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ECB Watch

Europe

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Economic Analysis

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The ECB signals a July increase as it holds its rate at 1.25%

- **No surprises, "strong vigilance" wording is used –thereby signalling a 25bp rate hike in July– and the fixed rate "full allotment" is extended for Q3**
- **Tough line on Greece was reiterated. ECB's position is strongly against restructuring and excludes anything that is not absolutely voluntary and that would trigger a credit event**

Bottom line: all in all, and although nothing in this meeting invalidates our baseline scenario of only one further hike during the rest of the year, recent events reinforce our bias that the ECB might bring forward our expected hikes for early 2012 (in January and April), taking official rates to 1.75% by year-end and 2.0% by Q1 12. More gradualism thereafter (a pause beginning in Q2 12) is highly likely, particularly as risks on the periphery have recently intensified. Today's decisions show the "separation principle". If necessary the ECB could once again delay the "phasing-out" of the exceptional liquidity measures and extend them for Q4. With respect to Greece, the ECB has no choice but to strongly oppose against any kind of restructuring which is "not purely voluntary" to try to influence on decisions that will be not taken by them. For the ECB it will be an "enormous mistake to embark on a decision that would trigger a credit event" i.e. they judge that there is no difference between "soft" restructuring and restructuring as the impact (contagion) will be the same.

As broadly expected, the ECB kept rates unchanged at 1.25%. In the context of upward revisions to the projections for 2011 HICP inflation and real GDP growth (2012 broadly unchanged), the ECB uses the code phrase "strong vigilance" in its statement, thereby signalling that a 25bp hike will most likely take place in July. Also as expected, the Government Council decided to extend the fixed rate "full allotment" liquidity provision to banks during 3Q11 for the weekly MRO operations and the 1-month LTRO"as long as necessary" and "at least until 11 October 2011", as well as for the 3-month LTROs –which would have otherwise ended on June 29th–for July, August and September (the rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO). In turn, the ECB guarantees enough liquidity at least until the end of the year. The acute problems in peripheral countries (some banks are still too dependent on the loose liquidity provision) have forced the ECB once again to delay the "phasing-out" of the exceptional liquidity measures. In contrast, and although not explicitly mentioned or implicitly hinted, the SMP -bond purchase program- has de facto stopped. Resumption is unlikely given the recent debate on the possibility of a "soft" restructuring for Greece. About this, the ECB maintained the tough line that members have taken in the course of the last month.

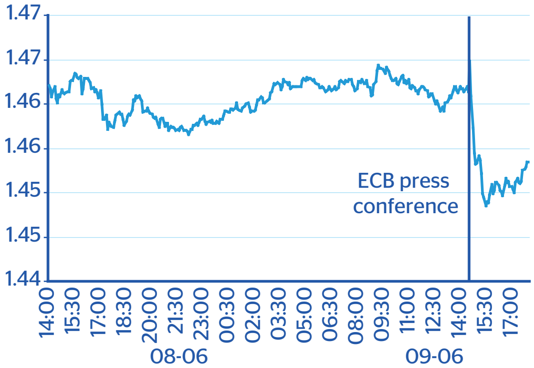
Regarding forecasts, economic growth for 2011 was revised slightly upwards from 1.7% to 1.9%, as economic momentum in Q1 was stronger than anticipated. In spite of this revision, the Eurosystem updated forecast envisages further moderation in economic growth for the remainder of the year. For 2012, the Staff's projection for GDP growth remains broadly unchanged at 1.7%. These figures now imply a slight deceleration in economic activity, in line with our macroeconomic scenario (1.7% for 2011 and 1.5% for 2012). Nevertheless, we also see some upside risks to our projections for this year. Overall, the ECB continue to see the risks to this economic outlook as broadly balanced, although with high uncertainty. Regarding the outlook for prices, inflation has been revised upwards by 0.3pp to 2.6% in 2011, mainly due to upward innovations observed over the first quarter as a consequence of higher commodity prices. For 2012, annual inflation is expected to revert below the ECB's target to 1.7%, as projected three months ago.

Overall, these figures are in line with our projections that envisage a further increase in inflation in coming months to rates close to 3% y/y in the third quarter, moderating afterwards to remain slightly below the ECB's target from the second quarter of next year. Nevertheless, along with the ECB Staff, we continue to see upside risks to this inflation outlook, coming from further increases in energy prices than anticipated that could end up materialising into higher indirect effects.

