Europe

ECB Watch

Madrid, 7 October 2010

Economic Analysis

Europe
Agustín García Serrador
agustin.garcia@grupobbva.com
(+34) 91 374 79 38

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com
(+34) 91 374 44 323

María Martínez Álvarez
maria.martinez.alvarez@grupobbva.com
(+34) 91 537 66 83

Cristina Varela Donoso
cvarela@grupobbva.com
(+34) 91 537 7825

Victoria de Zuriarrain
victoria.zuriarrain@grupobbva.com
(+34) 91 537 7584

Leanne Ryan
leanne.ryan@grupobbva.com

Greater focus on FX than expected

- In the Q&A, the main novelty was that Mr. Trichet showed certain concern with recent exchange rates
- As we expected, the ECB Chairman seems comfortable with the current liquidity situation. Thus, he emphasized that the recent increase in money markets rates do not reflect a change in the monetary policy stance

No major changes in the ECB statement today (you can find below a complete comparison with September's Statement). As expected, the official rate was kept unchanged at 1%. However the ECB´s chairman showed some concern on the exchange rates.

Exchange rates: Mr. Trichet showed concern with recent exchange rates and pressed for a future appreciation of emerging countries' currencies with specific mention of China. He stated that, "more than ever exchange rates should reflect economic fundamentals" probably referring to recent movements by the euro which he rejects, as well as the high volatility (which he believes it affects economic growth and financial stability) and the disordered currency movements. We could understand, from what he said that pressure for currency appreciation is most probably going to happen in emerging countries. Although he explicitly mentioned China, other countries are expected to follow. Structural and profound changes, he said, would be the result of remarkable economic growth. He hopes for a medium/long term scenario where non free floating currencies would convert. On the dollar, Trichet repeated the argument that a "strong dollar" is in the interest of the US, an idea that he also endorses. As we already know, the currency issue was already discussed with the Chinese authorities this week and he argued on the need for greater flexibility, as it would "bring positive growth for China". He also said that exchange rates views will be discussed with Central banks and financial authorities in the coming days. This issue will be reviewed this weekend in Washington. He avoided however positioning or commenting on the possibility of a currency war and made no references on possible future coordinated actions.

Liquidity issues: The ECB chairman remarked that there is less liquidity in the markets. This is a reaction from banks, because they judged that they needed less liquidity than before. He concretely stated that this is the result of the interaction of banks in an environment of full allotment. He also added that there is absolutely no monetary policy signal at all. In our view, with less liquidity in the system, the ECB could feel more comfortable with its process of phasing out of exceptional measures. Regarding Eonia, he said that the recent increase in money-market rates does not reflect any intentional policy tightening by the ECB. In our opinion, this evaluation gives the chance for increasing movements in money-market rates in the short-term, confirming that the ECB is comfortable with a normalization of the Eonia near 1%. Regarding the time on the exit strategy he said that, "we are all assessing the situation". He did not give a specific date for stimuli withdrawal

Government bond purchases program: Mr. Mr. Trichet only said that they are implementing the program as it had been decided several months ago. He remarked that the aim of the program is to help correcting (as far as possible) the monetary policy transmission. He didn't mention the increase in the size of the program from a weekly average of € 0.16 bn in the last 10 weeks to €1.34 bn in the last week, amounting to €63.08 bn. Regarding Ireland, recent market turbulence has been worrying investors, and the question is whether further support would be offered and how if pressure persists or even increases on peripherals

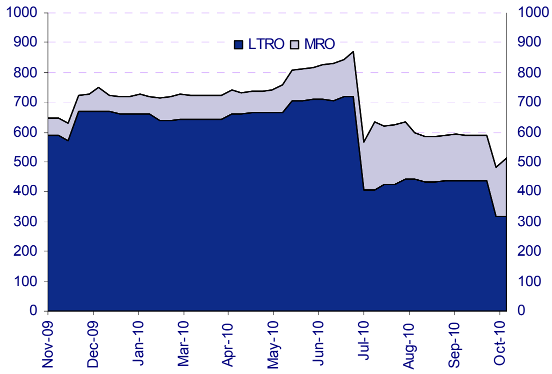
Economic developments: Mr Trichet maintained his cautious tone emphasizing that "the risks to this economic outlook are slightly tilted to the downside, with uncertainty still prevailing" and volatility is part of the world.

