The ECB delivers a strong easing package

Sonsoles Castillo / Agustín García / Miguel Jiménez / María Martínez
September 2019

- **A charged package: further negative rates, strengthened forward guidance, more QE, two-tier system for reserve remuneration, easing TLTRO conditions.**
- **The door remains open for further easing if needed, but the ECB makes a strong call for more active fiscal policy.**
- **Inflation projections have been revised down over the forecast horizon. GDP growth also, but less.**

The big question mark before the meeting was to see the size of the pre-announced packaged of measures, in particular if it was going to include further QE or not -given the doubts expressed by several Governing Council members prior to the meeting.

And **the central bank came in line with what we were expecting announcing a strong package of further accommodative measures.** By unanimity (for some measures) or with broad consensus (for others), **the ECB enhanced the forward guidance on rates, cut the depo rate by 10bps, announced a two-tier system for bank reserves and a new open-ended asset purchase program (APP) and sweetened TLTRO-III conditions**. Only the last one came at a relative surprise.

At the same time, Mr. Draghi gave **a strong message on the need to activate fiscal policy**. At every other answer during the Q&A session he introduced the issue, and he took care to point out that the ECB has shifted significantly its call for more active fiscal policy for countries with space do it (i.e. mostly Germany) while others should let automatic stabilizers do their work.

The ECB pointed out three elements which had driven today's decision: a protracted slowdown, the persistence of downside risks in global trade and the downward revision in inflation projections. Moreover, the central bank reaffirmed its readiness to adjust its instruments further if needed (as risks remain tilted to the downside). Specifically, the ECB mentions that rates are expected to remain at present or lower levels until inflation convincingly approaches its target (more on this later).

More in detail, the package of monetary policy measures includes:

i) **As expected, the ECB lowered the deposit facility rate. The cut was by 10bps to -0.50%**, while keeping unchanged the refi and marginal facility rates at 0% and 0.25% respectively. Additionally, **the central bank left the door open to further rate cuts** by noting that key ECB interest rates will "remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon." **The ECB also strengthened its forward guidance dropping the calendar-based forward guidance and replacing it with inflation-linked guidance.**

ii) As widely expected, **the ECB will introduce a two-tier system for reserve remuneration** whereby part of banks' holdings of excess liquidity will be exempted from the negative deposit facility rate, trying to mitigate their adverse impact to banks' profitability. **A multiple of six times minimum reserve system will be exempted**, along the lines of the Swiss model, which is more egalitarian among Eurozone countries than other alternative systems. Although such a multiple factor is lower more conservative than expected, **it may be adjusted according to the ECB "such that short-term money market rates are**

not unduly influenced". With this system, and this multiplier, we estimate that around 40% of excess reserves of Eurozone banks will be exempted from a negative depo rate.

iii) **The ECB will restart the Assets Purchase Programme. The new QE package amounts to a (relatively low) 20 billion EUR per month, starting in November, and is open ended** (as opposed to the previous program which had a time limit). This implies that, unless current 33% issuer limits are changed, QE will continue for only several months unless the ECB widens the limits of purchases (or moves to other types of assets). In this regard, Mr Draghi clarified that the Governing Council did not discuss these, as there is still margin to continue with the current ones.

iv) In a not much anticipated decision, **the ECB also eased TLTRO-III conditions,** with a lower rate for banks exceeding the net lending benchmark, and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation **(the 10bp surcharge has been suppressed)**. Additionally, **the maturity of the operations will be extended from two to three years,** with a repayment option after two years.

v) As expected, **the ECB strengthened alto its forward guidance by:**

- Switching from calendar-based rate hikes to increases contingent on inflation measures.
- Making QE open-ended, that will be phased out shortly before the next rate hike (which suggests a long programme if needed but also flexibility to hike rates).
- Strengthening the language on inflation convergence to target: convergence has to be "robust" and reflected in underlying inflation (which is a novelty for the ECB, which has always rejected to switch the emphasis from headline to core inflation).

