Europe

ECB Watch

Madrid, 14 January 2011

Economic Analysis

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The ECB accommodates its wording to a context of higher inflation risks

- The tone is more hawkish than expected. The wording changes are aimed at securing maximum flexibility and thus, anchoring inflation expectations
- However, the changes also mark a shift in their risk assessment: risks to inflation have heightened while the assessment on growth is more positive
- The ECB reinforces its flexible approach on both monetary policy and non-standard measures
- Trichet joins declarations by other European authorities to improve the EFSF qualitatively and quantitatively

Bottom line: The ECB decided to accommodate its wording to a context of higher inflation risks but the tone is more hawkish than expected. The changes are not only aimed at securing maximum flexibility and preserving the stability in inflation expectations but also mark a shift in their balance of risks: risks to inflation have increased while the assessment on growth is more positive. By clearly stating that there are no implications for policy arising from the divergence between ECB's improving macroeconomic assessment and its views on financial stability/sovereign issues (ie, no dilemma between standard monetary policy and non-standard measures) the ECB gains enough flexibility to act on either front if necessary. In this sense, if the medium-term inflation outlook were to deteriorate (unlikely at least in the short-term) the lingering sovereign debt tensions would not necessarily be an impediment to an adjustment in interest rates. Their message is that they could well continue purchasing bonds and keep liquidity loose (full allotment) if necessary, even in the scenario that the balance of risks forces them to adjust interest rates, and viceversa. That is, the ECB reinforces its flexible approach on both fronts.

Introductory statement – main changes: While some wording changes to secure the anchoring in inflation expectations were anticipated, the tone was more hawkish than expected. The changes reflect a shift in their risk assessment coming from both a worsening short-term inflation outlook and a more positive assessment of the economic recovery. With respect to inflation, risks to inflation were heightened in the statement: "Risks to the medium-term outlook for price developments are still broadly balanced but could move to the upside" (vs. broadly balanced in the previous statement). Moreover, the ECB states that "a very close monitoring is warranted". Nothwithstanding the important changes, the ECB emphasized that were mainly due to energy prices (ie, a supply shock) and that the underlying trend will remain in line with price stability over the policy-relevant horizon. Furthermore, they also cited some downside risks to inflation related mainly "to the impact on inflation of potentially lower growth, ...:". That view is consistent with our base scenario; we think that inflation should not be a matter of concern for the ECB as short-term upward pressures will prove transitory. Meanwhile, the assessment of risks to activity improved. The language now mentions that risks are "still slightly tilted to the downside" (vs. tilted to the downside in the previous statement). Moreover, the statement highlights that "strong business confidence could provide more support to domestic economic activity in the euro area than is currently expected" which could be reflecting ECB's increasing confidence on the sustainability of the economic recovery. To achieve enough flexibility if the medium-term inflation outlook deteriorates (which is not anticipated) the ECB decided to add the word "still" in their description of the monetary policy stance: "the current key ECB interest rates still remain appropriate" (vs. are appropriate in the previous statement).

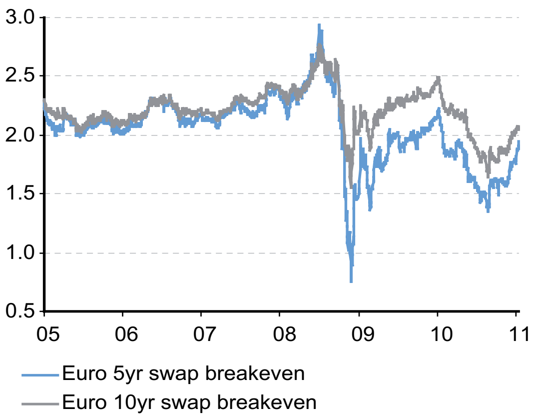
Q&A session: With respect to upside inflation risks and their monetary policy stance, Trichet stressed that they are permanently alert on the former while they are “never pre-committed not to move interest rates”. These remarks are aimed at preserving the current anchoring of inflation expectations as well as securing maximum flexibility. Meanwhile, Trichet repeatedly insisted that decisions on monetary policy are “totally independent” from decisions on non-standard measures (no dilemma), and that the latter are there to permit the best possible transmission of the former.

In reference to the EFSF, governance, and fiscal consolidation, Trichet stressed the need for authorities to improve the EFSF both quantitatively and qualitatively, mainly on the flexibility. Likewise, Trichet’s insistence on authorities “to be up to their responsibility” reflects that the ECB wants governments to act in parallel with structural reforms and fiscal consolidation in order to regain confidence and reduce risk premia. The SMP program is “ongoing” and the ECB will continue with their market interventions but they urge authorities to “be ahead of the curve”. In this sense, their recurrent message has been that the responsibility to stop the recent worsening in market conditions should not fall on them. Other parties are accountable and should engage in ambitious reforms and remain firm with their fiscal consolidation measures. In this sense, the ECB wants to prevent complacency on other fronts and aims at aligning incentives of all involved.

