

Europe

ECB Watch

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Economic Analysis

Europe

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Full provision of liquidity “at least” until 1Q11

- As it was widely expected, the ECB will provide liquidity to the financial system with the full-allotment tender operations “for as long as necessary and at least until” January 2011. Importantly, the extension of liquidity was taken “by consensus”, in contrast with the unanimity on keeping interest rates unchanged.
- In spite of being a continuation of the QE policies, the ECB intends to present it just as a part of the normalization of the liquidity situation as it aims to smooth the replacement of the maturities of 6- and 12-M full allotment tenders.
- On economic outlook, the ECB has revised upwards, as expected, its projection of economic growth for 2010 and 2011 due to positive surprises in 2Q10 and 3Q10 data. However, the ECB mode remains cautious and sees some downside risks to this outlook. On inflation, there were few surprises since June so the ECB’s inflation forecasts for 2010 and 2011 have been revised only very marginally upwards.
- The tone of the statement and of the Q&A was more cautious in comparison with August’s meeting. In a context of high uncertainty, core central banks are giving signals that will keep on providing liquidity, as it is evident on today’s ECB statement, recent declarations from Fed members and this week’s BoJ decision.

The ECB did not surprise anyone as it maintained the key official rates unchanged and extended the provision of liquidity in the 1-week, 1-month and 3-month full allotment tenders “at least” until 1Q10. Also, there were no surprises in the upward growth revision and the minor revision of inflation forecasts. However, the tone was –in general- much more cautious compared to last meeting’s position, and more in line with the Fed.

Liquidity: the main focus of this meeting was on the ECB’s non-standard policies of liquidity provision as the 3-Month full allotment tender operation were planned to end on September 29. On this issue, the ECB decided to extend these LTRO operations until December 2010, so there will be three additional 3-Month LTRO (on October, November and December). It guarantees enough liquidity at least until March 2011. In addition, the ECB also decided to continue with the 1-week MRO and 1-month LTRO with fixed rate tender procedures with full allotment “as long as necessary” and “at least until 18 January 2011”. The ECB also introduced three additional “fine tuning” operations on 30 September, 11 November and 23 December coinciding with the maturity of the last 6- and 12-M LTRO. The extension of these non-standard measures had been anticipated on recent declarations of Mr. Weber and did not surprise markets. As a final novelty the rate on the 3-M operations will not be fixed but will be an average rate on the corresponding MRO rates. Still, this is just a technicality with no implications if the official rate remains unchanged.

While we consider these decisions to be a continuation of the QE policies, Mr. Trichet intends to present them just as a part of the normalization of the liquidity situation as he considers that the ECB is “in a process of phasing out exceptional measures”. In this vein, the continuation of the non-standard measures is presented as a mechanism to smooth the replacement of the maturities of 6- and 12-M FA tenders, a move in “synchrony with markets” which “will take time”. Still, this normalization is occurring at a very slow pace. It is true that the use of Deposit window facility by EMU banks is decreasing, and the Eonia rate has closed part of the gap with the official refi rate. Nonetheless, the spread between the two rates is very high in comparison with historical levels. Moreover, the provision of liquidity in the LTRO and MRO has remained in very high levels in the last two months (after the substantial decrease when the first 12-Month FA matured). Furthermore, the concentration of the ECB liquidity provision on some of the most vulnerable countries is increasing. In fact, Mr. Trichet was explicitly asked whether this move was an intention to “support” banks in the periphery. While –of course- he denied this, it is clear that some parts of the EMU financial system are highly dependent on the liquidity provision of the ECB. The openness of credit markets for EMU financial institutions is, hence, the key event to monitor in the coming months.

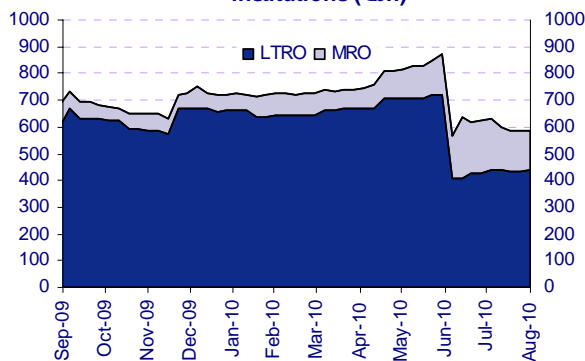
Activity: on economic outlook, the ECB has revised upwards, as expected, its projection of economic growth for both 2010 and 2011, from 1% to 1.6% and from 1.2% to 1.4%, respectively. This significant revision is due to positive surprises in 2Q10 and good incoming data for 3Q10 (especially soft data). However, the ECB mode remains cautious, as drivers behind this strong growth are temporary and a possible slowdown in the US and Asia economies could dampen external demand. The GC sees some downside risks to this outlook (in contrast with the “broadly balanced” risks of August’s statement), but its economic scenario does not envisage a possible double-dip recession. These ECB forecasts seem reasonable to us and in line with our sub-consensus forecast (once the positive surprise for 2Q10 is factored in), which incorporates a significant slowdown in the second half of the year.

