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ECB Watch

Europe

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Economic Analysis

Financial Scenarios
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The ECB kept rates unchanged and did not hint for a June hike

- **Hawkish tone but not hinting for a June hike. The Statement did not include the phrase "strong vigilance" but repeated that the ECB will continue to "monitor very closely" upside inflation risks**
- **Monetary policy stance was described as "still accommodative", suggesting that April's move was not a one off pre-emptive move. We continue therefore to expect a 25bp hike at the July policy meeting**

Bottom line: By not including the code phrase "strong vigilance", the statement did not hint for a June hike. Yet, we think that by referring to monetary policy conditions as being "still accommodative", this month's ECB statement is possibly setting the ground for wording changes at its June meeting to signal a 25bp interest rate increase at the July policy meeting. We maintain our baseline scenario for only one additional rate hike in 2011 but our bias –considering ECB's proactive approach– is still that the ECB might bring forward one of our expected hikes for early 2012 (in January and April) taking official rates to 1.75% by yearend.

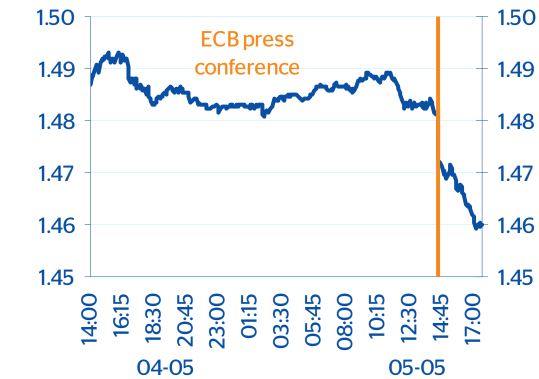
As broadly expected, the ECB kept rates unchanged at 1.25%. The decision was taken unanimously by the Governing Council. The main interest was on the wording of the statement ie, whether the code phrase "strong vigilance" would be used to hint for a June hike. The language was in fact very much alike to that used last month. Despite recent upside surprises on inflation, the overall tone used in the Q&A was somewhat less hawkish. Although Mr. Trichet retained a tough tone alerting on the upside risks to inflation and insisting that the ECB "can increase rates whenever [they] judge it appropriate", he did not repeatedly sent strong pre-emptive warnings about second-round effects as he did last month. Furthermore, when asked, Mr. Trichet took distance from the concept of "rate normalisation". Overall, consistent with our base scenario, the implicit message is that a steep path for interest rates is unlikely, particularly as risks on the periphery have recently intensified..

However, there was a slight wording change that might be relevant. By referring to monetary policy conditions as being "still accommodative" (as opposed to "accommodative" last month), this month's ECB statement is possibly setting the ground for wording changes in June –when the new projections for 2011 HICP inflation will most likely be revised upwards– to signal a 25bp interest rate increase at the following policy meeting. We continue therefore to expect a second move in July. Additionally, considering ECB's proactive approach –it is clear that they do not want to take any risks on the slight chance of second-round effects– our bias is still that the ECB might bring forward one of our expected hikes for early 2012 (in January and April), taking official rates to 1.75% by yearend.

On issues other than the monetary policy stance there were no comments on sovereign purchases while Mr. Trichet deferred any decision on liquidity policies until June. Regarding the rises in Eonia, he said that "volatility we saw at certain moments has quite significantly reduced" and this is evidence of more normal functioning. In our opinion this evaluation confirms that the ECB is comfortable with the normalisation of the Eonia (getting closer to the refi rate).

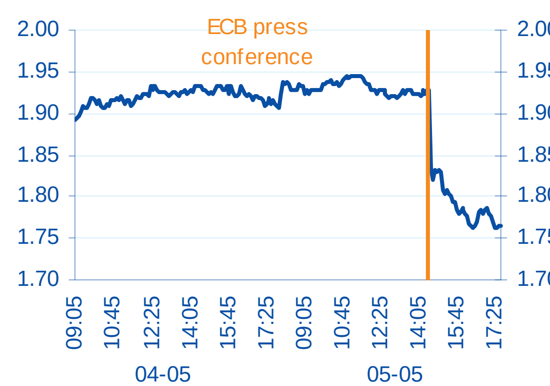
Market reaction was significant (see charts below) as the tone was less hawkish than expected.

