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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

Sonsoles Castillo
s.castillo@bbva.com

María Martínez Álvarez
maria.martinez.alvarez@bbva.com

Cristina Varela Donoso
cvarela@bbva.com

Alejandro Neut
robertoalejandro.neut@bbva.com

Europe
Miguel Jiménez
mjimenezg@bbva.com

Agustín García
agustin.garcia@bbva.com

A more dovish ECB after the cold shower in March

- **Rates were kept unchanged while the ECB's tone remained dovish.**
- **Another twist to verbal intervention, this time reassuring markets of the "unanimous" commitment to using unconventional instruments.**
- **QE is definitely on the table.**
- **Increasing concern on risks surrounding a prolonged period of low inflation.**

As expected, at today's monetary policy meeting the ECB left the key policy rate unchanged at 0.25% and took no additional steps on non-standard measures. Mr. Draghi said that there was a wide-ranging and rich discussion within the Governing Council (GC), but members decided to wait until more information was available. Today, the ECB reinforced its forward guidance, including in the statement an explicit reference to its pledge to maintain a "high degree of accommodation" and the GC's unanimity in its commitment to the additional use of "unconventional" tools as part of its mandate to cope with the risks of "a too prolonged period of low inflation". The reference to the "unanimity" in the statement is very unusual. The ECB also emphasised its "determination to maintain a high degree of monetary accommodation and to act swiftly if required", and thus did "not exclude further monetary policy easing". In the GC's view, medium-term inflation risks remain "broadly balanced" (exchange-rate developments were explicitly mentioned) and risks to the economic outlook continue to be to the downside.

At the press conference, the attention was on the possibility that the central bank could embark on a QE programme. Mr Draghi stated that QE was discussed but also that the central bank has not exhausted its conventional measures, and QE is only one the tools available. He highlighted that the effects of this programme in the eurozone would be different from the US due to the heavy reliance of the eurozone economy on the banking sector: "In the US, the effect of QE is immediate on all asset prices … because the economy is based on capital markets" … "whereas we are based on bank lending". Regarding which QE modalities would be more effective (buying public or private debt), Draghi said that there are different preferences within the GC. Regarding the QE on private assets, he stressed that this instrument is difficult to design as the market is not large enough and there are risks of financial instability.

Regarding other non-standard measures, Mr Draghi said that the GC discussed mostly the non- sterilization of the SMP programme, and also a negative deposit rate (as well as a narrowing of the rates corridor), and briefly a new LTRO. In this regard, he explained that a new LTRO would have to be carefully designed in order to stimulate lending.

Low inflation in March (0.5% YoY) was another focus at the press conference. Mr Draghi downplayed the March inflation surprise explaining that it was mainly (but not only) due to lower energy and food prices and to seasonal factors (the Easter holidays falling late this year). He also stressed that this time, unlike the surprise which triggered November´s rate cut, the data came in lower than the bank had expected but did not change its medium-term outlook, and hence it will wait for more information. Draghi reiterated that the central bank does not see deflation risk in the eurozone, but he warned (and repeated) that the "risks increase if inflation stays low for longer". In this context, we foresee a (genuine) increasing concern on the part of the ECB regarding the persistence of inflation at low levels, despite the fact that deflationary risks remain low. If this were the case, the obstacles to swift action might be lower than communicated last month.

Mr. Draghi remained cautious on the economic outlook, mentioning that the biggest risk for the eurozone is "protracted stagnation". As at the March meeting, he said that the output gap is "pretty wide", and despite the fact that the GC is observing continuous improvements in the real economy (both in hard and survey data), it still sees "plenty of slack in the euro area economy".

We still do not see immediate action neither with standard nor with non-standard measures. The ECB today sounded as if further action could be taken due to persistence of low inflation rather than only due to a negative shock to inflation. However, this might be difficult to justify as we expect 0.8-0.9% inflation in the second quarter.

PLEASE NOTE: TRACKING CHANGES IN FOLLOWING STATEMENTS

in black, wording common to both the current and previous statements, in red and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES IS ON POURPOSE)

Mario Draghi, President of the ECB,
Frankfurt am Main, ~~6 March~~3 April 2014

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 of the Governing Council, which was also attended by the Commission Vice-President, Mr Rehn.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. Incoming information confirms that the moderate recovery of the euro area economy is proceeding in line with our previous assessment. At the same time, ~~the latest ECB staff macroeconomic projections, now covering the period up to the end of 2016, support earlier expectations~~ recent information remains consistent with our expectation of a prolonged period of low inflation~~, to be~~ followed by a gradual upward movement in HICP inflation rates ~~towards levels closer to 2%. In keeping with this picture, monetary and credit dynamics remain subdued.~~. The signals from the monetary analysis confirm the picture of subdued underlying price pressures in the euro area over the medium term. Inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%.

