ECB Watch

Europe

Madrid, 12 January 2012
Economic Analysis

Financial Scenarios

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ECB: cautiously alert while it assesses the effects of recent policy moves

- **As widely expected, the ECB left interest rates on hold at 1.0%**
- **The ECB retained a dovish tone while it signalled that at this stage it is cautiously alert as it assesses the effects of recent policy moves**
- **The ECB thinks that the three-year LTRO was successful in avoiding a "credit crunch", and it anticipates substantial demand at the next three-year LTRO (29 February) as a broader collateral base will likely apply**
- **Mr Draghi was careful to let the door open for a rate cut if financial tensions step up or the economic outlook further deteriorates. We continue to think that the last cut will not be the last**

As widely expected and following the two consecutive 25bp cuts, at today's monetary policy meeting the ECB left interest rates unchanged at 1.0%. The decision was unanimous and a rate cut was not discussed. Overall, the tone remained dovish, the economic assessment downbeat, while the easing bias was retained. It seems that at this stage it is cautiously alert as it assesses the effects of recent policy moves. The economic outlook "remains subject to high uncertainty and substantial downside risks" and the ECB continues to believe that economic activity will "very gradually" recover during 2012. However, based on recent soft data (ie, survey indicators), the ECB judges that there are "tentative signs of stabilisation of economic activity at low levels". Besides, Mr. Draghi seemed to be encouraged by initial and still timid signs of easing market tensions (eg, today's positive results of Spanish and Italian bond auctions) following the policy measures recently undertaken by the ECB.

Regarding liquidity, some part of the Q&A was focus on the 3.year auction held last December. Mr. Draghi took a defensive position of its liquidity policies. He remarked that the ECB sees "signs that the LTRO has been effective preventing a possible major funding constrain." He stated that the "funds do not simply stay at the deposit facility and he remarked that they have signs that this money is actuality flowing through the economy". He also added that they are some "unsecured bond markets have reopened". In our view, this is an optimistic view of the results of the auction, but we agree with the argument that these new measures have prevented a major funding constrain. So far, we see a slightly improvement in money markets while banks continue hoarding funds, mainly to face debt repayments, and only the strongest European banks have returned to primary markets. Hence, we think that it is too soon to infer that the latest liquidity injection from ECB is working appropriately.

When asked, Mr. Draghi did not explicitly answered on whether there might be a further rate cut ahead; however, he was careful not to rule it out if confronted with a re-escalation of financial tensions and/or if the current deterioration in the economic outlook ends up proving worse than expected. Moreover, even as the aim of recent measures was to avoid a "credit crunch" and the "lack of bank funding has been addressed", concerns on this front continue given that "credit supply effects can manifest themselves with lags", and thus, "close scrutiny of credit developments is warranted in the period ahead".

As the ECB wants to take hold of recent policy moves, a potential additional rate cut would depend on the market effects of the three-year LTROs, the evolution of sovereign tensions, the degree of deterioration in economic activity and the absence of inflation pressures. Having said that, we continue to think that activity will continue on a moderately downward trend, while further easing in financial tensions will be gradual and volatility will remain high. Therefore, our base scenario continues to be a 25bp rate cut on 8 March, but the odds that it would take place further ahead seem to have increased somewhat today.

Annex 1: Introductory statement, tracking the changes

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~8 December 2011~~12 January 2012

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. Let me wish you all a Happy New Year. We will now report on the outcome of today's meeting of the Governing Council.

