Europe

ECB Watch

Madrid, 8 April 2011

Economic Analysis

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com
+34 91 374 44 323

María Martínez Álvarez
maria.martinez.alvarez@grupobbva.com
+34 91 537 66 83

Javier Amador
javier.amadord@grupobbva.com
+34 91 537 3161

Cristina Varela Donoso
cvarela@grupobbva.com
+34 91 537 7825

Leanne Ryan
leanne.ryan@grupobbva.com
+34 91 537 8432

Europe
Miguel Jiménez González-Anleo
mjimenez@grupobbva.com
+34 91 537 37 76

Agustín García Serrador
agustin.garcia@grupobbva.com
+34 91 374 79 38

The ECB raised rates (+25bp to 1.25%) and retained a hawkish tone

- The statement dropped the “vigilance” code word but remained hawkish, while Mr. Trichet retained a tough tone on the Q&A.
- We continue to expect another 25 bp hike in July followed by a pause for the remainder of the year.
- Considering the tough tone, the risk is that the ECB raises rate beyond our current 1.50% forecast in 2011.

Bottom line: Our view continues to be that the ECB is not embarking in a series of rate increases. The timing of the next hike will be data dependent and it is clear that the move will not be in May. We continue to expect another 25 bp hike in July which will allow some normalization from the “accommodative” stance and should be enough to fight risks of second-round effects and keep inflation expectations in check. As well, we continue to anticipate a pause for the remainder of the year following July’s move. However, given that from today’s messages it seems clear that the ECB does not see today’s increase as a one off pre-emptive move; the risk is that they decide to embark in a more usual hiking cycle (raising rates beyond our forecasts in 2011). For now, we continue to expect that the ECB will be forced to adopt a wait-and-see approach until uncertainties –both in terms of the economic cycle and of the weaknesses of the financial system– fade away ie, continued unconventional support might not be enough to offset the negative effects on peripheral countries of higher interest rates.

As broadly expected, the ECB raised its interest rates by 25bp to 1.25% the decision was taken unanimously by the Governing Council. As we expected, the ECB did not re-widen its interest rate corridor, leaving it at +/- 75 bp ie, new deposit and lending rates at 0.5% and 2.0%, respectively. They discussed the widening of the corridor but in the end they considered that at this stage it was appropriate to maintain it.

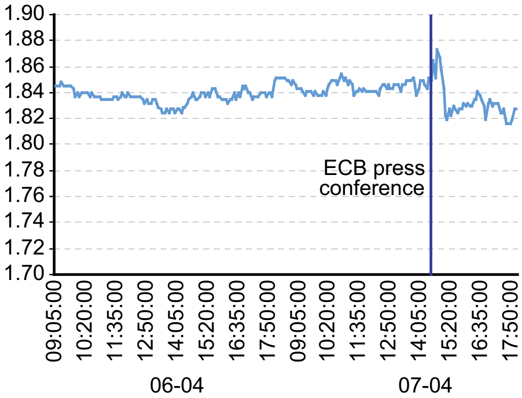
The policy statement did not turn dovish, although as anticipated it dropped the “vigilance” reference when referring to the need of containing upside risks to price stability –ie, the code word signalling an interest rate hike at the next monetary policy meeting– and replaced it with monitoring very closely. By qualifying the monetary policy stance as “accommodative” in the introductory paragraph (dropping “very”) the wording as a whole is slightly less hawkish. However, the statement continued to judge the balance of risks of economic activity as “broadly balanced” and more importantly, it maintained the view that risks to the medium-term outlook for price stability remain “on the upside”. Moreover, while the wording continued to characterize the underlying pace of monetary expansion as moderate, the word was preceded by “still” and it was added that liquidity remains ample and “may facilitate the accommodation of price pressures”.

In slight contrast with a somewhat less hawkish policy statement, in the Q&A Mr. Trichet retained a tough tone and repeatedly sent strong pre-emptive warnings about second-round effects. In no way he signalled that it was the first of a series of rate hikes; yet, he insisted on ECB’s primary mandate, he said the ECB is “extremely alert” on second-round effects, and he repeated that anchored inflation expectations were good for growth (and thus, for all EZ countries).

