BBVA RESEARCH

ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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ECB stands ready to act within its mandate

- **The ECB seems less confident on the economic recovery**
- **The ECB is considering both standard and non-standard measures. We think they take further non-standard measures in the near future**
- **Cyprus is no template for other rescues. The entry into force of SSM is essential for reducing fragmentation**

At today's meeting, the ECB left interest rates unchanged at 0.75%, as widely expected, and also signalled that other measures would be implemented if the situation worsens. Mr Draghi said that the discussion on the rate cut "was extensive, but the general consensus for the time being was to not look at rates." As in other meetings, he also emphasized that the ECB does not "pre-commit" to future rate cuts.

The ECB seems more worried about the economic outlook. In this sense, there were some significant changes in wording. On growth, "weak economic activity has extended into the early part of the year and a gradual recovery is projected for the second half of the year subject to downside risks" including "even weaker than expected domestic demand." Hence, in the statement a reference to "monitor very closely all incoming information on economic and monetary developments and assess any impact on the outlook for price stability" was added. What is more important, Mr Draghi also emphasized that the weakness is spreading to countries where fragmentation is not an issue (meaning mostly France). Against this background, he reiterated that the ECB is ready to act and that the policy stance "will remain accommodative as long as needed." In this sense, the ECB opened further the door to a rate cut. Yet, it seems that such a move would require a further worsening in the outlook, which is not our projection (we expect 1Q13 GDP growth to improve with respect 4Q12 figures). Thus, we still feel comfortable with our forecast for rates to remain steady, though incoming data for 2Q13 remain key.

Regarding other, non-standard, instruments, Mr Draghi said that the ECB is considering more measures to boost the economy and is looking experiences of other countries, which could be implemented within the ECB mandate. In particular, he indicated that the Governing Council is discussing measures to improve small and medium sized enterprises (SME) lending. However, the ECB recognizes that it is not an easy task and even the involvement of national central banks or public agencies should be considered. In our view, any action in this front is likely to be announced in the near future. He also strongly defended the role of the OMT to tackle the recent episodes of the European debt crisis.

In the press conference, attention was mainly focused on Cyprus. Mr Draghi emphasized that the first decision to impose a levy on all bank deposits "was not smart and was quickly corrected"; and he also said that "the ECB had presented a proposal where no bail in of insured depositors was foreseen." He took the opportunity to highlight that "Cyprus is no template neither a turning point in the euro policy." In this context, Mr Draghi also took the opportunity to emphasize the importance of going ahead with the current plans of banking union, and underlined that the better way to prevent crisis is to have a single supervisory mechanism (SMM) and its entry into force and implementation is absolutely essential. He also pointed to 2015 as an adequate date to introduce a single resolution framework in Europe, ahead of proposed dates (around 2018).

Annex 1. Introductory statement, tracking the changes:

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.

Mario Draghi, President of the ECB, Vítor Constâncio, Vice-President of the ECB, Frankfurt am Main, ~~7 March~~4 April 2013

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.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. HICP inflation rates have declined further, as anticipated, and ~~fell below 2% in February. Over the policy-relevant horizon, inflationary pressures~~price developments over the medium term should remain contained. ~~The underlying pace of monetary expansion continues to be subdued.~~Monetary and loan dynamics remain subdued. Inflation expectations for the euro area ~~remain~~ continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. ~~Overall, this will allow our monetary policy stance to remain accommodative. Available data continue to signal that economic weakness in the euro area has extended into the beginning of the year, while broadly confirming signs of stabilisation in a number of indicators, albeit at low levels. At the same time, necessary balance sheet adjustments in the public and private sectors will continue to weigh on economic activity. Later in 2013 economic activity~~ At the same time, weak economic activity has extended into the early part of the year and a gradual recovery is projected for the second half of this year, subject to downside risks. Against this overall background our monetary policy stance will remain accommodative for as long as needed. In the coming weeks, we will monitor very closely all incoming information on economic and monetary developments and assess any impact on the outlook for price stability. It is essential for governments to intensify the implementation of structural reforms at national level and to strengthen euro area governance, including the implementation of the banking union. They should ~~gradually recover, supported by a strengthening of global demand and our accommodative monetary policy stance. In order to support confidence, it is essential for governments to continue implementing structural reforms, to~~ also build ~~further~~ on ~~the~~ progress made in fiscal consolidation~~,~~ and ~~to~~ proceed with financial sector restructuring.

