ECB Watch
Europe

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Economic Analysis

Financial Scenarios
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Priority for the ECB still to repair the transmission mechanism channels

- **ECB holds policy and gives no hints on what it would do in terms of monetary policy as the economy weakens**
- **The ECB will lower its growth projections in December and risks remain on the downside, while inflation risks remain "broadly balanced" and inflation expectations "solidly anchored"**
- **Although since the OMT announcement "there have been a series of improvements" equivalent to a "further expansion of monetary policy", governments need to do their bit as the OMT backstop is not the only key to improving the monetary policy transmission mechanism**

At today's meeting, the ECB left interest rates unchanged at 0.75% as widely expected. Although the ECB once again painted a gloomy picture of the economic outlook ("certainly the outlook is being revised and there's a picture of a weaker economy") and reiterated that risks continue to be on the downside, gave no clues on what it would do as the economy weaknens (when asked on whether a rate cut had been discussed, Mr. Draghi answered that they decided to keep rates unchanged and had "not discussed what we're going to do next year in terms of monetary policy") but given that the economic scenario is still deteriorating, it seems that the the probability of an additional rate cut going forward, after having decreased over the last two meetings, increased somewhat after today's meeting but its probability remains low as the easing of financial tensions is "equivalent to a further expansion of monetary policy". Thus, we still feel comfortable with our call for rates to remain steady as inflation risks remain "broadly balanced", monetary policy is "very accomodative" and the priority for the ECB is to restore the transmission mechanism of monetary policy ie, to further reduce financial fragmentation. Although no indication of what it would require to cut rates again was given by the ECB, it seems that a significant worsening of economic conditions from the current bad situation that tilts inflation risks to the downside is what it would take. According to our macroeconomic projections, a scenario of steady rates is still the most likely.

In the press conference, attention was focused again on ECB's readiness to undertake OMTs. (i.e., to start buying government bonds in secondary markets). He declined to answer on when and whether Spain should seek a bailout and pointed out that since the OMT announcement "there have been a series of improvements" such as a return of US money market funds, a moderate pickup in corporate bond issuance, a shift in lending from secured to unsecured markets, and a stabilization of target balances. He also added that Italy and Spain have quasi-completed their funding plans, and that Portugal and Ireland have achieved successful bond issuances. Improvements "are equivalent to further expansion of monetary policy". However, there is still high fragmentation in the euro area and thus the ECB is "not at all satisfied with financing conditions". Mr Draghi reminded took the opportunity to emphasize that the origin of the fragmentation has been policy mistakes and that governments need to do their bit as the OMT backstop is not the only key to improving the monetary policy transmission mechanism: there has been "substantial progress" on efforts to reform economies and cut deficits but there's "a lot more to do" and the faster the pace of reforms, "the sooner financial conditions will return to normal". When asked on whether if the situation worsens the ECB might consider unconditional OMTs Mr. Draghi rejected the possibility. Finally, for those who were unsure about it, Mr Draghi reiterated that the ECB "cannot give any assurance ex-ante" on bringing down spreads to a certain level.

When asked on whether is worrying for the ECB that some banks might return LTROs, Draghi said that is not a matter for concern as the objective of removing tail-risks coming from a lack of funding that would have happened in 1Q12 had already been achieved and that it might respond to two reasons: either banks are fearful to lend or because there's no demand for credit.

Mr. Draghi also signalled that the ECB agrees with using the profits the ECB will get from Greek bond holdings bought under the SMP to help relieve Greek debt (the ECB will pass the profits to national central banks, who would then pass it to governments which pass those profits to Greece).

Regarding the question if the ECB had improperly calculated haircuts on Spanish government bonds posted as collateral for ECB refinancing, Mr Draghi recognized that a mistake had been made but he argued there had been no impact on ECB lending. However, the Governing Council has mandated the Eurosystem audit committee to asses what went wrong with the collateral use and will provide an initial assessment at the next meeting.

Annex 1. Introductory statement, tracking the changes:

in black, wording common to both the current and previous statements, in red and crossed, previous wording that was replaced by new wording, in blue and underlined.