Finally, regarding whether the ECB is creating a measure to wean to addicted banks off of central bank liquidity, Mr Trichet confirmed that "it is an issue that we are looking at,"… "when and if we have a decision", we will make it public (as he said at the March press conference). What is clear is that the ECB wants to put an end to the problem of addicted banks. Even though the new facility's announcement has been delayed, it appears to be in progress and could be announced along with the European banks´ stress tests in June and the ECB's decision whether or not to extend the auctions with full allotment beyond the second quarter of 2011.

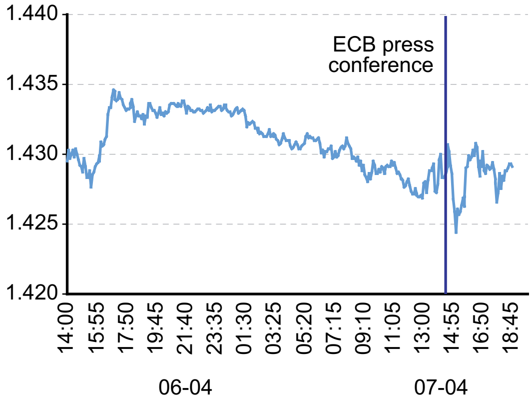
As the decision was fully anticipated and neither the statement nor the Q&A contained any surprises there was no much market reaction: The Euro returned to 1.42 after appreciating yesterday, while the market is still expecting two more 25bp hikes in 2011.

Chart 1
2-year German yields: intraday change (yield each 5 minutes)



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 March~~7 April 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~We will now~~ Before we 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 decided to leave the **key ECB interest rates** unchanged. The information which has become available since~~we wish to express our ~~meeting on 3 February 2011 indicates a rise in inflation, largely reflecting higher commodity prices. The economic analysis indicates that risks~~sincere sympathy to the ~~outlook for price developments are on the upside, while the underlying pace~~people of ~~monetary expansion remains moderate. Recent economic data confirm that the underlying momentum of economic activity in the euro area remains positive; however, uncertainty remains elevated. 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~~Japan, after the tragic events and lamentable loss of life. All our thoughts are with those who have suffered directly or indirectly from the natural and nuclear disaster.

~~The 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.~~

Let me now start reporting on the outcome of today's meeting.

Based on its regular economic and monetary analyses, the Governing Council decided to increase the **key ECB interest rates** by 25 basis points, after maintaining them unchanged for almost two years at historically low levels. The adjustment of the current very accommodative monetary policy stance is warranted in the light of upside risks to price stability that we have identified in our economic analysis. While our monetary analysis indicates that the underlying pace of monetary expansion is still moderate, monetary liquidity remains ample and may facilitate the accommodation of price pressures. All in all, it is essential that the recent price developments do not give rise to broad-based inflationary pressures over the medium term. Our decision will contribute to keeping inflation expectations in the euro area firmly anchored 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 contribute to economic growth in the euro area. At the same time, interest rates across the entire maturity spectrum remain low. Thus, the stance of monetary policy remains accommodative and thereby continues to lend considerable support to economic activity and job creation. Recent economic data confirm that the underlying momentum of economic activity continues to be positive, with uncertainty remaining elevated. We will continue to monitor very closely all developments with respect to upside risks to price stability.

As ~~we have~~ stated ~~before~~on previous occasions, the provision of liquidity and the allotment modes for refinancing operations will also be adjusted ~~as~~when 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 continue to confirm the~~ indicators point towards a continued positive underlying momentum of economic activity in the euro area ~~at the beginning of~~in early 2011. Looking ahead, euro area exports should ~~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 economic growth, 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~~ remain broadly balanced in ~~a context of~~ an environment of elevated uncertainty. On the one hand, global trade may continue to grow more rapidly than expected, thereby supporting euro area exports. Moreover, continued 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 spill~~that may potentially spill over to the euro area real economy. Downside risks also relate to further increases in ~~commodity~~ energy prices, in particular in view of ~~renewed~~ ongoing geopolitical tensions, and to protectionist pressures and the possibility of a disorderly correction of global imbalances. Finally, there are potential risks stemming from the economic impact on the euro area and elsewhere of the recent natural and nuclear disaster in Japan.

