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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Dovish tone continues despite upward macro revision

- **A rate cut was discussed as the recovery is "still green"**
- **The ECB did not emphasize better-than-expected data. Minor changes in ECB´s projections**
- **The ECB closely watches developments in money markets**
- **Draghi clarifies "forward guidance"**

As expected, at today's monetary policy meeting the ECB left the key policy rate unchanged at 0.5% and took no additional steps on non-standard liquidity measures. Mr. Draghi said there had been a debate within the Governing Council (GC) on the possibility of an interest rate cut, emphasizing that the economy is "too weak to exclude a discussion on rates." In this regard, Mr Draghi remained cautious on the recovery as he emphasized that "the shoots are still very green." He reiterated that the monetary stance continues to be accommodative for as long as necessary, in line with the forward guidance provided in July, that medium-term inflation risks remain "broadly balanced" and that risks for the economic outlook continue to be on the downside.

The ECB´s statement included an explicit reference to money markets conditions. In particular, the central bank would remain "particularly attentive to the implications" that developments on these markets may have on its monetary policy stance. Mr Draghi pointed out that money markets have been influenced by a gradual reduction in excess liquidity. Although he signalled the current excess of liquidity as adequate, he said that that the ECB "stands ready to react on liquidity." The liquidity surplus has remained stable at about EUR 250 bn over the past two months. In its monthly bulletin the ECB stated that "in general, if excess liquidity remains above a certain threshold, estimated to be in the range of EUR100 bn to EUR 200 bn, short-term money market rates are expected to stay slightly above the deposit rate." The ECB could once again consider further actions in this front. Overall, our baseline scenario continues to be that the ECB will not take further action in the coming quarters, although we do not discard additional moves if the recovery does not set in.

In response to questions about the forward guidance strategy introduced in July, Mr Dragui wanted to emphasize the unanimity of the GC on maintaining the current guidance while he reiterated that they "have a downward bias for interest rates for an extended period of time." He also took the opportunity to clarify that its forward guidance is "qualitative" type (vs. quantitative) and they "wish to maintain this type of forward guidance". Moreover, he said that forward guidance "is the explanation of the reaction function and it is not a change in its reaction function."

The updated ECB's forecasts showed only minor tweaks due to incoming data, but did not imply any significant change in its assessment of the economic outlook in the forecast horizon: A slow and gradual recovery in activity in coming quarters, somewhat more moderate in 2H13, with inflation remaining relatively stable and well below the ECB's target. In particular, GDP is now expected to fall by -0.4% in 2013 (instead of -0.6% projected in June), in line with our forecast of three months ago. We think that a revision of +0.2pp or +0.3pp basically responds to the incorporation of new data (+0.3% q/q in 2Q13 and perhaps the small upward revisions for 4Q12 and 1Q13 by +0.1pp each, although we are not sure the ECB has used this latter information, which was only published yesterday), so to achieve the current ECB forecast there should be a growth moderation in the second half of the year.

This is in line with Draghi's assessment about the transiency of the activity rebound in 2Q13 and consistent with their downward revision of -0.1pp of GDP growth in 2014 to 1% (BBVA Research: 1%). In contrast, and taking into account the data available through August, our models suggest that quarterly GDP growth may be accelerating in 3Q13 (to around 0.3% / 0.4% t/t), so we think that the decline in GDP could be even a few tenths lower in 2013, improving on our latest projection of -0.4% for 2013. Overall, as the ECB highlighted, risks still remain clearly downward biased from potential increases in raw material prices, a slowdown in global demand or lack of response in Europe. Regarding price developments, the ECB continues to expect inflation to remain at current low levels in coming months to stand at 1,5% in 2013 (+0.1pp from June) and 1.3% in 2014, in line with our forecasts (1.5% and 1.4%, respectively), with broadly balanced risks. Draghi emphasized that inflation will remain subdued in the medium term due to the weakness of aggregate demand and the slow activity upturn, so nothing new here.

