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ECB Watch

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Economic Analysis

Financial Scenarios
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Focus on helping euro area bank funding

- **Focus on "non-standard" support to banks; a lot was announced**
- **The ECB opened the door to interest rate cuts a bit more...**
- **... but it seems unlikely that they would act pre-emptively**

Bottom line: the aim of the ECB was to provide significant support to euro area banks. A lot was announced (Mr. Triched stressed in the Q&A the "amplitude" of the decisions taken) and by doing so they sent a strong signal that the ECB would do whatever necessary to sustain bank funding. The ECB also opened the door to interest rate cuts a bit more (a rate cut was discussed) but it seems clear that they are not likely to act pre-emptively as they have done when facing upside inflation risks.

The ECB focus was on helping euro area bank funding. The main objective of the ECB was to provide further liquidity measures aimed at easing strains in bank funding markets. The ECB will conduct two LTROs: a 12-month in October and one with a maturity of around 13 months in December[1]. In addition, the central bank will continue to offer short-term unlimited liquidity[2] for as long as necessary and at least until July next year. Lastly, the ECB announced a new covered bond purchase programme (CBPP2) to buy bonds issued by banks and backed by collateral. Purchases will amount to EUR40bn, will be conducted in primary and secondary markets, will start in November 2011 and will be fully implemented by October 2012. This measure aims at easing liquidity strains as the covered bond market has been closed in the past few months. As (and if) conditions gradually improve there would also be an improvement in prices. Mr. Trichet expects that the EFSF will intervene in the secondary markets "as soon as possible" ("all governments must implement July's decisions") and considered that the "government themselves have the capacity to leverage the EFSF" ie, the Council is opposed to granting an ECB credit line to the EFSF which is consistent with their view that the responsibility to solve problems should not fall only on them.

The ECB also took the opportunity to open the door to interest rates cuts a bit more. The ECB decided by consensus (rather than unanimously) to keep its main interest rate unchanged at 1.5%. After turning dovish last month, the ECB reiterated its implicit easing bias and further adapted its wording (given the deteriorating economic outlook and moderating inflation pressures) to pave the way for lower rates if need arises (ie, if downside risks to growth intensify further). Changes to ECB's tone went in a dovish direction. At the last meeting, the ECB acknowledged that "some financing conditions [had] tightened". Now, it seems that the ECB no longer judges that the monetary policy stance remains accommodative as they dropped the phrase and replaced it with "short-term interest rates remain low". Meanwhile, they continue to see downside risks to growth while they perceive risks to inflation as "broadly balanced". The overall tone is clearly dovish and albeit there were no hints that there will be a rate cut soon, Mr. Trichet noted that the Governing Council discussed the pros and cons of both leaving rates unchanged and lowering them and said that the decision was by consensus, which means that at least one member wanted to cut rates now instead of waiting. In spite of the dovish tone, Mr. Trichet insisted not only on the responsibility of delivering price stability but also on the importance of being credible on the delivery. It is our view that by saying that, the ECB is signalling that they would rather wait until inflation falls below 2% (in Q1 12 in our scenario) before taking a rate cut decision.

1: Demand might be high as banks may be inclined to its liquidity needs for next year; the ECB last offered a 12-month LTRO in December 2009
2: One-week and one-month MROS, and 3-month LTROs

Annex 1: Introductory statement to the press conference

Jean-Claude Trichet, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
~~Frankfurt am Main, 8 September~~Berlin, 6 October 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference~~. We will~~ here in Berlin. Let me take the opportunity to warmly thank President Weidmann for his invitation and kind hospitality. I would also like to express our special gratitude to the staff of the Deutsche Bundesbank for the excellent organisation of our meeting. Let me now report on the outcome of today's meeting of the Governing Council, which was also attended by the President of the Eurogroup, Prime Minister Juncker, and Commissioner Rehn.

