ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Edging back towards 1%

- ECB adopted a surprisingly pre-emptive approach, cutting rates by 0.25%
- The gloomy activity outlook dominates over inflation concerns
- No changes on SMP program

Bottom line: The ECB decided unanimously to cut the main policy rate by 0.25% . We expect another 25 bp cut soon, as it seems that the ECB will continue with a more pragmatic approach in coming months.

The ECB decided unanimously to cut the main policy rate by 0.25% to 1.25%, in an unanticipated move. It also cut the deposit rate and marginal lending rate by 25bp, thus leaving unrevised the interest rate corridor (at +/-75bp). This surprising move comes at the first meeting of Mario Draghi as ECB President.

The rate cut has been justified on the materialization of downside risks to economic activity, along with sharp drops in confidence early in October. The Governing Council declared that "some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely ". Moreover when Mr. Draghi was asked about activity risks he replied that "what we observe is that slow growth was heading towards a mild recession by year end". Arguments for the (bold) action are convincing, but to some extent surprising after the recent approach of the Governing council. It is understandable under a pre-emptive (a pragmatic) view, considering the balance of risks that is facing the Eurozone. If this, more realistic approach is maintained, another rate cut can be expected as soon as December.

Strictly speaking, the economic data over the third quarter confirmed both a revival of the financial turmoil and the lower momentum of global growth, but they did not represent a major novelty compared to September, when the ECB staff estimated annual GDP growth of 1.3% for 2012. Our own scenario confirms the gloomy outlook for the end of the year. Confidence data, especially PMI, were disappointing again in October, pointing to a mild contraction in the last quarter of the year according to our short-term model.

The statement also emphasizes that "the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond". The wording “and beyond” shows that the eventual impact on euro zone growth of the worsening debt crisis would be long-lasting and that price, cost and wage (inflationary) pressures should also moderate. In this context, the weight of the inflation argument (currently at 3%) versus the expected sharp decline in activity seems to have diminished. We agree with this view, as we continue to see inflation to moderate by the end of the year, driven by favourable base effects in energy prices along with the weakness of domestic demand, and reverting below the ECB target by the end of Q1 2012.

Much part of the Q&A was dominated by the Securities Markets Program (SMP). In this respect, Mr. Draghi did not change Mr Trichet’s line. He stressed that SMP is temporary, limited in amount, and justified on basis of restoring monetary transmission channels. He also emphasized that governments have to focus on domestic reforms, stabilizing their public finances and embarking on measures to stimulate growth, in order to reduce tensions in debt markets. He also pointed out that the ECB as lender of last resort “is not really in the remit of the ECB”. Having said that, we expect the ECB to maintain bond purchases as long as needed.

Annex 1: Introductory statement to the press conference

~~Jean-Claude Trichet~~**Mario Draghi**, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
~~Berlin, 6 October~~**Frankfurt am Main, 3 November** 2011

Ladies and gentlemen, ~~the Vice-President and I are very pleased to~~ welcome ~~you~~ to our press conference ~~here in Berlin. Let me take~~. Today is the ~~opportunity to warmly thank President Weidmann for his invitation and kind hospitality.~~first time that I ~~would also like to express our special gratitude to~~have had the ~~staff~~privilege and pleasure of chairing the ~~Deutsche Bundesbank for the excellent organisation of our meeting. Let me now report on the outcome of today's~~ meeting of the Governing Council~~, which was also attended by the President~~ of the ~~Eurogroup, Prime Minister Juncker, and Commissioner Rehn~~ECB. I am delighted to proceed now with our well-established practice of real-time communication and to report on the outcome of our meeting, together with the Vice-President.

Based on its regular economic and monetary analyses, the Governing Council decided to ~~keep~~reduce the **key ECB interest rates** ~~unchanged. Inflation~~ by 25 basis points. While inflation has remained elevated and ~~incoming information has confirmed our view that inflation~~ is likely to stay above 2% ~~over the~~ for some months ~~ahead but to~~ to come, inflation rates are expected to decline ~~thereafter.~~further in the course of 2012 to below 2%. At the same time, the underlying pace of monetary expansion continues to be moderate. ~~Ongoing tensions in financial markets and~~ After today's decision, inflation should remain in line with price stability over the policy-relevant horizon. Owing to their unfavourable effects on financing conditions and confidence, the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond. The economic outlook ~~remains~~ continues to be subject to particularly high uncertainty and intensified downside risks. ~~At the same time, short-term interest rates remain low. It~~Some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely. In such an environment, price, cost and wage pressures in the euro area should also moderate; today's decision takes this into account. Overall, it remains 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~~.