As usual, there was no guidance on policy moves beyond the July meeting. However, the ECB has maintained a hawkish tone and a pro-active approach. Recent comments from members have been on the hawkish side and have signalled that "if the economy continues to grow" more gradual moves are possible as "the very low level of interest rates that we have does not seem fully justified" (Bini Smaghi) and therefore "there is now a greater need to proceed with monetary policy normalization so as to prevent expectations of higher inflation from becoming entrenched". Therefore, 25bp hikes in the following three quarters seem likely now but continued increases thereafter are unlikely, particularly as risks on the periphery have recently intensified.

Chart 1

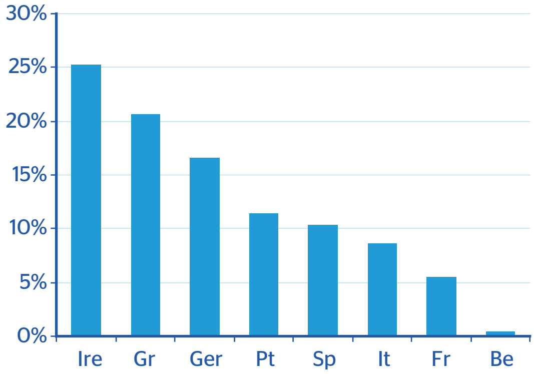
Euro-Dollar: intraday change (ER each 5 minutes)



Source: Bloomberg and BBVA Research

Chart 2

ECB: use of MROs and LTRO (% by country, April data)



Source: Bloomberg and BBVA Research

Annex 1: Tracking the changes...

Jean-Claude Trichet, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
~~Helsinki, 5 May~~Frankfurt am Main, 9 June 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference ~~here in Helsinki. I would like to thank Governor Liikanen for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council~~. We will now report on the outcome of ~~the~~ today's meeting, which was also attended by Commissioner Rehn.

Based on its regular economic and monetary analyses, the Governing Council decided to keep **the key ECB interest rates** unchanged ~~following the 25 basis point increase on 7 April 2011~~. The information that has become available since ~~then~~our meeting on 5 May 2011 confirms ~~our assessment that an adjustment of the very accommodative monetary policy stance was warranted. We continue to see~~ continued upward pressure on overall inflation, mainly owing to energy and commodity prices. ~~While the monetary analysis indicates that the~~The underlying pace of monetary expansion is ~~still moderate, monetary~~gradually recovering. Monetary liquidity remains ample ~~and may facilitate the accommodation of~~, with the potential to accommodate price pressures in the euro area. Furthermore, the most recent ~~economic~~ data confirm the positive underlying momentum of economic activity in the euro area, ~~with~~ while uncertainty ~~continuing to be~~ remains elevated. ~~All~~Overall, our monetary policy stance remains accommodative, lending support to economic activity. On balance, risks to the outlook for price stability are on the upside. Accordingly, strong vigilance is warranted. On the basis of our assessment, we will act in a firm and timely manner. We will do all~~, it is essential that~~ that is needed to prevent recent price developments ~~do not give~~giving rise to broad-based inflationary pressures. ~~Inflation expectations in the euro area must~~We remain ~~firmly anchored~~ strongly determined to secure 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~~ This is a prerequisite for monetary policy to make an ongoing contribution towards supporting ~~economic~~ growth and job creation in the euro area. ~~With interest rates across the entire maturity spectrum remaining low and the monetary policy stance still accommodative, we will continue to monitor very closely all developments with respect to upside risks to price stability. Maintaining price stability over the medium term is our guiding principle, which we apply when assessing new information, forming our judgements and deciding on any further adjustment of the accommodative stance of monetary policy.~~

~~As stated on previous occasions, the provision of liquidity and the allotment modes for refinancing operations will also be adjusted 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.~~

~~Let me now explain our assessment in greater detail, starting with the economic analysis. Following the 0.3% quarter-on-quarter increase in~~ The Governing Council today also decided to continue conducting its main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the ninth maintenance period of 2011 on 11 October 2011. This procedure will also remain in use for the Eurosystem's special-term refinancing operations with a maturity of one maintenance period, which will continue to be conducted for as long as needed, and at least until the end of the third quarter of 2011. The fixed rate in these special-term refinancing operations will be the same as the MRO rate prevailing at the time. Furthermore, the Governing Council decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted on 27 July, 31 August and 28 September 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.

As stated on previous occasions, the provision of liquidity and the allotment modes for refinancing operations will be adjusted 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.

