CENTRAL BANKS

Recent data push the ECB to act again

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- The Council cut the Refi rate to a record low of 0.05% and announced a (still undefined) ABS purchase programme and a new covered bond purchase programme.
- The Staff revised its projections only slightly downwards, yet Draghi´s tone was clearly gloomier.
- The door remains open for a “pure” QE

Unexpectedly, the ECB Governing Council (GC) decided to cut the main policy rate by 10bp to 0.05%, a historic low, at today’s monetary policy meeting. The GC also cut the deposit facility by 10bp to -0.20% and the marginal lending rate by 10bp to 0.30%, thus maintaining the symmetric corridor for interest rates. Moreover, the ECB decided to strengthen the package announced in June, as it will start buying asset-backed securities (ABS) and covered bonds next month. Mr. Draghi said that today´s decision was not unanimous, but he highlighted that a comfortable majority was in favour of the programme. The tone remained dovish, the easing bias was retained and unanimity in their commitment to use further unconventional instruments remains in place. The statement dropped a previous reference about medium-term inflation risks being “broadly balanced”, while stating that the GC continues to closely monitor risks to the outlook for inflation. Risks to the economic outlook continue on the downside.

At the press conference, the attention was focused on the ABS purchase programme (ABSPP). The ECB will only purchase senior tranches of securitised debts and loans, including residential mortgage-backed securities (RMBS), as well as mezzanine tranches with guarantees. Mr. Draghi stressed that this measure is aimed at easing credit and that, together with the TLTROs, it will have a sizeable impact on the ECB balance sheet (yet Mr. Draghi did not advance the potential amounts involved). The ECB will provide the details of this programme after the GC meeting of 2 October.

In response to a question about the possibility of a “pure” QE (i.e. purchase of public assets), Mr. Draghi said that such a measure was discussed, with some GC members favouring a more aggressive move than today´s “mid-road solution”. This statement signalled once again that positions within the GC remain misaligned on this front.

Regarding the rate cuts, Mr. Draghi said that the drop in the Refi rate should ensure a successful take up of the TLTROs (in the auction to be held on 18 September), adding that there will be no more rate cuts as the ECB is now at the “lower bound, where technical adjustments will not be possible.” Moreover, a more negative deposit rate helps the ECB to maintain a low exchange rate.

The ECB staff macroeconomic projections were revised only slightly downwards despite the lower-than-expected growth in Q2 and the weak sentiment indicators incoming in Q3, but contrasted with a gloomy assessment by Mr. Draghi of the economic outlook. The ECB staff expects GDP to grow 0.9% in 2014, around -0.2pp lower compared to the June figures, 1.6% in 2015 (-0.1pp from June) and 1.9% for 2016 (+0.1pp). The drivers underlying this scenario remain broadly unchanged, but now include the TLTROs announced in June (although the staff stresses that their impact is likely to be underestimated) while the impact of tensions between the EU and Russia on the eurozone's trade outlook is estimated to be small. Mr. Draghi said that risks continue to be tilted to the downside, and that soft data up to August suggest that the "cyclical growth is losing momentum". Our calculations point to the same growth rates in 2014 or even lower, as the eurozone would need to grow at quarterly rates of at least 0.3% QoQ over 2H14 to reach that 0.9%. Annual inflation was revised down by 0.1pp to 0.6% in 2014, but was unchanged at sub-target levels for 2015 and 2016 (1.1% and 1.4% respectively). The slight downward revision was mainly due to the evolution of prices of more volatile components. Again, Mr. Draghi was more dovish than this slight revision could suggest, stressing that although inflation expectations "are still firmly anchored", the GC members have "seen the downside risks increasing" (especially as inflation is expected to remain low for a prolonged period of time), although they "don't see deflation".