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, ~~1 August~~ 5 September 2013

Ladies and gentlemen, ~~the Vice-President and~~ I ~~are~~am very pleased to welcome you to our press conference. ~~We~~I 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. Incoming information ~~has confirmed~~and analysis have further underpinned our previous assessment. Underlying price pressures in the euro area are expected to remain subdued over the medium term. In keeping with this picture, monetary and, in particular, credit dynamics remain subdued. Inflation expectations for the euro area continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. ~~At the same time, recent confidence indicators based on survey data have shown some further improvement from low levels and tentatively confirm the expectation of a stabilisation in economic activity.~~At the same time, real GDP growth in the second quarter was positive, after six quarters of negative output growth, and confidence indicators up to August confirm the expected gradual improvement in economic activity from low levels. Our monetary policy stance continues to be geared towards maintaining the degree of monetary accommodation warranted by the outlook for price stability and promoting stable money market conditions. It thereby provides support to a gradual recovery in economic activity ~~in the remaining part of the year and in 2014~~. Looking ahead, our monetary policy stance will remain accommodative for as long as necessary, in line with the forward guidance provided in July. The Governing Council confirms that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation continues to be based on an unchanged overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the economy and subdued monetary dynamics. In the period ahead, we will monitor all incoming information on economic and monetary developments and assess any impact on the medium-term outlook for price stability. With regard to money market conditions, these have also been influenced by a gradual reduction in excess liquidity. Repayments of funds taken up in the context of the three-year longer-term refinancing operations reflect improvements in financial market confidence, some reduction in financial market fragmentation and the ongoing deleveraging by euro area banks. We will remain particularly attentive to the implications that these developments may have for the stance of monetary policy.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Following a six-quarter economic contraction in the euro area, recent confidence indicators based on survey data have shown some further improvement from low levels and tentatively confirm the expectation of a stabilisation in economic activity at low levels. At the same time, labour market conditions remain weak. Looking ahead to the remainder of the year and to 2014, euro area export growth should benefit from a gradual recovery in global demand, while domestic demand should be supported by the accommodative monetary policy stance as well as the recent gains in real income owing to generally lower inflation.~~ Following six quarters of negative output growth, euro area real GDP rose, quarter on quarter, by 0.3% in the second quarter of 2013. This increase is partly explained by transitory effects related to weather conditions in the first half of this year. Since then, survey-based confidence indicators up to August have improved further from low levels, overall confirming our previous expectations of a gradual recovery in economic activity. Looking ahead to the remainder of the year and to 2014, in line with our baseline scenario, output is expected to recover at a slow pace, in particular owing to a gradual improvement in domestic demand supported by the accommodative monetary policy stance. Euro area economic activity should, in addition, benefit from a gradual strengthening of external demand for exports. Furthermore, the overall improvements in financial markets seen since last summer appear to be gradually working their way through to the real economy, as should the progress made in fiscal consolidation. In addition, real incomes have benefited recently from generally lower inflation. This being said, ~~the remaining~~ unemployment in the euro area remains high, and the necessary balance sheet adjustments in the public and private sectors will continue to weigh on economic activity. ~~Overall, euro area economic activity should stabilise and recover at a slow pace.~~

This assessment is also reflected in the September 2013 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP declining by 0.4% in 2013 and increasing by 1.0% in 2014. Compared with the June 2013 Eurosystem staff macroeconomic projections, the projection for 2013 has been revised upwards by 0.2 percentage point, largely reflecting incoming data. For 2014 there has been a downward revision of 0.1 percentage point.

The risks surrounding the economic outlook for the euro area continue to be on the downside. Recent developments in global money and financial market conditions and related uncertainties may have the potential to negatively affect economic conditions. Other downside risks include ~~the possibility of~~higher commodity prices in the context of renewed geopolitical tensions, weaker than expected ~~domestic and~~ global demand and slow or insufficient implementation of structural reforms in euro area countries.

