Europe

ECB Watch

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Economic Analysis

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The ECB is now ready to pre-emptively hike rates starting in April

- The change in the wording of the ECB makes it clear that rates will increase in April.
- In our view, second-round effects will not materialise and inflation expectations will not become unanchored.
- As a consequence, we expect a pre-emptive cumulative increase of 50bp in the next few months before a wait-and-see period re-emerges.

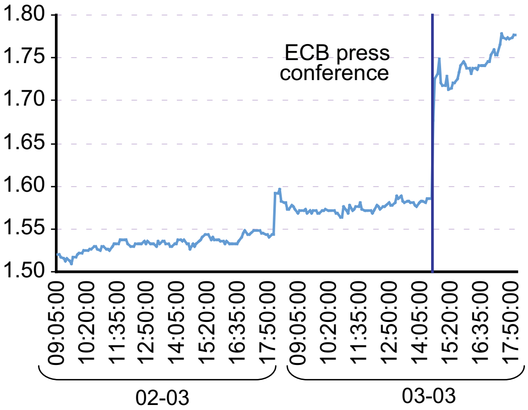
Bottom line: Our interpretation is that the ECB will decide to implement a pre-emptive move, and that they are not embarking in a series of rate increases towards policy normalisation (ie, neutrality). Considering that they are increasingly uncomfortable with the current stance at a time of (slight) economic recovery and with inflation above 2% with increasing commodity prices, two +25 bp hikes in the remainder of the year seem now likely. From then on, they will adopt a wait-and-see approach until uncertainties dissipate. Further increases would require a de-anchoring of inflation expectations or second-round effects which we don't expect.

- The ECB has changed its assessment of the stance from "accommodative" to "very accommodative", the balance of economic activity from "slightly tilted to the downside" to "broadly balanced", and risks to the outlook for prices from "broadly balanced" to "on the upside".
- In an unanticipated degree of hardening in its hawkish tone, perhaps not completely explained by recent data, the ECB went as far as stating that "strong vigilance" is warranted to avoid second-round effects. The ECB judgement is that the monetary policy stance is no longer appropriate.
- It can be assumed that the ECB will increase rates at its April meeting: in the previous hiking cycle, every +25 bp hike was preceded by this "strong vigilance" or "vigilance" reference. Moreover, in the Q&A Mr. Trichet commented that it was a "traditional" message to signal that an increase in interest rates in the next meeting is possible.
- Recent upside surprises in both prices and activity end up reflecting in an upward revision of the ECB Staff macroeconomic projections. On activity, GDP growth was revised by 0.3pp and 0.1pp to 1.7% and 1.8% in 2011 and 2012, respectively. These figures match our forecasts, but while the risks are broadly balanced for the ECB, we see recent downward risks with regards to the date in which our projection was updated. Increasing concerns around final results from European Council by end-March, combined with the potential negative effect of higher commodity prices, as well as higher interest rates on output, have drawn some negative risks. In addition, a higher interest rate, especially compared with other economic areas, should end up reflecting in an appreciation of the euro that could dampen the support from global demand via exports. On inflation, the upward revision was more significant, from 1.8% to 2.3% for 2011 and from 1.5% to 1.7% for 2012.

REFER TO IMPORTANT DISCLOSURES ON PAGE 7 OF THIS REPORT

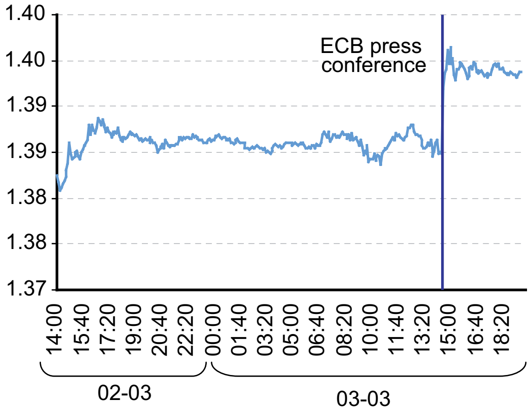
- The ECB stressed that these projections were elaborated with commodity future prices by mid-February, and therefore do not take into account the most recent oil prices hikes. Hence, risks to this outlook remain on the upside, especially with regards to further price increases due to geopolitical strains. If we incorporate in our models recent oil Brent futures, they also point to inflation at around 2.4% y/y for 2011 as a whole, mainly due to direct effects. Nevertheless, we continue to expect indirect effects to have limited impact (around 0.2pp), especially due to the sluggishness of private consumption along with still very high unemployment rates. In particular, Mr.Trichet said that second round effects have not been observed yet, stressing that the possible interest rate hike next month should be pre-emptive, only to avoid inflationary pressures in the medium term.
- Meanwhile, as we expected the ECB will continue offering full allotment liquidity provision to banks during 2Q11. This issue was important as the 3-Month full allotment tender operation was planned to end on March 30th. Concretely, the ECB decided to extend these LTRO operations until June 2011, so there will be three additional 3-Month LTRO (on April, May and June). The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO. Thus, this will have implications if as we now expect the official rate increases in April. The ECB guarantees enough liquidity at least until September 2011. In addition, the ECB also decided to continue with the 1-week MRO and 1-month LTRO with fixed rate tender procedures with full allotment "as long as necessary" and "at least until 12 July 2011" coinciding with the sixth maintenance period.
- **Market reaction:** The signal of an imminent rate hike caused sharp market reactions. There was a big reaction in fix income: 2Y German bond yield increased by 19 b.p. and the 10Y German bond yield increased 13b.p. Equity markets also registered some correction while the peripherals countries were the ones who suffered the most, especially Portugal. The Euro made impressive gains against the US dollar after the ECB press conference today, rising to a 4 month high of $1.3962 immediately after Mr. Trichet spoke.

