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ECB Watch
Europe

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Economic Analysis

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Less hawkish ECB seems more worried

- **ECB seems more worried about the downside risks to economic activity**
- **Extends liquidity provision; signals resumption of bond-buying program**
- **Still warning about upside inflation risks but less hawkish**

Bottom line: the ECB seems more worried about the downside risks to growth and adapted its wording accordingly. Although Mr. Trichet signalled a resumption of the bond-buying program, it is unlikely to be substantial and therefore, spreads will not narrow and contagion will not stop. ECB's liquidity provision will continue beyond Q4 (it was extended today until year end) as a return to a normal functioning of markets seems unlikely in the short-term. Wording changes but especially the current deterioration in the economic outlook reduces the probability of our expected additional hike this year.

Less hawkish ECB seems more worried about the downside risks to economic activity. The ECB kept official interest rates unchanged and adapted its wording to a more uncertain growth outlook ("uncertainty is particularly high". Albeit the ECB did not soften its remarks on the risks to price stability –still warning about upside risks– and on the importance of stable inflation expectations –"must remain" firmly anchored–, it made a number of wording changes that make the overall statement less hawkish. Concerning the risks to the economic outlook, after downplaying somewhat the recent deceleration in the previous Statement, the ECB said that downside risks to growth "may have intensified" and mentioned "global developments" as a new risk (from the last Statement). As regards the assessment of monetary data, changes also tilt the language to a less hawkish side. M3 growth "broadly stabilised" (vs. "continue to edge up) while the underlying pace of monetary expansion "remains moderate" (vs. "has continued its gradual recovery"). Therefore, although the ECB continues to view risks to the growth outlook as "broadly balanced" and risks to price stability "remain on the upside", wording changes are significant and could further change in the same direction next month if conditions continue to worsen (the next language step would be changing risks to growth from "broadly balanced" to "tilted to the downside"). All in all, it seems unlikely that the ECB will incline to reintroduce the "strong vigilance" reference at either the next or the following meeting and will rather likely repeat that they will continue "monitor very closely" the upside risks to inflation, implying at least that the pace of hikes (one every three-months) will slow down. Moreover, the probability of additional hikes in coming months has declined after today's meeting but especially following the recent sharp deceleration and to a lesser extent due to the spike in contagion spread (due to the "separation principle" between monetary policy and non-standard measures).

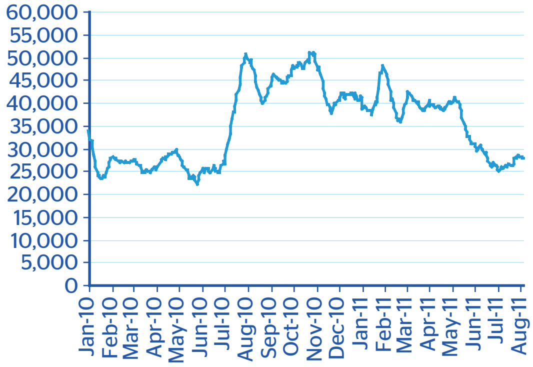
ECB extends liquidity provision; signals a reluctant resumption of bond-buying program waiting on the decisions taken on the EFSF to be implemented "fully" and "rapidly". Given renewed tensions in financial markets, the ECB decided to conduct a new extraordinary six-month LTRO which is to be reintroduced next week, to be conducted in full allotment on 10 August and to mature on 1 March 2012. In May of 2010 the ECB took a similar decision –reintroducing one six-month LTRO which had already been phased out– to address the severe tensions in certain market segments due to the Greek crisis. Mr. Trichet justified this decision by saying that they "have observed in the last days tendencies which combine a high level of liquidity with absence of smooth market functioning". Also, the Government Council decided to extend the fixed rate "full allotment" liquidity provision to banks during 4Q11. Concretely, the ECB decided to extend 3M and 1M LTROs operations until December 2011, so there will be three additional 3-Month LTRO (on 26 October, 30 November and 21 December). The ECB guarantees enough liquidity until the first quarter of 2012. In addition, the ECB also decided to continue with the 1-week MRO with 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".

Mr. Trichet signalled that the bond-buying program was re-activated (in a non-unanimous decision but favored by an "overwhelming majority") but made clear that ECB's stance has not changed a bit. The "working assumption" of the ECB is that decisions taken on 21 July will be implemented "fully" and "rapidly" and thus, "it would eliminate the reason why from time to time we're intervening".