The Staff macroeconomic projections have been revised down over the forecast horizon, as a result of the persistence of the weaker economic momentum in the area driven by the worsening of global trade and manufacturing sector. GDP growth is now projected at 1.1% (1.2% in June's forecasts) in 2019, 1.2% (1.4%) in 2020 and 1.4% (1.4%) in 2021. Despite the resilience of domestic demand and tightening labour market conditions, Mr Draghi stressed that the pass-through of higher labour costs to inflation is taking longer than previously expected. This, along with lower oil prices forecasts, lead also to a significant downward revision for inflation in 2020 (-0.4pp to 1% for headline and -0.2pp to 1.2% for core inflation) and a more gradual increase in 2021 (-0.1pp for both headline and core figures to 1.5%). **Draghi stressed that the updated forecasts continue to reflect a favourable scenario** (no hard Brexit, no trade war escalation) **and risks are tilted to the downside** (trade war, geopolitical and vulnerabilities in emerging markets), **adding that the probability of recession is still small but it is gone up.**

All in all, **Mr. Draghi has not disappointed on the expectations generated by the ECB itself. The message from the ECB has been dovish enough, as the ECB reacts to the increasing and prolonged uncertainty with a combination of non-standard measures and opening the door for further easing. But the question remains open if the actual conditions and risks of the Eurozone economy call for such a package. In addition, the marginal effect of further monetary measures is rapidly decreasing, as seems to be recognized by the ECB itself with such a strong call for fiscal policy.**

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

in black, wording common to both the current and previous statements, in light grey 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,

Luis de Guindos, Vice-President of the ECB,

Frankfurt am Main, ~~25 July~~12 September 2019

INTRODUCTORY STATEMENT

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 Dombrovskis~~.

Based on our regular economic and monetary analyses, we ~~decided to keep~~have conducted a thorough assessment of the economic and inflation outlook, also taking into account the latest staff macroeconomic projections for the euro area. As a result, the Governing Council took the following decisions in pursuit of its price stability objective.
First, as regards the **key ECB interest rates**~~.~~, we decided to lower the interest rate on the deposit facility by 10 basis points to -0.50%. The interest rate on the main refinancing operations and the rate on the marginal lending facility will remain unchanged~~.~~ at their current levels of 0.00% and 0.25% respectively. We now expect ~~them~~the key ECB interest rates to remain at their present or lower levels ~~at least through the first half of 2020, and in any case~~until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.

Second, the Governing Council decided to restart net purchases under its asset purchase programme (APP) at a monthly pace of €20 billion as from 1 November. We expect them to run for as long as necessary to ~~ensure~~reinforce the ~~continued sustained convergence~~accommodative impact of ~~inflation~~our policy rates, and to ~~our aim over~~end shortly before we start raising the ~~medium term~~key ECB interest rates.

~~We~~Third, we intend to continue reinvesting, in full, the principal payments from maturing securities purchased under the ~~asset purchase programme~~APP for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Fourth, we decided to change the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III) to preserve favourable bank lending conditions, ensure the smooth transmission of monetary policy and further support the accommodative stance of monetary policy. The interest rate in each operation will now be set at the level of the average rate applied in the Eurosystem's main refinancing operations over the life of the respective TLTRO. For banks whose eligible net lending exceeds a benchmark, the rate applied in TLTRO III operations will be lower, and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation. The maturity of the operations will be extended from two to three years.

Fifth, in order to support the bank-based transmission of monetary policy the Governing Council ~~also underlined~~decided to introduce a two-tier system for reserve remuneration in which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate.

Separate press releases with further details of the measures taken by the Governing Council will be published this afternoon at 15:30 CET.

The Governing Council reiterated the need for a highly accommodative stance of monetary policy for a prolonged period of time~~, as inflation rates, both realised and projected, have been persistently below levels that are in line with its aim. Accordingly, if the medium-term inflation outlook~~ and continues to ~~fall short of our aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim. It therefore stands~~stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry.

~~In this context, we have tasked~~ Today's decisions were taken in response to the ~~relevant Eurosystem Committees~~ continued shortfall of inflation with ~~examining options, including ways to reinforce~~ respect to our ~~forward guidance on policy rates, mitigating measures, such as the design of a tiered system for reserve remuneration, and options for the size and composition of potential new net asset purchases.~~

~~Incoming~~aim. In fact, incoming information since the last Governing Council meeting ~~in early June indicates that, while~~ indicates a more protracted weakness of the euro area economy, the persistence of prominent downside risks and muted inflationary pressures. This is reflected in the new staff projections, which show a further downgrade of the inflation outlook.