Chart 1
2-year German yields: intraday change (yield each 5 minutes €mn, 20dma)



Source: Bloomberg and BBVA Research

Chart 2
Euro-Dollar: intraday change (ER 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, 3 ~~February~~March 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, which was also attended by Commissioner Rehn.

Based on its regular economic and monetary analyses, the Governing Council ~~confirmed that~~ decided to leave the ~~current~~ **key ECB interest rates** ~~still remain appropriate. It therefore decided to leave them~~ unchanged. ~~Taking into account all the new~~ The information ~~and analyses~~ which ~~have~~ has become available since our meeting on ~~13 January 2011, we continue to see evidence of short-term upward pressure on overall~~ 3 February 2011 indicates a rise in inflation, ~~mainly owing to energy and~~ largely reflecting higher commodity prices. ~~This has not so far affected our assessment that price developments will remain in line with price stability over the policy-relevant horizon. At the same time, very close monitoring is warranted.~~The economic analysis indicates that risks to the outlook for price developments are on the upside, while the underlying pace of monetary expansion remains moderate. Recent economic data confirm that the underlying momentum of economic activity in the euro area remains positive~~ underlying momentum of economic activity in the euro area, while~~ ; however, uncertainty remains elevated. ~~Our monetary analysis indicates~~The current very accommodative stance of monetary policy lends considerable support to economic activity. It is essential that the recent rise in inflation does not give rise to broad-based inflationary pressures over the medium ~~to long~~ term~~ should remain contained. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.~~. Strong vigilance is warranted with a view to containing upside risks to price stability. Overall, the Governing Council remains prepared to act in a firm and timely manner to ensure that upside risks to price stability over the medium term do not materialise. The continued firm anchoring of inflation expectations is of the essence.

~~Overall, we expect price stability to be maintained over the medium term, and the current monetary policy stance remains accommodative.~~ The ~~stance~~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 sixth maintenance period of 2011 on 12 July 2011. Furthermore, the Governing Council decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 27 April, 25 May and 29 June 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 we have stated before, 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.** Following the 0.3% quarter-on-quarter increase in euro area real GDP in both the third and the fourth quarter of 2010, recent statistical releases and survey-based evidence ~~for the fourth quarter and the beginning of the year~~ continue to confirm the positive underlying momentum of economic activity in the euro area at the beginning of 2011. Looking ahead, euro area exports should ~~benefit from the~~ continue to be supported by the ongoing recovery in the world economy. At the same time, taking into account the relatively high level of business confidence in the euro area, private sector domestic demand should increasingly contribute to growth, ~~supported by the~~ benefiting from the very accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system. However, the recovery in activity is expected to be dampened somewhat by the process of balance sheet adjustment in various sectors.

This assessment is also reflected in the March 2011 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between 1.3% and 2.1% in 2011 and between 0.8% and 2.8% in 2012. Compared with the December 2010 Eurosystem staff macroeconomic projections, the lower ends of these ranges have been shifted upwards, reflecting better prospects for the global economy – and thus for euro area exports – as well as for domestic demand. The March 2011 ECB staff projections are broadly in line with forecasts by international organisations.