On activity: The statement emphasizes that the strong economic growth in Q2, driven by domestic demand, was driven by due to temporary factors. The latter is in line with our view that part of the recovery in investment observed in Q2 could be temporary as housing investment in Northern Europe soared after the severe winter. During Q&A session, Mr. Trichet acknowledged that economic growth in H1 2010 was better than previously expected, leading to most international institutions to revise economic growth upwards for this year (around 1.6%). However, Mr. Trichet made it clear that the Government Council position remains “prudent and cautious”, envisaging a modest growth pace for next quarters.

On inflation: On consumer prices, not many news, accelerating inflation in Q3 was expected and primarily reflects the base effect resulting from the energy component. Looking forward, inflation is expected to hover around current rates (1.8% y/y), as our projections, tending to slow again next year. Overall, monetary policy should not be conditional on inflation development, allowing it to be accommodative enough to stimulate economic growth (still below potential).

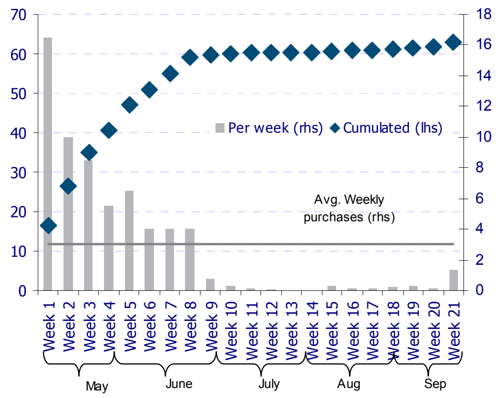
Market reaction: The euro depreciated against the dollar (it is now trading at $1.395). More muted impact in stocks and bonds, being almost flat at the end of the Q&A

ECB: lending to EMU credit institutions (€bn)

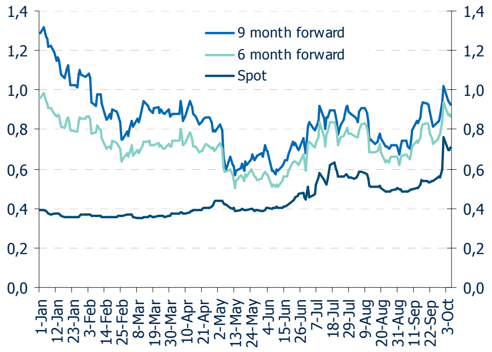


Source: Datastream and BBVA Research

ECB: sovereign bond purchase program



OIS 3 month rates implicit in OIS swaps



Source: Datatstream and BBVA Research

Euro-Dollar: intraday change ($/€, Price each 5 minutes)

Source: Bloomberg and BBVA Research

Annex 1: Tracking the changes…

Jean-Claude Trichet, President of the ECB, Vítor Constâncio, Vice-President of the ECB Frankfurt am Main, ~~2 September~~ 7 October 2010

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~~, which was also attended by Commissioner Rehn~~.

Based on its regular economic and monetary analyses, the Governing Council continues to view the current **key ECB interest rates** as appropriate. It therefore decided to leave them unchanged. Considering all the new information and analyses which have become available since our meeting on ~~5 August~~2 September 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon~~, benefiting from low domestic price pressures~~. Recent economic data ~~for the euro area have been stronger than expected, partly owing to temporary factors. Looking ahead,~~ are consistent with our expectation that the recovery should proceed at a moderate pace in the second half of this year, ~~with~~with the underlying momentum remaining positive. At the same time, uncertainty is still prevailing. Our monetary analysis confirms that inflationary pressures over the medium term remain contained, as suggested by weak money and credit growth. ~~Overall, we~~ We expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations remains of the essence.

Overall, the current monetary policy stance remains accommodative. The ~~Governing Council has today also decided to continue to conduct its main refinancing operations (MROs) and its special-term refinancing operations with a maturity of one maintenance period as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of this year's twelfth maintenance period on 18 January 2011. The fixed rate in these special-term refinancing operations will be the same as the MRO rate prevailing at the time. Furthermore, it has decided to conduct the 3-month longer-term refinancing operations (LTROs), to be carried out in October, November and December 2010, as fixed rate tender procedures with full allotment. The rates in these 3-month operations will be fixed at~~ stance, the provision of liquidity and the allotment modes will be adjusted as appropriate, taking into account the ~~average rate of the MROs over the life of the respective LTRO. The Governing Council has also decided to carry out three additional fine-tuning operations on 30 September, 11 November and 23 December when 6-month and 12-month refinancing operations mature.~~