Based on its regular economic and monetary analyses, the Governing Council decided today to ~~lower~~keep the **key ECB interest rates** ~~by 25 basis points~~unchanged, following the 25 basis point ~~decrease~~decreases on 3 November and 8 December 2011. ~~Inflation is likely to stay above 2% for several months to come, before declining to below 2%. The intensified~~ The information that has become available since early December broadly confirms our previous assessment. Inflation is likely to stay above 2% for several months to come, before declining to below 2%. At the same time, the underlying pace of monetary expansion remains moderate. As expected, ongoing financial market tensions ~~are continuing~~continue to dampen economic activity in the euro area ~~and the~~ , while, according to some recent survey indicators, there are tentative signs of a stabilisation in activity at low levels. The economic outlook remains subject to high uncertainty and substantial downside risks. In such an environment, cost, wage and price pressures in the euro area should remain modest and inflation rates should develop in line with price stability over the policy-relevant horizon. ~~At the same time, the underlying pace of monetary expansion remains moderate.~~ Overall, it is essential for monetary policy to maintain price stability over the medium term, thereby ensuring a firm anchoring of inflation expectations in the euro area 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 make its contribution towards supporting economic growth and job creation in the euro area. A very thorough analysis of all incoming data and developments over the period ahead is warranted.

~~In its continued efforts to support the liquidity situation of euro area banks, and following the coordinated central bank action on 30 November 2011 to provide liquidity to the global financial system, the Governing Council today also decided to adopt further non-standard measures. These measures should ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market. They are expected to support the provision of credit to households and non-financial corporations. In this context, the Governing Council decided:~~

~~First, to conduct two longer-term refinancing operations (LTROs) with a maturity of 36 months and the option of early repayment after one year. The operations will be conducted as fixed rate tender procedures with full allotment. The rate in these operations will be fixed at the average rate of the main refinancing operations over the life of the respective operation. Interest will be paid when the respective operation matures. The first operation will be allotted on 21 December 2011 and will replace the 12-month LTRO announced on 6 October 2011.~~

~~Second, to increase collateral availability by reducing the rating threshold for certain asset-backed securities (ABS). In addition to the ABS that are already eligible for Eurosystem operations, ABS having a second best rating of at least "single A" in the Eurosystem harmonised credit scale at issuance, and at all times subsequently, and the underlying assets of which comprise residential mortgages and loans to small and medium-sized enterprises, will be eligible for use as collateral in Eurosystem credit operations. Moreover, national central banks will be allowed, as a temporary solution, to accept as collateral additional performing credit claims (namely bank loans) that satisfy specific eligibility criteria. The responsibility entailed in the acceptance of such credit claims will be borne by the national central bank authorising their use. These measures will take effect as soon as the relevant legal acts have been published.~~

~~Third, to reduce the reserve ratio, which is currently 2%, to 1%. This will free up collateral and support money market activity. As a consequence of the full allotment policy applied in the~~

~~ECB's main refinancing operations and the way banks are using this option, the system of reserve requirements is not needed to~~The provision of liquidity and the allotment modes for refinancing operations will continue to support euro area banks, and thus the financing of the real economy. The extensive recourse to the first three-year refinancing operation indicates that our non-standard policy measures are providing a substantial contribution to improving the funding situation of banks, thereby supporting financing conditions and confidence. In addition, we are actively working towards the implementation of all the measures announced at our December meeting, which should provide additional support to the economy. As stated on previous occasions, all the non-standard monetary policy measures are temporary in nature.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP in the euro area grew by 0.1% quarter on quarter in the third quarter of 2011. At present, a number of factors seem to be dampening the underlying growth momentum in the euro area. They include moderate global demand growth and weak business and consumer confidence in the euro area. Domestic demand is likely to be dampened by the ongoing tensions in euro area sovereign debt markets, as well as the process of balance sheet adjustment in the financial and non-financial sectors. At the same ~~extent as under normal circumstances to steer money market conditions. This measure will take effect as of the maintenance period starting on 18 January 2012.~~

~~Fourth, to discontinue for the~~ time ~~being, as of the maintenance period starting on 14 December 2011, the fine-tuning operations carried out on the last day of each maintenance period. This is a technical measure to support money market activity.~~

~~A detailed press release will be published at 3.30 p.m. today on the ECB's website. As stated on previous occasions, all the non-standard monetary policy measures are, by construction, temporary in nature.~~

~~Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP in the euro area grew by 0.2% quarter on quarter in the third quarter of 2011, unchanged from the previous quarter. Evidence from survey data points to weaker economic activity~~, we continue to expect euro area economic activity to recover, albeit very gradually, in the course of 2012, supported by developments in ~~the fourth quarter of this year. A number of factors seem to be dampening the underlying growth momentum in the euro area. They include a moderation in the pace of global demand growth and unfavourable effects on overall financing conditions and on confidence resulting from ongoing tensions in euro area sovereign debt markets, as well as the process of balance sheet adjustment in the financial and non-financial sectors. At the same time, we expect euro area economic activity to recover, albeit very gradually, in the course of next year, supported by resilient~~ global demand, very low short-term interest rates and all the measures taken to support the functioning of the financial sector.

