

Europe

ECB Watch

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Economic Analysis

Europe

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No further change in hawkish tone

- The wording remains broadly unchanged; the ECB maintained its hawkish tone but it was not stressed further.
- The ECB was cautious and did not want to sound more concerned about inflation.
- Rate hikes continue to be unlikely in the medium-term/during this year.

Bottom line: The ECB was cautious and did not want to sound more hawkish ie, more concerned about inflation. The fact that the hawkish tone was not stressed further even as they indicated that inflation was likely to remain above of 2% for longer than previously thought confirms that their tone is all about prevention. By saying in the Q&A that inflation “might have humps from time to time” but what counts is that the ECB delivers price stability over the medium-term” they signal that the shift in the focus (to inflation) and the hawkish tone aims anchoring inflation expectations, not on indicating that they might bring forward the eventually needed interest rate hikes. They do not intend to raise rates anytime soon, and hikes will continue to be unlikely in coming months unless inflation expectations become unanchored elevating the risks of second-round effects. Meanwhile, the ECB maintains a flexible approach with respect to non-standard measures.

Introductory statement – broadly unchanged: Despite the strength in recent economic activity data and the upward surprises on January’s inflation, the statement contained only minor changes to the wording used in the last meeting. While the focus remains on inflation, the risk-assessment did not change. Interest rates are considered “appropriate” as the ECB continues to expect price stability over the medium-term –ie, the policy relevant horizon–. Although the hawkish tone was not stressed further, there were some careful changes on the inflation paragraph anticipating that they will upwardly revise their inflation forecasts at the March (quarterly) meeting. The statement underlined that inflation could remain above 2% for longer: “inflation is likely to stay slightly above 2% for most of 2011, before moderating again around the turn of the year” (vs. “... is likely to stay slightly above 2% before moderating again towards the end of the year”). They added that pressures were also “discernible in the earlier stages of the production process”, perhaps suggesting that they do not see second round effects for the moment –which is sensible. However, they confirmed that inflation expectations continue to be firmly anchored while short-term upward pressures have not so far affected their assessment on inflation which will remain in line with price stability “over the policy relevant horizon”.

Q&A session: Perhaps the most relevant fact we can highlight is that it was clear that Mr. Trichet did not want to sound more hawkish ie, more concerned about inflation. The tone was more cautious than last month’s. Although he repeated that they are permanently alert –ie, that they stand ready to raise rates if inflation expectations are no longer firmly anchored –, Mr. Trichet did not make any reference to the July 2008 rate increase (as he did at January’s meeting, which in our view reflects that they want to anchor of inflation expectations but do not want to indicate that they might bring forward the eventually needed interest rate hikes. On non-standard measures, with respect to the decision -to be taken next month- on a possible extension of the 3-month full liquidity provision nothing was revealed as expected, but they continue to hint that it will be kept if necessary. On SMP, as usual nothing new –“it is still ongoing”- but as in previous meetings Mr. Trichet’s insistence on EFSF’s flexibility hints that they are uncomfortable buying bonds. Finally, regarding recent rises in Eonia, Mr.Trichet ascribed them to technical factors related with the short maintenance period while remarking that “they have observed the EONIA trading volume has been rising” reflecting that markets seem to be functioning better but not all of them.

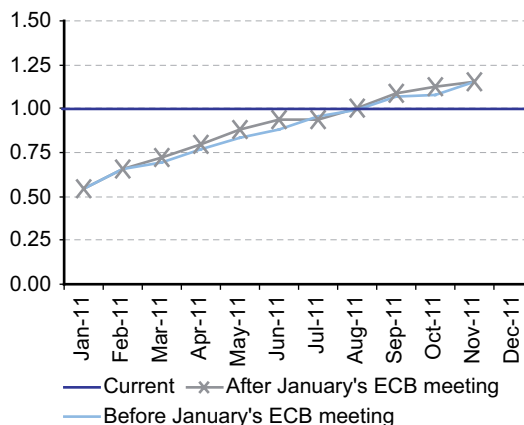
Market reaction: The cautious tone might put a brake on market expectations which were starting to anticipate an increase in interest rates before long. Yet, the EONIA curve moved only very slightly during the Q&A after showing large increases over the past three weeks. Meanwhile, the Euro depreciated markedly from the start of the Q&A and is currently at 1.363 (-1.3%) whereas the 2-year German yields are decreasing 10bp (from 1.46% to 1.36%).

Chart 1

Euro inflation-linked swap breakevens

Source: Bloomberg and BBVA Research

Chart 2

Implicit official rates in EONIA futures

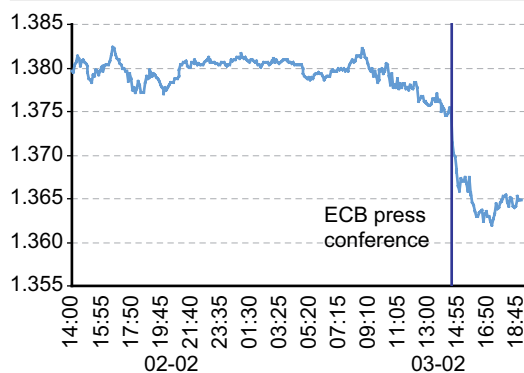
Source: Bloomberg and BBVA Research

Chart 3

EONIA Volume (€mn, 20dma)

Source: Bloomberg and BBVA Research

Chart 4

Euro-Dollar: intraday change (\$/€, price each 5 minutes)

Source: Bloomberg and BBVA Research

Annex 1: Tracking the changes...