In the Governing Council’s assessment, the risks to this economic outlook are ~~still slightly tilted to the downside, while~~ broadly balanced in a context of elevated uncertainty ~~remains elevated~~. On the one hand, global trade may continue to grow more rapidly than expected, thereby supporting euro area exports. Moreover, strong business confidence could provide more support to domestic economic activity in the euro area than is currently expected. On the other hand, downside risks relate to the ongoing tensions in some segments of the financial markets and their potential spillover to the euro area real economy. ~~Further downside risks~~ Downside risks also relate to ~~renewed~~ further increases in ~~oil and other~~ commodity prices, in particular in view of renewed geopolitical tensions, and to protectionist pressures and the possibility of a disorderly correction of global imbalances.

With regard to price developments, euro area annual HICP inflation was 2.4% in ~~January~~February 2011, according to Eurostat’s flash estimate, after 2.~~2~~3% in ~~December. This further~~ January. The increase ~~was broadly anticipated and~~ in inflation rates in early 2011 largely reflects higher ~~energy prices. Looking ahead to the next few months, inflation rates could temporarily increase further and are likely to stay slightly above 2% for most of 2011, before moderating again around the turn of the year. Overall, we continue to see evidence of short-term upward pressure on overall inflation, mainly owing to energy and~~ commodity prices. ~~Such pressure~~Pressure stemming from the sharp increases in energy and food prices is also discernible in the earlier stages of the production process. ~~These developments have not so far affected our assessment that price developments will remain in line with price stability over the policy-relevant horizon. At the same time, very close monitoring is warranted.~~It is paramount that the rise in HICP inflation does not lead to second-round effects and thereby give rise to broad-based inflationary pressures over the medium term. Inflation expectations over the medium to longer term ~~continue to be~~must remain firmly anchored in line with the Governing Council’s aim of ~~keeping~~maintaining inflation rates below, but close to, 2% over the medium term.

The March 2011 ECB staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 2.0% and 2.6% for 2011 and between 1.0% and 2.4% for 2012. In comparison with the December 2010 Eurosystem staff macroeconomic projections, the ranges for HICP inflation have been shifted upwards. This is mainly due to the considerable rise in energy and food prices. It should be stressed that the projections are based on commodity price futures as of mid-February 2011, and therefore do not take into account the most recent oil price increases. Moreover, it needs to be emphasised that the projections assume continued moderate domestic wage and price-setting behaviour.

Risks to the medium-term outlook for price developments are ~~still broadly balanced but, as already indicated in January, could move to~~on the upside. ~~Currently, upside risks~~ They relate, in particular, to ~~developments~~higher than assumed increases in energy and non-energy commodity prices. Furthermore, increases in indirect taxes and administered prices may be greater than currently ~~expected~~assumed, owing to the need for fiscal consolidation in the coming years~~, and~~ . Finally, risks also relate to stronger than expected domestic price pressures in the ~~production chain could rise further. On~~ context of the ~~downside, risks relate mainly to the impact on inflation of potentially lower growth, given the prevailing uncertainties.~~ongoing recovery in activity. Price and wage setters’ behaviour should not lead to broadly based second-round effects stemming from higher commodity prices.

Turning to the **monetary analysis**, the annual growth rate of M3 declined to 1.5% in January 2011, from 1.7% in December 2010, ~~from 2.1% in November. The~~while the annual growth rate of loans to the private sector ~~also declined, albeit marginally, to~~increased to 2.4% in January, from 1.9% in December~~, after 2.0% in November. These declines partly reflect the reversal~~. Looking beyond the movements in individual months and the effects of special factors ~~that operated~~, trends in ~~November and do not indicate a general weakening of monetary dynamics. Overall, however,~~ broad money and loan growth ~~is still low, confirming~~confirm the assessment that the underlying pace of monetary expansion is still moderate and that inflationary pressures over the medium to ~~long~~longer term should remain contained. At the same time, the low level of money and credit growth has thus far led to only a partial unwinding of the large amounts of monetary liquidity accumulated in the economy prior to the period of financial tensions. This liquidity may facilitate the accommodation of price pressures currently emerging in commodity markets as a result of strong economic growth and ample liquidity at the global level.

Looking at M3 components, annual M1 growth moderated further to stand at ~~4.4~~3.2% in ~~December 2010~~January 2011, reflecting the prevailing low remuneration of overnight deposits. At the same time, the yield curve ~~has~~ steepened somewhat further at the start of the year, implying that the attractiveness of short-term instruments included in M3 continues to decline compared with more highly remunerated longer-term instruments outside M3.

