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Europe

ECB Watch

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Economic Analysis

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Amid financial strains, ECB shows more dovish tone and flexible approach

- The ECB will continue offering full-allotment liquidity provision to banks through 1Q11 and will keep buying government bonds
- More importantly, the ECB president's comments on the exit strategy mark a shift and signal a more flexible approach that could imply a further delay if necessary
- The Governing Council has revised downwards the balance of risks, both for growth and inflation

Bottom line: In an (unexpected) more dovish statement aimed at reducing tensions in bond markets, the ECB announced an (expected) delay of its "exit strategy" of gradually reducing the maturity of its full-allotment refinancing operations. More importantly, given recent events, and although in the statement there is a precise timing to resume the phasing-out on non-standard measures, the ECB president's comments regarding this matter mark a significant shift from his stance in previous meetings, when he suggested that a resumption of the exit strategy was possible in this meeting. He left the doors wide open and signalled a flexible approach from the ECB that could imply a further delay in the non-standard measures if conditions warrant. This flexible approach is closer to what other central banks, especially the Federal Reserve, have recently shown. Moreover, the ECB president commented on the unanimity of the decision and stated that they do not have any predisposition and are not pre-committed to either direction –ie, to resume its exit strategy or, to extend it beyond 1Q11. Contrary to market expectations, the ECB did not announce any change in its bond buying, but they verbally supported it and the reduction in spreads suggests that they are supporting the government bond market.

On liquidity: The unlimited liquidity provision remained in place for weekly MROs and monthly refinancing operations –and will continue for as long as necessary, and at least until the third maintenance period of 2011 on April 12. Likewise, the full-allotment for the 3m LTROs supply of liquidity was also extended until March 2011. The Governing Council's decision to delay the end of liquidity measures acknowledges the fact that liquidity normalization is occurring at a slow pace and constitutes a signal of the willingness of the ECB to reduce uncertainties and market nervousness. It is true that the use of deposit 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 LTROs and MROs has remained at high levels in the current quarter, specifically regarding weekly MROs which have rallied since September's maturing, and have remained constant during this quarter at approximately EUR 180 bn. Furthermore, the concentration of the ECB liquidity provision on some of the most vulnerable countries remain at high levels, such as in the case of the Greek and Portuguese banking systems, or even worse, in the Irish banking system ECB liquidity provision is increasing.

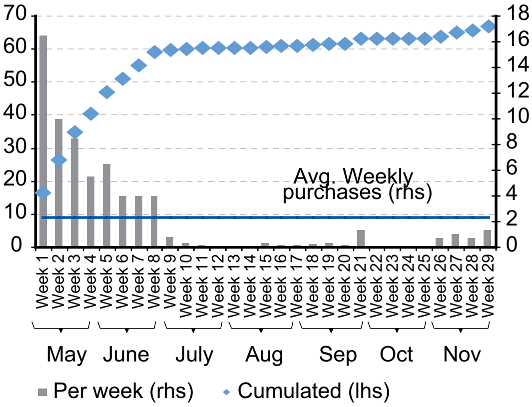
Government bond purchases program: Despite speculation, the ECB did not announce any change in its bond buying. There was no mention in the statement concerning the SMP after Mr. Trichet commented on Tuesday that "we will see what we decide". Yet, he observed that it was "ongoing" and will likely continue in the absence of normal functioning of markets. Thus, the ECB could step up its buying of corporate bonds without pre-committing to any amount, which together with the extension of the unlimited provision of liquidity should contribute to reducing interest rates and spreads as the recent deterioration process was becoming self-reinforcing: investors' concerns drove rates higher –ie, to compensate for a possible default– and higher rates increased difficulties, which led to still higher rates, and so on.

On governance, fiscal consolidation and reforms: Scarce focus on Governance (there were barely any questions regarding this matter and Trichet did not take advantage of other questions to approach the subject, either), although he has stressed the importance of having strong governments and institutions. Furthermore, he stressed the necessity of reinforcing the "E" in the EMU. See Annex on Governance. Meanwhile, although the ECB seems ready to step up its efforts to stop the contagion from spreading if necessary, its message is that the responsibility to stop the recent worsening in market conditions should not fall on them. Other parties are accountable and should accelerate their efforts to stop financial contagion. The ECB president appealed to European authorities to take responsibility and engage in ambitious reforms while calling on all authorities "to substantiate as convincingly and clearly as possible" the fiscal consolidation measures. In this sense, the ECB wants to prevent complacency on other fronts and aims at aligning incentives of all involved.

