RESEARCH

ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Wait-and-see stance on both monetary policy and non-standard measures

- **Policy rate unchanged; no further steps on non-standard measures**
- **Mr. Draghi encourages a large demand for the 3Y LTRO as there is no stigma associated with using these facilities**
- **It seems that the ECB could participate in the Greek PSI provided that it sells its holdings to the EFSF without a loss**

As expected, at today's monetary policy meeting the ECB left the key policy rate unchanged at 1.0% and took no additional steps on non-standard liquidity measures . The decision was unanimous and a rate cut was not discussed. Overall, albeit the tone remained dovish and the easing bias was retained, it was more upbeat. The statement dropped the word "substantial" from the phrase "substantial downside risks to the economic outlook" as it seems that the ECB has become a bit more positive with "tentative signs of a stabilisation in economic activity at a low level around the turn of the year"[1]. Medium-term inflation risks remain "broadly balanced" and "underlying price pressures should remain limited". Regarding monetary analysis, there are increasing concerns on the evolution of credit to both households and, particularly, to non-financial corporate sector. Thus, in the near-term the ECB will most likely be on a wait-and-see mode. A rate cut on 8 March is now unlikely. Yet, the odds that it would take place further ahead, in the second quarter, still remain.

Regarding non-standard measures, Mr. Draghi took the opportunity to emphasize that there is no stigma in using these facilities. By saying that, Mr. Draghi suggested that the ECB wants the demand on the 29 February three-year LTRO auction to be large. With respect to looser collateral rules, the ECB released the details on the new collateral it will accept for funding at February's three-year LTRO. In particular, the Governing Council (GC) approved, for the seven national central banks (NCBs) that have put forward relevant proposals[2], specific national eligibility criteria and risk control measures for the temporary acceptance in a number of countries of additional credit claims. Mr Draghi said that the decision on changes in collateral rules was not unanimous showing that some part of the GC is reluctant to take on more risk. Mr Dragui stated that "the new collateral rules will be more risky but the risk is being managed very well". The new collateral framework could represent an additional EUR600-700bn, but on account of rigourous haircuts, the amount of new financing would reduce that amount by two-thirds (EUR200bn of new financing). He also said that the ECB will review collateral situation in 6 months' time.

In the Q&A Mr. Draghi branded as "unfounded" the rumours on the possibility of the ECB taking lossess on its Greek debt holdings (as it would be equivalent to monetary financing which is forbidden in the ECB statute); however, at the same time, he was careful not to rule out the possibility that the ECB could participate in the Greek debt restructuring by saying that the sale of Greek government bonds to the EFSF without a loss is not monetary financing. This could well be the case at the average purchasing price of about 75 of ECB's holdings ie, Greece would need to repay 25% less at the time of maturity.

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[1] In the Q&A Mr. Draghi said that this stabilisation is now also supported by hard data (and not only by survey-data as was the case a month ago), and that the Governing Council is less pessimistic than the IMF's latest projections
[2] Details of these specific national measures will be made available on the websites of the respective NCBs: Central Bank of Ireland, Banco de España, Banque de France, Banca d'Italia, Central Bank of Cyprus, Oesterreichische Nationalbank and Banco de Portugal.

Annex 1: Introductory statement, tracking the changes

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~12 January~~ **9 February** 2012

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~Let me wish you all a Happy New Year.~~ We will now report on the outcome of today's meeting of the Governing Council**, which was also attended by the Commission Vice-President, Mr Rehn**.

Based on ~~its~~ **our** regular economic and monetary analyses, ~~the Governing Council~~ **we** decided ~~today~~ to keep the **key ECB interest rates** unchanged~~, following the 25 basis point decreases on 3 November and 8 December 2011~~. The information that has become available since ~~early December~~ **mid-January** broadly confirms our previous assessment. Inflation is likely to stay above 2% for several months to come, before declining to below 2%. ~~At~~**Available survey indicators confirm some tentative signs of a stabilisation in economic activity at a low level around** the ~~same time,~~**turn of** the **year, but the economic outlook remains subject to high uncertainty and downside risks. The** underlying pace of monetary expansion remains ~~moderate. As expected, ongoing financial market tensions continue to dampen economic activity in the euro area, while, according to some recent survey indicators, there are tentative signs of a stabilisation in activity at low levels. The economic outlook remains subject to high uncertainty and substantial downside risks. In such an environment, cost, wage and price pressures in the euro area should remain modest and inflation rates should develop in line with price stability over the policy-relevant horizon. Overall,~~ **subdued. Looking ahead,** it is essential for monetary policy to maintain price stability ~~over the medium term, thereby ensuring~~**for the euro area as a whole. This ensures** a firm anchoring of inflation expectations in ~~the euro area in~~ line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Such anchoring is a prerequisite for monetary policy to make its contribution ~~towards~~ **to** supporting economic growth and job creation in the euro area. A very thorough analysis of all incoming data and developments over the period ahead is warranted.