Chart 1
12-month ahead EONIA

Source: Bloomberg and BBVA Research

Chart 2
Eonia Volume €mn (20d moving average)



Source: Bloomberg and BBVA Research

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, ~~7 July~~4 August 2011

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 Commissioner Rehn.

Based on its regular economic and monetary analyses, the Governing Council decided to ~~increase~~ keep the key ECB interest rates ~~by~~ unchanged, following the 25 basis ~~points, after raising rates by 25 basis points in April 2011 from historically low levels.~~point increase on 7 July 2011. The ~~further~~ information that has become available since then confirms our assessment that an adjustment of the ~~current~~ accommodative monetary policy stance ~~is~~ was warranted in the light of upside risks to price stability. ~~The~~ While the monetary analysis indicates that the underlying pace of monetary expansion is ~~continuing to gradually recover, while~~still moderate, monetary liquidity remains ample ~~with the potential to accommodate~~and may facilitate the accommodation of price pressures. As expected, recent economic data indicate a deceleration in the ~~euro area. All~~pace of economic growth in ~~all~~the past few months, following the strong growth rate in the first quarter. Continued moderate expansion is expected in the period ahead. However, uncertainty is particularly high. For monetary policy, it is essential that ~~the~~ recent price developments do not give rise to broad-based inflationary pressures ~~over the medium term. Our decision will contribute to keeping inflation~~. 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 ~~contribute to~~make an ongoing contribution towards supporting economic growth and job creation in the euro area. At the same time, short-term interest rates ~~across the entire maturity spectrum remain low.~~remain low and financing conditions are favourable. Thus, our monetary policy stance remains accommodative~~, lending support to economic activity and job creation. As expected, recent economic data indicate some deceleration in the pace of economic growth in the second quarter of 2011. While the underlying momentum of economic growth in the euro area continues to be positive, uncertainty remains elevated~~. We will continue to monitor very closely all developments with respect to upside risks to price stability.

~~The provision of liquidity and the allotment modes for refinancing operations will be adjusted when appropriate, taking into account the fact that 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. In the first quarter of 2011 euro area real GDP posted a strong quarter-on-quarter increase of 0.8%, following the 0.3% increase in the last quarter of 2010. Recent statistical releases and survey-based indicators point towards a continued expansion of economic activity in the euro area in the second quarter of this year, albeit at a slower pace. This moderation reflects the fact that the strong growth in the first quarter was in part due to special factors. The positive underlying momentum of economic activity in the euro area remains in place. Euro area exports should continue to be supported by the ongoing expansion in the world economy. At the same time, taking into account the present level of business confidence in the euro area, private sector domestic demand should contribute to economic growth. However, activity is expected to continue to be dampened somewhat by the process of balance sheet adjustment in various sectors.~~

~~In the Governing Council's assessment, the risks to this economic outlook remain broadly balanced in an environment of elevated uncertainty. On the one hand, favourable business confidence could provide more support to domestic economic activity in the euro area than currently expected and higher foreign demand could also contribute more strongly to growth than expected.~~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. They relate to the ongoing tensions in some segments of the euro area financial markets ~~that may potentially~~ 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 ~~2011 according to Eurostat's flash estimate – the same rate as in May~~. The relatively high inflation rates seen over the past few months largely reflect higher energy and other commodity prices. 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.

Risks to the medium-term outlook for price developments remain on the upside. They relate, in particular, to higher than assumed increases in energy prices. Furthermore, there is a risk of 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 ~~context of increasing capacity utilisation in the~~ euro area.

Turning to the monetary analysis, the annual growth rate of M3 ~~increased~~decreased to 2.~~4~~1% in ~~May~~June 2011, from 2.~~0~~5% in ~~April.~~May. Looking through the recent monthly volatility ~~in broad money growth owing to special factors~~, M3 growth has ~~continued to edge up~~ broadly stabilised over recent months, after edging up until the first quarter of 2011. The annual growth rate of loans to the private sector ~~continued~~declined to ~~strengthen slightly, rising to 2.7% in May after~~ 2.~~6~~5% in ~~April.~~June, from 2.7% in May. Overall, the underlying pace of monetary expansion ~~has continued its gradual recovery.~~remains moderate. At the same time, monetary liquidity accumulated prior to the period of financial market tensions continues to be ample, ~~with the potential to accommodate~~and may facilitate the accommodation of price pressures in the euro area.

