



ECB Watch

Next Meeting: March 4th 2010

1st March 2010

ECB to provide some light on gradual exit

- After two relatively uninteresting meetings, the March Governing Council gathering on Thursday 4th is important for two reasons: First and most important, the ECB will provide more clues on its exit strategy for its quantitative easing strategy; second, it will publish new macroeconomic projections. The official interest rate will remain stable at 1% for the refinancing operations.
- There are several relevant news since the February meeting. **GDP decelerated in Q4 more than expected, from 0.4% q/q in Q3 to 0.1%**. We are expecting that the decomposition of Q4 growth, to be published the same of the meeting, will show clearly negative consumption and investment, and a strong positive contribution of net exports to growth. Additionally, the climate is relatively gloomy in the turn of the year as confirmed by confidence data, both PMI and EC Survey. A difficult weather in winter is also likely to drag activity down in the first quarter. We have been projecting very slow growth for 2010 (+0.6%) as we think once the fiscal stimulus wanes private demand will not be able to take the lead. These results confirm our view, even if the weakness has been apparent earlier than we thought. **The ECB, which in December was projecting growth of 0.8% for this year, is not likely to change its forecast significantly** (the EC has just published its new forecast, confirming its previous 0.7% from November).
- On **inflation**, the annual rate rose by 0.1pp to 1% y/y in January, while the expectation was 1.2%. The surprise came mostly from core inflation, which fell by 0.1pp from 1%, instead of rising to 1.1%, as we expected, driven by non-energy industrial goods and services. Now we expect headline inflation to remain around 1% in the first half of the year, accelerating somewhat in the last quarter of the year. As for core inflation, we expect it to remain stable around 0.8% in the coming months as activity remains weak and the output gap stays large

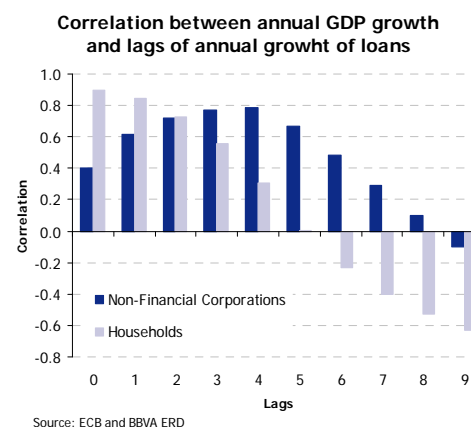
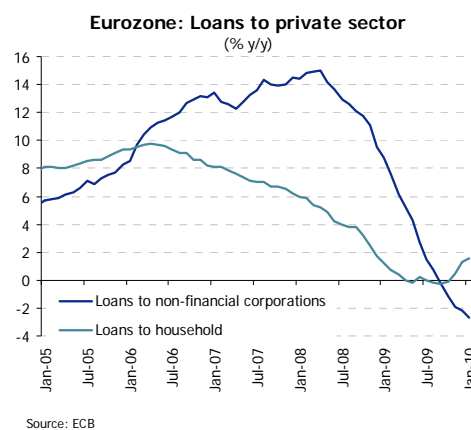
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- Credit data** to firms continues to be gloomy. The annual rate of change of loans to the private sector declined again in January to -0.6% y/y, from -0.1% y/y in the previous month. Loans to non-financial corporations fell by -0.1% m/m (-2.7% y/y), continuing the downward trend observed since mid-2008, while loans to households increased further in January (+0.2% m/m), reaching an annual growth rate of 1.6%. This divergent development in loans to both households and companies is consistent with historical patterns, as household loans usually recover together with economic activity, but loans to non-financial corporations are often delayed by around four quarters. According to this pattern, loans to companies should start to increase by mid-2010 if demand factors were the main driver of activity. However, the possibility of strong credit supply restrictions, as banks adjust their balance sheets, are still looming behind these data and constitute a risk factor for any meaningful growth in the quarters ahead.
- The **evolution of the Greek fiscal crisis is another key factor which will shape monetary policy in coming months**. ECB officials had tough words on the need of Greece to adjust its deficit, although once the EU started its (verbal) support of Greece the language has turned more “encouraging” rather than “demanding”. On top of this, the ECB will play an important role in the monitoring of Greek accounts in the months to come, as a way of reinforcing the credibility of the EU plan for Greece. This month, Lorenzo Bini Smaghi stressed that it is a European problem that must be solved by means of financial support from the EU side. Specifically, he said that “the amount will be more limited than what has been reported”, referring to Der Spiegel report that mentioned loans or guarantees for €20bn to €25bn, conditional on effectiveness of government’s measures in reducing the deficit.
- Putting together all these factors, **we do not see an immediate withdrawal of ECB non-conventional measures**. In December the ECB decided to eliminate the 12 month fixed-rate auctions (the one in December was the last one) and also the six-month auctions (the one in March will be the last one). It also prolonged the full allotment provision of liquidity on weekly and 3 month auctions for at least until March. Therefore, on Thursday it should specify until when they will extend full-allotment auctions. Given the softer activity and inflation data, pervasive weakness of credit data and especially the seriousness of the Greek crisis, we expect they will remain in place during the rest of the year, with an “at least” clause of probably six months on Thursday. As for official interest rates, and consistent with our very week projections, we continue to see the first hike by mid-2011.