Jean-Claude Trichet, President of the ECB,
Vitor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~13 January~~ 3 February 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** 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 ~~2 December 2010~~ 13 January 2011, we continue to see evidence of short-term upward pressure on overall inflation, mainly owing to energy and commodity prices, ~~but this~~. 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~~ confirm the positive underlying momentum of economic activity in the euro area, while uncertainty remains elevated. Our monetary analysis indicates that inflationary pressures over the medium to long term should remain contained. ~~Overall, we expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households.~~ Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The continued firm anchoring of inflation expectations is of the essence.

Overall, we expect price stability to be maintained over the medium term, and 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**. Following the 0.3% quarter-on-quarter increase in euro area real GDP in the third quarter of 2010, recent statistical releases and survey-based evidence for the fourth quarter and the beginning of the year continue to confirm ~~that~~ the positive underlying momentum of economic activity in the euro area ~~remained in place towards the end of 2010~~. Looking ahead ~~at 2011~~, euro area exports should benefit from ~~a continued~~ the ongoing 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~~ improve 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.

In the Governing Council's assessment, the risks to this economic outlook are still slightly tilted to the downside, ~~with~~ while uncertainty ~~remaining~~ remains 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 2.24% in ~~December~~ January 2011, according to Eurostat's flash estimate, after 1.9% in November. ~~This was somewhat higher than expected 2.2% in December. This further increase was broadly anticipated~~ and largely reflects higher energy prices. Looking ahead to the next few months, inflation rates could temporarily increase further. ~~They and~~ are likely to stay slightly above 2%, ~~largely owing to commodity price developments~~ for most of 2011, before moderating again ~~towards~~ around the ~~end~~ turn of the year. Overall, we continue to see evidence of short-term upward pressure on overall inflation, ~~stemming largely from global~~ mainly owing to energy and commodity prices. ~~While this has~~ Such pressure is also discernible in the earlier stages of the production process. These developments have 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 ~~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.

Risks to the medium-term outlook for price developments are still broadly balanced but, ~~as already indicated in January~~, could move to the upside. ~~Upside~~Currently, 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, 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 ~~increased to 1.9% in November 2010, after 0.9% in October. This strong increase is in part related to base effects and volatile factors.~~declined to 1.7% in December 2010, from 2.1% in November. 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~~declined, albeit marginally, to 1.9% in December, after 2.0% in November. These declines partly reflect the reversal of special factors that operated in November and do not indicate a general weakening of monetary dynamics. Overall, however, broad money and loan growth is still low, ~~corroborating~~confirming the assessment that the underlying pace of monetary expansion is moderate and that inflationary pressures over the medium to long term should remain contained.

~~The interest rate constellation continued to exert a significant impact on the growth of monetary aggregates. Looking at M3 components, the interest rates paid on short-term time deposits remained higher than those paid on overnight deposits. As a result, annual M1 growth continued to moderate, standing at 4.6% in November 2010, while the annual growth rate of other short-term deposits continued to become less negative. Looking at M3 components, annual M1 growth moderated further to stand at 4.4% in December 2010, reflecting the prevailing low remuneration of overnight deposits.~~ At the same time, the yield curve has ~~lately become steeper again~~steepened somewhat further, implying that the attractiveness of short-term ~~deposits~~instruments included in M3 ~~has declined somewhat~~continues to decline compared with more highly remunerated longer-term ~~assets~~instruments outside M3.

~~The~~On the counterpart side, the annual growth rate of bank loans to the private sector continued to ~~increase in November, partly owing to special factors. At the sectoral level, this strengthening increasingly reflects the upward movement~~conceal differences 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~~0.2% in December, after -0.1% in the previous month, while the growth of loans to households strengthened to 3.0% in December, after 2.8% in November. Taking into account the effect of derecognition of loans from bank balance sheets and looking through short-term volatility, the latest data confirm a continued gradual strengthening in the annual growth of lending to the non-financial private sector.

~~Over the past few months banks have expanded the provision of credit to the private sector 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. At the same time, the latest data point to the overall size of bank balance sheets having contracted again after expanding for most of 2010, mainly on account of a reduction in lending between banks. 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.

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 ~~2 December 2010~~13 January 2011, we continue to see evidence of short-term upward pressure on overall inflation, mainly owing to energy and commodity prices, ~~but this~~. 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~~confirm the positive underlying momentum of economic activity in the euro area, while uncertainty remains elevated. A **cross-check** of the outcome of our economic analysis with that of the monetary analysis indicates that inflationary pressures over the medium to long term should remain contained. ~~Overall, we expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households.~~ Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The continued firm anchoring of inflation expectations is of the essence.

~~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. This will help~~
[Turning to **fiscal policies**, it is now essential that all governments 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 concrete policy measures in their multi-year adjustment programmes so as to underpin the credibility of their fiscal consolidation targets. Experience shows that expenditure restraint is an important step towards achieving and maintaining fiscal soundness, notably when enshrined in binding domestic policy rules. Such a commitment helps to strengthen confidence in the sustainability of public finances, ~~reduce~~\[reduces\]\(#\) interest rate risk premia ~~in interest rates~~ and ~~improve~~\[improves\]\(#\) 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.](#)
[The implementation of credible policies is crucial in view of ongoing financial market pressures.](#)

Substantial and far-reaching **structural reforms**, complementing fiscal adjustment, should be ~~rapidly~~[urgently](#) implemented to ~~enhance~~[improve](#) the prospects for higher sustainable growth ~~and employment~~. 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~~[Increased product market competition and](#) labour market ~~rigidities~~[flexibility](#) would further support the ~~necessary~~ adjustment ~~process of these economies~~. Increasing product market competition, particularly ~~processes~~ in the ~~services sectors~~, would also facilitate the restructuring of the economy and encourage innovation. 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 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.

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