Regarding non-standard measures there was no specific announcement on the full-allotment (unlimited liquidity provision) which was extended in the previous meeting until March 2011 for the 3m LTROs. Likewise, nothing detailed was mentioned concerning its bond buying program (SMP). Yet, the flexible approach adopted in December remains and constitutes a signal of the willingness of the ECB to reduce uncertainties and market nervousness. As is the case with their monetary policy stance, the ECB is not pre-committed to neither resume its exit strategy nor further delay it.

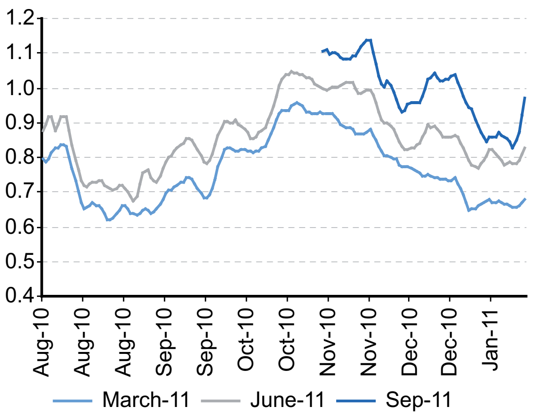
Market reaction: The Euro appreciated significantly since the start of the ECB meeting and is currently at 1.332 (+1.13%) On the back of a more hawkish tone, 2-year German yields are increasing 10bp (from 0.98% to 1.08%). Stock markets are increasing sharply today but are flat since the start of the ECB meeting, reflecting that the positive momentum rests on the successful Spanish auction. Likewise, the spreads are narrowing.

Chart 1
Euro inflation-linked swap breakevens



Source: Bloomberg and BBVA Research

Chart 2
Eonia futures (5dma)



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, ~~2 December 2010~~13 January 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. Let me wish you all a very Happy New Year. I would also like to take this opportunity to welcome Estonia as the seventeenth country to adopt the euro as its currency. Accordingly, Mr Lipstok, the Governor of Eesti Pank, became a member of the Governing Council on 1 January 2011. Following the adoption of the euro by Estonia there are now 331 million citizens using the euro as their currency. We will now report on the outcome of today's meeting, which was also attended by Commissioner Rehn.

Based on its regular economic and monetary analyses, the Governing Council confirmed that the current **key ECB interest rates** ~~are~~ still remain appropriate. It therefore decided to leave them unchanged. Taking into account all the new information and analyses which have become available since our meeting on ~~4 November 2010~~2 December 2010, we ~~continue to expect price developments to remain moderate over the policy-relevant medium~~see evidence of short-term upward pressure on overall inflation, mainly owing to energy prices, but this has not so far affected our assessment that price developments will remain in line with price stability over the policy-relevant horizon. At the same time, very close monitoring is warranted. Recent economic data are consistent with a positive underlying momentum of ~~the recovery~~economic activity, while uncertainty ~~is~~ remains elevated. Our monetary analysis ~~confirms~~indicates that inflationary pressures over the medium term should remain contained. ~~We~~Overall, we expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations ~~are~~remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations is of the essence.

~~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 third maintenance period of 2011 on 12 April 2011.~~

~~Furthermore, the Governing Council decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 26 January, 23 February and 30 March 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.~~

Overall, the current monetary policy stance remains accommodative. The stance, the provision of liquidity and the allotment modes will be adjusted as appropriate, taking into account the fact that all the non-standard measures taken during the period of acute financial market tensions are, by construction, temporary in nature. Accordingly, the Governing Council will continue to monitor all developments over the period ahead very closely.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Euro area real GDP grew by~~ Following the 0.~~4%~~ 3% quarter-on~~ a quarterly basis~~-quarter increase in euro area real GDP in the third quarter of 2010, ~~following exceptional growth of 1.0% in the second quarter. Recent~~recent statistical releases and survey-based evidence ~~generally~~ confirm that the positive underlying momentum of ~~the~~ economic ~~recovery~~ activity in the euro area ~~remains~~ remained in place~~. In line with previous expectations, this implies ongoing real GDP growth in the fourth quarter of this year. Euro~~ towards the end of 2010. Looking ahead at 2011, euro area exports should ~~further~~ benefit from a continued recovery in the world economy. At the same time, and particularly taking into account the relatively high level of business confidence in the euro area, private sector domestic demand should increasingly contribute to growth, supported by the accommodative monetary policy stance and the measures adopted to restore the functioning of the financial system. However, the recovery in activity is expected to be dampened by the process of balance sheet adjustment in various sectors.

