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ECB Watch

Europe

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Economic Analysis

Financial Scenarios
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25bp hike as widely expected; slightly more hawkish tone than anticipated

- **ECB's risk assessments for economic growth and inflation remain unchanged; the current policy stance "remains accommodative"**
- **The ECB wants to reach an interest rate level that they feel more comfortable with; the tone of the statement supports our forecast of another 25bp hike (to 1.75%) this year**
- **The ECB announced that it would waive the minimum credit rating required for Portugal's debt to be used as collateral**

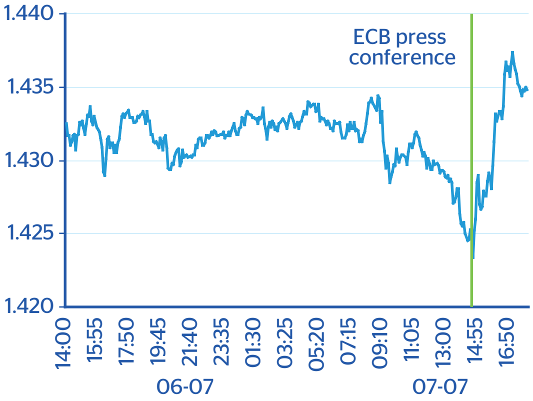
Bottom line: with a hawkish tone the ECB hints that it still does not feel comfortable with rates at 1.50%. This supports our view of one additional hike to 1.75% in Q4 and another one in Q1 2012. We believe that once interest rates reach that 2.0% level, the ECB will feel more comfortable and see no need to continue with the current pre-emptive approach as current low risks of second-round effects will diminish even further.

As broadly anticipated, the ECB hiked interest rates by 25bp, taking its main refinancing rate to 1.50%, while leaving the corridor width unchanged at +/-75bp ie. the deposit and marginal lending rates were also raised by 25bp to 0.75% and 2.25%, respectively. There was no news regarding a new measure address the addicted banks issue ("it's a work in progress"). The wording tilted slightly further to the hawkish side in our view. The slight change was a bit surprising in the context of underlying uncertainties on the financial front (a permanent solution to the fundamental problems is still not in sight) and the current slowdown in economic activity. On the one hand, although the wording acknowledged the recent soft-patch, it was downplayed somewhat as the "positive underlying momentum … remains in place". Risks to the growth outlook continue to be seen as "broadly balanced". On the other hand, the paragraphs on price developments and the assessment of medium-term risks to inflation were not softened at all as ECB's view continues to be that risks to price stability "remain on the upside".

With respect to monetary policy, the ECB repeated that the stance remains accommodative and introduced a new sentence both on the introductory and the summing up paragraphs which signalled that at some point in coming months interest rates will possibly need to be increased again: "The further adjustment of the current monetary policy stance is warranted in the light of upside risks to price stability". We think that the hawkish twist added with that reference (opening the door to further hikes) was unnecessary at this moment and thus hint that with rates at 1.50% the ECB still does not feel comfortable. This supports our view that one additional hike to 1.75% later this year is likely despite the economic slowdown and the ongoing financial tensions. Our baseline scenario also anticipates one further rise one further rise in March 2012. We believe that once interest rates reaches that 2.0% level, the ECB will feel more comfortable and see no need to continue with the current pre-emptive approach in a context of: i) slower growth and stable inflation expectations ie. current low risks of second-round effects will diminish even further; and ii) with the underlying problems of the financial crisis still unresolved.

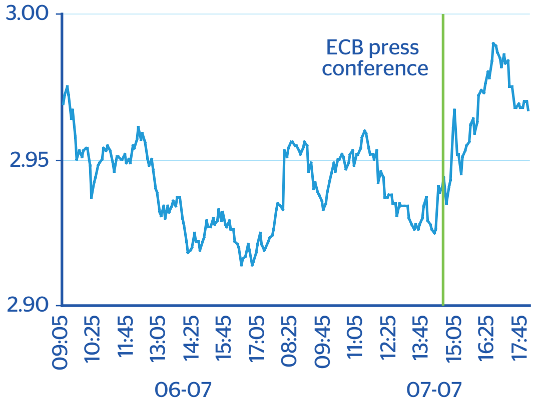
In an additional statement –read by Mr. Trichet in the Q&A session–, which was not a surprise given Tuesday's decision by Moody's to downgrade Portuguese debt to junk status, the ECB announced the suspension of its minimum credit rating threshold for all Portuguese government debt "until further notice" as they did last year in an attempt to aid Greek banks.