On economic outlook: The ECB Statement highlighted the elevated uncertainty surrounding the current economic outlook, unlike last month's statement. GDP growth staff projections for 2010 have been revised slightly upwards by 0.1pp to 1.7%, while the 2011 figure remained unchanged at 1.4%. For 2012, GDP is expected to increase by 1.7%. We think that these projections are quite reasonable, as recent data suggest that our forecasts (1.6% for 2010, 1.2% for 2011 and 1.4% for 2012) are subject to upside risks. With regards to price, according to Staff projections, annual average inflation will be at 1.6%, increasing marginally to 1.8% in 2011 (revising up by 0.1pp from September forecasts) and moderating to 1.5% in 2012, these figures are broadly in line with our forecast (1.6% in 2011, 1.7% in 2011 and 1.3% in 2012). Most importantly, the Governing Council has revised downwards the balance of risk, both for growth and inflation. The Governing Council sees that risks on growth are tilted to the downside due to potential spillover from the renewed financial strains to the real economy. Regarding prices, risks are broadly balanced, unlike its vision of slightly tilted on the upside in the previous month. In all, a more dovish statement and growing concerns on financial tensions and elevated uncertainty.

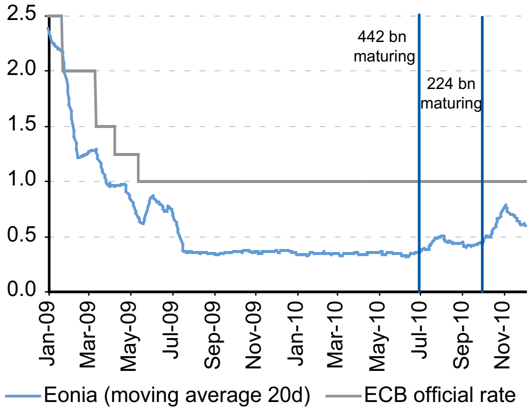
Market reaction: Initially the reaction was negative, shortly after however and once investors overcame their initial disappointment markets turned around (Ibex 35 increased by 4.1% and the Eurostoxx raised 2.8%) as well as the euro reversing and going even further than before. The euro boosted up by 1.4% achieving $1.32 while stocks also had impressive gains although the current level still reflects present uncertainties. Bourses managed to close for the second consecutive day with relatively high gains.

Chart 1
ECB: sovereign bond purchase program



Source: BBVA Research

Chart 2
ECB official rate and Eonia



Source: Datatstream and BBVA Research

Annex 1: Tracking the changes…

Jean-Claude Trichet, President of the ECB,
Vítor Constâncio, Vice-President of the ECB
Frankfurt am Main, ~~4 November~~2 December 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.

Based on its regular economic and monetary analyses, the Governing Council ~~continues to view the~~ confirmed that the current **key ECB interest rates** ~~as~~ are appropriate. It therefore decided to leave them unchanged. Taking into account all the new information and analyses which have become available since our meeting on ~~7 October~~4 November 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon. Recent economic data are consistent with ~~our assessment that the~~ a positive underlying momentum of the recovery~~ remains positive. At the same time, ~~, while uncertainty is ~~prevailing.~~elevated. Our monetary analysis confirms that inflationary pressures over the medium term remain contained. We expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations ~~remain~~ are 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~~ is of the essence.

~~Overall, the current monetary policy stance remains accommodative. The stance, the provision of liquidity and the allotment modes will be adjusted as appropriate, taking into account the fact that all the non-standard measures taken during the period of acute financial market tensions are fully consistent with our mandate and, by construction, temporary in nature.~~The Governing Council today also decided to continue conducting its main refinancing operations (MROs) and the 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 the third maintenance period of 2011 on 12 April 2011.

Furthermore, the Governing Council decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 26 January, 23 February and 30 March 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.

Overall, the current monetary policy stance remains accommodative. The stance, the provision of liquidity and the allotment modes will be adjusted as 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. 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**. Euro area real GDP grew by 0.4% on a quarterly basis in the third quarter of 2010, following exceptional growth of 1.0% in the second quarter. Recent ~~data~~statistical releases and survey-based evidence generally confirm ~~our view~~ that the positive underlying momentum of the economic recovery in the euro area remains in place. In line with previous expectations, this implies ongoing real GDP growth in the ~~second half~~fourth quarter of this year. ~~The global recovery is expected to proceed, and this should imply a continued positive impact on the demand for euro area exports.~~Euro area exports should further benefit from a continued recovery in the world economy. At the same time, private sector domestic demand should increasingly contribute to growth, supported by the accommodative monetary policy stance and the measures adopted to restore the functioning of the financial system. However, the recovery in activity is expected to be dampened by the process of balance sheet adjustment in various sectors.