Chart 1
Euro-Dollar: intraday change (ER each 5 minutes)



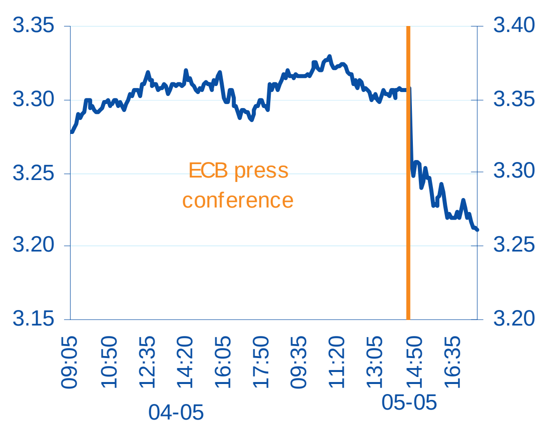
Source: Bloomberg and BBVA Research

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



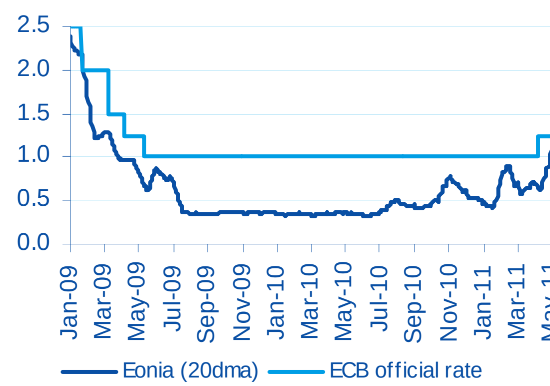
Source: Bloomberg and BBVA Research

Chart 3
10-year German yields: intraday change (yield each 5 minutes)



Source: Bloomberg and BBVA Research

Chart 4
ECB official rate and EONIA



Source: Bloomberg and BBVA Research

Jean-Claude Trichet, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
~~Frankfurt am Main, 7 April~~Helsinki, 5 May 2011

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference~~. Before we report on the outcome of today's meeting, we wish to express our sincere sympathy to the people of 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~~ 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 meeting, which was also attended by Commissioner Rehn.

~~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~~ keep the **key ECB interest rates** ~~by 25 basis points, after maintaining them~~ unchanged ~~for almost two years at historically low levels.~~following the 25-basis point increase on 7 April 2011. The information that has become available since then confirms our assessment that an adjustment of the ~~current~~ very accommodative monetary policy stance ~~is~~ was warranted~~ in the light of upside risks to price stability that we have identified in our economic analysis.~~. We continue to see upward pressure on overall inflation, mainly owing to energy and commodity prices. While ~~our~~ the 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~~Furthermore, 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~~the positive underlying momentum of economic activity ~~continues to be positive~~in the euro area, with uncertainty continuing to be elevated. All in all, it is essential that recent price developments do not give rise to broad-based inflationary pressures. Inflation expectations in the euro area must remain 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 make an ongoing contribution towards supporting economic growth and job creation in the euro area. With interest rates across the entire maturity spectrum remaining ~~elevated. We~~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. ~~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 fourth quarter of 2010, recent statistical releases and survey-based indicators point towards a continued positive underlying momentum of economic activity in the euro area ~~in early~~during the first quarter of 2011 and at the beginning of the second quarter. Looking ahead, euro area exports should be supported by the ongoing ~~recovery~~ expansion 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 contribute increasingly ~~contribute~~ to economic growth, benefiting from the accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system. However, ~~the recovery in~~ activity is expected to continue to be dampened somewhat by the process of balance sheet adjustment in various sectors.

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, ~~continued~~ strong business confidence could provide more support to domestic economic activity in the euro area than currently 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, ~~in particular~~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 ~~recent~~ natural and nuclear ~~disaster~~disasters in Japan.