~~Overall, the current monetary policy stance remains accommodative. Monetary policy will do~~ fact that all ~~that is needed to maintain price stability in the euro area over the medium term. This is the necessary and central contribution that monetary policy makes to fostering sustainable economic growth, job creation and financial stability. All~~ the non-standard measures taken during the period of acute financial market tensions~~, referred to as "enhanced credit support" and the Securities Markets Programme,~~ are fully consistent with our mandate and, by construction, temporary in nature.~~We remain firmly committed to maintaining price stability over the medium to longer term. The monetary policy stance, the overall provision of liquidity and the allotment modes will be adjusted as appropriate.~~ Accordingly, the Governing Council will continue to monitor all developments over the period ahead very closely.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~After a period of sharp decline, euro area economic activity has been expanding since mid-2009.~~ Euro area real GDP grew strongly on a quarterly basis, increasing by 1.0% in the second quarter of 2010, supported ~~by ongoing growth at the global level~~mainly by domestic demand, but ~~also in part~~ partly reflecting temporary ~~domestic~~ factors. Recent ~~data~~statistical releases and survey evidence generally confirm ~~the~~our expectation of a moderation in the second half of this year~~, both at the global level and~~ in the euro area and elsewhere. Nevertheless, ~~while uncertainty still prevails, they continue to indicate a~~the positive underlying momentum of the recovery in the euro area. ~~Ongoing growth at the~~ remains in place. The global ~~level~~recovery is expected to go on, and ~~its~~this should imply a continued positive impact on the demand for euro area exports~~, together with~~. At the same time, private sector domestic demand should gradually strengthen further, supported by the accommodative monetary policy stance and the measures adopted to restore the functioning of the financial system~~, should continue to support the euro area economy~~. However, the recovery in activity is expected to be dampened by the process of balance sheet adjustment in various sectors~~ and labour market prospects.~~

~~This assessment is also reflected in the September 2010 ECB staff macroeconomic projections for the euro area, according to which annual real GDP growth will range between 1.4% and 1.8% in 2010 and between 0.5% and 2.3% in 2011. Compared with the June 2010 Eurosystem staff macroeconomic projections, the range for real GDP growth this year has been revised upwards, owing to the stronger than expected rebound in economic growth in the second quarter as well as better than expected developments over the summer months. For 2011 the range has also been revised upwards, reflecting mainly carry-over effects from the projected stronger growth towards the end of 2010~~.

In the Governing Council's assessment, the risks to this ~~improved~~ economic outlook are slightly tilted to the downside, with uncertainty still prevailing. On the one hand, global trade may continue to ~~perform~~grow more ~~strongly~~rapidly than expected, thereby supporting euro area exports. On the other hand, concerns remain relating to the emergence of renewed tensions in financial markets~~ and to some uncertainty about growth prospects in other advanced economies and at the global level~~. In addition, downside risks relate to renewed increases in oil and other commodity prices, and protectionist pressures, as well as the possibility of a disorderly correction of global imbalances.

With regard to price developments, euro area annual HICP inflation was 1.~~6~~8% in ~~August~~September, according to Eurostat's flash estimate, compared with 1.~~7~~6% in ~~July.~~August. The ~~small decline~~ increase in inflation ~~is likely to reflect~~was anticipated and reflects base effects ~~in~~ mainly stemming from the energy component. ~~Later in the year annual HICP inflation rates are expected to increase~~

~~slightly while displaying some volatility. Looking further ahead,~~ In the next few months HICP inflation rates will hover around current levels before moderating again in the course of next year. Overall, in 2011 inflation rates should remain moderate ~~overall~~, benefiting from low domestic price pressures. Inflation expectations over the medium to longer term continue to be firmly anchored in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.

~~This assessment is also reflected in the September 2010 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation in a range between 1.5% and 1.7% for 2010 and between 1.2% and 2.2% for 2011. Compared with the Eurosystem staff macroeconomic projections of June 2010, the ranges have been revised slightly upwards, largely on account of higher commodity prices.~~

Risks to the outlook for price developments are slightly tilted to the upside. They relate, in particular, to the evolution of energy and non-oil commodity prices. Furthermore, increases in indirect taxation and administered prices may be greater than currently expected, owing to the need for fiscal consolidation in the coming years. At the same time, risks to domestic price and cost developments are contained.

Turning to the **monetary analysis**, the annual growth rate of M3 ~~stood at~~ rose to 1.1% in August 2010, from 0.2% in July ~~2010, unchanged from June~~. The annual growth rate of loans to the private sector~~, which has been gradually increasing, rose further to~~ also rose, standing at 1.2%, after 0.~~9%, but still remains relatively weak.~~8% in the previous month. In both cases, the rise reflects relatively strong monthly flows. The ~~subdued developments in money and loan~~ still low growth rates continue to support the assessment that the underlying pace of monetary expansion is moderate and that inflationary pressures over the medium term are contained.