~~The Governing Council has decided to conduct two longer-term refinancing operations (LTROs), one with a maturity of approximately 12 months in October and the other with a maturity of approximately 13 months in December. The operations will be conducted as fixed rate tender procedures with full allotment. The rate in both operations will be fixed at the average rate of the main refinancing operations (MROs) over the life of the respective LTRO, and interest will be paid when each operation matures. These operations will be conducted in addition to the regular and special-term refinancing operations, which remain unaffected.~~

~~The Governing Council has also decided to continue conducting its MROs as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the sixth maintenance period of 2012 on 10 July 2012. 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 sixth maintenance period (i.e. around the end of the second quarter) of 2012. The fixed rate in these special-term refinancing operations will be the same as the MRO rate prevailing at the time.~~

~~In addition, the Governing Council has decided to conduct the three-month LTROs to be allotted on 25 January, 29 February, 28 March, 25 April, 30 May and 27 June 2012 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.~~

~~Furthermore, the Governing Council has decided to launch a new covered bond purchase programme (CBPP2). The programme will have the following modalities:~~

- ~~The purchases will be for an intended amount of EUR 40 billion.~~
- ~~The purchases will have the capacity to be conducted in the primary and secondary markets and will be carried out by means of direct purchases.~~
- ~~The purchases will start in November 2011 and are expected to be fully implemented by the end of October 2012.~~

~~Further details on the modalities of CBPP2 will be announced after the Governing Council meeting of 3 November 2011.~~

~~The provision of liquidity and the allotment modes for refinancing operations will continue to ensure that euro area banks are not constrained on the liquidity side. 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**. Real GDP growth in the euro area, after slowing in the second quarter of 2011 to 0.2% quarter on quarter, is now expected to be very moderate in the second half of this year. In particular, a number of factors seem to be dampening the underlying growth momentum in the euro area, including a moderation in the pace of global demand, falling consumer and business confidence, and unfavourable effects on financing conditions resulting from ongoing tensions in a number of euro area sovereign debt markets. At the same time, we continue to expect euro area economic activity to benefit from continued positive growth in the emerging market economies as well as from the low short-term interest rates and the various measures taken to support the functioning of the financial sector.~~

~~In the Governing Council's assessment, the risks to the economic outlook for the euro area remain on the downside in an environment of particularly high uncertainty. Downside risks notably relate to the ongoing tensions in some segments of the financial markets in the euro area and at the global level, as well as to the potential for these pressures to further spill over into the euro area real economy. They also relate to the still high energy prices, 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% in September 2011, according to Eurostat's flash estimate, after 2.5% in August. Inflation rates have been at elevated levels since the end of last year, mainly driven by higher energy and other commodity prices. Looking ahead, inflation rates are likely to stay clearly above 2% over the coming months but to decline thereafter. This pattern reflects the expectation of relatively stable wage growth developments in the context of moderate economic growth.~~

The provision of liquidity and the allotment modes for refinancing operations will continue to ensure that euro area banks are not constrained on the liquidity side. All the non-standard monetary policy 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**. Real GDP growth in the euro area, which slowed in the second quarter of 2011 to 0.2%

quarter on quarter, is expected to be very moderate in the second half of this year. There are signs that previously identified downside risks have been materialising, as reflected in unfavourable evidence from survey data. Looking forward, a number of factors seem to be dampening the underlying growth momentum in the euro area, including a moderation in the pace of global demand and unfavourable effects on overall financing conditions and on confidence resulting from ongoing tensions in a number of euro area sovereign debt markets. At the same time, we continue to expect euro area economic activity to benefit from continued positive economic growth in the emerging market economies, as well as from the low short-term interest rates and the various measures taken to support the functioning of the financial sector.

