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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Forward guidance is strengthened

- **The ECB reiterates its forward guidance with an increasingly firm voice.**
- **The ECB is willing to take further "decisive action" if required.**
- **The ECB´s stance remains dovish, as the Council continues to observe a fragile and weak recovery.**

As expected, at today's monetary policy meeting the ECB left the key policy rate unchanged at 0.25% and took no additional steps on non-standard measures. The overall tone was dovish as the ECB strengthened its forward guidance using verbal intervention. Draghi strongly pledged that monetary policy would remain "accommodative" as long as necessary. He said that "we used firmer words for indicating the strengthening of our forward guidance, which basically means we reiterate our decisiveness to act if needed." In the statement was included: "we remain determined to maintain the high degree of monetary accommodation and to take further decisive action if required."

As expected, Mr. Draghi remained cautious on the economic outlook, emphasizing that the recovery remains "weak, modest and fragile." He highlighted that there are several risks (financial, economic and geopolitical) that could undermine the current recovery. He highlighted the fact that the recovery is being based exclusively on export growth and is very gradually extending into domestic demand; yet it is "still premature to declare any victory." In response to questions about December´s low inflation levels (eurozone inflation slowed down to 0.8%), Mr. Draghi said they had remained in line with the ECB outlook. He said that technical factors in German inflation data had distorted the eurozone index, adding that the inflation rate would likely remain around its current level in coming months. Despite acknowledging that the Council is aware of potential downside inflationary risks, the ECB president said that he does not see Japan-style deflation and that medium-term inflation risks remain "broadly balanced". On the other hand, risks for the economic outlook continue to be on the downside.

At the press conference, the focus was on the ECB´s future policy actions. Mr Draghi reiterated the Council´s readiness to act if needed, adding for the first time that such action would be "decisive." He also made explicit the two main contingencies that would prompt the central bank to act: unwarranted tightening in money markets and a worse inflation outlook, but he added that "present market developments are okay." Regarding non-standard measures, Mr Draghi said that the Council continues to discuss the merits of different policy tools (which policy is chosen would depend on which of the two broad contingencies materializes). In particular, he stated that "some of these instruments would address more easily a development in the short-term money markets while others would be meant to address broader worsening of our medium-term outlook." The ECB president stressed that the central bank is ready to consider all available instruments allowed by the Treaty.

With regard to the Asset Quality Review, Mr Draghi said that additional information will be provided by the end of January.

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 IS ON POURPOSE)

Mario Draghi, President of the ECB, Frankfurt am Main, ~~5 December 2013~~9 January 2014

Ladies and gentlemen, the Vice-President and I ~~am~~ are very pleased to welcome you to our press conference. ~~I will now report on the outcome of today's meeting of the Governing Council, which was also attended by the Commission Vice-President, Mr Rehn~~ Let me wish you all a Happy New Year. I would also like to take this opportunity to welcome Latvia as the eighteenth country to adopt the euro as its currency. Accordingly, Mr Rimšēvičs, the Governor of Latvijas Banka, became a member of the Governing Council on 1 January 2014. 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. Incoming information and analysis have ~~confirmed~~ continued to confirm our previous assessment ~~and monetary policy decisions of last month~~. Underlying price pressures in the euro area are expected to remain subdued over the medium term. In keeping with this picture, monetary and credit dynamics remain subdued. At the same time, inflation expectations for the euro area over the medium to long term ~~continue to be~~ are firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%. Such a constellation ~~suggests~~continues to suggest that we may experience a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on. ~~Our monetary policy stance~~ Against this background, the Governing Council strongly emphasises that it will ~~remain~~ maintain an accommodative stance of monetary policy for as long as necessary, ~~and~~ which will ~~thereby continue to~~ assist the gradual economic recovery in the euro area. ~~In this context, the Governing Council confirmed its~~ Accordingly, we firmly reiterate our forward guidance that ~~it continues to~~ we continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time. ~~This~~ As previously stated, this expectation ~~continues to be~~ is based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy and subdued monetary dynamics. With regard to money market conditions and their potential impact on our monetary policy stance, we are monitoring developments closely and are ready to consider all available instruments. Overall, we remain determined to maintain the high degree of monetary accommodation and to take further decisive action if required.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Following a rise of 0.3% in the second quarter of 2013, real~~Real GDP in the euro area ~~increased~~ rose by 0.1%, quarter on quarter, in the third quarter of 2013, following an increase of 0.3% in the second quarter. ~~Developments in survey-based confidence indicators up to November are consistent with a positive~~

~~growth rate also in the fourth quarter of the year.~~While developments in industrial production data for October point to a weak start to the fourth quarter, survey-based confidence indicators up to December have improved further from low levels, overall indicating a continuation of the gradual recovery in economic activity. Looking ~~ahead to~~at 2014 and 2015, output is expected to recover at a slow pace, in particular owing to some improvement in domestic demand supported by the accommodative monetary policy stance. Euro area economic activity should, in addition, benefit from a gradual strengthening of demand for exports. Furthermore, the overall improvements in financial markets seen since ~~last year~~ the summer of 2012 appear to be working their way through to the real economy, as should the progress made in fiscal consolidation. In addition, real incomes have benefited recently from lower energy price inflation. At the same time, unemployment in the euro area remains high, and the necessary balance sheet adjustments in the public and the private sector will continue to weigh on economic activity.