~~With regard to the liquidity situation of banks, counterparties have so far repaid €224.8 billion of the €1,018.7 billion obtained in the two three-year longer-term refinancing operations (LTROs) settled in December 2011 and March 2012. In net terms, this implies that, of the increase in the outstanding volume of bank refinancing through the ECB's monetary policy operations of around €500 billion between mid-December 2011 and early March 2012, about €200 billion have now been repaid. These repayments reflect improvements in financial market confidence over the last few months and receding financial market fragmentation.~~ We are also closely monitoring money market conditions ~~in the money market~~ and their potential impact on ~~the stance of~~our monetary policy stance and ~~the functioning of the~~its transmission ~~of our monetary policy~~ to the economy. ~~Our monetary policy stance will remain accommodative with the full allotment mode of liquidity provision~~As said on previous occasions, we will continue with fixed rate tender procedures with full allotment for as long as necessary.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. The ~~GDP~~ outcome for real GDP in the fourth quarter of 2012 was weak, with Eurostat's second estimate indicating a contraction of 0.6% quarter on quarter. The decline was largely due to a fall in domestic demand but also reflected ~~weak~~ a drop in exports. ~~As regards 2013, recent~~Recent data and indicators ~~suggest~~confirm that the economic ~~activity should start stabilising in the first~~weakness extended into the early part of the year. ~~A gradual recovery should commence in the second part, with export growth benefiting from a strengthening of global demand and domestic demand being supported by our accommodative monetary policy stance.~~Looking forward, euro area export growth should benefit from a recovery in global demand and our monetary policy stance should contribute to support domestic demand. Furthermore, the improvements in financial markets seen since ~~July~~ last ~~year and the continued implementation of structural reforms~~ summer should work their way through to the real economy, notwithstanding recent uncertainties.

Together, this should help stabilise euro area economic activity and lead to a gradual recovery in the second part of the year. At the same time, necessary balance sheet adjustments in the public and private sectors, and the associated tight credit conditions, will continue to weigh on economic activity.

~~This assessment is also reflected in the March 2013 ECB staff macroeconomic projections for the euro area, which foresee average annual real GDP growth in a range between -0.9% and -0.1% in 2013 and between 0.0% and 2.0% in 2014. Compared with the December 2012 Eurosystem staff macroeconomic projections, the ranges have been revised slightly downwards. The revision for 2013 mainly reflects a more negative carry-over effect from the outcome for real GDP in the fourth quarter of 2012, while the projected path of the recovery has remained broadly unchanged.~~

This economic outlook for the euro area remains subject to downside risks. The risks include the possibility of even weaker than expected domestic demand and slow or insufficient implementation of structural reforms in the euro area. These factors have the potential to dampen the improvement in confidence and thereby delay the recovery.

According to Eurostat's flash estimate, euro area annual HICP inflation was 1.7% in March 2013, down from 1.8% in February. The ~~Governing Council continues to see downside risks surrounding the economic outlook for the euro area. The risks relate to the possibility of weaker than expected domestic demand and exports and to slow or insufficient implementation of structural reforms in the euro area. These factors have the potential to dampen the improvement in confidence and thereby delay the recovery.~~

~~According to Eurostat's flash estimate, euro area annual HICP inflation was 1.8% in February 2013, down from 2.0% in January. The~~ on-going decline in annual inflation rates mainly reflects the energy ~~and food components~~component of the price index. Looking ahead, ~~while the monthly pattern of headline inflation rates may be somewhat volatile, underlying price pressures~~price developments over the medium term should remain contained ~~given the~~in an environment of weak economic activity in the euro area. Inflation expectations are ~~well~~ firmly anchored and in line with price stability over the medium to long term.