~~This assessment is also reflected in the December 2010 Eurosystem staff macroeconomic projections for the euro area, according to which annual real GDP growth will range between 1.6% and 1.8% in 2010, between 0.7% and 2.1%% in 2011 and between 0.6% and 2.8% in 2012. Compared with the September 2010 ECB staff macroeconomic projections, the range for 2010 has narrowed somewhat and shifted towards the upper end of September's range, while the range for 2011 is slightly narrower. The December 2010 Eurosystem staff projections are broadly in line with forecasts by international organisations.~~

~~In the Governing Council's assessment, the risks to this economic outlook are tilted to the downside, with uncertainty remaining elevated. On the one hand, global trade may continue to grow more rapidly than expected, thereby supporting euro area exports. At the same time, it is to be noted that the level of business confidence in the euro area remains relatively high. On the other hand, downside risks relate to the tensions in some segments of the financial markets and their potential spillover to the euro area real economy. Further downside risks relate to renewed increases in oil and other commodity prices, protectionist pressures and the possibility of a disorderly correction of global imbalances.~~

~~With regard to price developments, euro area annual HICP inflation was 1.9% in November, according to Eurostat's flash estimate, unchanged from October. In the next few months HICP inflation rates will hover around current levels before moderating again in the course of next year. Overall, in the period ahead inflation rates should remain moderate.~~In the Governing Council's assessment, the risks to this economic outlook are still slightly tilted to the downside, with uncertainty remaining elevated. On the one hand, global trade may continue to grow more rapidly than expected, thereby supporting euro area exports. Moreover, strong business confidence could provide more support to domestic economic activity in the euro area than is currently expected. On the other hand, downside risks relate to the tensions in some segments of the financial markets and their potential spillover to the euro area real economy. Further downside risks relate to renewed increases in oil and other commodity prices, protectionist pressures and the possibility of a disorderly correction of global imbalances.

With regard to price developments, euro area annual HICP inflation was 2.2% in December, according to Eurostat's flash estimate, after 1.9% in November. This was somewhat higher than expected and largely reflects higher energy prices. Looking ahead to the next few months, inflation rates could temporarily increase further. They are likely to stay slightly above 2%, largely owing to commodity price developments, before moderating again towards the end of the year. Overall, we see evidence of short-term upward pressure on overall inflation, stemming largely from global commodity prices. While this has not so far affected our assessment that price developments will remain in line with price stability over the policy-relevant horizon, very close monitoring of price developments is warranted. Inflation expectations over the medium to longer term continue to be firmly anchored in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.

~~This assessment is also reflected in the December 2010 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation in a range between 1.5% and 1.7% for 2010, between 1.3% and 2.3% for 2011 and between 0.7% and 2.3% for 2012. Compared with the ECB staff projections published in September, the range for 2010 is unchanged, while the range for 2011 is marginally higher. Available forecasts from international organisations provide a broadly similar picture.~~

Risks to the medium-term outlook for price developments are still broadly balanced but could move to the upside. Upside risks relate, in particular, to developments in energy and non-energy commodity prices. Furthermore, increases in indirect taxes and administered prices may be greater than currently expected, owing to the need for fiscal consolidation in the coming years~~. At the same time, risks to domestic price and cost developments are still expected to be contained.~~, and price pressures in the production chain could rise further. On the downside, risks relate mainly to the impact on inflation of potentially lower growth, given the prevailing uncertainties.

Turning to the **monetary analysis**, the annual growth rate of M3 ~~remained broadly unchanged at 1.0% in October, after 1.1% in September 2010. The annual growth rate of loans to the private sector~~ increased to 1.~~4% in October from 1.2% in the previous month. Broad~~9% in November 2010, after 0.9% in October. This strong increase is in part related to base effects and volatile factors. The annual growth rate of loans to the private sector also increased, rising to 2.0% in November from 1.5% in October. Looking beyond the special factors that operated in November, broad money and loan growth ~~hence remained~~ is still low, ~~supporting~~corroborating the assessment that the underlying pace of monetary expansion is moderate and that inflationary pressures over the medium term ~~are~~should remain contained.

~~The steepness of the yield curve has continued to lessen somewhat, implying a gradual softening of the dampening impact on~~ The interest rate constellation continued to exert a significant impact on the growth of monetary aggregates. Looking at M3 ~~that was associated with shifts of funds from monetary assets to longer-term financial assets outside M3. The interest rate constellation also includes a further widening in the spread between~~ components, the interest rates paid on short-term time deposits ~~and~~remained higher than those paid on overnight deposits. As a result, annual M1 growth ~~has~~ continued to moderate, standing at 4.~~9~~6% in ~~October~~November 2010~~, after 6.2% in September~~, while the annual growth rate of other short-term deposits ~~continues to~~ continued to become less negative. At the same time, the yield curve has lately become steeper again, implying that the attractiveness of short-term deposits included in M3 has declined somewhat compared with more highly remunerated longer-term assets outside M3.