~~This assessment is also reflected in the December 2013 Eurosystem staff macroeconomic projections for the euro area, which foresee annual real GDP declining by 0.4% in 2013 before increasing by 1.1% in 2014 and 1.5% in 2015. Compared with the September 2013 ECB staff macroeconomic projections, the projection for real GDP growth for 2013 has remained unchanged and it has been revised upwards by 0.1 percentage point for 2014.~~

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

According to Eurostat's flash estimate, euro area annual HICP inflation ~~increased in November 2013 to 0.9%, from 0.7% in October. The increase~~ was 0.8% in December 2013, compared with 0.9% in November. This outcome was broadly as expected and reflected~~, in particular, an upward base effect in energy prices and higher~~ lower services price inflation. On the basis of prevailing futures prices for energy, annual inflation rates are expected to remain at around current levels in the coming months. Over the medium term, underlying price pressures in the euro area are expected to remain subdued. At the same time, 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%.

~~Broadly in line with this assessment, the December 2013 Eurosystem staff macroeconomic projections for the euro area foresee annual HICP inflation at 1.4% in 2013, at 1.1% in 2014 and at 1.3% in 2015. In comparison with the September 2013 ECB staff macroeconomic projections, the projection for inflation for 2013 has been revised downwards by 0.1 percentage point and for 2014 it has been revised downwards by 0.2 percentage point.~~

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

~~Concerning the staff macroeconomic projections, let me inform you that the Governing Council has decided to publish more details as of December 2013. You will receive this material today after the press conference.~~

Turning to the **monetary analysis**, data for ~~October confirm~~November support the assessment ~~of~~of continued subdued underlying growth in broad money (M3) and credit. Annual growth in M3 ~~moderated to~~was broadly unchanged at 1.5% in November, after 1.4% in October, ~~from 2.0%~~following two consecutive declines in September~~. This moderation was partly related to a base effect.~~ and August. Annual growth in M1 remained strong at 6.~~6~~5%, reflecting a preference for liquidity, although it was below the peak of 8.7% observed in April~~. Net capital inflows into the euro area continued to be~~ 2013. As in previous months, the main factor supporting annual M3 growth~~, while~~ was an increase in the MFI net external asset position, which continued to reflect the increased interest of international investors in euro area assets. The annual rate of change of loans to the private sector remained weak. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.3% in ~~October~~November, broadly unchanged since the beginning of ~~the year.~~2013. The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was -~~2.9% in October, following -2.8% in September and -2.9% in August.~~3.1% in November, following -3.0% in October. Overall, weak loan dynamics for non-financial corporations continue to reflect their lagged relationship with the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets.

Since the summer of 2012 substantial progress has been made in improving the funding situation of banks. 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. The ~~ECB's~~forthcoming comprehensive assessment ~~before it adopts its supervisory role under~~by the ~~single supervisory mechanism~~ ECB will further support this confidence-building process. It will enhance the quality of information available on the condition of banks and result in the identification and implementation of necessary corrective actions. ~~Further decisive~~ A timely implementation of further steps to establish a banking union will help to restore confidence in the financial system.

To sum up, the economic analysis indicates that we may experience a prolonged period of low inflation, to be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on. A **cross-check** with the signals from the monetary analysis confirms this picture.

~~As regards **fiscal policies**, the Governing Council welcomes the European Commission's assessment of the 2014 draft budgetary plans which were submitted in October for the first time under the "two-pack" regulations. This new surveillance exercise needs to be fully effective. In order to put high public debt ratios on a downward path, governments should not unravel their efforts to reduce deficits and sustain fiscal adjustment over the medium term. In particular, consolidation measures should be growth-friendly and have a medium-term perspective, so as both to improve public services and minimise the distortionary effects of taxation. At the same time, there is a need to push ahead with **product and labour market reforms**, in order to improve competitiveness, raise potential growth, generate employment opportunities and foster the adaptability of our economies.~~

As regards **fiscal policies**, it is important not to unravel past efforts but to sustain fiscal consolidation over the medium term. Fiscal strategies should be in line with the fiscal compact and should ensure a growth-friendly composition of consolidation which combines improving the quality and efficiency of public services with minimising distortionary effects of taxation. When accompanied by the decisive implementation of **structural reforms**, this will further support the gradual economic recovery in the euro area and have a positive impact on public finances. Reforms in product and labour markets and a rigorous enactment of Single Market policies warrant particular focus to improve the outlook for economic growth and to foster job creation in an environment of high unemployment.

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