Introductory statement to the press conference~~ (with Q&A)~~

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
~~Brdo pri Kranju, 4 October~~Frankfurt am Main, 8 November 2012

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~I would like to thank Governor Kranjec for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council.~~ We will now report on the outcome of today's meeting of the Governing Council.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. Owing to high energy prices and increases in indirect taxes in some euro area countries, inflation rates are ~~expected~~likely to remain above 2% ~~throughout~~ for the remainder of 2012~~, but then to~~. They are expected to fall below that level ~~again~~ in the course of next year and to remain in line with price stability over the policy-relevant horizon. Consistent with this picture, the underlying pace of monetary expansion ~~remains~~ continues to be subdued. Inflation expectations for the euro area ~~continue to be~~ remain firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Economic ~~growth~~activity in the euro area is expected to remain weak, ~~with ongoing tensions in some euro area financial markets and high uncertainty still weighing on~~ although it continues to be supported by our monetary policy stance and financial market confidence ~~and sentiment. Our~~ has visibly improved on the back of our decisions as regards Outright Monetary Transactions (OMTs~~) have helped~~). At the same time, the necessary process of balance sheet adjustment in large parts of the financial and non-financial sectors as well as high uncertainty continue to weigh on the economic outlook. It is essential for governments to ~~alleviate such tensions over the past few weeks, thereby reducing concerns about the materialisation of destructive scenarios. It is now essential that governments continue to implement~~support confidence by forcefully implementing the necessary steps to reduce both fiscal and structural imbalances and to proceed with financial sector restructuring ~~measures~~.

The Governing Council remains firmly committed to preserving the singleness of its monetary policy and to ensuring the proper transmission of the policy stance to the real economy throughout the euro area. ~~OMTs will enable us to provide, under appropriate conditions, a fully effective backstop to avoid destructive scenarios with potentially severe challenges for price stability in the euro area. Let me repeat again what I have said in past months: we act strictly within our mandate to maintain price stability over the medium term; we act independently in determining monetary policy; and the euro is irreversible~~As we said before, we are ready to undertake OMTs, which will help to avoid extreme scenarios, thereby clearly reducing concerns about the materialisation of destructive forces.

~~We are ready to undertake OMTs, once all the prerequisites are in place. As we said last month, the Governing Council will consider entering into OMTs to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected. We would exit from OMTs once their objectives have been achieved or when there is a failure to comply with a programme. OMTs would not take place while a given programme is under review and would resume after the review period once programme compliance has been assured.~~

~~Let me now explain our assessment in greater detail, starting with the **economic analysis.** Euro area real GDP contracted by 0.2%, quarter on quarter, in the second quarter of 2012, following flat growth in the previous quarter. Economic indicators, in particular survey results, confirm the continuation of weak economic activity in the third quarter of 2012, in an environment characterised by high uncertainty. We expect the euro area economy to remain weak in the near term and to recover only very gradually thereafter. The growth momentum is~~ Let me now explain our assessment in greater detail, starting with the **economic analysis.** Euro area real GDP contracted by 0.2%, quarter on quarter, in the second quarter of 2012, following flat growth in the previous quarter. As regards the second half of 2012, the available indicators continue to signal weak activity. While industrial production data showed some resilience in July/August, most recent survey evidence for the economy as a whole, extending into the fourth quarter, does not signal improvements towards the end of the year.

Looking ahead to next year, the growth momentum is expected to remain weak. It continues to be supported by our standard and non-standard monetary policy measures, but ~~is expected to remain dampened by~~ the necessary process of balance sheet adjustment in the financial and non-financial sectors~~, the existence of high unemployment~~ and an uneven global recovery~~.~~

will continue to dampen the pace of recovery. The risks surrounding the economic outlook for the euro area ~~continue to be~~ remain on the downside.~~ They relate, in particular, to ongoing tensions in several euro area financial markets and the potential spillover to the euro area real economy. These risks should be contained by effective action by all policy-makers in the euro area.~~

Euro area annual HICP inflation was 2.~~7~~5% in ~~September~~October 2012, according to Eurostat's flash estimate, compared with 2.6% in ~~the previous month. This is higher than expected and mainly reflects past increases in indirect taxes and euro-denominated energy prices.~~September and August. On the basis of current futures prices for oil, inflation rates could remain at elevated levels, before declining to below 2% again in the course of next year. Over the policy-relevant horizon, in an environment of modest growth in the euro area and well-anchored long-term inflation expectations, underlying price pressures should remain moderate. Current levels of inflation should thus remain transitory~~ and not give rise to second-round effects~~. We will continue to monitor closely further developments in costs, wages and prices.

Risks to the outlook for price developments continue to be broadly balanced over the medium term. Upside risks pertain to further increases in indirect taxes owing to the need for fiscal consolidation. The main downside risks relate to the impact of weaker than expected growth in the euro area, in the event of a renewed intensification of financial market tensions, and its effects on the domestic components of inflation.~~ If not contained by effective action by all policy-makers in the euro area, such intensification has the potential to affect the balance of risks on the downside.~~

Turning to the **monetary analysis,** ~~recent data confirm~~ the ~~subdued~~ underlying pace of monetary expansion continues to be subdued. In ~~August~~September the annual growth rate of M3 decreased to 2.~~9~~7%, from ~~3.6~~2.8% in ~~July. While this decline was mainly due to a base effect, monthly inflows were also relatively contained. Conversely, strong monthly inflows into overnight deposits contributed to a further increase in~~ August. Monthly outflows from M3 reflected to some extent the reversal of portfolio shifts into the most liquid components of M3. Accordingly, the annual rate of growth of M1 declined to 5.~~1~~0% in September, from 5.2% in August~~, compared with 4.5% in July. This increase reflects a continuing high preference for liquidity in an environment of low interest rates and high uncertainty~~. At the same time, we have observed a strengthening in the deposit base of banks in some stressed countries, amid improvements in investors' confidence in the euro area.

