

ECB Watch

Europe

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Economic Analysis

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Wait-and-see stance; easing bias

- Risks to inflation are “broadly balanced” while in times of “enormous uncertainty, risks to the growth outlook are on the downside and”
- The deteriorating outlook together with financial tensions convinces ECB to adopt a wait-and-see stance
- With an easing bias the ECB paves the way for a rate cut if downside risks to growth intensify further

Bottom line: Overall, today’s statement and press conference marked a shift to a wait-and-see stance (as expected) but leaned (more than expected) to the dovish side. Significant wording changes were reinforced by the tone of the press conference. It is our view that by doing that, the ECB is not only signalling a “wait-and-see mode” but also an easing bias. The ECB seems prone to embark on a prolonged monetary policy pause. However, by implicitly adopting an easing bias, it paves the way for a rate cut if downside risks to growth intensify further.

A dovish ECB adopts a wait-and-see mode and in times of “enormous uncertainty” aims at gaining enough flexibility to act if downside risks to growth intensify further. The ECB kept official interest rates unchanged and made major wording changes to adapt it to a much more uncertain growth outlook and “intensified downside risks”. As expected, the deteriorating outlook together with financial tensions convinces ECB to adopt a wait-and-see stance. Changes to ECB’s tone strongly went in a “dovish” direction and are consistent not only with a wait-and-see stance but also with an easing bias. The ECB will continue to monitor “very closely all developments”

With respect to the growth outlook the ECB now sees downside risks (perceived as balanced in August). As expected, the ECB staff revised down its midpoint growth forecasts by around 0.3pp to 1.6% and 1.3% for 2011 and 2012, respectively. More significant is the fact that the Governing Council judges that “risks to the staff assessment [on growth] are on the downside”. It seems that the Governing Council judges that the new projections do not incorporate the latest information. GDP growth is expected to increase “very” moderately in H2. This is consistent with recent data which shows a gloomier economic outlook for the EZ in the near term. Thus, we see these downside risks as increasingly likely to materialize in coming quarters, resulting in a more marked slowdown going forward. To reinforce changes to the dovish direction, much emphasis was placed on the “enormous uncertainty” by Mr. Trichet on the press conference. As regards to inflation, midpoint staff projections were unrevised at 2.6% (2011) and 1.7% (2012), but band is narrower. More importantly, inflation risks are now seen as “broadly balanced” rather than “on the upside”. Overall, the assessment on the inflation outlook is much more balanced: the ECB even introduced downside risks in the Statement related to “the impact of weaker than expected growth”. This is consistent with our scenario: we see headline inflation moderating by year-end, driven by favourable base effects in energy prices, and to fall below the ECB target at the beginning of 2012. Regarding the monetary policy stance, changes also tilt the overall tone to the dovish side: while the ECB continues to judge that monetary policy stance remains accommodative, it acknowledges that “some financing conditions have tightened”.

With respect to NSM, Mr. Trichet stressed that liquidity was not an issue for the banking sector as the ECB stands ready to supply unlimited liquidity and as the stigma that had “been the case in the past” is not the case now. When asked with respect to Italian fiscal consolidation measures, Mr. Trichet emphasized the importance for the SMP that governments stick with announced plans.

Annex 1: Introductory statement to the press conference

Jean-Claude Trichet, President of the ECB,
Vitor Constâncio, Vice-President of the ECB,
Frankfurt am Main, 4 August 8 September 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. We will report on the outcome of today's meeting of the Governing Council, which was also attended by Commissioner Rehn.

Based on its regular economic and monetary analyses, the Governing Council decided to keep ~~the the~~ **key ECB interest rates** unchanged, ~~following the 25 basis point increase on 7 July 2011. The information that has become available since then confirms our assessment that an adjustment of. Inflation has remained elevated and is likely to stay above 2% over the months ahead before declining next year. At the accommodative monetary policy stance was warranted in the light of upside risks to price stability. While the monetary analysis indicates that same time,~~ the underlying pace of monetary expansion ~~is still continues to be moderate, while monetary liquidity remains ample and may facilitate the accommodation of price pressures.~~ As expected, ~~recent economic data indicate a deceleration in the pace of economic growth in the past few months, following the euro area decelerated in the second quarter, following strong growth rate in the first quarter. Continued moderate expansion is expected in the period ahead. However, uncertainty is~~ Looking ahead, we expect the euro area economy to grow moderately, subject to particularly high ~~For uncertainty and intensified downside risks. At the same time, short-term interest rates are low. While our monetary policy, it is~~ stance remains accommodative, some financing conditions have tightened. It remains essential for monetary policy to focus on its mandate of maintaining 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 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 ~~an ongoing its~~ contribution towards supporting economic growth and job creation in the euro area. ~~At the same time, short term interest rates remain low and financing conditions are favourable. Thus, our monetary policy stance remains accommodative.~~ We will continue to monitor very closely all developments ~~with respect to upside risks to price stability.~~