Let me now explain our assessment in greater detail, starting with the economic analysis. In the first quarter of 2011, the euro area recorded strong real GDP ~~in~~growth of 0.8% quarter-on-quarter, following the 0.3% increase of the fourth quarter of 2010~~, recent~~. Recent statistical releases and survey-based indicators point towards a continued ~~positive underlying momentum~~expansion of economic activity in the euro area ~~during the first quarter of 2011 and at the beginning of~~in the second quarter of this year, albeit at a slower pace. This easing reflects the fact that the strong growth in the first quarter was partly due to special factors, which will cease to play a role in the second quarter. Hence, it is appropriate to look through such short-term volatility and to emphasise the positive underlying momentum of economic activity in the euro area. Looking ahead, euro area exports should be supported by the ongoing expansion in the world economy. At the same time, taking into account the ~~high~~ favourable level of business confidence in the euro area, private sector domestic demand should contribute increasingly to economic growth, benefiting from the still accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system. However, activity is expected to continue to be dampened somewhat by the process of balance sheet adjustment in various sectors.

This assessment is also reflected in the June 2011 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between 1.5% and 2.3 % in 2011 and between 0.6 % and 2.8% in 2012. Compared with the March 2011 ECB staff macroeconomic projections, the range for 2011 has been revised upwards, while the range for 2012 remains broadly unchanged. The June 2011 Eurosystem staff projections are broadly in line with recent forecasts by international organisations.

In the Governing Council's assessment, the risks to this economic outlook remain broadly balanced in 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, strong~~ favourable business confidence could provide more support to domestic economic activity in the euro area than currently expected and higher foreign demand could also contribute more strongly to growth than expected. On the other hand, downside risks relate to the ongoing tensions in some segments of the financial markets that may potentially spill over to the euro area real economy. Downside risks also relate to further increases in energy prices, ~~particularly in view of ongoing geopolitical tensions in North Africa and the Middle East, and to~~ protectionist pressures and the possibility of a disorderly correction of global imbalances. ~~Finally, there are still potential risks stemming from the economic impact on the euro area and elsewhere of the natural and nuclear disasters in Japan.~~

With regard to price developments, euro area annual HICP inflation was 2.~~8~~7% in ~~April~~ May according to Eurostat's flash estimate, after 2.~~7~~8% in ~~March.~~April. The ~~increase in~~relatively high inflation rates ~~during~~seen over the ~~first four~~past few months ~~of 2011~~ largely reflect~~s~~ higher energy and commodity prices. Looking ahead, inflation rates are likely to stay clearly above 2% over the coming months. Upward pressure on inflation, mainly from energy and commodity prices, is also discernible in the earlier stages of the production process. It ~~is~~remains of paramount importance that the rise in HICP inflation does not translate into second-round effects in price and wage-setting behaviour and lead to broad-based inflationary pressures. Inflation expectations 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.

~~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 on account of the 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,~~ The June 2011 Eurosystem staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 2.5% and 2.7% for 2011 and between 1.1% and 2.3% for 2012. In comparison with the March 2011 ECB staff macroeconomic projections, the range for HICP inflation in 2011 has been revised upwards, largely reflecting higher energy prices. The projection range for 2012 has narrowed somewhat. It is appropriate to recall that the staff projections are conditional on a number of purely technical assumptions, including oil prices, interest rates and exchange rates. In particular, it is assumed that oil prices will decline somewhat and that short-term interest rates will rise, in accordance with market expectations. Overall the projections embody the view that the recent high rates of inflation do not lead to broader-based inflationary pressure in the euro area.

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. Furthermore, there is a risk of increases in indirect taxes and administered prices that may be greater than currently assumed, owing to the need for fiscal consolidation in the coming years. Finally, upside risks ~~also relate to~~ may come from stronger than expected domestic price pressures in the context of ~~the ongoing recovery in activity~~increasing capacity utilisation in the euro area.

Turning to the **monetary analysis**, the annual growth rate of M3 ~~increased to 2.3% in March 2011, from 2.1% in February.~~was 2.0% in April 2011, after 2.3% in March. Looking through the recent volatility in broad money growth ~~caused by special factors~~, M3 growth has continued to edge up over recent months. The annual growth rate of loans to the private sector ~~remained broadly unchanged at 2.5% in March, after 2.6% in February.~~strengthened slightly to 2.6% in April, after 2.5% in March. Overall, the underlying pace of monetary expansion is gradually ~~picking up, but it remains moderate.~~recovering. At the same time, monetary liquidity accumulated prior to the period of financial market tensions remains ample ~~and may facilitate the accommodation of~~, with the potential to accommodate price pressures in the euro area.

Looking at M3 components, the annual growth rate of M1 ~~remained broadly unchanged in March~~decreased in April, while that of other short-term deposits increased. The development partly reflects the gradual increase in the remuneration of these deposits over recent months. At the same time, the steep yield curve implies a dampening impact on overall M3 growth, as it reduces the attractiveness of monetary assets compared with more highly remunerated longer-term instruments outside M3. However, available information suggests that this impact may be waning.