The annual growth rate of loans to the private sector (adjusted for loan sales and securitisation) declined ~~in August~~further to -0.~~2% (~~4% in September, from ~~0.1% in July), reflecting a decrease in the annual rate of growth of loans to non-financial corporations to -0.5%, from -0.2% in July. By contrast, the~~ 0.2% in August. This development was mainly due to further net redemptions in loans to non-financial corporations, which led to an annual rate of decline in these loans of -1.2%, compared with -0.5% in August. The annual growth ~~of loans~~ in MFI lending to households remained unchanged~~,~~ at ~~1.~~0~~%, in August.~~.9% in September. To a large extent, subdued loan dynamics reflect the weak outlook for GDP, heightened risk aversion and the ongoing adjustment in the balance sheets of households and enterprises, all of which weigh on credit demand. At the same time, in a number of euro area countries, the segmentation of financial markets and capital constraints for banks restrict credit supply. The recent results of the bank lending survey for the third quarter of 2012 underpin this assessment.

The soundness of banks' balance sheets will be a key factor in facilitating both an appropriate provision of credit to the economy and the normalisation of all funding channels, thereby contributing to an adequate transmission of monetary policy to the financing conditions of the non-financial sectors in the ~~different~~individual countries of the euro area. It is thus essential that the resilience of banks continues to be strengthened where needed.

To sum up, the economic analysis indicates that price developments should remain in line with price stability over the medium term. A **cross-check** with the signals from the monetary analysis confirms this picture.

Other economic policy areas need to make substantial contributions to ensure a further stabilisation of financial markets and an improvement in the outlook for growth.~~ As regards **fiscal policies**, euro area countries are progressing with consolidation. It is crucial that efforts are maintained to restore sound fiscal positions, in line with the commitments under the Stability and Growth Pact and the 2012 European Semester recommendations. A rapid implementation of the fiscal compact will also play a major role in strengthening confidence in the soundness of public finances. At the same time, **structural reforms** are as essential as fiscal consolidation efforts and measures to improve the functioning of the financial sector. In the countries most strongly affected by the crisis, noticeable~~ **Structural reforms** are crucial to boost the growth potential of euro area countries and to enhance employment. Policy action is also necessary to increase the adjustment capacity of euro area economies in order to complete the ongoing process of unwinding existing imbalances. Visible progress is being made in the correction of unit labour ~~cost~~costs and current account ~~developments. Decisive product and labour market reforms will further improve the competitiveness of these countries and their capacity to adjust~~imbalances. However, further measures to enhance labour market flexibility and labour mobility across the euro area are warranted. Such structural measures would also complement and support fiscal consolidation and debt sustainability. As regards **fiscal policies**, there is clear evidence that consolidation efforts in euro area countries are bearing fruit. It is crucial that efforts are maintained to restore sound fiscal positions, in line with the commitments under the Stability and Growth Pact and the 2012 European Semester recommendations. Full compliance with the reinforced EU fiscal and governance framework, including the rapid implementation of the fiscal compact, will send a strong signal to markets and strengthen confidence in the soundness of public finances.

~~Finally, it is essential to push ahead with **European institution-building.** The ECB welcomes the Commission proposal of 12 September 2012 for a single supervisory mechanism (SSM) involving the ECB, to be established through a Council regulation on the basis of Article 127(6) of the Treaty. The Governing Council considers an SSM to be one of the fundamental pillars of a financial union and one of the main building blocks towards a genuine Economic and Monetary Union. We will formally issue a legal opinion in which we will, in particular, take into account the following principles: a clear and robust separation between supervisory decision-making and monetary policy; appropriate accountability channels; a decentralisation of tasks within the SSM; an effective supervisory framework ensuring coherent oversight of the euro area banking system; and full compatibility with the Single Market framework, including the role and prerogatives of the European Banking Authority. As the Commission proposal sets out an ambitious transition schedule towards the SSM, the ECB has started preparatory work so as to be able to implement the provisions of the Council regulation as soon as it enters into force.~~

The Governing Council takes note of the European Council conclusions on completing Economic and Monetary Union, adopted on 18 October 2012. In the context of measures to achieve an integrated financial framework, it welcomes in particular the objective of agreeing on the legislative framework for a Single Supervisory Mechanism (SSM) by 1 January 2013 with a view to the SSM becoming operational in the course of 2013.

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