~~This assessment is also reflected in the December 2011 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between 1.5% and 1.7% in 2011, between -0.4% and 1.0% in 2012 and between 0.3% and 2.3% in 2013. Compared with the September 2011 ECB staff macroeconomic projections, there is a narrowing of the range of the real GDP growth projection for 2011 and a significant downward revision of the range for 2012. These revisions mainly reflect the impact on domestic demand of weaker confidence and worsening financing conditions, stemming from the heightened uncertainty related to the sovereign debt crisis, as well as downward revisions of foreign demand.~~

In the Governing Council's assessment, substantial downside risks to the economic outlook for the euro area continue to exist in an environment of high uncertainty. ~~Downside risks~~ They notably relate to a further intensification of the tensions in euro area ~~financial~~ debt markets and their potential spillover to the euro area real economy. Downside risks also relate to the global economy, ~~which may be weaker than expected, as well as to~~ protectionist pressures and the possibility of a disorderly correction of global imbalances.

With regard to price developments, euro area annual HICP inflation was ~~3.0~~2.8% in ~~November~~December 2011, according to Eurostat's flash estimate, ~~unchanged from the two previous months.~~after 3.0% in the preceding three months. This decline was expected and reflects a downward base effect stemming from energy prices. Inflation rates have been at elevated levels since the end of ~~last year~~2010, mainly driven by higher energy and other commodity prices. Looking ahead, they are likely to stay above 2% for several months to come, before declining to below 2%. This pattern reflects the expectation that, in an environment of weaker growth in the euro area and globally, underlying cost, wage and price pressures in the euro area should ~~also~~ remain modest.

~~This assessment is also reflected in the December 2011 Eurosystem staff macroeconomic projections for the euro area, which foresee annual HICP inflation in a range between 2.6% and 2.8% for 2011, between 1.5% and 2.5% for 2012 and between 0.8% and 2.2% for 2013. Compared with the September 2011 ECB staff macroeconomic projections, the projection ranges for 2011 and 2012 have been revised slightly upwards. This results from the upward impact of higher oil prices in euro terms, as well as a higher contribution from indirect taxes. The upward impact of these factors is expected to more than compensate the downward adjustments to profit margins and wage growth that are related to the downward revision of activity.~~

The Governing Council continues to view the risks to the medium-term outlook for price developments as broadly balanced. On the upside, the main risks relate to further increases in indirect taxes and administered prices, owing to the need for fiscal consolidation in the coming years, and possible increases in commodity prices. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally.

Turning to the **monetary analysis**, taking the appropriate medium-term perspective, the underlying pace of monetary expansion continues to be moderate. The annual growth rate of M3 decreased to 2.~~6~~0% in ~~October~~November 2011, after ~~3.0% in September.~~ 2.6% in October. As in the previous three months, monetary developments in November were affected by the heightened uncertainty in financial markets.

The annual growth rate of loans to the private sector, adjusted for loan sales and securitisation, ~~increased to 3.0% in October, compared with 2.7% in September. As in the previous two months, the monetary data for October reflect the heightened uncertainty in financial markets.~~

~~On the counterpart side, the~~ decreased to 1.9% in November, from 3.0% in October. The annual growth rates of loans to non-financial corporations and loans to households, adjusted for loan sales and securitisation, ~~remained broadly unchanged in October, at 2.3% and 2.5%~~ both moderated in November, and stood at 1.8% and 2.3% respectively~~. The unadjusted growth rates were lower, owing to substantial securitisation activities in October.~~, with slightly negative monthly flows observed for MFI loans to non-financial corporations. Overall, despite the moderation in loan growth, the figures on lending do not so far suggest that the heightened financial market tensions ~~have significantly affected the supply of credit in the period to October. However,~~ led to a sizeable curtailment of credit in the euro area as a whole in the period to November. At the same time, given that credit supply effects can manifest themselves with lags, close scrutiny of credit developments is warranted in the period ahead.