Inflation: on the inflation outlook, there have been few surprises regarding projections since June, only a slight positive surprise for core inflation resulting from both tax increases and strains in food markets. As a consequence, and in line with what we expected, the ECB’s inflation forecasts for both 2010 and 2011 have been revised only very marginally upwards, by 0.1pp to 1.6% and 1.7%, respectively. Considering the recent evolution of inflation and that the uncertainty linked to the impact of VAT hikes is diminishing, the ECB inflation forecasts seems appropriate.

European Sovereign crisis: on this issue, the statement remarked that better-than-expected macroeconomic data could help to accelerate progresses in the ongoing fiscal consolidation plans, but it also warned that those countries that need to take additional measures should implement them quickly. On the Q&A, the focus was concentrated on the Irish banking rescue package, especially about the situation of the Anglo Irish bank. Mr. Trichet remarked that Ireland continue to take appropriate decisions in the fiscal domain. Regarding Anglo Irish bank he said that it is a nationalized bank and it is responsibility of the Irish authorities.

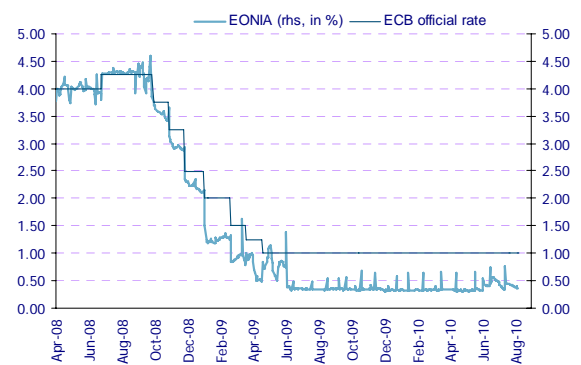
Market reaction: as there were practically no surprises in the ECB decisions and Mr. Trichet statements, market reaction was more or less muted, with stocks, bonds and the euro-dollar rate almost flat during the Conference and the Q&A. Market’s expectation of future monetary policy rates did not show any reaction, either.

ECB: lending to Euro area credit institutions (€bn)



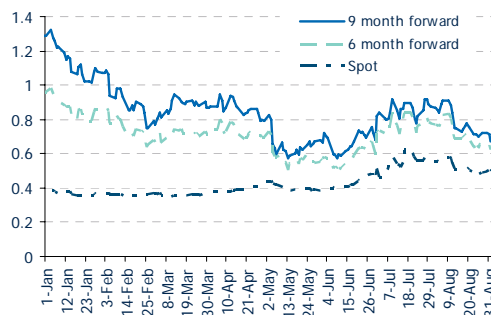
Source: Datastream and BBVA Research

ECB official rate and Eonia



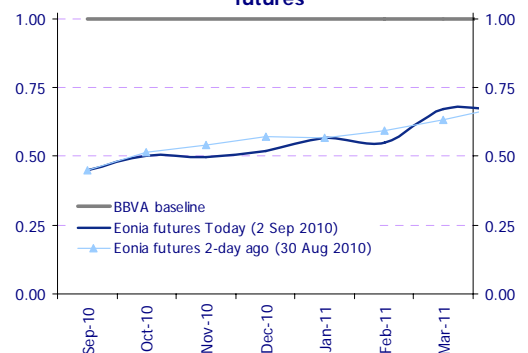
Source: Bloomberg and BBVA Research

OIS 3 month rates implicit in OIS swaps



Source: Datastream and BBVA Research

Euro area: implicit official rate in Eonia futures



Source: Bloomberg and BBVA Research

Annex 1: Tracking the changes...

Jean-Claude Trichet, President of the ECB,
Vitor Constâncio, Vice-President of the ECB
Frankfurt am Main, ~~5 August~~ 2 September 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 ~~views~~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 ~~has~~have become available since our meeting on ~~8 July~~5 August 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon, benefiting from low domestic price pressures. ~~The available economic data and survey-based indicators suggest a strengthening in economic activity in the second quarter of 2010, and the available data for the third quarter are better than expected. Recent economic data for the euro area have been stronger than expected, partly owing to temporary factors. Looking further ahead, and taking into account a number of temporary factors, we continue to expect the euro area economy to grow. The recovery should proceed at a moderate and still uneven pace, in an environment of with uncertainty 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 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.

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 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 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 ~~and the~~, 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 ~~increased, grew strongly~~increasing by ~~1.0~~2% in the ~~first~~second quarter of 2010. ~~The available economic data and survey-based indicators suggest a strengthening, supported by ongoing growth at the global level but also in economic activity in the second quarter of 2010 and the available data for the third quarter are better than expected. Looking further ahead, and taking into account temporary effects, the Governing Council continues to expect real GDP to grow at a moderate and still uneven pace over time and across economies and sectors of the euro area, part reflecting temporary domestic factors. Recent data and survey evidence generally confirm the expectation of a moderation in the second half of this year, both at the global level and in the euro area. Nevertheless, while uncertainty still prevails, they continue to indicate a positive underlying momentum of the recovery in the euro area.~~ Ongoing growth at the global level and its impact on the demand for euro area exports, together with 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 ~~the economic outlook are broadly balanced in an environment of uncertainty. On the upside, the global economy and foreign trade may recover more strongly than is now projected, thereby further supporting euro area exports. On the~~ this improved economic outlook are slightly tilted to the downside, with uncertainty still prevailing. On the one hand, global trade may continue to perform more strongly 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 ~~increased to~~ was 1.76% in ~~July~~ August, according to Eurostat's flash estimate, ~~from 1.4% in June, most~~ compared with 1.7% in July. The small decline in inflation is likely ~~owing to~~ upward reflect base effects in the energy ~~and food components. In the next few months~~ component. Later in the year annual HICP inflation rates are expected to ~~display some further increase slightly while displaying some~~ volatility around the current level. Looking further ahead, 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 ~~broadly balanced. Upside risks over the medium term~~ 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. ~~Overall, the Governing Council will monitor closely the future evolution of all available price indicators.~~