Chart 1
Euro-Dollar: intraday change (ER each 5 minutes)



Source: Bloomberg and BBVA Research

Chart 2
10-year German yields: intraday change (yield each 5 minutes)



Source: Bloomberg 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, ~~9 June~~7 July 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~~today's meeting~~, which was also attended by Commissioner Rehn~~.

Based on its regular economic and monetary analyses, the Governing Council decided to ~~keep~~ increase the key ECB interest rates ~~unchanged. The information that has become available since our meeting on 5 May 2011 confirms continued upward pressure on overall inflation, mainly owing to energy and commodity prices.~~by 25 basis points, after raising rates by 25 basis points in April 2011 from historically low levels. The further adjustment of the current accommodative monetary policy stance is warranted in the light of upside risks to price stability. The underlying pace of monetary expansion is continuing to gradually recover~~ing. Monetary~~ , while monetary liquidity remains ample~~,~~ with the potential to accommodate price pressures in the euro area. ~~Furthermore, the most recent data confirm the positive underlying momentum of economic activity in the euro area, while uncertainty remains elevated. Overall, our monetary policy stance remains accommodative, lending support to economic activity. On balance, risks to the outlook for price stability are on the upside. Accordingly, strong vigilance is warranted. On the basis of our assessment, we will act in a firm and timely manner. We will do all that is needed to prevent recent price developments giving rise to broad based inflationary pressures. We remain strongly determined to secure a firm anchoring of~~All in all, 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 expectations in the euro area firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. ~~This~~ Such anchoring is a prerequisite for monetary policy to ~~make an ongoing contribution towards supporting~~ contribute to economic growth ~~and job creation~~ in the euro area. At the same time, interest rates across the entire maturity spectrum remain low. 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 ~~Governing Council today also decided to continue conducting its main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the ninth maintenance period of 2011 on 11 October 2011. 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 third 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 decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 27 July, 31 August and 28 September 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.~~

~~As stated on previous occasions, 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~~, the~~ euro area ~~recorded strong~~ real GDP ~~growth of 0.8%~~ posted a strong quarter-on-quarter increase of 0.8%, following the 0.3% increase ~~of~~in the ~~fourth~~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 ~~easing~~moderation reflects the fact that the strong growth in the first quarter was ~~partly~~in part due to special factors~~, which will cease to play a role in the second quarter. Hence, it is appropriate to look through such short-term volatility and to emphasise the~~. The positive underlying momentum of economic activity in the euro area~~. Looking ahead, euro~~ 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 ~~favourable~~present level of business confidence in the euro area, private sector domestic demand should contribute ~~increasingly~~ to economic growth~~, benefiting from the still accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system~~. However, activity is expected to continue to be dampened somewhat by the process of balance sheet adjustment in various sectors.

~~This assessment is also reflected in the June 2011 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between 1.5% and 2.3 % in 2011 and between 0.6 % and~~

~~2.8% in 2012. Compared with the March 2011 ECB staff macroeconomic projections, the range for 2011 has been revised upwards, while the range for 2012 remains broadly unchanged. The June 2011 Eurosystem staff projections are broadly in line with recent forecasts by international organisations.~~

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. On the other hand, downside risks relate to the ongoing tensions in some segments of the financial markets that may potentially spill over to 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 2.7% in ~~May~~ June 2011 according to Eurostat's flash estimate~~, after 2.8% in April.~~ – the same rate as in May. The relatively high inflation rates seen over the past few months largely reflect higher energy and 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 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.

~~The June 2011 Eurosystem staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 2.5% and 2.7% for 2011 and between 1.1% and 2.3% for 2012. In comparison with the March 2011 ECB staff macroeconomic projections, the range for HICP inflation in 2011 has been revised upwards, largely reflecting higher energy prices. The projection range for 2012 has narrowed somewhat. It is appropriate to recall that the staff projections are conditional on a number of purely technical assumptions, including oil prices, interest rates and exchange rates. In particular, it is assumed that oil prices will decline somewhat and that short term interest rates will rise, in accordance with market expectations. Overall the projections embody the view that the recent high rates of inflation do not lead to broader based inflationary pressure in the euro area.~~

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 ~~come~~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 ~~was~~ increased to 2.4% in May 2011, from 2.0% in April ~~2011, after 2.3% in March~~. Looking through the recent volatility in broad money growth owing to special factors, M3 growth has continued to edge up over recent months. The annual growth rate of loans to the private sector ~~strengthened~~ continued to strengthen slightly, rising to 2.7% in May after 2.6% in April~~, after 2.5% in March~~. Overall, the underlying pace of monetary expansion ~~is gradually recovering.~~has continued its gradual recovery. At the same time, monetary liquidity accumulated prior to the period of financial market tensions ~~remains~~ continues to be ample, with the potential to accommodate price pressures in the euro area.