With regard to price developments, euro area annual HICP inflation was 2.~~6~~8% in ~~March 2011,~~April according to Eurostat's flash estimate, after 2.~~4~~ 7% in ~~February.~~March. The increase in inflation rates ~~in early~~ during the first four months of 2011 largely reflects higher commodity prices. ~~Pressure stemming from the sharp increases in energy and food 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 of paramount importance that the rise in HICP inflation does not ~~lead~~ translate into second-round effects in price and wage-setting behaviour and ~~thereby give rise~~lead to broad-based inflationary pressures~~ over the medium term~~. 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 ~~owing to~~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, 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.

Turning to the **monetary analysis**, the annual growth rate of M3 increased to 2.~~0% in February 2011, from 1.5% in January.~~3% in March 2011, from 2.1% in February. Looking through the recent volatility in broad money growth ~~owing to~~ caused by special factors, M3 growth has continued to 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~~remained broadly unchanged at 2.5% in March, after 2.6% in February. Overall, the underlying pace of monetary expansion is gradually picking up, but it remains moderate. At the same time, monetary liquidity accumulated prior to the period of financial market tensions remains ample and may facilitate the accommodation of price pressures in the euro area.

Looking at M3 components, ~~annual M1 growth moderated further to 2.9% in February 2011~~the annual growth rate of M1 remained broadly unchanged in March, while ~~the growth~~ that of other short-term deposits ~~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~~ 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.

On the counterpart side, ~~a further rise in the annual growth rate of bank loans to the private sector in February is due in part to~~there has been a further slight strengthening in the growth of loans to non-financial corporations, which rose to 0.8% in March, after 0.6% in February~~, after 0.5% in January~~. The growth of loans to households was 3.~~0~~4% in ~~February~~March, compared with 3.~~1~~0% in ~~January. Overall, in early 2011 the positive flow of lending to the non-financial private sector has become more broadly~~

~~based across the household and non-financial corporation sectors~~February. 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.

The ~~latest data confirm that banks have expanded their lending to the private sector further, while at the same time the~~ overall size of ~~their~~ 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 ~~increase~~keep the key ECB interest rates ~~by~~ unchanged following the 25~~-~~-basis ~~points.~~point increase on 7 April 2011. The information that has become available since then confirms our assessment that an adjustment of the ~~current~~ very accommodative monetary policy stance ~~is~~was warranted ~~in the light of upside risks to price stability that we have identified in our economic analysis.~~. We continue to see upward pressure on overall inflation, mainly owing to energy and commodity prices. A **cross-check** with the signals coming from our monetary analysis indicates that, while the underlying pace of monetary expansion is still moderate, monetary liquidity remains ample and may facilitate the accommodation of price pressures. Furthermore, recent economic data confirm the positive underlying momentum of economic activity in the euro area, with uncertainty continuing to be elevated. 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~~. Inflation expectations in the euro area must remain 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~~make an ongoing contribution towards supporting economic growth and job creation in the euro area. ~~At the same time,~~With 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~~ 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**, ~~it~~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 ~~achieve the consolidation~~ meet the fiscal balance 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.~~Where necessary, additional corrective measures must be implemented swiftly to ensure progress in achieving fiscal sustainability. The implementation of credible policies is crucial in view of ongoing financial market pressures.

At the same time, it is ~~crucial~~ of the utmost importance that substantial and far-reaching **structural reforms** be implemented urgently ~~implemented~~ in the euro ~~area~~area in order to strengthen its growth potential, competitiveness and flexibility. In particular, countries which have high fiscal and external deficits or which are suffering from a loss of competitiveness should embark on comprehensive economic reforms. 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~~bring about improvements in productivity. ~~On~~Regarding the labour market, the priority must be to enhance wage flexibility and incentives to work, and to remove labour market rigidities.

~~Finally, the Governing Council is of the view that the package of six legislative proposals on **economic governance**, adopted by the European Council at its summit on 24-25 March 2011, goes some way to improving economic and budgetary surveillance in the euro area. However, in our view, the proposals fall short of the necessary quantum leap in the surveillance of the euro area which is needed to ensure the smooth functioning of Economic and Monetary Union. Therefore, the~~ The Governing Council, in line with the ECB's opinion of 17 February 2011 on ~~these~~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. ~~All this would help to ensure that the new framework is effective in the long run.~~

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.

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