~~In the Governing Council's assessment, the risks to this economic outlook are still slightly tilted to the downside, with uncertainty prevailing.~~This assessment is also reflected in the December 2010 Eurosystem staff macroeconomic projections for the euro area, according to which annual real GDP growth will range between 1.6% and 1.8% in 2010, between 0.7% and 2.1%% in 2011 and between 0.6% and 2.8% in 2012. Compared with the September 2010 ECB staff macroeconomic projections, the range for 2010 has narrowed somewhat and shifted towards the upper end of September's range, while the range for 2011 is slightly narrower. The December 2010 Eurosystem staff projections are broadly in line with forecasts by international organisations.

In the Governing Council's assessment, the risks to this economic outlook are tilted to the downside, with uncertainty remaining elevated. On the one hand, global trade may continue to grow more rapidly than expected, thereby supporting euro area exports. At the same time, it is to be noted that the level of business confidence in the euro area remains relatively high. On the other hand, downside risks relate to the tensions in some ~~concerns remain relating to the re-emergence of tensions in~~ segments of the financial markets~~. In addition,~~ and their potential spillover to the euro area real economy. Further downside risks relate to renewed increases in oil and other commodity prices, protectionist pressures~~,~~ and the possibility of a disorderly correction of global imbalances.

With regard to price developments, ~~as anticipated,~~ euro area annual HICP inflation ~~rose to~~ was 1.9% in ~~October,~~ November, according to Eurostat's flash estimate, ~~compared with 1.8% in September.~~unchanged from October. In the next few months HICP inflation rates will hover around current levels before moderating again in the course of next year. Overall, in ~~2011~~ the period ahead inflation rates should remain moderate. 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 December 2010 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation in a range between 1.5% and 1.7% for 2010, between 1.3% and 2.3% for 2011 and between 0.7% and 2.3% for 2012. Compared with the ECB staff projections published in September, the range for 2010 is unchanged, while the range for 2011 is marginally higher. Available forecasts from international organisations provide a broadly similar picture.

Risks to the outlook for price developments are ~~slightly tilted to the upside. They~~broadly balanced. Upside risks relate, in particular, to ~~the evolution of~~ developments in energy and non-~~oil~~energy commodity prices. Furthermore, increases in indirect ~~taxation~~taxes 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 still expected to be contained.

Turning to the **monetary analysis**, the annual growth rate of M3 ~~was~~remained broadly unchanged~~,~~ at 1.0% in ~~September 2010~~October, after 1.1% in ~~August.~~September 2010. The annual growth rate of loans to the private sector~~, at 1.2%, remained unchanged from August. Looking beyond developments in individual months, broad~~ increased to 1.4% in October from 1.2% in the previous month. Broad money and loan growth ~~remains~~ hence remained low ~~and continues to support the~~ , supporting the assessment that the underlying pace of monetary expansion is moderate and that inflationary pressures over the medium term are contained.

~~The annual growth rate of M1 has continued to moderate, standing at 5.9% in September 2010, while the annual growth rate of other short-term deposits has become less negative. This reflects the~~ The steepness of the yield curve has continued to lessen somewhat, implying a gradual softening of the dampening impact on M3 that was associated with shifts of funds from monetary assets to longer-term financial assets outside M3. The interest rate constellation also includes a further widening in the spread between interest rates paid on short-term time deposits and those paid on overnight deposits. As a result, annual M1 growth has continued to moderate, standing at 4.9% in October 2010, after 6.2% in September, while the annual growth rate of other short-term deposits continues to become less negative.

The annual growth rate of bank loans to the private sector ~~is increasingly supported by the flow of loans to non-financial corporations. The annual~~continues to conceal positive growth ~~rate of these loans is still slightly negative, but developments~~ in ~~recent months suggest that a turning point was reached earlier in 2010. This would be consistent~~loans to households, with ~~the lagged response of loan developments to economic activity over the business cycle that was also observed in past cycles. The annual~~2.9% in October after 2.8% in September, and still negative growth ~~rate of~~in loans to ~~households~~non-financial corporations, which stood at ~~2.8% in September and thereby remained at levels seen~~ -0.6% in ~~previous months.~~ October, unchanged from September. When correcting for the impact of derecognition of loans from bank balance sheets, the growth in loans to non-financial corporations continued to strengthen, further confirming that a turning point was reached earlier in 2010.

~~Banks have continued to gradually increase the weight of credit to the private sector in the overall size of their balance sheets, but~~Over the past few months, banks have generally stabilised the size of their balance sheets while expanding the provision of credit to the private sector. However, the challenge remains to expand the availability of such credit when demand picks up further. ~~Where necessary, to~~ To address this challenge, where necessary, it is essential for banks ~~should~~ 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.

