ECB Watch

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Economic Analysis

Financial Scenarios

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The ECB delivers; the ball is now in the court of governments

- **Draghi outlines the bond-buying programme: the ECB refrained from fixing any explicit cap on yields and waived its preferred creditor status by acknowledging that it would participate in any debt restructuring should there be another one. Ex ante unlimited size of bond purchases**
- **Arguably the most important feature of the Outright Monetary Transactions (OMTs) is the strict conditionality attached: as widely expected, the programme will only kick in after countries' official request for aid to the rescue funds and could potentially be suspended for countries which fail to comply with the bailout terms**
- **Importantly, measures to increase liquidity in the banking sector (ie, to preserve collateral availability) were also announced**

At today's meeting, the ECB left interest rates unchanged and restrained from hinting that a rate cut was forthcoming[1]. The ECB president outlined the features of the bond-buying programme in secondary markets, named Outright Monetary Transactions (OMTs), aimed at countering "unfounded fears of the reversivility of the euro", preserving the "singleness" of euro area's monetary policy, and restoring the monetary policy transmission mechanism. The plan was backed by a "massive majority"; "there was one dissenting view".

As widely expected, Mr. Draghi emphasised that for the bond purchases by the ECB to kick in, "strict and effective" conditionality was a necessary condition ie, countries must first have to sign up a EFSF/ESM programme. In the Governing Council's view, for this programme to be perceived as an effective backstop to remove the tail risks in the euro area, it has to rest on two legs: one is the ECB, the other consists of governments, country specific conditionality and the monitoring of commitments. Mr. Draghi argued that it shouldn't be forget "how these countries found in a bad equilibrium[2] to begin with" and reminded that the SMP (which was officially terminated today) didn't work because you "need two legs for making it work" and that programme rested just on one leg. Although IMF's involvement is not a firm condition, it is a preffered scenario and "if they want to intervene, they're more than welcome". It seems clear that IMF's involvement is likely to be sought. When countries already under a programme regain bond market access, they would also be considered. Also as expected, all bond purchases will be sterilised. A positive surprise was the signal of potentially unlimited purchases: ex ante unlimited size "adequate to reach" ECB's objectives. However, and crucially, if a government fails to comply with the bailout terms, the ECB will stop buying its bonds. As expected, the ECB refrained from fixing any explicit cap on yields. As already filtered through the press yesterday, the programme will apply to bonds of maturity between one and three years.

[1] In the Q&A, Mr Draghi pointed out that the las trate cut (to 0.75%) anticipated the weakening economy seen both in recent data and in ECB's revised growth projections
[2] A point of no return in which if a country is left alone, high yields take it to the "bad equilibrium" of default

Importantly, the ECB waived its preferred creditor status and will be treated (only for new purchases, not for SMP's holdings) the same way as any other bond buyer. As we've argued, this was key to improve the chances of being successful.

Regarding other measures, as expected, the ECB announced a more flexible collateral policy in order to expand the ability of European banks, to access ECB liquidity. Particularly the central bank "decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements" for debt issued or guaranteed by euro zone governments that are eligible for its new bond-buying programme "or are under an EU/IMF programme." Moreover, the central bank will also accept marketable debt instruments denominated in other currencies than the Euro as collateral. Concerning the possibility of further LTROs, Mr. Dragui said that there was no discussion on this, hinting that at this stage there is no need for further LTROs. However, if liquidity conditions worsen in the months to come, the ECB would not refrain from offering another LTRO. Finally, regarding the possibility of buying private sector assets outside of government bonds, he refrained from making any comment by saying that he "wouldn't want to speculate" on other measures. Yet, under Draghi the ECB has showed that is pragmatic and flexible enough to implement measures if needed.

The ECB downgraded its growth projections: it now expects the eurozone economy to contract by between 0.2 and 0.6% this year (midpoint forecast of -0.4% vs -0.1% anticipated in June; BBVA: -0.3%). The midpoint forecast for 2013 is now 0.5%, down from the. 1.0% estimated in June (BBVA: 0.3%). Unsurprisingly, risks to the outlook remain tilted to the downside. Given the increased likelihood of further hikes to indirect taxes, inflation forecasts were revised upwards to 2.5% (+0.1pp) in 2012 and to 1.9% (+0.3pp) in 2013.

Broadly speaking, all that was expected was unveiled. The plan is very likely to stabilise the front end of the curve and contribute to an increase in private demand for peripheral bonds on that sector of the curve. It is unclear what would happen if countries do all they are asked to in the bailout terms, but are unable to comply with fiscal consolidation commitments. All in all, and without minimising this huge step forward to the solution of euro area problems, a complete recovery of trust (ie, of government's ability to raise new debt) depends on growth prospects, which sadly still remain negative and uncertain.

Annex 1. Introductory statement, tracking the changes: in black, wording common to both the current and previous statements, in blue and crossed, previous wording that was replaced by new wording, in green and underlined.