~~Regarding the medium-term outlook for prices and growth, the information and analysis now available fully confirm our decision to maintain an accommodative~~Looking ahead, we will monitor developments very closely and will consider all instruments available to us. We are resolute in our determination to maintain a high degree of monetary accommodation and to act swiftly if required. Hence, we do not exclude further monetary policy ~~stance for as long as necessary. This will assist the gradual economic recovery in the euro area. We~~ easing and we firmly reiterate ~~our forward guidance. We~~that we continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy, the high degree of unutilised capacity and subdued money and credit creation.

~~We are monitoring~~ At the same time, we are closely following developments on money markets ~~closely and are ready to consider all instruments available to us. Overall, we remain firmly determined to maintain the high degree of monetary accommodation and to take further decisive action if required~~. The Governing Council is unanimous in its commitment to using also unconventional instruments within its mandate in order to cope effectively with risks of a too prolonged period of low inflation.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP in the euro area rose by 0.~~3~~2%, quarter on quarter, in the last quarter of 2013, ~~thereby increasing for three consecutive~~after 0.1% and 0.3% in the previous two quarters~~. Developments in survey-based confidence indicators up to February~~ respectively. Survey data that encompass the first quarter of this year are consistent with continued moderate growth ~~also in the first quarter of this year. Looking ahead, the~~ , confirming previous expectations that the ongoing recovery is ~~expected to proceed, albeit at a slow pace. In particular,~~ increasingly supported by firmer domestic demand. Looking ahead, some further improvement in domestic demand should materialise, supported by the accommodative monetary policy stance, ~~improving~~ ongoing improvements in financing conditions working their way through to the real economy, and the progress made in fiscal consolidation and structural reforms. In addition, real incomes are supported by moderate price developments, in particular lower energy prices. Economic activity is also expected to benefit from a gradual strengthening of demand for euro area exports. At the same time, although labour markets have shown the first signs of improvement, unemployment in the euro area ~~is stabilising, it~~ remains high~~,~~ and, overall, unutilised capacity is sizeable. Moreover, the necessary balance sheet adjustments in the public and private sectors will continue to weigh on the pace of the economic recovery.

~~This assessment is also broadly reflected in the March 2014 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 1.2% in 2014, 1.5% in 2015 and 1.8% in 2016. Compared with the December 2013 Eurosystem staff macroeconomic projections, the projection for real GDP growth for 2014 has been revised slightly upwards.~~

The risks surrounding the economic outlook for the euro area continue to be on the downside. Developments in global financial markets and in emerging market economies, as well as geopolitical risks, may have the potential to affect economic conditions negatively. Other downside risks include weaker than expected domestic demand and ~~export growth and~~ insufficient implementation of structural reforms in euro area countries, as well as weaker export growth.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.~~8% in February 2014, unchanged from the (upwardly revised) outcome for January. While energy prices fell more strongly in February than in the previous month, increases in industrial goods and services prices were higher than in January.~~5% in March 2014, down from 0.7% in February. The decrease reflects falls in the annual rates of change of the food, goods and services components, partly offset by a more moderate decline in energy prices. On the basis of current ~~information and~~ exchange rates and prevailing futures prices for energy, annual HICP inflation ~~rates are~~is expected to ~~remain at~~ pick up somewhat in April, partly related to the volatility of service prices in the months around ~~current levels in~~Easter. Over the ~~coming~~following months~~. Thereafter,~~, annual HICP inflation ~~rates should~~is expected to remain low, before gradually ~~increase and~~ increasing during 2015 to reach levels closer to 2~~%, in line with inflation expectations for~~% towards the ~~euro area over~~end of 2016. At the same time, medium to long~~-~~-term inflation expectations remain firmly anchored in line with price stability.