To sum up, the current key ECB interest rates remain appropriate. We therefore decided to leave them unchanged. Taking into account all the new information and analyses which have become available since our meeting on ~~7 October~~ 4 November 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon. Recent economic data are consistent with ~~our assessment that the~~a positive underlying momentum of the recovery ~~remains positive. At the same time,~~ , while uncertainty is ~~prevailing.~~elevated. 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. We expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations ~~remain~~are 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~~is of the essence.

Turning to **fiscal policies**, while budgetary developments for some euro area countries are more favourable than expected, concerns about unsustainable fiscal positions and their vulnerability to adverse market reactions remain very high for others and have had repercussions throughout the euro area. In this environment, there is a clear need for the responsible authorities to strengthen ~~public~~ confidence in ~~the capacity of governments to return to sustainable~~sound public finances, ~~reduce~~thereby reducing risk premia in interest rates and ~~thus support~~supporting sustainable growth over the medium term. ~~To this end, it is essential that countries~~ At the same time, all euro area countries should pursue ambitious and credible multi-year consolidation ~~plans and fully~~strategies and implement fully the planned ~~consolidation~~corrective measures, focusing on the expenditure side. In their 2011 budgets, ~~they~~ countries need to specify ~~credible~~the necessary fiscal adjustment measures~~, focusing on the expenditure side. Any positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected environment, should be exploited to make faster progress with~~ in detail, while standing ready to correct any slippages from the fiscal ~~consolidation~~objectives announced.

~~The urgent implementation of~~Substantial and far-reaching **structural reforms** ~~is essential~~should be rapidly implemented to enhance the prospects for higher sustainable growth. Major reforms are particularly necessary in those countries that have experienced a loss of competitiveness in the past or that are suffering from high fiscal and external deficits. The removal of labour market rigidities ~~and the strengthening of productivity growth~~ would further support the adjustment process of these economies. Increasing product market competition, particularly in the services sectors, would also facilitate the restructuring of the economy and encourage innovation and the adoption of new technologies. Such measures are crucial for enhancing productivity growth, one of the main drivers of long-term growth. All these structural reforms should be supported by an appropriate restructuring of the banking sector. Sound balance sheets, effective risk management and transparent, robust business models remain key to strengthening banks' resilience to shocks and to ensuring adequate access to finance, thereby laying the foundations for sustainable growth and financial stability.

~~At their meeting on 28-29 October 2010 the EU Heads of State and Government agreed on the **reform of the European Union's economic governance**. The proposals put forward by President Van Rompuy represent a strengthening of the existing framework for fiscal and macroeconomic surveillance in the European Union. However, the Governing Council considers that they do not go as far as the quantum leap in the economic governance of Monetary Union that it has been calling for.~~

~~In particular, the Governing Council is concerned that there would be insufficient automaticity in the implementation of fiscal surveillance, that there is no specification of the rule to reduce the government debt ratio, and that financial sanctions have not been explicitly retained under the macroeconomic surveillance procedure.~~

~~With regard to the macroeconomic surveillance procedure in particular, the new system of mutual surveillance would need to concentrate firmly on euro area countries experiencing sustained losses of competitiveness and large current account deficits. It should be determined by transparent and effective trigger mechanisms. It would be essential that the assessments of macroeconomic imbalances and recommendations for corrective action be given broad publicity at all stages of the surveillance process.~~

~~The public and the markets can be confident that the Governing Council remains firmly committed to delivering on its mandate of maintaining price stability over the medium term.~~Finally, let me recall that the Governing Council welcomes the economic and financial adjustment programme which was agreed by the Irish government following the successful conclusion of the negotiations with the European Commission, in liaison with the ECB, and the International Monetary Fund. The programme contains the necessary elements to bring about a sustainable stabilisation of the Irish economy. It addresses in a decisive manner the economic and financial causes underlying current market concerns and will thereby contribute to restoring confidence and safeguarding financial stability in the euro area. The Governing Council welcomes the commitment of the Irish public authorities to take any further measures that may become appropriate to achieve the objectives of the programme.

