Economic Research Department

BBVA

EMU

ECB Watch

Meeting: June 4th 2009
Next meeting: July 2nd 2009

Dampening QE

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- **As expected, the ECB left key interest rates unchanged today, maintaining the *refi* rate at 1%.**
- **Details of the € 60bn covered bond programme were disclosed, but the ECB expects that this injection will be sterilised through less demand for other sources of liquidity.**
- **ECB Staff projections for GDP in 2009 were adjusted to the bad incoming data; apart from that, the outlook for output and inflation does not change much for 2010.**
- **We maintain our expectation of further rate cuts after the summer.**

When last month the ECB lowered the *refi* rate to 1%, Mr Trichet made clear that they were taking into account the very negative outlook for activity that was going to be incorporated in this month's Staff projections, implying that we should not expect a further cut this month. This has been the case, as the ECB has cut its projections for GDP in 2009 very substantially (see table), but has not changed key interest rates, and maintains the assertion that current levels are "appropriate", taking into account "our decisions of early May, including the enhanced credit support measures" (i.e., the covered bond programme). The ECB continues to say that they have not taken further decisions on the interest rate floor, implying they are open to further cuts in case they are necessary. In both respects, there are no news from what was announced last month and what was expected for this one.

The ECB sees growth "much less negative" for the coming quarters than for the first one, and expects growth to become positive "by mid-2010". Overall, despite the negative growth expected for 2010, Mr Trichet made the effort to interpret it positively as an average effect from a flat first semester, together with a negative carryover form the second half of 2009 and positive growth in the second half of the year. Risks to this outlook are "broadly balanced" for the ECB: higher effect from stimulus so far and stronger confidence on the upside, against, on the downside, the usual negative risks (protectionism, financial turmoil, disorderly correction of global imbalances) and now also "more unfavourable developments in labour markets".

Inflation projections are basically unchanged from March, as price dynamics have been mostly determined by base effects from energy prices and the surprises have been relatively minor. The ECB's projection of inflation for 2010 (1%) which seemed to us low at the time coincides now with our forecast. Risks to inflation are also broadly balanced for the

Eurosystem Staff Macroeconomic Projections for the Euro Area

	March 09		June 09	
	2009	2010	2009	2010
GDP	-2,7	0,0	-4,6	-0,3
HICP	0,4	1,0	0,3	1,0

Average annual percentage changes
Source: ECB

ECB (lower activity on the downside and higher commodity prices on the upside). When asked, Mr Trichet said they continue to see risks of deflation quite far away (we are less optimistic on this point), underlying that medium-term inflation expectations continue to be close to 2%.

The main focus of attention this month was centred on the “technicalities” of the purchase programme for covered bonds and the **possible clues for a further extension of this to larger quantities and/or other assets**. On this second point, Mr Trichet did not say much (“We have decided to embark on 60-billion euro purchase of covered bonds. Full stop”, “no other decision at this stage”). **This lack of information on future moves** could be seen as a way of avoiding the damaging debate among ECB council members last month on eventual extensions of the programme (contaminated now by the recent remarks by German Chancelor Ms Merkel, on which Mr Trichet was repeteadly asked today) while leaving the door open to future decisions, although at the moment we do not see the ECB prone to a further expansion.

This view is strengthened by the comments by Mr Trichet about sterilization. The ECB expects that this injection will be “automatically” sterilized by the markets through less demand of other sources of liquidity. In case this does not happen, they will decide what measures to take. This suggests that the ECB does not expect the purchase programme to result in a net expansion of the balance (“we are not embarking in quantitative easing”) and that therefore they are not thinking in expanding a measure which is very small in magnitude (0.7% of GDP). The calendar provided for the operation (from July this year to June 2010) is very long as well and points in the same direction.

Other details from the programme are also relevant: the ECB will buy both in the primary and secondary markets (when asked, Mr Trichet did not say in what proportions, a detail which could be relevant because primary markets are concentrated in a few countries), and will buy assets that include exposure to both private and private entities. The requirements the type of bonds included in the programme (UCITS-compliant but not only, a minimum rating of AA but not lower than BBB-) do not seem very restrictive.

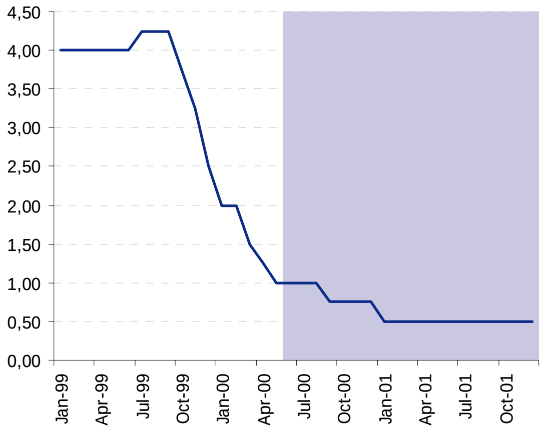
Markets’ reaction

Two year government bond yields rose from 1.43% to 1.51%, while ten year bonds rose by 6 bp to 3.64. The euro appreciated against the dollar by 0.7% to 1.419 (similar to the closing from the previous day), while the Eonia curve firmed up substantially. Now markets foresee rates between 0.75% and 1% by the end of the year.

