 0.2% to 0.8% as a central point for 2010, much in line with those by the European Commission; and 1.2% for 2011), and the balance of risks surrounding the activity is balanced and remains broadly unchanged.

The outlook for inflation has been barely changed (from 1.2% to 1.3% in 2010 as a central point). As the projection for 2011 (1.4%) remains will below the reference value for the ECB, Mr Trichet was asked (quite correctly in our view) why the ECB did not provide more liquidity instead of withdrawing the current, to which he replied that decisions on liquidity are separated from those on rates.

The monetary analysis remains also broadly unchanged. M3 and loans to the non-financial private sector continue to decelerate, though loans to households have increased in October (which Mr Trichet stressed during the Q&A). The ECB insists that loans to non-financial corporations tend to lag the cycle and therefore should pick up in future months.

Answering questions on the exchange rate, Mr Trichet was perhaps more vehement than usual in backing the US position in defence of a strong dollar (“we have a very important stake in the US dollar to be strong”), in logical correspondence with the high value the euro has reached in recent weeks vis-à-vis the dollar.

On fiscal policy, the message sent this time by the ECB was less strong than in previous months, once the Ecofin has issued its recommendations on the pace of fiscal adjustment, and probably trying to avoid sending the wrong signal to markets after the high spreads reached by the Greek sovereign debt in recent days.

Summing up

The ECB has not changed its views on the pace of the recovery, which will be moderate and bumpy, nor on inflation risks, which are low. Rates continue to be appropriate, and the GC insists in separating rates decision from exit from non-conventional measures. The design of the exit has been in line to what was announced (retiring 12-months auctions, maintaining full allotment for the moment) but harder on other points (retiring 6-months auctions, ensuring full allotment until March) in what we interpret as a concession to hardliners. We see however, a bleaker outlook for the Eurozone economy, both in activity and inflation, and a still far from clear situation on the financial front, and hence we think that those measures maintained until March will be prolonged further.

Box: ECB Statements

	September 3rd	October 8th	November 5th	December 4rd	Concluding remarks*
Monetary policy stance	**Rates remain appropriate**. The GC will make sure that **measures taken are unwound in a timely fashion and the liquidity provided absorbed**.	**Rates remain appropriate**. The GC will make sure that **measures taken are unwound in a timely fashion and the liquidity provided absorbed**.	**Rates remain appropriate**. **Not all our liquidity measures will be needed to the same extent as in the past**. The GC will make sure that the **extraordinary liquidity measures taken are phased out in a timely and gradual fashion and the liquidity provided absorbed**.	**Rates remain appropriate**. **Not all our liquidity measures will be needed to the same extent as in the past**. 6 and 12 month auctions phased out; full allotment maintained as long as needed and at least until March	**Rates remain appropriate**
Growth	Recent data are consistent with the expectation that the **significant contraction in economic activity has come to an end and is now followed by a period of stabilization and very gradual recovery**.	**Economy is stabilizing and is expected to recover at a gradual pace.**	Latest information continues to signal an **improvement in economic activity in H209**. They expect the euro area economy **in 2010 to recovery at a gradual pace**.	Available survey data suggest that the recovery is continuing during Q4. **Euro area economy is expected to grow only at a moderate pace** (0.8%) **in 2010**, and the recovery process is likely to be uneven.	**Further improvement in activity, but gradual recovery and "bumby road" ahead. Risks are balanced**
Inflation	Owing to base effects, **annual inflation rates are projected to turn positive again within coming months**. Inflation **forecasts** from ECB Staff have been **revised slightly upwards**.	Current negative inflation rates are expected. Owing to base effects, **annual inflation rates are projected to turn positive again in the coming months**, but staying subdued reflecting ongoing sluggish demand.	Current negative inflation rates are in line with previous expectations. Owing to base effects, **annual inflation rates are projected to turn positive again in the coming months**, but staying subdued reflecting ongoing sluggish demand.	Inflation is **expected to rise further in coming months** (upward base effects in energy and food components), but **remaining moderate over the policy-relevant horizon** as a consequence of the slow recovery in demand.	**Inflation rates will remain well below 2% in 2010. Inflation expectations remain firmly anchored**
Risks	Risks to these projections are **broadly balanced**. Cautious interpretation of available information.	Risks to these projections are **broadly balanced**. Cautious interpretation of available information.	Risks to these projections are **broadly balanced**.	Risks to these projections are **broadly balanced**.	**Broadly balanced**
Monetary analysis	**Continued deceleration in both broad money and credit growth**. Gradual improvement in financing conditions and lower market interest rates should support the demand for credit in the period ahead.	Developments in broad money and credit growth remain subdued, being in line with the lag that normally prevails between trends in economic activity and developments in loans to enterprises.	In the next few months, the annual growth rates of monetary aggregates will **most likely be affected downwards** by base effect associated with the intensification of the turmoil one year ago. The growth of loans to enterprises typically only picks up with some lag compared with the cycle in economic activity.	The monetary analysis confirms low inflation pressures as money and credit continue to slow down. Loans to households level off at low rates. The growth of loans to enterprises typically only picks up with some lag compared with the cycle in economic activity.	**Money and credit continue to slow down. Low inflationary pressures**
Movement	0.00	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 (January 14th)

December, 14	Euro Area industrial production, October
December, 14	Euro Area employment, Q3/09
December, 15	Euro Area labour cost index, Q3/09
December, 16	Euro Area inflation, November
December, 17	Euro Area construction output, October
December, 18	Euro Area trade balance, November
December, 30	Euro Area PMI, December
January, 5	Euro Area monetary aggregates, November
January, 5	Euro Area flash inflation estimate, December
January, 6	Euro Area industrial new orders, October
January, 6	Euro Area industrial producer prices, November
January, 7	Euro Area business and consumer survey, December
January, 7	Euro Area retail trade, November
January, 8	Euro Area unemployment, November
January, 8	Euro Area national accounts, Q3/09 2nd release
January, 13	Euro Area industrial production, November