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~2 August~~6 September 2012

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 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~~, following the decrease of 25 basis points~~. Owing to high energy prices and increases in ~~July. As we said a month ago~~indirect taxes in some euro area countries, inflation ~~should decline further in the course of~~ rates are expected to remain above 2% throughout 2012~~ and be~~, to fall below ~~2%~~ that level again in ~~2013.~~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. ~~At the same time, economic~~ Economic growth in the euro area ~~remains~~is expected to remain weak, with the ongoing tensions in financial markets and heightened uncertainty weighing on confidence and sentiment. A ~~further~~ renewed intensification of financial market tensions ~~has~~would have the potential to affect the balance of risks for both growth and inflation~~ on the downside~~.

~~The Governing Council extensively discussed the policy options to address the severe malfunctioning in the price formation process in the bond markets of euro area countries. Exceptionally high risk premia are observed in government bond prices in several countries and financial fragmentation hinders the effective working of monetary policy. Risk premia that are related to fears of the reversibility of the euro are unacceptable, and they need to be addressed in a fundamental manner. The euro is irreversible.~~

~~In order to create the fundamental conditions for such risk premia to disappear~~It is against this background that 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 to preserve the singleness of our monetary policy and to ensure the proper transmission of our policy stance to the real economy throughout the 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, 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 what I said last month: 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 ~~reform~~reforms to enhance competitiveness and European institution-building~~ with great determination. As implementation takes~~. At the same time~~ and financial markets often only adjust once success becomes clearly visible~~, 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 by the EFSF/ESM of their role are necessary conditions~~. The Governing Council, within its mandate to maintain price~~

~~stability over the medium term and in observance of its independence in determining monetary policy, may undertake~~ for our outright ~~open market operations of a size adequate to reach its objective. In this context, the concerns of private investors about seniority will be addressed. Furthermore, the Governing Council may consider undertaking further non-standard monetary policy measures according to what is required to repair monetary policy transmission. Over the coming weeks, we will design the appropriate modalities for such policy measures~~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**. ~~On a quarterly basis,~~Recently published statistics indicate that euro area real GDP ~~growth was flat in the first~~contracted by 0.2%, quarter on quarter, in the second quarter of 2012, following ~~a decline of 0.3%~~ zero growth in the previous quarter. Economic indicators point to continued weak economic activity in the ~~second quarter~~remainder of 2012~~ and at the beginning of the third quarter~~, in an environment of heightened uncertainty. Looking beyond the short term, we expect the euro area economy to recover only very gradually~~, with~~. The growth momentum ~~being further~~is expected to remain dampened by ~~a number of factors. In particular, tensions in some euro area sovereign debt markets and their impact on financing conditions, the~~the necessary process of balance sheet adjustment in the financial and non-financial sectors~~ and~~, the existence of high unemployment ~~are expected to weigh on the underlying growth momentum, which is also affected by the ongoing~~and an uneven global ~~slowdown~~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 ~~continue~~are assessed to be on the downside. They relate, in particular, to the tensions in several euro area financial markets and their potential spillover to the euro area real economy. ~~Downside risks also relate to possible renewed increases in energy prices over the medium term~~These risks should be contained by effective action by all euro area policy-makers.

Euro area annual HICP inflation was 2.~~4~~6% in ~~July~~August 2012, according to Eurostat's flash estimate, ~~unchanged from~~compared with 2.4% in the previous month. This increase is mainly due to renewed increases in 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 ~~further~~to below 2% again in the course of ~~2012 and be below 2% again in 2013.~~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.

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~~, and higher than expected energy prices over the medium term~~. The main downside risks relate to the impact of weaker than expected growth in the euro area, ~~in particular~~particularly resulting from a further intensification of financial market tensions~~. Such~~, and its effects on the domestic components of inflation. If not contained by effective action by all euro area policy-makers, such intensification has the potential to affect the balance of risks on the downside.

Turning to the **monetary analysis,** the underlying pace of monetary expansion remained subdued. The annual growth rate of M3 ~~stood at~~ increased to 3.~~2~~8% in ~~June~~July 2012, ~~slightly higher than the~~ up from 3.~~1% observed~~2% in ~~the previous month and close~~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 ~~observed at the end~~ of the ~~first quarter. Overall, inflows into broad money in the second quarter were weak. Annual growth in~~narrow monetary aggregate M1 ~~increased further~~ to 4.5% in July, from 3.5% in June~~, in line with the increased preference of investors for liquid instruments 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) ~~declined to~~remained weak at 0.5% in July (after 0.3% in June ~~(from 0.5% in May). As net redemptions of~~). Annual growth in MFI loans to both non-financial corporations and households remained subdued, at -0.2% and 1.1% respectively (both adjusted for loan sales and securitisation~~) were observed in June, the annual growth rates for loans to both non-financial corporations and households (adjusted for loan sales and securitisation) decreased further in June, to -0.3% and 1.1% respectively.~~). To a large extent, subdued loan growth reflects ~~the current cyclical situation~~a 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. ~~A considerable contribution of demand factors to weak MFI loan growth is confirmed by the euro area bank lending survey for the second quarter of 2012. This survey also shows that the net tightening of banks' credit standards at the euro area level was broadly stable in the second quarter of 2012, as compared with the previous quarter, for loans to both enterprises and households~~Furthermore, in a number of euro area countries, the segmentation of financial markets and capital constraints for banks continue to weigh on 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.