We consider that the most likely scenario is for the ECB to remain on hold, waiting for the impact of its two latest measures (today´s and last June´s). In our view, a "pure" QE remains an option, with a probability that has been increasing over the past month due to the worsening of the economic outlook. The take-up of September´s and December´s TLTROs will be key in determining the chances of such a measure; the higher the take-up, the greater the balance sheet expansion and the greater the impact on exchange rates, and the lower the probability of a QE program of public bonds.

PLEASE NOTE: **TRACKING CHANGES IN FOLLOWING STATEMENTS**

in black, wording common to both the current and previous statements, in red and crossed, previous wording that was replaced by new wording, in blue and underlined (YES, TRACK CHANGES ARE THERE ON PURPOSE)

Mario Draghi, President of the ECB, Frankfurt am Main, ~~7 August~~ 4 September 2014

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. We will now report on the outcome of today's meeting of the Governing Council, which was also attended by the Commission Vice-President, Mr Katainen.

Based on our regular economic and monetary analyses, ~~we~~ the Governing Council decided today to ~~keep~~lower the ~~**key ECB**~~ **interest** ~~**rates** unchanged. The available information remains consistent with our assessment~~ **rate** on the main refinancing operations of ~~a continued moderate~~ the Eurosystem by 10 basis points to 0.05% and ~~uneven recovery of the euro area economy, with low rates of inflation and subdued monetary and credit dynamics. At the same time, inflation expectations for the euro area over the medium to long term continue~~the rate on the marginal lending facility by 10 basis points to ~~be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%. The monetary policy measures decided in early June have led to an easing of the monetary policy stance. This is in line with our forward guidance and adequately reflects the outlook for the euro area economy, as well as the differences in terms of the monetary policy cycle between major advanced economies. The targeted longer-term refinancing operations (TLTROs) that are to take place over the coming months will enhance our accommodative monetary policy stance. These operations will provide long-term funding at attractive terms and conditions over a period of up to four years for all banks that meet certain benchmarks applicable to their lending to the real economy. This should help to ease funding conditions further and stimulate credit provision to the real economy. As our measures work their way through to the economy they will contribute to a return of inflation rates to levels closer to 2%~~0.30%. The rate on the deposit facility was lowered by 10 basis points to -0.20%. In addition, the Governing Council decided to start purchasing non-financial private sector assets. The Eurosystem will purchase a broad portfolio of simple and transparent asset-backed securities (ABSs) with underlying assets consisting of claims against the euro area non-financial private sector under an **ABS purchase programme** (ABSPP). This reflects the role of the ABS market in facilitating new credit flows to the economy and follows the intensification of preparatory work on this matter, as decided by the Governing Council in June. In parallel, the Eurosystem will also purchase a broad portfolio of euro-denominated covered bonds issued by MFIs domiciled in the euro area under a new **covered bond purchase programme** (CBPP3). Interventions under these programmes will start in October 2014. The detailed modalities of these programmes will be announced after the Governing Council meeting of 2 October 2014. The newly decided measures, together with the targeted longer-term refinancing operations which will be conducted in two weeks, will have a sizeable impact on our balance sheet.

~~As stated previously, and as a follow-up to our decision in early June, we have intensified preparatory work related to outright purchases in the asset-backed securities market to~~These decisions will add to the range of monetary policy measures taken over recent months. In particular, they will support our forward guidance on the key ECB interest rates and reflect the fact that there are significant and increasing differences in the monetary policy cycle between major advanced economies. They will further enhance the functioning of the monetary policy transmission mechanism~~.~~