~~The March 2013 ECB staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 1.2% and 2.0% in 2013 and between 0.6% and 2.0% in 2014. In comparison with the December 2012 Eurosystem staff macroeconomic projections, the ranges are broadly unchanged.~~

~~In the Governing Council's assessment, risks~~Risks to the outlook for price developments continue to be ~~seen as~~ broadly balanced over the medium term, with upside risks relating to stronger than expected increases in administered prices and indirect taxes, as well as higher oil prices, and downside risks stemming from weaker economic activity.

Turning to the **monetary analysis**, ~~monetary figures for January 2013 support our assessment that~~ the underlying pace of monetary expansion continues to be subdued. The annual growth rate of M3 ~~remained broadly unchanged at~~ moderated to 3.1% in February, down from 3.5% in January~~, after 3.4% in December 2012~~. The annual growth rate of ~~growth of~~ the narrow monetary aggregate, M1, increased to ~~6.7%~~ 7.0% in February, from 6.~~3~~6% in ~~December 2012. The deposit base of MFIs~~January. At the same time, MFI deposits in a number of stressed countries strengthened further in ~~January~~February.

The annual growth rate of loans (adjusted for loan sales and securitisation) to non-financial corporations ~~stood~~and households remained broadly unchanged in February, at -1.~~5% in January, after -1.3% in December 2012. The annual growth in MFI loans to households moderated slightly to 0.5%, from 0.7% in December.~~4% and 0.4% respectively. To a large extent, subdued loan dynamics reflect the current stage of the business cycle, heightened credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. At the same time, available information on ~~the access to financing of~~ non-financial ~~corporates~~ corporates' access to financing indicates tight credit conditions, particularly for small and medium-sized enterprises in several euro area countries.

In order to ensure adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential ~~to continue reducing~~ that the fragmentation of euro area credit markets ~~and strengthening~~ is reduced further and the resilience of banks strengthened where needed. ~~Decisive~~However, considerable progress has been made since last summer in improving the funding situation of banks, in strengthening the domestic deposit base in stressed countries and in reducing reliance on the Eurosystem as reflected in repayments of the three-year LTROs. Further decisive steps for establishing ~~an integrated financial framework~~a banking union will help to accomplish this objective. ~~The~~ In particular, in the light of recent experience, we must emphasise that the future Single Supervisory Mechanism ~~(SSM) is one of the main building blocks, together with~~ and a Single Resolution Mechanism ~~(SRM). Both~~ are crucial elements for moving towards re-integrating the banking system and therefore require swift implementation.

To sum up, taking into account today's decision, the economic analysis indicates that price developments should remain in line with price stability over the medium term. A **cross-check** with the signals from the monetary analysis confirms this picture.

~~While the accommodative monetary policy stance will continue to support the recovery in the euro area, it is essential that **fiscal and structural policies** strengthen the prospects for economic growth over the medium term. As regards fiscal policies, the European Commission's 2013 winter forecast reflects progress in reducing fiscal imbalances in the euro area. The euro area-wide general government deficit is expected to have declined from 4.2% of GDP in 2011 to 3.5% of GDP in 2012 and is projected to be reduced further to 2.8% of GDP this year. Governments should build on this progress with a view to further restoring confidence in the sustainability of public finances. At the same time, fiscal consolidation must be part of a comprehensive structural reform agenda to improve the outlook for job creation, economic growth and debt sustainability. In the view of the Governing Council, it is of particular importance at this juncture to address the current high long-term and youth unemployment. To this end, further product and labour market reforms are needed to create new job opportunities by supporting a dynamic, flexible and competitive economic environment.~~As regards **fiscal policies**, euro area countries should build on their efforts to reduce government budget deficits and continue to implement **structural reforms**, thereby mutually reinforcing fiscal sustainability and economic growth. Fiscal policy strategies need to be complemented by growth-enhancing structural reforms. Such reforms should be ambitious and broad-ranging, encompassing product markets, including network industries, labour markets and the modernisation of public administration. To support employment, wage-setting should become more flexible and better aligned with productivity. These reforms will help countries in their efforts to regain competitiveness, set the foundations for sustainable growth and support the return of macroeconomic confidence.

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