With regard to price developments, euro area annual HICP inflation was 2.~~4~~6% in ~~February~~March 2011, according to Eurostat's flash estimate, after 2.~~3~~4 % in ~~January.~~February. The increase in inflation rates in early 2011 largely reflects higher commodity prices. Pressure stemming from the sharp increases in energy and food prices is also discernible in the earlier stages of the production process. It is of paramount importance that the rise in HICP inflation does not lead to second-round effects in price and wage-setting behaviour and thereby give rise to broad-based inflationary pressures over the medium term. Inflation expectations ~~over the medium to longer term~~ must remain firmly anchored in line with the Governing Council's aim of 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.~~Risks to the medium-term outlook for price developments remain on the upside. They relate, in particular, to higher than assumed increases in energy prices, not least owing to ongoing political tensions in North Africa and the Middle East. More generally, strong economic growth in emerging markets, supported by ample liquidity at the global level, may further fuel commodity price rises. 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 on the upside. They relate, in particular, to higher than assumed increases in energy and non-energy commodity prices. Furthermore,~~ increases in indirect taxes and administered prices may be greater than currently assumed, owing to the need for fiscal consolidation in the coming years. Finally, risks also relate to stronger than expected domestic price pressures in the context of the 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, while the annual growth rate of loans to the private sector~~ increased to 2.~~4~~0% in ~~January~~February 2011, from 1.~~9~~5% in ~~December.~~January. Looking ~~beyond~~through the ~~movements in individual months and the effects of special factors, trends~~recent volatility in broad money ~~and loan~~ growth ~~confirm the assessment that the underlying pace of monetary expansion is still moderate and that inflationary pressures over the medium~~owing to ~~longer term should remain contained. At the same time, the low level of money and credit~~special factors, M3 growth has ~~thus far led~~continued to ~~only a partial unwinding of the large amounts of~~ edge up over recent months. The annual growth rate of loans to the private sector also increased further to 2.6% in February, from 2.4% in the previous month. Hence, the underlying pace of monetary expansion is gradually picking up, but remains moderate. At the same time, monetary liquidity accumulated ~~in the economy~~ prior to the period of financial market tensions~~. This liquidity~~ remains ample and 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.~~euro area.

Looking at M3 components, annual M1 growth moderated further to ~~stand at 3.2% in January 2011, reflecting the prevailing low remuneration of overnight~~ 2.9% in February 2011, while the growth of other short-term deposits~~. At the same time, the yield curve steepened somewhat further at the start of the year, implying that~~ and marketable instruments has increased. This rebalancing within M3 reflects the impact of the recent steepening of the yield curve on the remuneration of different monetary assets. However, this steeper yield curve also implies a dampening impact on overall M3 growth, as it reduces the attractiveness of ~~short-term instruments included in M3 continues to decline~~monetary assets compared with more highly remunerated longer-term instruments outside M3.

On the counterpart side, ~~the~~ a further rise in the annual growth rate of bank loans to the private sector in ~~January was due to stronger lending to both households and non-financial corporations. The growth~~February is due in part to a further slight strengthening in the growth of loans to non-financial corporations~~ turned positive, to stand at 0.4% in January, after -0.2% in December, while the~~ , which rose to 0.6% in February, after 0.5% in January. The growth of loans to households ~~strengthened further to~~was 3.~~1%, from 2.9~~0% in ~~December.~~February, compared with 3.1% in January. Overall, in early 2011 the positive flow of lending to the non-financial private sector has ~~gradually strengthened over~~become more broadly based across the ~~past few quarters, as the economic recovery gathered momentum~~household and non-financial corporation sectors.