~~Looking ahead, we will maintain~~ and support the provision of credit to the broad economy. In our analysis, we took into account the overall subdued outlook for inflation, the weakening in the euro area's growth momentum over the recent past and the continued subdued monetary and credit dynamics. Today's decisions, together with the other measures in place, have been taken with a ~~high degree of monetary accommodation. Concerning our forward guidance, the key ECB interest rates will remain at present levels for an extended period of time in~~ view ~~of the current outlook for inflation. Moreover, the Governing Council is unanimous in its commitment to also using unconventional instruments within its mandate, should it become necessary to further address risks of too prolonged a period of low inflation. We are strongly determined to safeguard~~to underpinning the firm anchoring of medium to long-term inflation expectations ~~over the medium to long term~~, in line with our aim of maintaining inflation rates below, but close to, 2%. As our measures work their way through to the economy they will contribute to a return of inflation rates to levels closer to 2%. Should it become necessary to further address risks of too prolonged a period of low inflation, the Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~In the first quarter of this year euro area real GDP rose by 0.2%, quarter on quarter. With regard to the second quarter, monthly indicators have been somewhat volatile, partly reflecting technical factors. Overall, recent information, including survey data available for July, remains consistent with our expectation of a continued moderate and uneven recovery of the euro area economy. Looking ahead, domestic~~Following four quarters of moderate expansion, euro area real GDP remained unchanged in the second quarter of this year compared with the previous quarter. While it partly reflected one-off factors, this outcome was weaker than expected. With regard to the third quarter, survey data available up to August indicate a loss in cyclical growth momentum, while remaining consistent with a modest expansion.

Domestic demand should be supported by ~~a number~~the range of ~~factors, including the accommodative~~our monetary policy ~~stance and~~measures, the ongoing improvements in financial conditions~~. In addition~~, the progress made in fiscal consolidation and structural reforms, ~~as well as gains in~~ and lower energy prices supporting real disposable income~~, should make a positive contribution to economic growth~~. Furthermore, demand for exports should benefit from the ~~ongoing~~ global recovery. ~~However, although labour markets have shown some further signs of improvement,~~ At the same time, the recovery is likely to continue to be dampened by high unemployment~~ remains high in the euro area and, overall,~~ , sizeable unutilised capacity~~ continues to be sizeable. Moreover, the annual rate of change of~~ , continued negative MFI ~~loans~~loan growth to the private sector~~ remained negative in June~~ , and the necessary balance sheet adjustments in the public and private sectors~~ are likely to continue to dampen the pace of the economic recovery~~. Looking ahead, the key factors and assumptions shaping the outlook for growth need to be monitored closely.

These elements are reflected in the September 2014 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP increasing by 0.9% in 2014, 1.6% in 2015 and 1.9% in 2016. Compared with the June 2014 Eurosystem staff macroeconomic projections, the projections for real GDP growth for 2014 and 2015 have been revised downwards and the projection for 2016 has been revised upwards.

The Governing Council sees the risks surrounding the economic outlook for the euro area ~~remain~~ on the downside.~~ In particular, heightened geopolitical risks, as well as developments in emerging market economies and global financial markets, may have the potential to affect economic conditions negatively, including through effects on energy prices and global demand for euro area products. A further~~ In particular, the loss in economic momentum may dampen private investment, and heightened geopolitical risks could have a further negative impact on business and consumer confidence. Another downside risk relates to insufficient structural reforms in euro area countries~~, as well as weaker than expected domestic demand~~.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.~~4~~3% in ~~July~~August 2014, after 0.~~5~~4% in ~~June.~~July. ~~This~~This decline reflects primarily lower energy price inflation, while the other main components ~~of the HICP~~ remained broadly ~~unchanged .~~unchanged in aggregate. Inflation rates have now remained low for a considerable period of time. As said, today's decisions, together with the other measures in place, have been taken to underpin the firm anchoring of medium to long-term inflation expectations, in line with our aim of maintaining inflation rates below, but close to, 2%. On the basis of current information, annual HICP inflation is expected to remain at low levels over the coming months, before increasing gradually during 2015 and 2016.~~ Meanwhile, inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%.~~

~~The Governing Council sees both upside and downside risks to the outlook for price developments as limited and broadly balanced over the medium term.~~The September 2014 ECB staff macroeconomic projections for the euro area foresee annual HICP inflation at 0.6% in 2014, 1.1% in 2015 and 1.4% in 2016. In comparison with the June 2014 Eurosystem staff macroeconomic projections, the projection for inflation for 2014 has been revised downwards. The projections for 2015 and 2016 have remained unchanged.