At the same time, robust employment ~~gains~~growth and increasing wages continue to underpin the resilience of the ~~economy, softening global growth dynamics and weak international trade are still weighing on the~~ euro area ~~outlook. Moreover, the prolonged presence of uncertainties, related to geopolitical factors, the rising threat of protectionism, and vulnerabilities in emerging markets, is dampening economic sentiment, notably in the manufacturing sector. In this environment, inflationary pressures remain muted and indicators of inflation expectations have declined. Therefore, a significant degree~~economy. With today's comprehensive package of monetary policy decisions, we are providing substantial monetary stimulus ~~continues to be necessary~~ to ensure that financial conditions remain very favourable and support the euro area expansion, the ongoing build-up of domestic price pressures and, thus, ~~headline~~the sustained convergence of inflation ~~developments over the~~ to our medium-term inflation aim.
Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Following a rise of 0.2% in the fourth quarter of 2018, euro~~Euro area real GDP increased by 0.~~4~~2%, quarter on quarter, in the ~~first~~second quarter of 2019, following a rise of 0.4% in the previous quarter ~~of 2019~~. Incoming economic data and survey information continue to point to ~~somewhat slower~~moderate but positive growth in the ~~second and~~ third ~~quarters~~quarter of this year. This slowdown in growth mainly reflects the ~~ongoing~~prevailing weakness ~~in~~of international trade in an environment of prolonged global uncertainties, which are particularly affecting the euro area manufacturing sector.

At the same time, ~~activity levels in~~ the services and construction sectors ~~are resilient~~show ongoing resilience and the ~~labour market is still improving. Looking ahead, the~~ euro area expansion ~~will continue to be~~is also supported by favourable financing conditions, further employment gains and rising wages, the mildly expansionary euro area fiscal stance and the ongoing – albeit somewhat slower – growth in global activity.

This assessment is broadly reflected in the September 2019 ECB staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 1.1% in 2019, 1.2% in 2020 and 1.4% in 2021. Compared with the June 2019 staff macroeconomic projections, the outlook for real GDP growth has been revised down for 2019 and 2020.

The risks surrounding the euro area growth outlook remain tilted to the downside~~, reflecting~~. These risks mainly pertain to the prolonged presence of uncertainties, related to geopolitical factors, the rising threat of protectionism~~,~~ and vulnerabilities in emerging markets.

~~Euro~~According to Eurostat's flash estimate, euro area annual HICP inflation ~~increased to~~was 1.~~3~~0% in ~~June~~August 2019, unchanged from ~~1.2 % in May, as~~July. Lower energy inflation was offset by higher food inflation, while the rate of HICP inflation excluding food and energy ~~more than offset lower energy price inflation.~~was unchanged. On the basis of current futures prices for oil, headline inflation is likely to decline ~~over the coming months,~~ before rising again towards the end of the year. ~~Looking through the recent volatility due to temporary factors, measures~~Measures of underlying inflation ~~remain~~remained generally muted~~. Indicators~~ and indicators of inflation expectations ~~have declined.~~stand at low levels. While labour cost pressures ~~have~~ strengthened and broadened amid high levels of capacity utilisation and tightening labour markets, ~~the~~their pass-through ~~of cost pressures~~ to inflation is taking longer than previously anticipated. Over the medium term underlying inflation is expected to increase, supported by our monetary policy measures, the ongoing economic expansion and ~~stronger~~robust wage growth.

This assessment is also broadly reflected in the September 2019 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.2% in 2019, 1.0% in 2020 and 1.5% in 2021. Compared with the June 2019 staff macroeconomic projections, the outlook for HICP inflation has been revised down over the whole projection horizon, reflecting lower energy prices and the weaker growth environment.
Turning to the **monetary analysis**, broad money (M3) growth ~~stood at 4.~~increased to 5.2% in ~~June~~July 2019, after 4.~~8~~5% in ~~May~~June. Sustained rates of broad money growth reflect ongoing bank credit creation for the private sector and low opportunity costs of holding M3. The narrow monetary aggregate M1 continues to be the main contributor to broad money growth on the components side.