On the counterpart side, there has been a further slight strengthening in the growth of loans to non-financial corporations, which rose to 1.0% in April, after 0.8% in March~~, after 0.6% in February~~. The growth of loans to households was 3.4% in ~~March, compared with 3.0% in February. Looking through short-term volatility, the~~April, unchanged from the previous month. The latest data confirm a continued gradual strengthening in the annual growth of lending to the non-financial private sector.

The overall size of bank balance sheets has remained broadly unchanged over the past few months, notwithstanding some volatility. 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, based on its regular economic and monetary analyses, the Governing Council decided to keep the key ECB interest rates unchanged ~~following the 25 basis point increase on 7 April 2011~~. The information that has become available since ~~then~~our meeting on 5 May 2011 confirms ~~our assessment that an adjustment of the very accommodative monetary policy stance was warranted. We continue to see~~continued upward pressure on overall inflation, mainly owing to energy and commodity prices. A cross-check of the outcome of the economic analysis with that of the ~~signals coming from our~~ monetary analysis indicates that~~, while~~ the underlying pace of monetary expansion is ~~still moderate, monetary~~ gradually recovering. Monetary liquidity remains ample ~~and may facilitate~~ ~~,~~ with the ~~accommodation of~~ potential to accommodate price pressures in the euro area. Furthermore, the most recent ~~economic~~ data confirm the positive underlying momentum of economic activity in the euro area, ~~with~~ while uncertainty ~~continuing to be~~ remains elevated. ~~All in all, it is essential~~Overall, our monetary policy stance remains accommodative, lending support to economic activity. On balance, risks to the outlook for price stability are on the upside. Accordingly, strong vigilance is warranted. On the basis of our assessment, we will act in a firm and timely manner. We will do all that is needed to prevent recent price developments ~~do not give~~giving rise to broad-based inflationary pressures. ~~Inflation expectations in the euro area must~~ We remain ~~firmly anchored~~ strongly determined to secure 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~~ This is a prerequisite for monetary policy to make an ongoing contribution towards supporting ~~economic~~ growth and job creation in the euro area. ~~With interest rates across the entire maturity spectrum remaining low and the monetary policy stance still accommodative, we will continue to monitor very closely all developments with respect to upside risks to price stability. Maintaining price stability over the medium term is our guiding principle, which we apply when assessing new information, forming our judgements and deciding on any further adjustment of the accommodative stance of monetary policy.~~

~~Turning to **fiscal policies**, current information points to uneven developments in countries' adherence to the agreed fiscal consolidation plans. There is a risk that, in some countries, fiscal balances may fall behind the targets agreed by the ECOFIN Council for the necessary and timely correction of excessive deficits. It is essential that all governments meet the~~ Turning to **fiscal policies**, all parties involved in the preparation of the 2012 national budgets must ensure that they are fully in line with the requirement to support confidence in fiscal policies. A comparison between the latest economic forecasts by the European Commission and the fiscal plans embodied in the stability programmes points to the need for many countries to underpin their budget targets with concrete consolidation measures in order to correct their excessive deficits by the commonly agreed deadlines. The implementation of credible fiscal ~~balance targets for 2011 that they have announced. Where necessary, additional corrective measures must be implemented swiftly to ensure progress in achieving fiscal sustainability. The implementation of credible policies~~adjustment strategies is crucial in view of ongoing financial market pressures.

At the same time, ~~it is of the utmost importance that substantial~~the implementation of ambitious and far-reaching **structural** reforms ~~be implemented~~ is urgently required in the euro area ~~in order~~ to strengthen substantially its ~~growth potential,~~ competitiveness~~ and~~, flexibility and longer-term growth potential. In particular, countries which have high fiscal and external deficits or which are suffering from a loss of competitiveness should ~~embark on~~rapidly carry out comprehensive economic reforms. In the case of product markets, policies that enhance competition and innovation should~~, in particular, be further~~ be vigorously pursued to ~~speed up restructuring and to bring about improvements in~~ facilitate productivity growth. Regarding the labour market, the priority must be to enhance wage flexibility and incentives to work, and to remove labour market rigidities.

~~The Governing Council, in line with the ECB's opinion of 17 February 2011 on the six legislative proposals on economic governance, urges the ECOFIN Council, the European Parliament and the European 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.~~

~~Finally, the Governing Council welcomes the economic and financial adjustment programme which was agreed by the Portuguese 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 Portuguese 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 Portuguese public authorities to take all the necessary measures to achieve the objectives of the programme. It considers very important the broad political support for the adjustment programme, which enhances the overall credibility of the programme.~~

We are now at your disposal for questions.

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