~~Taking the appropriate medium-term perspective and looking through short-term volatility, overall, the underlying pace of monetary expansion remains moderate.~~

The soundness of bank balance sheets, supported by the increase in capital positions, will be a key factor in ~~reducing potential negative feedback loop effects related to tensions in financial markets, thereby~~ facilitating an appropriate provision of credit to the economy over time. ~~The agreement of the European Council of 26 October to proceed with the increase in the capital position of banks to 9% of core Tier 1 by the end of June 2012 should improve the euro area banking sector's resilience over the medium term. In this respect, it~~It is essential that ~~national supervisors ensure that~~ the implementation of banks' recapitalisation plans does not result in developments that are detrimental to the financing of economic activity in the euro area.

To sum up, ~~inflation~~incoming information broadly confirms our previous assessment. Inflation is likely to stay above 2% for several months to come, before declining to below 2%. ~~Intensified~~As expected, ongoing financial market tensions ~~are continuing~~continue to dampen economic activity in the euro area~~ and the~~, while, according to some recent survey indicators, there are tentative signs of a stabilisation in activity at low levels. The economic outlook remains subject to high uncertainty and substantial downside risks. In such an environment, ~~price,~~ cost, wage and ~~wage~~price pressures in the euro area should remain modest and inflation rates should develop in line with price stability over the policy-relevant horizon. A **cross-check** with the signals from the monetary analysis confirms this picture, with the underlying pace of monetary expansion ~~remaining~~continuing to be moderate.

Turning to **fiscal policies**, ~~all~~ euro area governments ~~urgently~~ need to do their utmost to support fiscal sustainability ~~in the euro area as a whole. A new fiscal compact, comprising a fundamental restatement of the fiscal rules together with the fiscal commitments that euro area governments have made, is the most important precondition for restoring the normal functioning of financial markets. Policy-makers need to correct~~ by correcting excessive deficits in accordance with the agreed timetables and ~~move~~by moving to a structural balanced ~~budgets in the coming years by specifying and implementing the necessary adjustment measures. This will support~~budget or surplus position over the medium term. Slippages in the implementation of fiscal consolidation plans of vulnerable countries must be corrected swiftly by structural fiscal improvements. With regard to the new provisions of the EU economic governance framework that recently came into force, it is crucial that all the elements be implemented rigorously. Only ambitious policies to prevent and correct macroeconomic and fiscal imbalances will foster public confidence in the soundness of policy actions, and thus strengthen overall economic sentiment.

The Governing Council welcomes the European Council's agreement to move to a stronger economic union, which was announced on 9 December 2011. The new fiscal compact, comprising a fundamental restatement of the fiscal rules together with the fiscal commitments that euro area governments have made, is an important contribution to ensuring the long-run sustainability of public finances in the euro area countries. The wording of the rules needs to be unambiguous and effective. The further development of the European financial stability tools should make the operation of the European Financial Stability Facility and the European Stability Mechanism more effective. The swift deployment of these tools is now urgently needed. Concerning the involvement of the private sector in financial assistance for indebted countries, we welcome the reaffirmation that the decisions taken on 21 July and 26 and 27 October 2011 concerning Greek debt are unique and exceptional.

To accompany fiscal consolidation, the Governing Council ~~has repeatedly called for~~ calls for the urgent implementation of bold and ambitious **structural reforms**. Going hand in hand, fiscal consolidation and structural reforms would strengthen confidence, growth prospects and job creation. Key reforms should be ~~immediately~~rapidly carried out to help the euro area countries to improve competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. Product market reforms should focus on fully opening up markets to increased competition. Labour market reforms should focus on removing rigidities and enhancing wage flexibility. ~~Product market reforms should focus on fully opening up markets to increased competition.~~

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