# ECB Watch

## Europe

Madrid, 4 October 2012
Economic Analysis

Financial Scenarios

**Javier Amador Díaz**
javier.amadord@bbva.com

**María Martínez Álvarez**
maria.martinez.alvarez@bbva.com

# A “fully effective backstop” is in place, the decision is up to governments

- **ECB holds policy and gives no hints on what it would do if economic conditions worsen further**
- **The ECB is ready to undertake OMTs but is up to governments: “The ECB is there to make an environment that is conducive to reforms, but the decision is with governments”**

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 (“economy to remain weak in the near term and to recover only very gradually thereafter) and reiterated that risks continue to be on the downside, a rate cut was not discussed. In our opinion, the probability of an additional rate cut going forward has decreased over the last two meetings[1] and we feel comfortable with our call for rates to remain steady. Importantly, a reference regarding that the ECB will “monitor closely” price developments was added to the statement even though it is judged that underlying price pressures are likely to remain moderate and the transitory increase in inflation should “not give rise to second-round effects” in a context of low growth and well-anchored long-term inflation expectations. In our opinion, although the door for an additional rate cut is still open, is not as open as it was two months ago, and even if 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 is what it would take. Besides, two elements suggest that steady rates is the most likely scenario. On the one hand, what is important at this time for the ECB is to to ensure the proper transmission of the current policy stance, not to shift it to an easier stance. On the other hand, Bundesbank’s opposition to OMTs reduces the ECB’s leeway for further decisions.

In the press conference, attention was focused on ECB’s readiness to undertake OMTs “once all the prerequisites are in place”. Mr. Draghi emphasized that the ECB that a “fully effective backstop mechanism [is] in place” (i.e., that it stands ready to start buying government bonds in secondary markets) but “at this point is up to the governments to decide what they want to do”. That is, the ECB insisted again that the ball is in the court of governments and not only in regard to OMTs activation but also in that it is “now essential that governments continue to implement the necessary steps”. The ECB is ready to start buying government bonds in the secondary markets as soon as the necessary conditions are fulfilled by any countries needing assistance: the ECB is ready to undertake Outright Monetary Transactions “once all the prerequisites are in place”. The plan has “helped to alleviate tensions over the past few weeks” and “it is now essential that governments continue to implement the necessary steps to reduce both fiscal and structural imbalances”. Much emphasis was put on the importance of conditionality and the reasons why it is an essential part of the activation of the OMTs, namely: 1) it reduces the moral hazard of governments, 2) it protects ECB’s independence, and 3) it creates a “credit enhancement” for the government bonds. It gives the “incentive to pursue the right economic policies which has benefits for all parties concerned”. Importantly, Mr. Draghi insisted that the ECB will “actively seek IMF’s involvement in the process”.

[1] At the last meeting, Mr. Draghi pointed out that the last rate cut (to 0.75%) anticipated the weakening economy seen; at this meeting, with ongoing worries over the economic outlook, there was no discussion on the possibility.

Notwithstanding that the mechanism has not been activated yet, Mr Draghi said that OMTs' mechanism has reduced the tail risk in the euro area; stressing that the program has helped relieve tensions in euro-zone financial markets over the past few weeks. Particularly he remarked that there has been a sizable issuance by corporations and banks, various interest rates spreads have dropped significantly since then and the Target2 imbalances have somewhat stabilized. He also added that there have been deposit inflows into Italy, and Spain's recourse to ECB financing has decreased. Nonetheless, he kept a cautious tone highlighting that the volatility is still very high, that credit flows are non- existent in some euro area countries, and that there is still an unacceptable level of fragmentation in the euro area. Finally, when asked on whether the the ECB could intervene in rescued countries as Portugal, he reiterated that countries would not gain access to the OMT until they regain full primary market access: "the OMT is not a replacement for a lack of primary market access".

# 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.

## Mario Draghi, President of the ECB,
## Vítor Constâncio, Vice-President of the ECB,
## ~~Frankfurt am Main, 6 September~~Brdo pri Kranju, 4 October 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, which was also attended by the President of the Eurogroup, Prime Minister Juncker, and by the Commission Vice-President, Mr Rehn~~.

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 to remain above 2% throughout 2012, but then 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 subdued. Inflation expectations for the euro area ~~economy~~ continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Economic growth in the euro area is expected to remain weak, with ~~the~~ ongoing tensions in some euro area financial markets and ~~heightened~~ high uncertainty still weighing on confidence and sentiment. ~~A renewed intensification of financial market tensions would have the potential to affect the balance of risks for both growth and inflation~~Our decisions as regards Outright Monetary Transactions (OMTs) have helped 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 the necessary steps to reduce both fiscal and structural imbalances and proceed with financial sector restructuring measures.

~~It is against this background that the~~ The Governing Council ~~today decided on the modalities for undertaking Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds in the euro area. As we said a month ago, we need to be in the position to safeguard the monetary policy transmission mechanism in all countries of the euro area. We aim~~remains firmly committed to ~~preserve~~preserving the singleness of ~~our~~ its monetary policy and to ~~ensure~~ensuring the proper transmission of ~~our~~ the policy stance to the real economy throughout the euro area. OMTs will enable us to ~~address severe distortions in government bond markets which originate from, in particular, unfounded fears on the part of investors of the reversibility of the euro. Hence~~provide, under appropriate conditions, ~~we will have~~ 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 ~~said last month~~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.