The Governing Council, taking into account the measures decided today, will continue to closely monitor the risks to the outlook for price developments over the medium term. In this context, we will ~~closely monitor the~~ focus in particular on the possible repercussions of ~~heightened~~dampened growth dynamics, geopolitical ~~risks and~~developments, exchange rate developments and the pass-through of our monetary policy measures.

Turning to the **monetary analysis**, data for ~~June~~July 2014 continue to point to subdued underlying growth in broad money (M3), with annual growth standing at 1.~~5~~8% in ~~June~~July, compared with 1.~~0~~6% in ~~May.~~June. The growth of the narrow monetary aggregate M1 stood at 5.~~3~~6% in ~~June~~July, up from 5.~~0~~4% in ~~May.~~June. The increase in the MFI net external asset position, reflecting in part the continued interest of international investors in euro area assets, remained an important factor supporting annual M3 growth.

The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) remained negative at -2.~~3% in June, compared with -~~2~~.5% in May and -3.2% in February.~~% in July, unchanged compared with the previous month. However, net redemptions were again sizeable in July. Lending to non-financial corporations continues to ~~be weak, reflecting~~reflect the lagged relationship with the business cycle, credit risk, credit supply factors and the ongoing adjustment of financial and non-financial sector balance sheets.~~ At the same time, in terms of monthly flows, loans to non-financial corporations have shown some signs of a stabilisation over recent months, after recording sizeable negative monthly flows earlier in the year. This is consistent with the results of the bank lending survey for the second quarter of 2014 in which banks reported that credit standards for loans to enterprises had eased in net terms. However, they remain rather tight overall, when seen from a historical perspective. In addition, banks reported an improvement in net loan demand by non-financial corporations and households.~~ The annual growth rate of loans to households (adjusted for loan sales and securitisation) was 0.5% in ~~June~~July, broadly unchanged since the beginning of 2013.

Against the background of weak credit growth, the ~~ECB's ongoing~~ ECB is finalising the comprehensive assessment of banks' balance sheets, which is of key importance~~. Banks should take full advantage of this exercise to improve their capital position, thereby supporting the scope for credit expansion during the next stages of the recovery~~ to overcome credit supply constraints.

To sum up, a **cross-check** of the outcome of the economic analysis ~~indicates that the current low level of inflation should be followed by a gradual upward movement in HICP inflation rates towards levels closer to 2%. A **cross-check**~~ with the signals coming from the monetary analysis ~~confirms this picture~~led the Governing Council to decide on measures to provide further monetary policy accommodation and to support lending to the real economy.

With regard to **structural reforms**, important steps have been taken in several Member States, while in others such measures still need to be legislated for and implemented. These efforts now clearly need to gain momentum to achieve higher sustainable growth and employment in the euro area. Determined structural reforms in product and labour markets as well as action to improve the business environment are warranted. As regards **fiscal policies**, comprehensive fiscal consolidation in recent years has contributed to reducing budgetary imbalances. ~~Important **structural reforms** have increased competitiveness and the adjustment capacity of countries' labour and product markets. These efforts now need to gain momentum to enhance the euro area's growth potential. Structural reforms should focus on fostering private investment and job creation. To restore sound public finances, euro~~Euro area countries should ~~proceed in line with the Stability and Growth Pact and should~~ not unravel the progress made with fiscal consolidation~~. Fiscal consolidation should be designed in a growth-friendly way.~~ and should proceed in line with the Stability and Growth Pact. The Pact acts as an anchor for confidence, and the existing flexibility within the rules allows the budgetary costs of major structural reforms to be addressed and demand to be supported. There is also leeway to achieve a more growth-friendly composition of fiscal policies. A full and consistent implementation of the euro area's existing fiscal and macroeconomic surveillance framework is key to bringing down high public debt ratios, to raising potential growth and to increasing the euro area's resilience to shocks.

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