~~This assessment is also broadly reflected in the March 2014 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.0% in 2014, 1.3% in 2015 and 1.5% in 2016. In the last quarter of 2016, annual HICP inflation is projected to be 1.7%. In comparison with the December 2013 Eurosystem staff macroeconomic projections, the projection for inflation for 2014 has been revised slightly downwards. In view of the first publication of a three-year projection horizon in the March 2014 ECB staff macroeconomic projections, it should be stressed that the projections are conditional on a number of technical assumptions, including unchanged exchange rates and declining oil prices, and that the uncertainty surrounding the projections increases with the length of the projection horizon.~~

~~Regarding the Governing Council's risk assessment, both upside and downside risks to the outlook for price developments are seen as limited and are considered to be broadly balanced over the medium term.~~

~~Turning to the **monetary analysis**, data for January 2014 confirm the assessment of subdued underlying growth in broad money (M3) and credit. Annual growth in M3 increased to 1.2% in January, from 1.0% in December. The monthly inflow to M3 in January was substantial, compensating for the strong outflow in December. The increase in M3 growth reflected a stronger annual growth rate of M1, which rose to 6.2% from 5.7% in December. As in previous months, the main factor supporting annual M3 growth was an increase in the MFI net external asset position, which continued to reflect the increased interest of international investors in euro area assets. The annual rate of change of loans to the private sector continued to contract. The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was -2.9% in January, unchanged from December. Weak loan dynamics for non-financial corporations continue to reflect their lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.2% in January 2014, broadly unchanged since the beginning of 2013.~~

~~Since the summer of 2012 substantial progress has been made in improving the funding situation of banks. In order to ensure an adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed. This is the objective of the ongoing comprehensive assessment by the ECB, while a timely implementation of additional steps to establish a banking union will further help to restore confidence in the financial system.~~

~~To sum up, the economic analysis confirms our expectation of a prolonged period of low inflation, to be followed by a gradual upward movement towards levels of inflation closer to 2%.~~The Governing Council sees both upside and downside risks to the outlook for price developments as limited and broadly balanced over the medium term. In this context, the possible repercussions of both geopolitical risks and exchange rate developments will be monitored closely.

Turning to the **monetary analysis**, data for February 2014 point to subdued underlying growth in broad money (M3). Annual growth in M3 was broadly stable in February at 1.3%, compared with 1.2% in January. The growth of the narrow monetary aggregate M1 remained robust at 6.2% in February, after 6.1% in January. The main factor supporting annual M3 growth continued to be the increase in the MFI net external asset position, reflecting the keen interest of international investors in euro area assets.

MFI loans to the private sector continued to decline in February. The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was -3.1%, compared with -2.8% in January. Weak loan dynamics for non-financial corporations continue to reflect their lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.4% in February 2014, still broadly unchanged since the beginning of 2013.

Since the summer of 2012, substantial progress has been made in improving the funding situation of banks. In order to ensure an adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed. This is the objective of the ongoing comprehensive assessment by the ECB.

To sum up, the economic analysis confirms our expectation of a prolonged period of low inflation followed by a gradual upward movement in HICP inflation rates towards levels closer to 2%. A **cross-check** with the signals from the monetary analysis confirms the picture of subdued underlying price pressures in the euro area over the medium term.

As regards **fiscal policies**, ~~the ECB staff macroeconomic projections indicate continued~~euro area countries have made important progress in ~~reducing~~correcting fiscal imbalances~~ in the euro area. The aggregate euro area general government deficit is expected to have declined to 3.2% of GDP in 2013 and is projected to be reduced further to 2.7% of GDP this year. General government debt is projected to peak at 93.5% of GDP in 2014, before declining slightly in 2015. Looking ahead, euro area countries ~~. They should not unravel past consolidation ~~efforts~~achievements and should put high government debt ratios on a downward trajectory over the medium term~~. Fiscal strategies should be~~, in line with the Stability and Growth Pact~~ and~~. Fiscal strategies should ensure a growth-friendly composition of consolidation ~~which combines improving the~~to achieve better quality and ~~efficiency of~~more efficient public services~~ with ~~, while minimising the distortionary effects of taxation. ~~National authorities should also continue with the decisive implementation of **structural reforms** in all euro area countries. These reforms should aim, in particular, to make it easier to do business and to boost employment, thus enhancing the euro area's growth potential and reducing unemployment in the euro area countries. To this end, the Governing Council welcomes the European Commission's communication of yesterday on the prevention and correction of macroeconomic imbalances and on the Excessive Deficit Procedure. Looking ahead, it is key that the macroeconomic surveillance framework in the euro area, which was significantly strengthened in the wake of the sovereign debt crisis, is implemented fully and in a consistent manner~~Further decisive steps are needed to **reform product and labour markets** with a view to improving competitiveness, raising potential growth, generating employment opportunities and making euro area economies more flexible.