~~In order to restore confidence, policy-makers in the euro area need to push ahead with great determination with fiscal consolidation, structural reforms to enhance competitiveness and European institution-building. At the same time, governments must stand ready to activate the EFSF/ESM in the bond market when exceptional financial market circumstances and risks to financial stability exist – with strict and effective conditionality in line with the established guidelines. The adherence of governments to their commitments and the fulfilment~~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 supported by ~~the EFSF/ESM of their role are necessary conditions for~~ our ~~outright transactions to be conducted and to be effective. Details of the Outright Monetary Transactions are described in a separate press release.~~

~~Furthermore, the Governing Council took decisions with a view to ensuring the availability of adequate collateral in Eurosystem refinancing operations. The details of these measures are also elaborated in a separate press release.~~

~~Let me now explain our assessment in greater detail, starting with the **economic analysis**. Recently published statistics indicate that euro area real GDP contracted by 0.2%, quarter on quarter, in the second quarter of 2012, following zero growth in the previous quarter. Economic indicators point to continued weak economic activity in the remainder of 2012, in an environment of heightened uncertainty. Looking beyond the short term, we expect the euro area economy to recover only very gradually. The growth momentum is~~ 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.

~~The September 2012 ECB staff macroeconomic projections for the euro area foresee annual real GDP growth in a range between -0.6% and -0.2% for 2012 and between -0.4% and 1.4% for 2013. Compared with the June 2012 Eurosystem staff macroeconomic projections, the ranges for 2012 and 2013 have been revised downwards.~~

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

Euro area annual HICP inflation was 2.~~6~~7% in ~~August~~September 2012, according to Eurostat's flash estimate, compared with 2.~~4~~6% in the previous month. This ~~increase is~~ is higher than expected and mainly ~~due to renewed~~reflects past increases in indirect taxes and euro-denominated energy prices. On the basis of current futures prices for oil, inflation rates could ~~turn out somewhat higher than expected a few months ago, but they should decline~~ 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.

~~The September 2012 ECB staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 2.4% and 2.6% for 2012 and between 1.3% and 2.5% for 2013. These projection ranges are somewhat higher than those contained in the June 2012 Eurosystem staff macroeconomic projections.~~

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, ~~particularly resulting from~~ in the event of a ~~further~~renewed intensification of financial market tensions, and its effects on the domestic components of inflation. If not contained by effective action by all ~~euro area~~ 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**, ~~the~~recent data confirm the subdued underlying pace of monetary expansion ~~remained subdued. The~~. In August the annual growth rate of M3 ~~increased~~decreased to 2.9%, from 3.~~8~~6% in July ~~2012, up from 3.2% in June. The rise in M3 growth was mainly attributable to a higher preference for liquidity, as reflected in the further increase in the annual growth rate of the narrow monetary aggregate M1 to 4.5% in July, from 3.5% in June~~. 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 the annual rate of growth of M1 to 5.1% 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.

The annual growth rate of loans to the private sector (adjusted for loan sales and securitisation) ~~remained weak at 0.5~~declined in August to -0.2% (from 0.1% in July ~~(after 0.3%)~~, reflecting a decrease in ~~June). Annual~~the annual rate of growth ~~in MFI~~ of loans to ~~both~~ non-financial corporations ~~and households remained subdued, at -0.2% and 1.1% respectively (both adjusted for loan sales and securitisation).~~ to -0.5%, from -0.2% in July. By contrast, the annual growth of loans to households remained unchanged, at 1.0%, in August. To a large extent, subdued loan ~~growth reflects a~~ 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. ~~Furthermore,~~ At the same time, in a number of euro area countries, the segmentation of financial markets and capital constraints for banks ~~continue to weigh on~~restrict credit supply.

~~Looking ahead, it is essential for banks to continue to strengthen their resilience where this is needed.~~ 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 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.

~~Although good progress is being made, the need for structural and fiscal adjustment remains significant in many European countries. On the **structural side**, further swift and decisive product and labour market reforms are required across the euro area to improve competitiveness, increase adjustment capacities and achieve higher sustainable growth rates. These structural reforms will also complement and support fiscal consolidation and debt sustainability. On the **fiscal front**, it is crucial that governments undertake all measures necessary to achieve their targets for the current and coming years. In this respect, the expected rapid implementation of the fiscal compact should be a main element to help strengthen confidence in the soundness of public finances.~~ 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 progress is being made in the correction of unit labour cost and current account developments. Decisive product and labour market reforms will further improve the competitiveness of these countries and their capacity to adjust.

Finally, ~~pushing~~it is essential to push ahead ~~with~~ with **European institution-building** ~~with great determination is essential~~. 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 Eurosystem; 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.

We are now at your disposal for questions.

* * *

## DISCLAIMER