Turning to the **monetary analysis**, the annual growth rate of M3 ~~turned positive and was 0.2% in June 2010, after stood at 0.42% in May-July 2010, unchanged from June.~~ The annual growth rate of loans to the private sector ~~increased slightly further but, at, which has been gradually increasing, rose further to 0.3%, remained 9%, but still remains relatively weak. Together, these data~~ The subdued developments in money and loan growth continue to support the assessment that the underlying pace of monetary expansion is moderate and that inflationary pressures over the medium term are contained. ~~Shorter-term developments in M3 and some of its components and counterparts have remained volatile, and this volatility may well persist.~~

The ~~previously strong impact of the interest rate constellation on monetary dynamics, while still affecting the pace of underlying money growth, appears to be gradually waning. This implies a gradual reduction in the effect on actual M3 growth arising from the downward impact of the steep yield curve and the associated on monetary growth, which is reflected in the~~ allocation of funds into longer-term deposits and securities outside M3. ~~At the same time, is gradually waning. Moreover, the impact of the narrow spreads between different short-term interest rates on the growth of the components of M3 is continuing to diminish. As a result, the annual growth rate of M1 has continued to moderate, although it remained strong at 0.2% in June 2010. In part, this reflects somewhat higher opportunity costs of holding overnight from high levels, and stood at 8.1% in July 2010, while the annual growth rate of other short-term deposits relative to other short-term deposits has become less negative.~~

The still weak annual growth rate of bank loans to the non-financial private sector continues to conceal ~~countervailing developments, with increasingly positive growth in loans to households and stabilised~~ diminishing negative annual growth in loans to non-financial corporations. ~~A~~ These developments are consistent with a normal, lagged response of loans/loan developments to ~~non-financial corporations to developments in~~ economic activity is a normal feature of over the business cycle.

~~The data up to June indicate that, after expanding for a few months earlier in the year, the size of~~ Given the subdued developments in banks' overall balance sheets ~~has not increased further. The,~~ the challenge remains for banks to expand the availability of credit to the non-financial sector when demand picks up. 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.

~~In this respect, we welcome the EU-wide stress-testing exercise, which was prepared and conducted by the Committee of European Banking Supervisors (CEBS) and national supervisory authorities, in close cooperation with the ECB. This stress-testing exercise was comprehensive and rigorous, and the results confirm the resilience of EU and euro area banking systems as a whole to severe economic and financial shocks. The stress test has also significantly enhanced transparency regarding the current financial conditions and risk exposures of the 91 institutions that participated in the exercise. Hence, the exercise represents an important step forward in restoring market confidence.~~

~~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. Sound balance sheets, effective risk management and transparent, robust business models are key to strengthening banks' resilience to shocks and to ensuring adequate access to finance, thereby laying the foundations for sustainable growth, job creation and financial stability.~~

To sum up, the current key ECB interest rates remain appropriate. Considering all the new information which has become available since our meeting ~~on 8 July~~ 5 August 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon, benefiting from low domestic price pressures. ~~The available economic data and survey-based indicators suggest a strengthening in economic activity in the second quarter of 2010, and the available data for the third quarter are better than expected. Recent economic data for the euro area have been stronger than expected, partly owing to temporary factors.~~ Looking further ahead, ~~and taking into account a number of temporary factors, we continue to expect the euro area economy to grow~~ the recovery should proceed at a moderate ~~and still uneven~~ pace, in an environment of with uncertainty 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 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**, it is essential that budget plans for 2011 and beyond reflect a strong commitment to returning to sound public finances. Given the exceptional fiscal deterioration over the past two years, there is an urgent need to implement credible medium-term consolidation strategies aimed at restoring fiscal sustainability and creating room for budgetary manoeuvre. As a minimum, countries' budgetary targets must comply with the fiscal consolidation requirements foreseen under the respective excessive deficit procedures. More ambitious targets, as already adopted by a number of euro area countries, may become necessary where current plans fall short of meeting the main objective of halting and reversing the increase in the government debt ratio. Moreover, all countries must specify credible fiscal adjustment measures, focusing on the expenditure side, while being prepared to implement additional measures, where needed, over the coming years.~~

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 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. Major reforms are particularly needed in those countries that have experienced 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 and losses in competitiveness. Reforms to strengthen productivity growth would further support the adjustment process of these economies.

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