Based on its regular economic and monetary analyses, the Governing Council decided to keep ~~the~~ the **key ECB interest** ~~rates~~ **rates** unchanged. Inflation has remained elevated and incoming information has confirmed our view that inflation is likely to stay above 2% over the months ahead ~~before declining next year.~~but to decline thereafter. At the same time, the underlying pace of monetary expansion continues to be moderate~~, while monetary liquidity remains ample. As expected,~~. Ongoing tensions in financial markets and unfavourable effects on financing conditions are likely to dampen the pace of economic growth in the euro area ~~decelerated~~ in the second ~~quarter, following strong growth in the first quarter. Looking ahead, we expect the euro area economy to grow moderately,~~ half of this year. The economic outlook remains subject to particularly high uncertainty and intensified downside risks. At the same time, short-term interest rates ~~are~~ remain low. ~~While our monetary policy stance remains accommodative, some financing conditions have tightened.~~ It remains essential for monetary policy to ~~focus on its mandate of maintaining~~maintain price stability over the medium term, thereby ensuring ~~that recent price developments do not give rise to broad-based inflationary pressures. A very thorough analysis of all incoming data and developments over the period ahead is warranted. Inflation~~a firm anchoring of inflation expectations in the euro area ~~must remain firmly anchored~~ in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Such anchoring is a prerequisite for monetary policy to make its contribution towards supporting economic growth and job creation in the euro area. ~~We will continue to monitor~~A very ~~closely~~thorough analysis of all incoming data and developments over the period ahead is warranted.

The Governing Council has decided to conduct two longer-term refinancing operations (LTROs), one with a maturity of approximately 12 months in October and the other with a maturity of approximately 13 months in December. The operations will be conducted as fixed rate tender procedures with full allotment. The rate in both operations will be fixed at the average rate of the main refinancing operations (MROs) over the life of the respective LTRO, and interest will be paid when each operation matures. These operations will be conducted in addition to the regular and special-term refinancing operations, which remain unaffected.

The Governing Council has also decided to continue conducting its MROs as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the sixth maintenance period of 2012 on 10 July 2012. This procedure will also remain in use for the Eurosystem's special-term refinancing operations with a maturity of one maintenance period, which will continue to be conducted for as long as needed, and at least until the end of the sixth maintenance period (i.e. around the end of the second quarter) of 2012. The fixed rate in these special-term refinancing operations will be the same as the MRO rate prevailing at the time.

In addition, the Governing Council has decided to conduct the three-month LTROs to be allotted on 25 January, 29 February, 28 March, 25 April, 30 May and 27 June 2012 as fixed rate tender procedures with full allotment. The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO.

Furthermore, the Governing Council has decided to launch a new covered bond purchase programme (CBPP2). The programme will have the following modalities:

- The purchases will be for an intended amount of EUR 40 billion.
- The purchases will have the capacity to be conducted in the primary and secondary markets and will be carried out by means of direct purchases.

- The purchases will start in November 2011 and are expected to be fully implemented by the end of October 2012.

Further details on the modalities of CBPP2 will be announced after the Governing Council meeting of 3 November 2011.

The provision of liquidity and the allotment modes for refinancing operations will continue to ensure that euro area banks are not constrained on the liquidity side. All the non-standard measures taken during the period of acute financial market tensions are, by construction, temporary in nature.

Let me now explain our assessment in greater detail, starting with ~~the~~ the **economic analysis**. ~~Euro area real~~Real GDP growth ~~decelerated to 0.2% quarter on quarter~~in the euro area, after slowing in the second quarter of 2011~~, after 0.8% in the first quarter. As~~ to 0.2% quarter on quarter, is now expected~~,~~ ~~temporary~~ to be very moderate in the second half of this year. In particular, a number of factors ~~which had boosted~~ seem to be dampening the underlying growth ~~in the early part of the year ceased,~~momentum in the euro area, including a moderation in the pace of global demand, falling consumer and ~~adverse effects resulted from the Japanese earthquake and the lagged impact of past oil price increases. Looking ahead, a number of developments seem to be dampening the underlying momentum in the euro area, including a moderation in the pace of global growth, related declines in equity prices and in~~ business confidence, and unfavourable effects on financing conditions resulting from ongoing tensions in a number of euro area sovereign debt markets.~~ As a consequence, real GDP growth is expected to increase very moderately in the second half of this year.~~ At the same time, we continue to expect euro area economic activity to benefit from ~~ongoing~~continued positive growth in the ~~global economy~~ emerging market economies as well as from the ~~accommodative monetary policy stance~~ low short-term interest rates and the various measures taken to support the functioning of the financial sector.

~~This assessment is also reflected in the September 2011 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between 1.4% and 1.8% in 2011 and between 0.4% and 2.2% in 2012. Compared with the June 2011 Eurosystem staff macroeconomic projections, the ranges for real GDP growth in 2011 and 2012 have been revised downwards.~~

In the Governing Council's assessment, the risks to the economic outlook for the euro area ~~are~~ remain on the downside~~,~~ in an environment of particularly high uncertainty. Downside risks ~~mainly~~ notably relate to the ongoing tensions in some segments of the financial markets in the euro area and at the global level, as well as to the potential for these pressures to further spill over into the euro area real economy. They also relate to ~~further increases in~~ the still high energy prices, protectionist pressures and the possibility of a disorderly correction of global imbalances.