Looking at M3 components, the annual growth rate of M1 ~~decreased in April, while that of~~ moderated further in May, whereas growth in other short-term deposits increased. ~~The development partly reflects~~These developments reflect in part the gradual increase in the remuneration of ~~these~~short-term time and savings deposits over recent months. At the same time, the 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, ~~available~~ recent information suggests that this impact may be waning.

On the counterpart side, ~~there has been a further slight strengthening in~~ the annual growth of loans to non-financial corporations~~, which rose to 1.~~ and to households remained unchanged from April at 0~~% in April, after 0.8% in March. The growth of loans to households was 3.4% in April, unchanged from the~~ .9% and 3.4% respectively, confirming the pattern of developments in previous month~~. The latest data confirm a continued gradual strengthening in the annual growth of lending to the non financial private sectors~~s.

The overall size of bank balance sheets has remained broadly unchanged over ~~the past few~~recent months~~, notwithstanding some volatility~~. It is important that banks continue 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.

To sum up, based on its regular economic and monetary analyses, the Governing Council decided to ~~keep~~increase the key ECB interest rates ~~unchanged. The information that has become available since our meeting on 5 May 2011 confirms continued upward pressure on overall inflation, mainly owing to energy and commodity prices.~~by 25 basis points, after raising rates by 25 basis points in April 2011 from historically low levels. The further adjustment of the current accommodative monetary policy stance is warranted in the light of upside risks to price stability. A cross-check of the outcome of the economic analysis with that of the monetary analysis indicates that the underlying pace of monetary expansion is continuing to gradually recover~~ing. Monetary~~, while monetary liquidity remains ample~~;~~, with the potential to accommodate price pressures in the euro area. ~~Furthermore, the most recent data confirm the positive underlying momentum of economic activity~~All in ~~the euro area, while uncertainty remains elevated. Overall, our monetary policy stance remains accommodative, lending support to economic activity. On balance, risks to the outlook for price stability are on the upside. Accordingly, strong vigilance is warranted. On the basis of our assessment, we will act in a firm and timely manner. We will do~~ all ~~that is needed to prevent~~, it is essential that the recent price developments ~~giving~~do not give rise to broad-based inflationary pressures. ~~We remain strongly determined~~ over the medium term. Our decision will contribute to ~~secure a firm anchoring of~~keeping inflation expectations in the euro area firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. ~~This~~Such anchoring is a prerequisite for monetary policy to ~~make an ongoing contribution towards supporting~~contribute to economic growth ~~and job creation~~ in the euro area. At the same time, interest rates across the entire maturity spectrum remain low. 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, all parties involved in the preparation of the 2012 national budgets must ensure that they are fully in line with the requirement to support confidence in fiscal policies. A comparison between the latest economic forecasts by the European Commission and the fiscal plans embodied in the stability programmes points to the need for many countries to underpin their budget targets with concrete consolidation measures in order to correct their excessive deficits by the commonly agreed deadlines. The implementation of credible fiscal adjustment strategies is crucial in view of ongoing financial market pressures.~~

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 better than expected economic and fiscal developments should be exploited to achieve faster deficit 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.

At the same time, ~~the implementation of ambitious and far-reaching~~it remains essential that substantial and comprehensive structural reforms ~~is~~ are urgently ~~required~~implemented in the euro area to strengthen ~~substantially its~~ competitiveness, flexibility and longer-term growth potential. ~~In particular,~~ This is particularly relevant for countries ~~which have~~ with high fiscal and external deficits or ~~which are suffering from a loss of~~ with past losses in competitiveness ~~should rapidly carry out comprehensive economic reforms. In the case of product markets, policies that enhance competition and innovation should be vigorously pursued to facilitate productivity growth. Regarding the labour market, the priority must be to enhance wage flexibility and incentives to work, and to remove labour market rigidities~~. We welcome the introduction of the European Semester, including 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 which enhance wage flexibility, such as the elimination of automatic wage indexation, would help to accomplish the necessary adjustment.

We are now at your disposal for questions.

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