Conclusion

Overall, the ECB fulfilled our expectations on the pace of interest rate cuts (i.e. a pause despite lower growth projections, no floor determined), although we think that there is margin for further cuts, given that core inflation is low enough and the risks to activity are large enough such that deflation risks are not negligible. For the same reason, we would have also preferred to see more readiness to embark in further QE measures and less willingness to sterilize the one approved today. Our current view on growth and inflation is not dissimilar to the one by the ECB, but our balance of risks is clearly more downbeat. We continue to forecast two 25 bp rate cuts for the Autumn and early 2010.

ECB: Official repo rate



Source: ECB

Box: ECB Statements

	March 5th	April 2nd	May 7th	June 4th	Concluding remarks*
Monetary policy stance	We **will monitor very closely all developments** over the period ahead	We **will monitor very closely all developments** over the period ahead	We will monitor very closely all developments. **Rates are appropriate**	We will continue to monitor very closely all developments. **Rates are appropriate**. The GC will **ensure that the measures taken can be quickly unwound and the liquidity provided absorbed**.	**Monitor very closely.**
Growth	**Severe downturn in economic activity**. They projected gradual recovery in 2010 reflects the effects of the substantial macroeconomic stimulus under way as well as the extensive policy measures... to restore the functioning of financial markets. **The risks... now appear to be more balanced.**	**Severe downturn in economic activity**. They projected gradual recovery in 2010 reflects the effects of the substantial macroeconomic stimulus under way as well as the extensive policy measures... to restore the functioning of financial markets. **The risks are being broadly balanced.**	**Economic activity in Q109 was significantly weaker than expected**. More recently, there have been some tentative signs in survey data of stabilization, but at very low levels. Gradually recovering in the course of 2010. **The risks remain broadly balanced.**	Fresh confidence data indicate that **economic activity over the remainder of this year is expected to decline at much less negative rates**. After a stabilization phase, **positive quarterly growth rates are expected by mid-2010**. This assessment incorporates adverse lagged effects, such as a **further deterioration in labor markets**.	**Activity in coming quarters is expected to decline at much less negative rates. Risks are balanced**
Inflation	**Inflation rates have decreased significantly** and are now **expected to remain well below 2% over 2009 and 2010**... Primarily reflects... commodity prices. However, signs of a more broad-based reduction are also increasingly emerging	**Inflation rates have decreased significantly** and are now **expected to remain well below 2% over 2009 and 2010**... Primarily reflects... commodity prices. However, signs of a more broad-based reduction are also increasingly emerging	Signs of a more broad-based **reduction in inflationary pressure are increasingly emerging**. HICP annual rates will decline further and temporary remaining at negative levels for some months by mid year. Thereafter, they will increase again, **remaining positive but below 2% in 2010**	The further decline in inflation rates was fully anticipated**, projecting further declines to negative rates in coming months, before returning to positive territory by the end of 2009**.	**Negative inflation rates by mid-year, remaining well below 2% in 2010. Inflation expectations remain firmly anchored**
Risks	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	Risks to these projections are **broadly balanced**. They relate in particular to the **risks to the outlook for economic activity as well as to risks to commodity prices.**	**Broadly balanced**
Monetary analysis	The monetary analysis confirms that inflationary pressure has been diminishing... **Ongoing deceleration in the underlying pace of monetary expansion**... Despite the tensions in financial markets**, the transmission mechanism of monetary policy is not significantly hampered in the euro area**	**The pace of monetary expansion in the euro area has continued to decelerate markedly** and supports the assessment of **diminishing risk to price stability** in the medium-term.	**Continued deceleration in the pace of underlying monetary expansion**, supporting the assessment of **diminishing inflationary pressures** in the medium term.	**Continued deceleration in the pace of underlying monetary expansion** and thus support **the assessment of moderate inflationary pressures**.	**Continued deceleration in the underlying pace of monetary expansion. Moderate inflationary pressures**
Movement	-0.50	-0.25	-0.25	0.00	
“Refi” rate	1.50	1.25	1.00	1.00	

* BBVA interpretation of the ECB opinion according the statement and the press conference

Relevant events before the next ECB meeting (July 2nd)

June, 12	Euro Area industrial production, April
June,15	Euro Area employment, Q1/09
June, 16	Euro Area labour cost index, Q109
June, 16	Euro Area inflation, May
June, 17	Euro Area trade balance, April
June, 17	Euro Area construction output, April
June, 25	Euro Area industrial new orders, April
June, 29	Euro Area business and consumer survey, June
June, 29	Euro Area flash estimate inflation, June
July, 1	Euro Area monetary aggregates, May
July, 1	Euro Area PMI, June
July, 2	Euro Area unemployment, May
July, 2	Euro Area industrial producer prices, May