Annex: A permanent solution to the debt crisis in Europe

Today's non-announcement of a stepped-up debt purchase program by the ECB seemed to disappoint market participants, at least initially, until reports circulated that the ECB had actually been purchasing sovereign bonds this week. Yesterday such an expectation generated gains in the stock market and falling yields in the debt markets. However, we think debt purchasing programs are just a temporary measure to ease tensions in the markets, but do not address the underlying problem: doubts about the sustainability of debt in some countries, in some instances fuelled by the weakness of national financial systems. In short, stepping-up bond purchases would have been a welcome relief but just a temporary one, which would have just bought time without solving the underlying problems. In this regard, market participants have discussed possible ways to put an end to the debt crisis: (i) monetary expansion; (ii) a eurozone break-up; or (iii) institutional reform and a crisis resolution mechanism for future crises. We think only the last option could end up as a feasible, permanent solution as it would anchor credibility and reduce uncertainty about existing sovereign debt, especially if accompanied by grandfathering rules.

1) Monetary expansion: the "inflationary" exit

As seen in the market reaction to Trichet's words at the European Parliament, ECB bond purchases would ease tensions, but only in the short term. In order to generate a more permanent effect on bond yields, the ECB would probably have to accept an expansion of its balance sheet (similar to programs implemented by the Fed and the Bank of England) as liquidity could not be drained in the same amount as necessary bond purchases. This would then raise the risk of inflationary pressures down the road.

As it has signaled in the past, the ECB continues to be reluctant to take these actions, beyond partial programs that could be justified under the objective of financial stability. Given the key role of price stability within the ECB objectives we give a small chance to the ECB increasing its purchases significantly to make for a long-lasting solution to current tensions. There is also the problem that large purchases of the kind needed to significantly lower yields could also be close to breaching European law and/or German constitutional law. But in any case, ECB bond purchases could prove a temporary respite that allows more time while European authorities reach a truly permanent solution.

2) The non-option: leaving the Euro.

The market has been weighing the possibility that some countries leave the Euro as a way to restore their competitiveness. However, Europe's problems are not of competitiveness in the first place. Further, the costs of such action are enormous and are not offset by the gains in competitiveness resulting from the depreciation of the "new" currency and the milder fiscal consolidation arising from a debt restructuring. Past experience with breaking pegs or currency boards shows that these events severely restrict and increase the cost of tapping international markets, induce bank runs, capital outflows and, as a result force the adoption of capital controls and debt restructuring. Further, one country leaving the Euro would immediately increase the market perception that more would follow, increasing tensions for those still in the monetary union. In short, this is an option that is not considered due to its high and lasting impact on the financial sector and, thus, also on growth.

3) Institutional reform and a crisis resolution mechanism for future crisis

In our view, only the establishment of a permanent mechanism for debt restructuring of future crises, with clear and transparent rules, could provide a solution to the debt crisis, as it would help anchor credibility in Europe. But this is only possible if this mechanism establishes the right incentives and clarifies important details. Further, it has to be accompanied by grandfathering rules to clear uncertainty about existing debt. In particular, there are four issues on which progress should be made:

- The establishment of a **permanent mechanism for financial assistance** (ESM) is welcome, but it will require a reform of the Treaty, a protracted process that is best avoided, although as of now it is not clear if it can be done. Further, some important details are still to be clarified, such as available amounts, how they will be funded and how they will interact with other support mechanisms.

- Clarification of the **mechanism that activates the bail out/in**. In this regard, debt sustainability is a key criterion, but its definition is not clear cut. Also, there should be scope for financial aid before getting to the point of restructuring debt. Restructuring should be the last step in a process that starts with more specific rules for fiscal discipline.

- Specifying **which parameters are susceptible to being modified during a restructuring**. Apparently changes in maturities and rates are accepted, but the role of haircuts is not precisely defined. In particular, a clear statement is needed regarding whether they are a measure of last resort or if they will always be part of a restructuring program.

- **Clarification of the transition period**. The implementation of collective action clauses (CAC) just starting in 2013 might not be seen as realistic by market participants. If markets believe there is a solvency problem in a member state and preexisting debt is not affected by the new mechanism, solvency concerns are not going to be solved by restructuring just new debt issued after 2013. Thus, markets may anticipate that pre-existing debt will be exchanged for new debt and subject to CACs (and thus, restructuring). Working backwards, the possibility of future restructuring will end up being included in current bond yields. Thus, it is essential to state clearly that the new regime is intended for future crisis resolution and to reduce uncertainty about how existing debt will be treated by clarifying transition periods. Thus, an implicit European guarantee on existing issues or, better, grandfathering rules for existing debt would anchor credibility, reduce market tensions and allow for structural measures to have a positive effect on solvency.

In sum, in our view, the bond purchasing program or other measures of monetary expansion are only useful to buy time, but that extra time has to be used to tackle the source of the problem. This can only be achieved through clarification of the new debt restructuring mechanism to reach a permanent resolution for future European debt crises. This will provide the necessary credibility to reduce current market tensions.

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