The annual growth rate of loans to non-financial corporations remained unchanged at 3.~~8~~9% in ~~June~~July 2019. ~~Notwithstanding some moderation from the peak recorded in September 2018, the~~The annual growth rate of overall loans to non-financial corporations continues to be ~~robust.~~solid, although short-term loans – which are more sensitive to the cycle – show signs of weakness. The annual growth rate of loans to households ~~also remained unchanged~~stood at 3.4% in July, after 3.3% in June, continuing its gradual improvement. Overall, loan growth is still benefiting from historically low bank lending rates. ~~The euro area bank lending survey for the second quarter of 2019 indicates that loan growth continued to be supported by increasing demand across all loan categories. At the same time, credit standards for loans to enterprises tightened in the second quarter amid concerns about the economic outlook, while they remained broadly unchanged for loans for house purchase.~~

~~Our~~The monetary policy measures we have taken today, including the ~~forthcoming~~more accommodative terms of the new series of ~~targeted longer-term refinancing operations (TLTRO III),~~TLTROs, will help to safeguard favourable bank lending conditions and will continue to support access to financing, in particular for small and medium-sized enterprises.
To sum up, a **cross-check** of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed that an ample degree of monetary accommodation is still necessary for the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.
In order to reap the full benefits from our monetary policy measures, other policy areas must contribute more decisively to raising the longer-term growth potential, supporting aggregate demand at the current juncture and reducing vulnerabilities. The implementation of **structural** ~~**reforms**~~**policies** in euro area countries needs to be substantially stepped up to boost euro area productivity and growth potential, reduce structural unemployment and increase resilience. The 2019 country-specific recommendations should serve as the relevant signpost.
Regarding **fiscal policies**, the mildly expansionary euro area fiscal stance is currently providing some support to economic activity. ~~At~~In view of the ~~same time,~~weakening economic outlook and the continued prominence of downside risks, governments with fiscal space should act in an effective and timely manner. In countries where ~~government~~public debt is high, governments need to ~~continue rebuilding fiscal buffers~~pursue prudent policies that will create the conditions for automatic stabilisers to operate freely. All countries should reinforce their efforts to achieve a more growth-friendly composition of public finances.

Likewise, the transparent and consistent implementation of the European Union's fiscal and economic governance framework over time and across countries remains essential to bolster the resilience of the euro area economy. Improving the functioning of Economic and Monetary Union remains a priority. The Governing Council welcomes the ongoing work and urges further specific and decisive steps to complete the banking union and the capital markets union.

DISCLAIMER

This document has been prepared by BBVA Research Department. It is provided for information purposes only and expresses data, opinions or estimations regarding the date of issue of the report, prepared by BBVA or obtained from or based on sources we consider to be reliable, and have not been independently verified by BBVA. Therefore, BBVA offers no warranty, either express or implicit, regarding its accuracy, integrity or correctness.

Any estimations this document may contain have been undertaken according to generally accepted methodologies and should be considered as forecasts or projections. Results obtained in the past, either positive or negative, are no guarantee of future performance.

This document and its contents are subject to changes without prior notice depending on variables such as the economic context or market fluctuations. BBVA is not responsible for updating these contents or for giving notice of such changes.

BBVA accepts no liability for any loss, direct or indirect, that may result from the use of this document or its contents.

This document and its contents do not constitute an offer, invitation or solicitation to purchase, divest or enter into any interest in financial assets or instruments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

With regard to investment in financial assets related to economic variables this document may cover, readers should be aware that under no circumstances should they base their investment decisions on the information contained in this document. Those persons or entities offering investment products to these potential investors are legally required to provide the information needed for them to take an appropriate investment decision.

The content of this document is protected by intellectual property laws. Reproduction, transformation, distribution, public communication, making available, extraction, reuse, forwarding or use of any nature by any means or process is prohibited, except in cases where it is legally permitted or expressly authorised by BBVA.

ENQUIRIES TO:
BBVA Research: Azul Street. 4. La Vela Building – 4th and 5th floor. 28050 Madrid (Spain).
Tel. +34 91 374 60 00 y +34 91 537 70 00 / Fax (+34) 91 374 30 25
bbvaresearch@bbva.com www.bbvaresearch.com