With regard to price developments, euro area annual HICP inflation was ~~2.5~~3.0% in ~~August~~September 2011, according to Eurostat's flash estimate, ~~unchanged from July. We have now seen inflation rates~~ after 2.5% in August. Inflation rates have been at ~~relatively high~~ elevated levels since the end of last year, ~~with~~ mainly driven by higher energy and other commodity prices~~ as the main drivers~~. Looking ahead, inflation rates are likely to stay clearly above 2% over the coming months~~. Thereafter, on the basis of the path implied by futures markets for oil prices, inflation rates should fall below 2% in 2012.~~ but to decline thereafter. This pattern reflects the expectation of relatively stable wage growth developments in the context of moderate economic growth.

~~The September 2011 ECB staff macroeconomic projections for the euro area embody these considerations and foresee annual HICP inflation in a range between 2.5% and 2.7% for 2011 and between 1.2% and 2.2% for 2012. In comparison with the June 2011 Eurosystem staff macroeconomic projections, the range for HICP inflation in 2011 remains unchanged, while the range for 2012 is slightly narrower. It is necessary to recall that the staff projections are conditional on a number of purely technical assumptions.~~

The Governing Council ~~views~~continues to view the risks to the medium-term outlook for price developments as ~~being~~ broadly balanced. On the upside, the main risks relate to the possibility of ~~higher than assumed increases in oil and non-oil commodity prices as well as~~ increases in indirect taxes and administered prices, owing to the need for fiscal consolidation in the coming years. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally.

Turning to ~~the~~ the **monetary analysis**, the annual growth rate of M3 was 2.~~0% in July 2011, after 1.9% in June.~~8% in August 2011, up from 2.1% in July. The annual growth rate of loans to the private sector, adjusted for loan sales and securitisation, was 2.~~4~~8% in ~~July~~August, after 2.~~5~~6% in ~~June. Looking beyond the monthly data and the effects of special factors, trends in broad money and loan growth have broadly stabilised over recent months. Overall, the underlying pace of monetary expansion remains moderate. At the same time, monetary liquidity accumulated prior to the period of financial market tensions continues to be ample~~July. A number of factors, possibly related to the intensification of tensions in some financial markets, could have had an upward effect on the components of M3. In particular, sizeable inflows into overnight deposits and money market fund shares/units, as well as a substantial inflow into repurchase agreements, appear to have driven monetary developments in August. The inflow into repurchase agreements mainly reflected secured lending in the interbank market, which was increasingly settled via central counterparties that are allocated to the money-holding sector. Overall, M3 growth was driven in particular by the increase in the annual growth rate of M1 from 1.0% in July to 1.7% in August and the increase in the annual growth rate of marketable instruments.

~~Looking at M3 components, the annual growth rate of M1 decreased to 0.9% in July, whereas growth in other short-term deposits remained unchanged at 3.7%. These developments continue to partly reflect the gradual increase in the remuneration of short-term time and savings deposits over recent months. On the counterpart side, the annual growth of loans to non-financial corporations continued to edge up slightly, from 1.5% in June to 1.6% in July, whereas the annual growth of loans to households seems to have levelled off at around 3%.~~

~~The overall size of MFI balance sheets has remained broadly unchanged over recent months. Where it is necessary to provide adequate scope to expand the provision of credit to the private sector, it is essential for banks to retain earnings, to turn to the market to strengthen further their capital bases or to take full advantage of government support measures for recapitalisation, in line with the findings of the recent stress tests.~~

On the counterpart side, the annual growth rate of loans to non-financial corporations and to households in August, both adjusted for loan sales and securitisation, remained unchanged from July, at 2.2% and 2.7% respectively. Taking the appropriate medium-term perspective, trends in broad money and loan growth have broadly stabilised over recent months. Overall, the underlying pace of monetary expansion thus remains moderate.

The situation of the banking sector calls for particular attention, taking into account the interplay between sovereign risk issues and banks' funding needs. As we have done on previous occasions, the Governing Council urges banks to do all that is necessary to reinforce their balance sheets, to retain earnings, to ensure moderation in remuneration, and to turn to the market to strengthen further their capital bases. Where necessary, they should take full advantage of government support measures, which should be made totally operational, including the possibility in future for the European Financial Stability Facility (EFSF) to lend to governments in order to recapitalise banks.