Looking at M3 components, the annual growth rate of M1 ~~moderated further in May~~remained unchanged at 1.2%, whereas growth in other short-term deposits ~~increased. These developments~~ declined to 3.7%. The growth differentials continue to 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, ~~recent information suggests that~~ this impact ~~may~~ is likely to be waning.

On the counterpart side, the annual growth of loans to non-financial corporations ~~and~~ continued to edge up, from 0.9% in May to 1.5% in June, whereas the annual growth of loans to households ~~remained unchanged from April at 0.9% and~~ hovered over recent months around rates of slightly above 3.~~4% respectively, confirming the pattern of developments in previous months~~%.

The overall size of ~~bank~~MFI balance sheets has remained broadly unchanged over recent months. ~~It is important that banks continue~~Where it is necessary to provide adequate scope to expand the provision of credit to the private sector ~~in an environment of increasing demand. To address this challenge, where necessary~~, 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 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.

To sum up, based on its regular economic and monetary analyses, the Governing Council decided to ~~increase the~~ keep the key ECB interest ~~rates by~~rates unchanged, following the 25 basis ~~points, after raising rates by 25 basis points in April~~point increase on 7 July 2011~~ from historically low levels. The further~~. The information that has become available since then confirms our assessment that an adjustment of the ~~current~~ accommodative monetary policy stance ~~is~~was warranted in the light of upside risks to price stability. A cross-check ~~of the outcome of the economic analysis with that of~~with the signals coming from the monetary analysis indicates that while the underlying pace of monetary expansion is ~~continuing to gradually recover, while~~ still moderate, monetary liquidity remains ample ~~with the potential to accommodate price pressures in the euro area. All in all~~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 strong growth rate in the first quarter. Continued moderate expansion is expected in the period ahead. However, uncertainty is particularly high. For monetary policy, it is essential that ~~the~~ recent price developments do not give rise to broad-based inflationary pressures~~ over the medium term. Our decision will contribute to keeping inflation~~. 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 ~~contribute to economic growth~~make an ongoing contribution towards supporting economic growth and job creation in the euro area. At the same time, short-term interest rates ~~across the entire maturity spectrum~~ remain low and financing conditions favourable. Thus, our monetary policy stance remains accommodative~~, lending support to economic activity and job creation. As expected, recent economic data indicate some deceleration in the pace of economic growth in the second quarter of 2011. While the underlying momentum of economic growth in the euro area continues to be positive, uncertainty remains elevated~~. We will continue to monitor very closely all developments with respect to upside risks to price stability.

~~Turning to fiscal policies, the current environment is very demanding and requires decisive action. Euro area countries must, as a minimum, comply with their fiscal consolidation commitments for 2011 and beyond, as foreseen under the respective excessive deficit procedures. Adequate and more frontloaded adjustment should ensure that structural fiscal consolidation targets are met, in line with the ECOFIN Council recommendations, and any~~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 that enjoy better than expected economic and fiscal developments should ~~be exploited to achieve~~make full use of this room for manoeuvre for faster deficit and debt reduction.~~ The announcement of fully specified consolidation measures for 2012 and beyond is essential to convince the general public and financial market participants that the corrective policies will be sustained and that public debt developments will be put on a sustainable path~~ 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 inflexible determination of all euro area countries to fully honour their own individual sovereign signature is a decisive element in ensuring financial stability in the euro area as a whole.

~~At the same time, it remains essential that~~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 ~~are urgently~~ need to be implemented in the countries of the euro area ~~to strengthen competitiveness,~~ in order to increase the flexibility ~~and~~of their economies and their longer-term growth potential. ~~This is particularly relevant for countries with high fiscal and external deficits or with past losses in competitiveness. We welcome the introduction of the European Semester, including~~ The removal of labour market rigidities and the ~~recent submission of countries' National Reform Programmes that incorporate commitments made under the Euro Plus Pact. We also support the European Council conclusions calling for more ambitious and well-defined reforms that should be frontloaded in order to foster competitiveness. In addition, the removal of labour market rigidities would strongly support the adjustment process. Measures~~implementation of measures which enhance wage flexibility, ~~such as~~notably the elimination of automatic wage indexation~~, would help to accomplish the necessary adjustment~~ clauses, are of key importance.

We are now at your disposal for questions.

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