~~The provision of liquidity and the allotment modes for refinancing operations~~ **Through our non-standard monetary policy measures we** will continue to support **the functioning of the** euro area ~~banks~~**financial sector**, and thus the financing of the real economy. ~~The extensive recourse to the first three-year refinancing operation indicates that our non-standard policy measures are providing a substantial contribution to improving the funding situation of banks, thereby supporting financing conditions and confidence. In addition, we are actively working towards the implementation of all the measures announced at our December meeting, which should provide additional support to the economy.~~**Since the first three-year longer-term refinancing operation (LTRO) was conducted in December 2011 we have approved specific national eligibility criteria and risk control measures for the temporary acceptance in a number of countries of additional credit claims as collateral in Eurosystem credit operations, which should lead to an increase in available collateral. Further details will be provided in a press release to be published today at 3.30 p.m. At the start of the current reserve maintenance period on 18 January 2012 the reserve ratio was reduced, freeing up additional collateral.** As stated on previous occasions, all ~~the~~**our** non-standard ~~monetary policy~~ measures are temporary in nature.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP ~~in the euro area grew by 0.1% quarter on quarter~~ **growth** in the ~~third~~**fourth** quarter of 2011~~. At present, a number of factors seem to be dampening the underlying growth momentum in the euro area. They include moderate global demand growth and~~ **is likely to have been very** weak ~~business and consumer confidence in the euro area. Domestic demand is likely to be dampened by the ongoing tensions in euro area sovereign debt markets, as well as the process of balance sheet adjustment in the financial and non-financial sectors. At the same time, we continue to expect euro area economic activity~~ **. According to the survey data for the last two months, there are tentative signs of a stabilisation in economic activity at a low level. Looking ahead, we expect the euro area economy** to recover~~, albeit~~ very gradually~~,~~ in the course of 2012~~, supported by developments in global demand,~~**. The** very low short-term interest rates and all the measures taken to ~~support~~ **foster** the **proper** functioning of the **euro area** financial sector **are lending support to the euro area economy. Moreover, stress in financial markets has diminished in response to our monetary policy measures, but also in response to the progress made towards a stronger euro area governance framework and intensified fiscal consolidation in several euro area countries. However, subdued global demand growth, the remaining tensions in euro area sovereign debt markets and their impact on credit conditions, as well as the process of balance sheet adjustment in the financial and non-financial sectors, continue to dampen the underlying growth momentum**.

~~In the Governing Council's assessment, substantial downside risks to the economic outlook for the euro area continue to exist in an environment of high uncertainty.~~**This outlook is subject to downside risks.** They notably relate to ~~a further intensification of the~~ tensions in euro area debt markets and their potential spillover to the euro area real economy. Downside risks also relate to **possible adverse developments in** the global economy**, higher than assumed increases in commodity prices**, protectionist pressures and the ~~possibility of~~ **potential for** a disorderly correction of global imbalances. ~~With regard to price developments, euro~~

Euro area annual HICP inflation was 2.~~8% in December 2011~~**7% in January 2012**, according to Eurostat's flash estimate, ~~after 3.0% in the preceding three months. This decline was expected and reflects a downward base effect stemming~~**unchanged** from ~~energy prices. Inflation rates have been at elevated levels since the end of 2010~~**December. The average inflation rate for 2011 was 2.7%**, mainly driven by higher energy and other commodity prices. Looking ahead, ~~they are~~**inflation is** likely to stay above 2% for several months to come, before declining to below 2%. This pattern reflects the expectation that, in an environment of weak~~er~~ growth in the euro area and globally, underlying ~~cost, wage and~~ price pressures in the euro area should remain ~~modest~~**limited**.

~~The Governing Council continues to view the risks~~**Risks** to the medium-term outlook for price developments ~~as~~**remain** broadly balanced. On the upside, ~~the main risks~~ **they** relate to ~~further~~ **higher than assumed** increases in indirect taxes and administered prices, ~~owing to the need for fiscal consolidation in the coming years, and possible~~ **as well as** increases in commodity prices. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally.

~~Turning to the~~**The monetary analysis**~~, taking the appropriate medium-term perspective,~~ **indicates that** the underlying pace of monetary expansion ~~continues to be moderate.~~**remains subdued.** The annual growth rate of M3 decreased to ~~2.0% in November 2011, after 2.~~1.6% in ~~October. As~~**December 2011, after 2.0%** in ~~the previous three months, monetary developments in November were affected by the heightened uncertainty in financial markets~~**November, reflecting a further weakening of monetary dynamics towards the end of the year**.