To sum up, based on its regular economic and monetary analyses, the Governing Council decided to keep the key ECB interest rates unchanged. Inflation has remained elevated and incoming information has ~~remained elevated and~~ confirmed our view that inflation is likely to stay above 2% over the months ahead ~~before declining next year.~~but to decline thereafter. ~~A~~ A **cross-** ~~**check**~~ **check** with the information from our monetary analysis confirms that the underlying pace of monetary expansion continues to be moderate~~, while monetary liquidity remains ample. As expected,~~. Ongoing tensions in financial markets and unfavourable effects on financing conditions are likely to dampen the pace of economic growth in the euro area ~~decelerated~~ in the second ~~quarter, following strong growth in the first quarter. Looking ahead, we expect the euro area economy to grow moderately,~~ half of this year. The economic outlook remains subject to particularly high uncertainty and intensified downside risks. At the same time, short-term interest rates ~~are~~remain low. ~~While our monetary policy stance remains accommodative, some financing conditions have tightened.~~ It remains essential for monetary policy to ~~focus on its mandate of maintaining~~maintain price stability over the medium term, thereby ensuring ~~that recent price developments do not give rise to broad-based inflationary pressures. A very thorough analysis of all incoming data and developments over the period ahead is warranted. Inflation~~ a firm anchoring of inflation expectations in the euro area ~~must remain firmly anchored~~ in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Such anchoring is a prerequisite for monetary policy to make its contribution towards supporting economic growth and job creation in the euro area. ~~We will continue to monitor~~A very ~~closely~~thorough analysis of all incoming data and developments over the period ahead is warranted.

~~Turning to **fiscal policies**, a number of governments have announced additional measures to ensure the achievement of their consolidation targets and to strengthen the legal basis for national fiscal rules. To ensure credibility, it is now crucial that the announced measures be frontloaded and implemented in full. Governments need to stand ready to implement further consolidation measures, notably on the expenditure side, if risks regarding the attainment of the current fiscal targets materialise. Countries that enjoy better than expected economic and fiscal developments should make full use of this room for manoeuvre for faster deficit and debt reduction.~~Turning to **fiscal policies**, with financial market uncertainty remaining high, all governments need to take decisive and frontloaded action to bolster public confidence in the sustainability of government finances. All euro area governments need to ~~demonstrate~~show their inflexible determination to fully honour their own individual sovereign signature~~, which is a decisive~~ as a key element in ensuring financial stability in the euro area as a whole Countries under joint EU-IMF adjustment programmes as well as those particularly vulnerable to financial market conditions need to unambiguously implement all announced measures for fiscal consolidation and the strengthening of domestic fiscal frameworks, and they need to stand ready to take any additional measures that may become necessary owing to the evolution of their situation.

Fiscal consolidation and structural reforms must go hand in hand to strengthen confidence, growth prospects and job creation. The Governing Council therefore urges all euro area governments to decisively and swiftly implement substantial and ~~comprehensive~~ comprehensive **structural reforms**. This will help these countries to strengthen competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. In this respect, labour market reforms are key, with a focus on the removal of rigidities and the implementation of measures which enhance wage flexibility. In particular, we should see the elimination of automatic wage indexation clauses and a strengthening of firm-level agreements~~ so that wages and working conditions can be tailored to firms' specific needs.~~. More generally, in these demanding times, moderation is of the essence in terms of both profit margins and wages. These measures should be accompanied by structural reforms that increase competition in product markets, particularly in services – including the liberalisation of closed professions – and, where appropriate, the privatisation of services currently provided by the public sector, thereby facilitating productivity growth and supporting competitiveness. At the same time, the Governing Council urges all euro area governments to fully implement all aspects of the decisions they took on 21 July 2011.

~~We are now at your disposal for questions.~~

Let me close with some personal remarks. This is my last press conference following a meeting of the Governing Council. I remember my first press conference, eight years ago, as if it were yesterday. I want to tell you that it has been a great pleasure to have this regular dialogue with the press, with all of you. We have, together, each of us with our different responsibilities, analysed the European and global situation throughout these years. We were never in calm waters. But for more than four years now, we have been experiencing turbulent waters, storms, unexpected hurricanes. In demanding times, regular, real-time and transparent communication is more important than ever. The channels of national, European and global communication which you are responsible for are crucial for the appropriate functioning of markets, for the correct understanding of economists and economic agents, and for the information of the people of Europe, our fellow citizens, to whom, as an independent institution, we are accountable. Eight years ago the concept of a press conference immediately after the meeting of the Governing Council was still considered a bold innovation. Today it is part of the global state of the art. And the Vice-President and I also have to thank you for that.

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