~~Given the renewed tensions in some financial markets in the euro area, the Governing Council today also decided to conduct a liquidity providing supplementary longer term refinancing operation (LTRO) with a maturity of approximately six months. The operation will be conducted as a fixed rate tender procedure with full allotment. The rate in this operation will be fixed at the average rate of the main refinancing operations (MROs) over the life of the supplementary LTRO. The operation will be announced on 9 August 2011, with allotment on 10 August 2011 and settlement on 11 August 2011, and will mature on 1 March 2012.~~

~~The Governing Council 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 last maintenance period of 2011 on 17 January 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 last quarter of 2011. The fixed rate in these special term refinancing operations will be the same as the MRO rate prevailing at the time.~~

~~Furthermore, the Governing Council has decided to conduct the three-month LTROs to be allotted on 26 October, 30 November and 21 December 2011 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.~~

~~Let me now explain our assessment in greater detail, starting with the economic analysis. In the first quarter of 2011 euro area real GDP posted a strong quarter on quarter increase of 0.8%. Data and survey releases for the second quarter point towards ongoing real GDP growth, albeit, as expected, at a slower pace. This moderation also reflects the fact that the strong growth in the first quarter was in part due to special factors. The underlying positive momentum of economic growth in the euro area remains in place and continued moderate expansion is expected in the period ahead. Euro area exports should continue to be supported by the ongoing expansion in the world economy. In addition, the present level of consumer and business confidence in the euro area supports private sector domestic~~

demand. However, growth dynamics are currently weakened by a number of factors contributing to uncertainty, and activity is expected to be dampened somewhat by the ongoing process of balance sheet adjustment in various regions and sectors.

In the Governing Council's assessment, the risks to this economic outlook for the euro area remain broadly balanced in an environment of particularly high uncertainty. On the one hand, consumer and business confidence, together with improvements in labour market conditions, could continue to provide support to domestic economic activity. On the other hand, downside risks may have intensified. 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 **economic analysis**. Euro area real GDP growth decelerated to 0.2% quarter on quarter in the second quarter of 2011, after 0.8% in the first quarter. As expected, temporary factors which had boosted growth in the early part of the year ceased, 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 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 growth in the global economy as well as from the accommodative monetary policy stance 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 on the downside, in an environment of particularly high uncertainty. Downside risks mainly 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 spill over into the euro area real economy. They relate to the ongoing tensions in some segments of the euro area financial markets as well as to global developments, and the potential for these pressures to spill over into the euro area real economy. Downside risks also relate to further increases in 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% in July 2011, following 2.7% in June. The relatively high August 2011, according to Eurostat's flash estimate, unchanged from July. We have now seen inflation rates seen over the past few months largely reflect at relatively high levels since the end of last year, with 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. Upward pressure on inflation, mainly from energy and other commodity prices, is also still discernible in the earlier stages of the production process. It remains of paramount importance that the rise in HICP inflation does not translate into second-round effects in price and wage-setting behaviour and lead to broad-based inflationary pressures. Inflation expectations must remain firmly anchored in line with the Governing Council's aim of maintaining inflation rates below, but close to, 2% over the medium term. Thereafter, on the basis of the path implied by futures markets for oil prices, inflation rates should fall below 2% in 2012. This pattern reflects the expectation of relatively stable wage growth developments in the context of moderate economic growth.