According to Eurostat's flash estimate, as expected, euro area annual HICP inflation was 1.3% in August 2013, down from 1.6% in ~~July 2013, unchanged from June. Annual~~June and July. On the basis of current assumptions for energy and exchange rate developments, annual inflation rates are ~~currently~~ expected to ~~temporarily fall over~~remain low in the coming months, owing ~~particularly to base effects relating~~in particular to energy price developments ~~twelve months earlier~~. Taking the appropriate medium-term perspective, underlying price pressures are expected to remain subdued, reflecting the broad-based weakness in aggregate demand and the modest pace of the recovery. Medium to long-term inflation expectations continue to be firmly anchored in line with price stability.

This assessment is also reflected in the September 2013 ECB staff macroeconomic projections for the euro area, which foresee annual HICP inflation at 1.5% in 2013 and 1.3% in 2014. In comparison with the June 2013 Eurosystem staff macroeconomic projections, the projection for inflation for 2013 has been revised upwards by 0.1 percentage point, while the projection for 2014 remains unchanged.

The risks to the outlook for price developments are expected to be still broadly balanced over the medium term, with upside risks relating in particular to higher commodity prices as well as stronger than expected increases in administered prices and indirect taxes, ~~as well as higher commodity prices,~~ and downside risks stemming from weaker than expected economic activity.

Turning to the **monetary analysis**, data for July confirm that underlying broad money (M3) and, in particular, credit growth remained subdued~~ in June~~. Annual growth in ~~broad money~~ ~~(~~M3~~)~~ decreased further in ~~June~~July to 2.~~3~~2%, from 2.~~9~~4% in ~~May. Moreover, annual~~ June. Annual growth in M1 remained strong but decreased to 7.1% in July, from 7.5% in June~~, from 8.4% in May.~~. M3 growth continued to be mainly supported by net capital inflows into the euro area, while the annual rate of change of loans to the private sector weakened further. The annual ~~rate of change of loans to the private sector weakened further. While the annual~~ growth rate of loans to households (adjusted for loan sales and securitisation) remained at 0.3% in ~~June~~July, broadly unchanged since the turn of the year~~, the~~. The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was -2.8% in July, compared with -2.3% in June~~, after -2.1% in May~~. Weak loan dynamics continue to reflect primarily the current stage of the business cycle, heightened credit risk and the ongoing adjustment of financial and non-financial sector balance sheets. ~~The bank lending survey for the second quarter of 2013 confirms that borrowers' risk and macroeconomic uncertainty remained the main factors restraining banks' lending policies. At the same time, the degree of net tightening of credit standards for loans to non-financial corporations remained unchanged in the second quarter of 2013, compared with the first quarter, and declined for loans to households.~~

Since the summer of 2012 substantial progress has been made in improving the funding situation of banks and, in particular, in strengthening the domestic deposit base in a number of stressed countries. In order to ensure an adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential that the fragmentation of euro area credit markets declines further and that the resilience of banks is strengthened where needed. Further decisive steps ~~for establishing a Banking Union~~to establish a banking union will help to accomplish this objective.

To sum up, 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.

~~As regards **fiscal policies**, in order to bring debt ratios back on a downward path, euro area countries should not unravel their efforts to reduce government budget deficits.~~In order to further reduce imbalances and to foster competitiveness, growth and job creation, euro area countries need to continue with their reform agenda. As regards **fiscal policies**, governments should not unravel their efforts to reduce deficits and put debt ratios on a downward path. The ~~emphasis~~composition of fiscal consolidation should be ~~on~~geared towards growth-friendly ~~fiscal strategies~~measures which have a medium-term perspective and combine improving the quality and efficiency of public services with minimising distortionary effects of taxation. ~~To reinforce the overall impact of such a strategy, Member States must step up the implementation of the necessary **structural reforms** so as to foster competitiveness, growth and job creation. Removing rigidities in the labour market, lowering the administrative burden and strengthening competition in product markets will particularly support small and medium-sized enterprises. These structural reform measures are essential to bring down the currently high level of unemployment, in particular among the younger citizens of the euro area~~In terms of **economic policies**, product market reforms to increase competitiveness will facilitate the creation of new businesses, support the tradable goods sector and foster job creation, while high unemployment rates require decisive structural reforms to reduce rigidities in labour markets and to increase labour demand.

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