Box 1: Economic indicators

		2009	Nov-09	Dec-09	Jan-10	Feb-10	Impact on rates *
Euro- Manufacturing PMI	Obs.	43.3	51.2	51.6	52.4	54.2	
	Cons.		51.3	51.4	51.8	52.8	
Euro- Services PMI	Obs.	46.8	53.0	53.6	52.5	52.0	
	Cons.		52.6	53.2	54.1	52.5	
Euro- Economic Sentiment Indicator	Obs.	80.8	91.9	94.1	96.0	95.9	
	Cons.					92.3	
Euro- Industrial Production m/m	Obs.	-15.0	1.4	-1.7			
	Cons.		1.0	-1.2			
Germany - Retail Sales y/y	Obs.	-1.7	-1.9	-1.9			
	Cons.		-1.7	-1.2			
Germany - IFO Business Climate y/y	Obs.	87.7	93.9	94.6	95.8	95.2	
	Cons.		92.5	94.5	95.1	95.1	
Euro - HICP y/y	Obs.	0.3	0.5	0.9	1.0		
	Cons.		0.5	0.9	1.2		
Euro - M3 y/y	Obs.	3.0	-0.3	-0.3	0.1		
	Cons.		0.4	-0.6	-0.1		
Euro - Loans to Private Sector y/y	Obs.	1.4	-0.7	-0.1	-0.6		
	Cons.						

* According to BBVA, the direction that this data can affect the monetary Policy by the ECB. ** Flash estimate

Obs: actual data; Cons: forecasts by consensus

Box 2: Speeches and comments by members of the ECB Governing Council

ECB members continue to be cautious about the economic recovery in the euro area. Tough talk on fiscal issues continued, following similar lines as in the past Council's press conference.

Activity	Speech/Comment	Speaker	Context/Quote	Policy Implication	Impact on rates	
Activity	"The ECB has been more cautious than numerous forecasters in noting the fragility of the economy and noting that the recovery could still be bumpy." (Orphanides)	(Orphanides)	"To stop taking exceptional measures prematurely entails the risk of a new drop in economic activity."	"There's a trend of moderate growth that we expect to be maintained over time with some uneven behaviour probably and big uncertainty remaining"	"We still don't know to what extent the incipient global recovery has enough support on its own to allow for exceptional stimulus to be withdrawn without the danger of a relapse in activity."	Cautious about the economic recovery, given the temporary nature of some factors behind the timid recovery
Inflation	"Medium-term risks to inflation are balanced in the euro area." (Liikanen)	(Liikanen)	"Short-term risks to consumer-price stability are currently dampened by a drop below potential in most economies and rising unemployment."	"I don't really see the prospect of deflation risks at present being anywhere close to those of last spring when the economy was in freefall."	Euro area inflation is expected to remain "low in the years ahead."	Subdued inflation over the policy relevant horizon
Fiscal Policy	"Dealing with the large fiscal imbalances in a number of euro-area countries would not dampen would promote growth." (Orphanides)	(Orphanides)	"The challenges are in increasing imbalances within the European Union, especially with regard to the fiscal situation."	"It's clear that fiscal policy, as soon as the economic recovery has firmed, needs to embark on a path of consolidation."	"Communicating credible fiscal exit strategies is therefore crucial in order to anchor expectations."	Tough talk on fiscal issues. Emphasis on the need for fiscal consolidation
Non-standard monetary policy	"The gradual return to normal tender procedures in the longer-term operations will probably not happen for all different maturities at the same point of time." (Weber)	(Weber)	"The GC has already stated that the next six-month operation will be the last one."	"Policy accommodation continues to be needed in light of the very subdued inflation outlook and the unevenness and weakness of the economy."	"The GC is free to choose the way in which interest rate action is combined with the unwinding of the remaining non-standard measures."	The pace of retiring full allotment on 3 months and weekly auctions is still open, but is not immediate