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.

A~~While significant progress has been achieved with~~ ~~**fiscal consolidation**~~ ~~over recent years, further decisive and urgent steps need to be taken to improve competitiveness. From 2009 to 2011, euro area countries, on average, reduced the deficit-to-GDP ratio by 2.3 percentage points, and the primary deficit improved by about 2½ percentage points. Fiscal adjustment in the euro area is continuing in 2012, and it is indeed crucial that efforts are maintained to restore sound fiscal positions. At the same time,~~ ~~**structural reforms**~~ ~~are as essential as fiscal consolidation efforts and the measures to repair the financial sector. Some progress has also been made in this area. For example, unit labour costs and current account developments have started to undergo a correction process in most of the countries strongly affected by the crisis. However, further reform measures need to be implemented swiftly and decisively. Product market reforms to foster competitiveness and the creation of efficient and flexible labour markets are preconditions for the unwinding of existing imbalances and the achievement of robust, sustainable growth. It is now crucial that Member States implement their country-specific recommendations with determination.~~

lthough 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. Finally, pushing ahead with European institution-building with great determination is essential.

Annex 2.: Technical features of Outright Monetary Transactions

As announced on 2 August 2012, the Governing Council of the European Central Bank (ECB) has today taken decisions on a number of technical features regarding the Eurosystem's outright transactions in secondary sovereign bond markets that aim at safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy. These will be known as Outright Monetary Transactions (OMTs) and will be conducted within the following framework:

Conditionality

A necessary condition for Outright Monetary Transactions is strict and effective conditionality attached to an appropriate European Financial Stability Facility/European Stability Mechanism (EFSF/ESM) programme. Such programmes can take the form of a full EFSF/ESM macroeconomic adjustment programme or a precautionary programme (Enhanced Conditions Credit Line), provided that they include the possibility of EFSF/ESM primary market purchases. The involvement of the IMF shall also be sought for the design of the country-specific conditionality and the monitoring of such a programme.

The Governing Council will consider Outright Monetary Transactions to the extent that they are warranted from a monetary policy perspective as long as programme conditionality is fully respected, and terminate them once their objectives are achieved or when there is non-compliance with the macroeconomic adjustment or precautionary programme.

Following a thorough assessment, the Governing Council will decide on the start, continuation and suspension of Outright Monetary Transactions in full discretion and acting in accordance with its monetary policy mandate.

Coverage

Outright Monetary Transactions will be considered for future cases of EFSF/ESM macroeconomic adjustment programmes or precautionary programmes as specified above. They may also be considered for Member States currently under a macroeconomic adjustment programme when they will be regaining bond market access.

Transactions will be focused on the shorter part of the yield curve, and in particular on sovereign bonds with a maturity of between one and three years.

No ex ante quantitative limits are set on the size of Outright Monetary Transactions.

Creditor treatment

The Eurosystem intends to clarify in the legal act concerning Outright Monetary Transactions that it accepts the same (pari passu) treatment as private or other creditors with respect to bonds issued by euro area countries and purchased by the Eurosystem through Outright Monetary Transactions, in accordance with the terms of such bonds.

Sterilisation

The liquidity created through Outright Monetary Transactions will be fully sterilised.

Transparency

Aggregate Outright Monetary Transaction holdings and their market values will be published on a weekly basis. Publication of the average duration of Outright Monetary Transaction holdings and the breakdown by country will take place on a monthly basis.

Securities Markets Programme

Following today's decision on Outright Monetary Transactions, the Securities Markets Programme (SMP) is herewith terminated. The liquidity injected through the SMP will continue to be absorbed as in the past, and the existing securities in the SMP portfolio will be held to maturity.

Annex 3.: Measures to preserve collateral availability

On 6 September 2012 the Governing Council of the European Central Bank (ECB) decided on additional measures to preserve collateral availability for counterparties in order to maintain their access to the Eurosystem's liquidity-providing operations.

Change in eligibility for central government assets

The Governing Council of the ECB has decided to suspend the application of the minimum credit rating threshold in the collateral eligibility requirements for the purposes of the Eurosystem's credit operations in the case of marketable debt instruments issued or guaranteed by the central government, and credit claims granted to or guaranteed by the central government, of countries that are eligible for Outright Monetary Transactions or are under an EU-IMF programme and comply with the attached conditionality as assessed by the Governing Council.

The suspension applies to all outstanding and new assets of the type described above.

The decision on the collateral eligibility of bonds issued or guaranteed by the Greek government taken by the Governing Council on 18 July 2012 is still applicable (Decision ECB/2012/14).

Expansion of the list of assets eligible to be used as collateral

The Governing Council of the ECB has also decided that marketable debt instruments denominated in currencies other than the euro, namely the US dollar, the pound sterling and the Japanese yen, and issued and held in the euro area, are eligible to be used as collateral in Eurosystem credit operations until further notice. This measure reintroduces a similar decision that was applicable between October 2008 and December 2010, with appropriate valuation markdowns.

These measures will come into force with the relevant legal acts.

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