The annual growth rate of bank loans to the private sector ~~continues to conceal positive growth in loans to households, with 2.9% in October after 2.8% in September, and still negative growth in loans to non-financial corporations, which stood at -0.6% in October, unchanged from September. When correcting for the impact of derecognition of loans from bank balance sheets, the growth in loans to non-financial corporations continued to strengthen, further confirming that a turning point was reached earlier in 2010~~continued to increase in November, partly owing to special factors. At the sectoral level, this strengthening increasingly reflects the upward movement in the growth of loans to non-financial corporations, which stood at -0.1% in November, after -0.5% in October, thereby further confirming that a turning point was reached in the course of 2010. The growth of loans to households remained stronger, at 2.7% in November after 2.9% in October, but the latest data point to some signs of a levelling-off.

Over the past few months~~,~~ banks have ~~generally stabilised the size of their balance sheets while expanding~~expanded the provision of credit to the private sector~~. However,~~ in an environment in which the overall size of their balance sheets has remained broadly stable. The challenge remains to expand the availability of such credit when demand picks up further. 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.

To sum up, the current key ECB interest rates still remain appropriate. We therefore decided to leave them unchanged. Taking into account all the new information and analyses which have become available since our meeting on ~~4 November~~2 December 2010, we ~~continue~~see evidence of short-term upward pressure on overall inflation, mainly owing to ~~expect~~energy prices, but this has not so far affected our assessment that price developments ~~to~~will remain ~~moderate~~in line with price stability over the policy-relevant ~~medium-term~~ horizon. At the same time, very close monitoring is warranted. Recent economic data are consistent with a positive underlying momentum of ~~the recovery~~economic activity, while uncertainty ~~is~~ remains elevated. A **cross-check** of the outcome of our economic analysis with that of the monetary analysis ~~confirms~~indicates that inflationary pressures over the medium term should remain contained. ~~We~~Overall, we expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations ~~are~~ remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations is of the essence.

~~Turning to **fiscal policies**, while budgetary developments for some euro area countries are more favourable than expected, concerns about unsustainable fiscal positions and their vulnerability to adverse market reactions remain very high for others and have had~~

~~repercussions throughout the euro area. In this environment, there is a clear need for the responsible authorities to strengthen confidence in sound public finances, thereby reducing risk premia in interest rates and supporting sustainable growth over the medium term.~~Turning to **fiscal policies**, in view of the ongoing vulnerability to adverse market reactions, countries need to do their utmost to meet their deficit targets and put government debt-to-GDP ratios firmly on a downward trajectory. In this regard, the Governing Council takes note of the recently announced measures in some euro area countries to reduce their very large fiscal imbalances. Where necessary, additional corrective measures – preferably on the expenditure side – need to be swiftly defined and implemented. At the same time, all euro area countries should pursue ambitious and credible multi-year consolidation strategies~~ and implement fully the planned corrective measures, focusing on the expenditure side. In their 2011 budgets, countries need to specify the necessary fiscal adjustment measures in detail, while standing ready to correct any slippages from the fiscal objectives announced.~~. This will help to strengthen confidence in the sustainability of public finances, reduce risk premia in interest rates and improve the conditions for sound and sustainable growth. Any positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected economic environment, should be exploited to make faster progress with fiscal consolidation.

Substantial and far-reaching **structural reforms**, complementing fiscal adjustment, should be rapidly implemented to enhance the prospects for higher sustainable growth. Major reforms are particularly necessary in those countries that have experienced a loss of competitiveness in the past or that are suffering from high fiscal and external deficits. The removal of labour market rigidities would further support the adjustment process of these economies. Increasing product market competition, particularly in the services sectors, would also facilitate the restructuring of the economy and encourage innovation~~ and the adoption of new technologies~~. Such measures are crucial for enhancing productivity growth, which is one of the main drivers of long-term growth. All these structural reforms should be supported by ~~an appropriate restructuring~~the necessary improvements in the structure of the banking sector. Sound balance sheets, effective risk management and transparent, robust business models remain key to strengthening banks' resilience to shocks and to ensuring adequate access to finance, thereby laying the foundations for sustainable growth and financial stability.

~~Finally, let me recall that the Governing Council welcomes the economic and financial adjustment programme which was agreed by the Irish government following the successful conclusion of the negotiations with the European Commission, in liaison with the ECB, and the International Monetary Fund. The programme contains the necessary elements to bring about a sustainable stabilisation of the Irish economy. It addresses in a decisive manner the economic and financial causes underlying current market concerns and will thereby contribute to restoring confidence and safeguarding financial stability in the euro area. The Governing Council welcomes the commitment of the Irish public authorities to take any further measures that may become appropriate to achieve the objectives of the programme.~~

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