On the counterpart side, the rise in the annual growth rate of bank loans to the private sector ~~continued to conceal differences in the magnitude of growth across sectors.~~in January was due to stronger lending to both households and non-financial corporations. The growth of loans to non-financial corporations ~~stood~~turned positive, to stand at 0.4% in January, after -0.2% in December, ~~after -0.1% in the previous month,~~ while the growth of loans to households strengthened further to 3.~~0~~1%, from 2.9% in December~~, after 2.8% in November. Taking into account the effect of derecognition of loans from bank balance sheets and looking through short-term volatility, the latest data confirm a continued gradual strengthening in the annual growth of lending to the non-financial private sector~~. Overall, lending to the non-financial private sector has gradually strengthened over the past few quarters, as the economic recovery gathered momentum.

~~At the same time, the latest data point to the overall size of bank balance sheets having contracted again after expanding for most of 2010, mainly on account of a reduction in lending between banks.~~The latest data also confirm that banks have continued to expand their lending to the euro area economy, while at the same time keeping the overall size of their balance sheets broadly unchanged. 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, the ~~current~~ Governing Council decided to leave the key ECB interest rates ~~still remain appropriate. We therefore decided to leave them~~ unchanged. ~~Taking into account all the new~~ The information ~~and analyses~~ which ~~have~~ has become available since our meeting on ~~13 January~~3 February 2011~~, we continue to see evidence of short-term upward pressure on overall~~ indicates a rise in inflation, ~~mainly owing to energy and~~largely reflecting higher commodity prices. ~~This has not so far affected our assessment that price developments will remain in line with price stability over the policy-relevant horizon. At the same time, very close monitoring is warranted.~~The economic analysis indicates that risks to the outlook for price developments are on the upside, while the **cross-check** with the monetary analysis indicates that the underlying pace of monetary expansion remains moderate. Recent economic data confirm that the ~~positive~~ underlying momentum of economic activity in the euro area~~, while~~ remains positive; however, uncertainty remains elevated. ~~A **cross-check** of the outcome of our economic analysis with that of the monetary analysis indicates that inflationary pressures over the medium to long term should remain contained. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.~~The current very accommodative stance of monetary policy lends considerable support to economic activity. It is essential that the recent rise in inflation does not give rise to broad-based inflationary pressures over the medium term. Strong vigilance is warranted with a view to containing upside risks to price stability. Overall, the Governing Council remains prepared to act in a firm and timely manner to ensure that upside risks to price stability over the medium term do not materialise. The continued firm anchoring of inflation expectations is of the essence.

Turning to **fiscal policies**, ~~it is now essential that~~ all governments need to fully implement their fiscal consolidation plans in 2011. Where necessary, additional corrective measures must be implemented swiftly to ensure progress in achieving fiscal sustainability. Beyond 2011, countries need to specify ambitious and concrete policy measures in their multi-year adjustment programmes, so as to underpin the credibility of their fiscal consolidation targets~~. Experience shows that expenditure restraint is an important step towards achieving and maintaining fiscal soundness, notably when enshrined in binding domestic policy rules. Such a commitment helps to strengthen~~ of ensuring a rapid correction of excessive deficits and returning to a close-to-balance or surplus position. Strengthening confidence in the sustainability of public finances~~, reduces~~ is key, as this will reduce interest rate risk premia and improve~~s~~ the conditions for sound and sustainable growth. ~~The implementation of credible policies~~

At the same time, it is crucial ~~in view of ongoing financial market pressures.~~

~~Substantial~~that substantial and far-reaching **structural reforms**~~, complementing fiscal adjustment, should~~ be ~~urgently~~ implemented ~~to improve the prospects for higher sustainable~~in the euro area to strengthen its growth ~~and employment. Major reforms are particularly necessary in those countries that have experienced a loss of~~ potential, competitiveness ~~in~~ and flexibility. In the ~~past or~~case of product markets, policies that ~~are suffering from high fiscal and external deficits. Increased product market~~enhance competition and ~~labour market flexibility would~~ innovation should, in particular, be further ~~support the necessary adjustment processes in the economy. All these structural reforms should be supported by the necessary improvements in the structure 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.~~ pursued. On the labour market, the priority must be to enhance wage flexibility and incentives to work, and to remove labour market rigidities.

The current sovereign debt crisis in the euro area has reinforced the need for an ambitious **reform of the economic governance framework** of the euro area. The Governing Council of the ECB is of the view that the legislative proposals which have been put forward by the European Commission go some way to improving economic and budgetary surveillance in the euro area. However, they fall short of the necessary quantum leap in the surveillance of the euro area which is necessary to ensure the smooth functioning of Economic and Monetary Union. As outlined in the ECB's opinion of 17 February 2011 on these proposals, more stringent requirements, more automaticity in the procedures and a clearer focus on the most vulnerable countries with losses in competitiveness are required to ensure that the new framework will indeed be effective in the long run.

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