~~The annual growth rate of loans to the private sector, adjusted for loan sales and securitisation, decreased to 1.9% in November, from 3.0% in October.~~ The annual growth rates of loans to non-financial corporations and loans to households, adjusted for loan sales and securitisation, ~~both moderated in November~~**also decreased further in December**, and stood at 1.~~8% and 2.~~**3% and 1.9**% respectively~~, with slightly negative monthly flows observed for MFI loans to non-financial corporations. Overall, despite the moderation in loan growth, the figures on lending do not so far suggest that the heightened financial market tensions led to a sizeable curtailment of credit in the euro area as a whole in the period to November. At the same time, given that credit supply effects can manifest themselves with lags~~**. The volume of MFI loans to both sectors declined in December, and this was particularly pronounced in the case of the non-financial corporate sector. In addition, there are indications that bank lending conditions tightened further, affecting loan supply in several euro area countries in late 2011. It is not yet possible to draw firm conclusions from these developments, particularly given that the impact of the first three-year LTRO on bank funding is still unfolding and may not have been fully reflected in the most recent bank lending survey. In addition, other non-standard monetary policy measures announced in December are still to be implemented. Accordingly**, close scrutiny of credit developments ~~is warranted~~ in the period ahead **is essential**.

The soundness of bank balance sheets~~, supported by the increase in capital positions,~~ will be a key factor in facilitating an appropriate provision of credit to the economy over time. It is essential that the implementation of banks' recapitalisation plans does not result in developments that are detrimental to the financing of economic activity in the euro area.

~~To sum up, incoming information broadly confirms our previous assessment. Inflation is likely to stay above 2% for several months to come, before declining to below 2%. As expected, ongoing financial market tensions continue to dampen economic activity in the euro area, while, according to some recent survey indicators, there are tentative signs of a stabilisation in activity at low levels. The economic outlook remains subject to high uncertainty and substantial downside risks. In such an environment, cost, wage and price pressures in the euro area should remain modest and inflation rates should develop in line with price stability over the policy-relevant horizon.~~**To sum up, the economic analysis indicates that underlying price pressures should remain limited and risks to the medium-term outlook for price developments remain broadly balanced.** A **cross-check** with the signals from the monetary analysis confirms this picture~~, with the underlying pace of monetary expansion continuing to be moderate~~.

~~Turning to~~**A combination of structural reforms and fiscal discipline is essential for boosting confidence and delivering a favourable environment for sustainable growth. Regarding fiscal policies**, **all** euro area governments need to **continue to** do their utmost to ~~support~~**ensure** fiscal sustainability~~ by correcting excessive deficits in accordance with the agreed timetables and by moving to a structural balanced budget or surplus position over the medium term. Slippages in the implementation of fiscal consolidation plans of vulnerable countries must be corrected swiftly by structural fiscal improvements. With regard to the new provisions of the EU economic governance framework that recently came into force, it is crucial that all the elements be implemented rigorously. Only ambitious policies to prevent and correct macroeconomic and fiscal imbalances will foster public confidence in the soundness of policy actions, and thus strengthen overall economic sentiment~~**. It is essential that all countries adhere to the fiscal targets they announced for 2012. This should help to anchor expectations of sound fiscal policies and strengthen confidence. The rules guiding the design and implementation of national fiscal policies are being strengthened at the EU level as well as in the legal frameworks of several Member States. These are important steps in the right direction. With regard to structural reforms, these are key to increasing the adjustment capacity and competitiveness of euro area countries, thereby strengthening growth prospects and job creation. Notably, far-reaching and ambitious reforms should be implemented to foster competition in product markets, particularly in services sectors, while rigidities in labour markets should be reduced and wage flexibility should be enhanced**.

~~The Governing Council welcomes the European Council's agreement to move to a stronger economic union, which was announced on 9 December 2011. The new fiscal compact, comprising a fundamental restatement of the fiscal rules together with the fiscal commitments that euro area governments have made, is an important contribution to ensuring the long-run sustainability of public finances in the euro area countries. The wording of the rules needs to be unambiguous and effective. The further development of the European financial stability tools should make the operation of the European Financial Stability Facility and the European Stability Mechanism more effective. The swift deployment of these tools is now urgently needed. Concerning the involvement of the private sector in financial assistance for indebted countries, we welcome the reaffirmation that the decisions taken on 21 July and 26 and 27 October 2011 concerning Greek debt are unique and exceptional.~~

~~To accompany fiscal consolidation, the Governing Council calls for the urgent implementation of bold and ambitious **structural reforms**. Going hand in hand, fiscal consolidation and structural reforms would strengthen confidence, growth prospects and job creation. Key reforms should be rapidly carried out to help the euro area countries to improve competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. Product market reforms should focus on fully opening up markets to increased competition. Labour market reforms should focus on removing rigidities and enhancing wage flexibility.~~

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