In the Governing Council's assessment, the downside risks to the economic outlook for the euro area are confirmed in an environment of particularly high uncertainty. Downside risks notably relate to a further intensification of the tensions in some segments of the financial markets in the euro area and at the global level, as well as to the potential for these pressures to further spill over into the euro area real economy. They also relate to the impact of the still high energy prices, 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% in October according to Eurostat's flash estimate, unchanged from September. Inflation rates have been at elevated levels since the end of last year, mainly driven by higher energy and other commodity prices. Looking ahead, they are likely to stay above 2% for some months to come, before falling below 2% in the course of 2012. Inflation rates are expected to remain in line with price stability over the policy-relevant horizon. This pattern reflects the expectation that, in an environment of weaker euro area and global growth, price, cost and wage pressures in the euro area should also moderate.

The Governing Council continues to view the risks to the medium-term outlook for price developments as broadly balanced, taking also into account today's decision. On the upside, the main risks relate to the possibility of increases in indirect taxes and administered prices, owing to the need for fiscal consolidation in the coming years. In the current environment, however, inflationary pressure should abate. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally. In fact, if sustained, sluggish economic growth has the potential to reduce medium-term inflationary pressure in the euro area.

Turning to the **monetary analysis**, the annual growth rate of M3 ~~was 2.8% in August~~increased to 3.1% in September 2011, up from 2.~~1~~7% in ~~July.~~August. The annual growth rate of loans to the private sector, adjusted for loan sales and securitisation, was 2.~~8%~~ 7% in September, unchanged from August. As in August, ~~after 2.6% in July. A number of factors, possibly related to the intensification of~~ inflows into M3 also reflect the heightened tensions in some financial markets~~, could have had an upward effect on the components of M3~~. In particular, ~~sizeable~~ inflows into ~~overnight deposits and~~ money market fund shares/units, as well as ~~a substantial inflow~~ into repurchase agreements conducted through central counterparties, appear to have ~~driven~~significantly affected monetary developments in ~~August. The inflow into repurchase agreements mainly reflected secured lending in the interbank market, which was increasingly settled via central counterparties that are allocated to the money-holding sector. Overall, M3 growth was driven in particular by the increase in the annual growth rate of M1 from 1.0% in July to 1.7% in August and the increase in the annual growth rate of marketable instruments~~September. The annual growth rate of M1 increased to 2.0% in September, from 1.7% in August.

On the counterpart side, the annual growth rate of loans to non-financial corporations and to households in ~~August, both~~September, adjusted for loan sales and securitisation, remained broadly unchanged ~~from July,~~ compared with August, at 2.2% and 2.~~7~~6%

respectively. These figures do not signal that the heightened financial market tensions have affected the supply of credit up to September. However, as such effects can manifest themselves with lags, close scrutiny of credit developments is warranted in the period ahead. Taking the appropriate medium-term perspective~~, trends in~~ and looking through short-term volatility, underlying broad money and loan growth have ~~broadly~~ stabilised over recent months. Overall, the underlying pace of monetary expansion thus remains moderate.

~~The situation of the banking sector calls for particular attention, taking into account the interplay between sovereign risk issues and banks' funding needs. As we have done on previous occasions, the Governing Council urges banks to do all that is necessary to reinforce their balance sheets, to retain earnings, to ensure moderation in remuneration, and to turn to the market to strengthen further their capital bases. Where necessary, they should take full advantage of government support measures, which should be made totally operational, including the possibility in future for the European Financial Stability Facility (EFSF) to lend to governments in order to recapitalise banks.~~

The overall size of monetary financial institutions' balance sheets remained broadly unchanged over the past few months. The soundness of bank balance sheets 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. We therefore welcome the agreement of the European Council to proceed with the increase in the capital position of banks to 9% of core Tier 1 by the end of June 2012. We also fully support the call to national supervisors to ensure that banks' recapitalisation plans do not lead to excessive deleveraging.