Risks—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 the risks to the medium-term outlook for price developments ~~remain~~ ~~on~~ as being broadly balanced. On the upside, ~~They~~, the main risks relate, in particular, to the

possibility of higher than assumed increases in ~~energy~~oil and non-oil commodity prices. Furthermore, there is a risk of, as well as increases in indirect taxes and administered prices that may be greater than currently assumed, owing to the need for fiscal consolidation in the coming years. Finally, upside risks may stem from stronger than expected domestic price pressures in the euro area. 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 ~~decreased to 2.1% in June 2011, from 2.5% in May. Looking through the recent monthly volatility, M3 growth has broadly stabilised over recent months, after edging up until the first quarter of 2011. The annual growth rate of loans to the private sector declined to 2.5% in June, from 2.7% in May. was 2.0% in July 2011, after 1.9% in June. The annual growth rate of loans to the private sector was 2.4% in July, after 2.5% 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, and may facilitate the accommodation of price pressures in the euro area.~~

Looking at M3 components, the annual growth rate of M1 ~~remained unchanged at 1.2% decreased to 0.9% in July~~, whereas growth in other short-term deposits ~~declined to~~remained unchanged at 3.7%. The growth differentials ~~These developments~~ continue to partly reflect in part the gradual increase in the remuneration of short-term time and savings deposits over recent months. At the same time, the still relatively steep yield curve implies a dampening impact on overall M3 growth, as it reduces the attractiveness of monetary assets compared with more highly remunerated longer-term instruments outside M3. However, this impact is likely to be waning. On the counterpart side, the annual growth of loans to non-financial corporations continued to edge up slightly, from ~~0.9% in May to 1.5% in June to 1.6% in July~~, whereas the annual growth of loans to households ~~hovered over recent months seems to have levelled off at~~ around rates of slightly above 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 particular, banks that currently have limited access to market financing urgently need to increase their capital and their efficiency. In this respect, we welcome the EU-wide, in line with the findings of the recent stress-testing exercise, which was prepared by the European Banking Authority and national supervisors, in close cooperation with the ECB. We also welcome the commitment made by national authorities with regard to the provision of support facilities for banks where private sector means are insufficient. tests.

To sum up, based on its regular economic and monetary analyses, the Governing Council decided to keep ~~the~~the key ECB interest rates rates unchanged, following the 25 basis point increase on 7 July 2011. The information that has become available since then confirms our assessment that an adjustment of the accommodative monetary policy stance was warranted in the light of upside risks to price stability. Inflation has remained elevated and is likely to stay above 2% over the months ahead before declining next year. A cross-check check with the signals coming information from the our monetary analysis indicates confirms that while the underlying pace of monetary expansion is still continues to be moderate, while monetary liquidity remains ample and may facilitate the accommodation of price pressures. As expected, recent economic data indicate a deceleration in the pace of economic growth in the past few months euro area decelerated in the second quarter, following the strong growth rate in the first quarter. Continued moderate expansion is expected in the period ahead. However, uncertainty is particularly high. For Looking ahead, we expect the euro area economy to grow moderately, subject to particularly high uncertainty and intensified downside risks. At the same time, short-term interest rates are low. While our monetary policy stance remains accommodative, some financing conditions have tightened. It remains essential for monetary policy, it is essential to focus on its mandate of maintaining 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 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 an ongoing its contribution towards supporting economic growth and job creation in the euro area. At the same time, short-term interest rates remain low and financing conditions favourable. Thus, our monetary policy stance remains accommodative. We will continue to monitor very closely all developments with respect to upside risks to price stability.

Turning to **fiscal policies**, the Governing Council stresses the need for strict and timely implementation of the IMF/EU adjustment programmes in Greece, Ireland and Portugal. In addition, it underlines the importance of the renewed commitment of all Heads of State or Government of the euro area to adhere strictly to the agreed fiscal targets. For several countries, this requires announcing and implementing additional and more frontloaded fiscal adjustment measures. Those **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. ~~The common aim should be to put public debt ratios and public finances on a sustainable path as soon as possible. As emphasised by the Heads of State or Government of the euro area, the~~ **All euro area governments need to demonstrate their** inflexible determination ~~of all euro area countries~~ to fully honour their own individual sovereign signature, **which** is a decisive element in ensuring financial stability in the euro area as a whole.

~~The Governing Council also welcomes the renewed commitment of all Member States to improve competitiveness and address macroeconomic imbalances. Indeed, substantial and comprehensive~~ **structural reforms** ~~need to be implemented in the countries of the euro area in order to~~ 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 **structural reforms**. This will help these countries to strengthen competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. ~~The~~ In this respect, labour market reforms are key, with a focus on the removal of ~~labour market~~ rigidities and the implementation of measures which enhance wage flexibility, ~~notably~~. In particular, we should see the elimination of automatic wage indexation clauses, ~~are~~ and a strengthening of ~~key importance~~ firm-level agreements so that wages and working conditions can be tailored to firms' specific needs. 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.

We are now at your disposal for questions.

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