The ~~downward impact of the steep~~ yield curve has remained fairly steep, but the downward impact of this on monetary growth~~, which is reflected in the allocation of funds into longer-term deposits and securities outside M3,~~ is gradually waning. Moreover, ~~the impact of the narrow~~ while spreads between different short-term interest rates are still generally narrow, they have been widening somewhat between rates paid on ~~the growth of the components of M3 is continuing to diminish.~~ short-term time deposits and overnight deposits. As a result, the annual growth rate of M1 has continued to moderate from high levels, and stood at ~~8.1~~7.7% in ~~July~~August 2010, while the annual growth rate of other short-term deposits has become less negative.

The ~~still weak~~rise in the annual growth rate of bank loans to the non-financial private sector ~~continues to conceal~~ reflects both a further slight increase in the positive growth ~~in~~ of loans to households and ~~diminishing~~a gradually less negative annual growth rate in loans to non-financial corporations. ~~These~~The latest developments are consistent with ~~a normal,~~ the lagged response of loan developments to economic activity over the business cycle that was also observed in past cycles.

~~Given~~Banks have gradually increased the ~~subdued developments in banks'~~ overall size of their balance sheets~~,~~ recently, but the challenge remains for banks to expand the availability of credit to the non-financial sector when demand picks up further. Where necessary, to address this challenge, banks should retain earnings, turn to the market to strengthen further their capital bases or take full advantage of government support measures for recapitalisation.

To sum up, the current key ECB interest rates remain appropriate. We therefore decided to leave them unchanged. Considering all the new information and analyses which have become available since our meeting on ~~5 August~~2 September 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon~~, benefiting from low domestic price pressures~~. Recent economic data ~~for the euro area have been stronger than expected, partly owing to temporary factors. Looking ahead,~~ are consistent with our expectation that the recovery should proceed at a moderate pace in the second half of this year, with the underlying momentum remaining positive. At the same time, uncertainty is still prevailing. A **cross-check** of the outcome of our economic analysis with that of the monetary analysis confirms that inflationary pressures over the medium term remain contained, as suggested by weak money and credit growth. ~~Overall, we~~ We expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations remains of the essence.

~~Turning to **fiscal policies**, current developments at the euro area aggregate level appear to be broadly in line with previous expectations. At the country level, any~~Turning to **fiscal policies**, we take note of the recent announcements made in some euro area countries with regard to measures to tackle the existing fiscal imbalances. Indeed, a number of countries have to meet major challenges, and immediate, ambitious and convincing corrective action is required. Credible multi-year consolidation plans are needed and will strengthen public confidence in the capacity of governments to return to sustainable public finances, reduce risk premia in interest rates and thus support sustainable growth over the medium term. For all euro area countries, the 2011 budgets need to reflect the commitment to ambitious fiscal consolidation in line with countries' pledges under the excessive deficit procedures. Any positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected ~~macroeconomic~~ environment, should be exploited to make faster progress with fiscal consolidation. ~~At the same time, in countries where there is still a need to take additional specific measures to achieve consolidation targets, such measures should be adopted swiftly to ensure that consolidation commitments are fulfilled. This is a prerequisite for maintaining confidence in the credibility of governments' fiscal targets. Positive effects on confidence can compensate for the reduction in demand stemming from fiscal consolidation, when fiscal adjustment strategies are perceived as credible, ambitious and focused on the expenditure side. The conditions for such positive effects are particularly favourable in the current environment of macroeconomic uncertainty.~~

~~In order to support the process of fiscal consolidation, to underpin the proper functioning of the euro area and to strengthen the prospects for higher sustainable growth, the pursuit of far-reaching **structural reforms** is essential.~~The urgent implementation of far-reaching **structural reforms** is essential to enhance the prospects for higher sustainable growth. Major reforms are particularly needed

Increasing product market competition, particularly in the services sectors, would also facilitate industrial restructuring and encourage innovation and the adoption of new technologies.

in those countries that have experienced a loss of competitiveness ~~losses~~ in the past or that are suffering from high fiscal and external deficits. ~~Measures should ensure a wage bargaining process that allows wages to adjust flexibly and appropriately to the unemployment situation~~The removal of labour market rigidities and ~~losses in competitiveness. Reforms to strengthen~~ the strengthening of productivity growth would further support the adjustment process of these economies.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called “BBVA”) to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates’ proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA and the rest of entities in the BBVA Group which are not members of the New York Stock Exchange or the National Association of Securities Dealers, Inc., are not subject to the rules of disclosure affecting such members.

“BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance”.