To sum up, based on its regular economic and monetary analyses, the Governing Council decided to ~~keep~~reduce the key ECB interest rates ~~unchanged. Inflation~~ by 25 basis points. While inflation has remained elevated and ~~incoming information has confirmed our view that inflation~~ is likely to stay above 2% ~~over the~~ for some months ~~ahead but~~to come, inflation rates are expected to decline ~~thereafter.~~further in the course of 2012 to below 2%. A **cross-check** with the information from our monetary analysis confirms that the underlying pace of monetary expansion continues to be moderate. ~~Ongoing tensions in financial markets and~~ After today's decision, inflation should remain in line with price stability over the policy-relevant horizon. Owing to their unfavourable effects on financing conditions and confidence, the ongoing tensions in financial markets are likely to dampen the pace of economic growth in the euro area in the second half of this year and beyond. The economic outlook ~~remains~~ continues to be subject to particularly high uncertainty and intensified downside risks. ~~At the same time, short-term interest rates remain low. It~~Some of these risks have been materialising, which makes a significant downward revision to forecasts and projections for average real GDP growth in 2012 very likely. In such an environment, price, cost and wage pressures in the euro area should also moderate; today's decision takes this into account. Overall, it remains 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.~~

Turning to **fiscal policies**, ~~with financial market uncertainty remaining high,~~ all ~~governments need to take decisive and frontloaded action to bolster public confidence in the sustainability of government finances. All~~ euro area governments need to show their inflexible determination to fully honour their own individual sovereign signature as a key element in ensuring financial stability in the euro area as a whole. ~~Countries under joint EU-IMF adjustment programmes as well as those particularly vulnerable to financial market conditions need to unambiguously implement all announced measures for fiscal~~

~~consolidation and the strengthening of domestic fiscal frameworks, and they need to stand ready to take any additional measures that may become necessary owing to the evolution of their situation~~The Governing Council takes note of the fiscal commitments expressed in the Euro Summit statement of 26 October 2011 and urges all governments to implement fully and as quickly as possible the measures necessary to achieve fiscal consolidation and sustainable pension systems, as well as to improve governance. The governments of countries under joint EU-IMF adjustment programmes and those of countries that are particularly vulnerable should stand ready to take any additional measures that become necessary.

~~Fiscal~~It is crucial that fiscal consolidation ~~and~~ and **structural** ~~reforms must~~ **reforms** go hand in hand to strengthen confidence, growth prospects and job creation. The Governing Council therefore ~~urges~~calls upon all euro area governments to ~~decisively and swiftly implement~~ accelerate, urgently, the implementation of substantial and ~~comprehensive~~ comprehensive structural reforms. This will help ~~these~~the euro area countries to strengthen competitiveness, increase the flexibility of their economies and enhance their longer-term growth potential. In this respect, labour market reforms are ~~key, with a~~essential and should focus on ~~the removal of~~measures to remove rigidities and ~~the implementation of measures which~~ to enhance wage flexibility~~. In particular, we should see the elimination of automatic wage indexation clauses and a strengthening of firm-level agreements.~~, so that wages and working conditions can be tailored to the specific needs of firms. More generally, in these demanding times, moderation is of the essence in terms of both profit margins and wages. These measures should be accompanied by structural reforms that increase competition in product markets, particularly in services – including the liberalisation of closed professions – and, where appropriate, the privatisation of services currently provided by the public sector~~, thereby facilitating productivity growth and supporting competitiveness~~. At the same time, the Governing Council ~~urges all~~stresses that it is absolutely imperative that euro area ~~governments to fully~~ national authorities rapidly adopt and implement ~~all aspects of~~ the ~~decisions they took on 21 July~~measures announced and recommended in the Euro Summit statement of 26 October 2011.

~~Let me close with some personal remarks. This is my last press conference following a meeting of the Governing Council. I remember my first press conference, eight years ago, as if it were yesterday. I want to tell you that it has been a great pleasure to have this regular dialogue with the press, with all of you. We have, together, each of us with our different responsibilities, analysed the European and global situation throughout these years. We were never in calm waters. But for more than four years now, we have been experiencing turbulent waters, storms, unexpected hurricanes. In demanding times, regular, real-time and transparent communication is more important than ever. The channels of national, European and global communication which you are responsible for are crucial for the appropriate functioning of markets, for the correct understanding of economists and economic agents, and for the information of the people of Europe, our fellow citizens, to whom, as an independent institution, we are accountable. Eight years ago the concept of a press conference immediately after the meeting of the Governing Council was still considered a bold innovation. Today it is part of the global state of the art. And the Vice-President and I also have to thank you for that.~~

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