The latest data ~~also~~ confirm that banks have ~~continued to expand~~expanded their lending to the ~~euro area economy~~private sector further, while at the same time ~~keeping~~ the overall size of their balance sheets has remained 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 Governing Council decided to ~~leave~~increase the key ECB interest rates ~~unchanged. The information which has become available since our meeting on 3 February 2011 indicates a rise in inflation, largely reflecting higher commodity prices. The economic analysis indicates that risks to the outlook for price developments are on the upside, while the~~ by 25 basis points. The adjustment of the current very accommodative monetary policy stance is warranted in the light of upside risks to price stability that we have identified in our economic analysis. A **cross-check** with the signals from our monetary analysis indicates that while the underlying pace of monetary expansion ~~remains~~ is still moderate~~. Recent economic data confirm that the underlying momentum of economic activity in the euro area remains positive; however, uncertainty remains elevated. The current very accommodative stance of monetary policy lends considerable support to economic activity. It~~, monetary liquidity remains ample and may facilitate the accommodation of price pressures. All in all, it is essential that the recent ~~rise in inflation does not~~ price developments do 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.~~Our decision will contribute to keeping inflation expectations in the euro area firmly anchored 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 contribute to economic growth in the euro area. At the same time, interest rates across the entire maturity spectrum remain low. Thus, the stance of monetary policy remains accommodative and thereby continues to lend considerable support to economic activity and job creation. Recent economic data confirm that the underlying momentum of economic activity continues to be positive, with uncertainty remaining elevated. We will continue to monitor very closely all developments with respect to upside risks to price stability.

Turning to **fiscal policies**, it is 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 of ensuring a rapid correction of excessive deficits and returning to a close-to-balance or surplus position. Strengthening~~achieve the consolidation targets for 2011 that they have announced. Moreover, the announcement of fully specified consolidation measures for 2012 and beyond would help to convince the general public and market participants that the corrective policies will be sustained. Strengthened confidence in the sustainability of public finances is key, as this will reduce interest rate risk premia and improve the conditions for sound and sustainable growth.

At the same time, it is crucial that substantial and far-reaching **structural reforms** be urgently implemented in the euro area to strengthen its growth potential, competitiveness and flexibility. In the case of product markets, policies that enhance competition and innovation should, in particular, be further pursued to speed up restructuring and to facilitate advances in productivity. 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**~~ Finally, the Governing Council is of the view that the package of six legislative proposals on 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~~, adopted by the European ~~Commission go~~Council at its summit on 24-25 March 2011, goes some way to improving economic and budgetary surveillance in the euro area. However, ~~they~~ in our view, the proposals fall short of the necessary quantum leap in the surveillance of the euro area which is ~~necessary~~needed to ensure the smooth functioning of Economic and Monetary Union. ~~As outlined~~Therefore, the Governing Council, in line with the ECB's opinion of 17 February 2011 on these proposals, urges the ECOFIN Council, the European Parliament and the Commission to agree, in the context of their "trialogue", on more stringent requirements, more automaticity in the procedures and a clearer focus on the most vulnerable countries with losses in competitiveness~~ are required~~. All this would help to ensure that the new framework ~~will indeed be~~is effective in the long run.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates´ salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

In the United Kingdom, this document is directed only at persons who (i) have professional experience in matters relating to investments falling within article 19(5) of the financial services and markets act 2000 (financial promotion) order 2005 (as amended, the "financial promotion order"), (ii) are persons falling within article 49(2) (a) to (d) ("high net worth companies, unincorporated associations, etc.") Of the financial promotion order, or (iii) are persons to whom an invitation or inducement to engage in investment activity (within the meaning of section 21 of the financial services and markets act 2000) may otherwise lawfully be communicated (all such persons together being referred to as "relevant persons"). This document is directed only at relevant persons and must not be acted on or relied on by persons who are not relevant persons. Any investment or investment activity to which this document relates is available only to relevant persons and will be engaged in only with relevant persons.The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA is not a member of the FINRA and is not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".

BBVA is a bank supervised by the Bank of Spain and by Spain's Stock Exchange Commission (CNMV), registered with the Bank of Spain with number 0182.