



ECB Watch

Meeting: September 3rd 2009

Next meeting: October 8th 2009

Über-prudence

- The ECB maintained its key rates unchanged and remained very cautious in the face of recent relatively positive news, even more than we expected.
- It was announced that the next 12-month long-term refinancing operation will be held at the prevalent refi rate.
- Staff projections were revised upwards, both for inflation and growth, but changes were modest as we expected.

The main point of interest for this meeting was the attitude of the ECB (also embedded in their macroeconomic projections) in front of the upwards surprise in growth for the second quarter and to relatively positive incoming news for the third quarter. Given recent declarations by Governing Council (GC) members, we were waiting for a cautious approach, which has been more than fulfilled. The revision of projections is relatively modest, but especially the language of Mr Trichet was crystal-clear: “Uncertainty is higher than usual”; “prudence and caution is of the essence”; “the worst possible attitude would be to say that now financial markets are functioning... It would be absolutely wrong, plain wrong, we have to do the job”; “even at the global level I would say that prudence and caution remain of the essence”.

We were also expecting some signal that conditions for the next long-term full allotment auction on September 30th would not be strengthened, and indeed the Statement included an announcement in the first paragraph of its Statement saying that the rate will be the prevalent will be the *refi* rate.

Apart from that, the press conference was interesting in that most of the questions were looking for details on the exit strategy by the ECB, but Mr Trichet only said that it is not time yet, and that non standard measures are designed to ensure a rapid exit. “Today it isn’t time to exit”.

Some details:

- The ECB sees signs of “stabilization on activity”. GDP growth is expected to be around -4.1% in 2009 and +0.2% in 2010, up from -4.6% and -0.3%. The 0.5pp revision for 2009 reflects incoming information, both from national accounts for Q2 and from surveys for Q3. The ECB is unlikely to have changed much its quarterly estimate for Q4. The revision for 2010, also 0.5pp (to 0.2%), reflects partly the carryover effect from changes in 2009 and a very likely a couple of decimal points of higher growth for that year. When asked if the ECB sees now positive growth before

Miguel Jiménez

mjimenezg@grupobbva.com

Agustín García Serrador

agustin.garcia@grupobbva.com

Eurosystem Staff Macroeconomic Projections for the Euro Area

	June 2009		September 2009	
	2009	2010	2009	2010
Real GDP	-5.1 — -4.1	-1.0 — 0.4	-4.4 — -3.8	-0.5 — 0.9
HICP	0.1 — 0.5	0.6 — 1.4	0.2 — 0.6	0.8 — 1.6

Source: ECB

mid-2010 (its reference date for several months), Mr Trichet he did not discard it, but he did not discard either a “bumpy road” with “less flattering” quarterly rates after positive ones. He fell short of mentioning “negative rates” of “W-recovery”.

- The risks around these projections are balanced, but interestingly, the unemployment rate, which as a downward risk in the previous Statement is now a positive risk. Higher than expected exports, in line with what we are currently seeing, are also a new positive risk to activity.
- Inflation projections change upwards very slightly, by 0.1pp and 0.2pp, respectively, for 2009 and 2010, to 0.3% and 1.2%. This likely reflects higher growth. For 2010 we think inflation will be lower (closer to 0.5%), given the high output gap open for the euro area. Risks to inflation, for the ECB, are also balanced.
- On the analysis of money and credit aggregates, the ECB remarked again that the volatility within M3 and between M3 and other assets reflects changing relative prices. On loans to the business sector, which are very weak, the ECB basically says is a demand effect due to “strong net redemption of loans with a shorter maturity” due to the fall in production and trade. Due to usual lags, the ECB still expects further weakness in months to come.
- On fiscal policies, the ECB included again a reference in the statement underlying that the projected pace of structural tightening of 0.5% per annum is too slow. At least 1% is needed. Nonetheless, prudence remains key: “Of course it [fiscal stimulus] will have to be unwound when the time comes”.
- A new reference in the Statement signals that potential growth in the euro area will likely be affected by the financial crisis. Structural policies are needed to lift it, including “appropriate restructuring and consolidation of the banking sector... Sound balance sheets, solid risk management, and transparent and robust business models”.

Markets' reaction

Three-month interest rate' contracts for September, December and June moved downwards 7bp, while the euro depreciated against the US dollar by 0.4% to 1.426 as a consequence of the announcement.

Conclusion

The caution shown by the ECB goes broadly in line with our assessment of the situation. The recent positive news to activity reflect probably earlier and stronger than expected impact from stimulus measures and positive surprises from net exports, but a self-sustained recovery is very far from certain. It is far too early to talk about an exit strategy, and in fact we see negative growth rates in early 2010 once most of the impetus wanes.

The timing of our projection of drops in rates in December is now more uncertain than before, although we continue to see pressures for lower interest rates to 0.5%, given our forecast of slightly negative growth in H110, and in any case very low rates for a protracted period.

Box: ECB Statements

	June 4 th	July 2 nd	August 6 th	September 3 rd	Concluding remarks*
Monetary policy stance	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.	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.	We will continue to ensure a firm anchoring of medium term inflation expectations. Rates are appropriate. The GC will ensure that the measures taken can be quickly unwound and the liquidity provided absorbed.	Rates remain appropriate. The GC will make sure that measures taken are unwound in a timely fashion and the liquidity provided absorbed.	Monitor very closely.
Growth	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.	Economic activity over the remainder of this year is expected to remain weak but should decline less strongly than was the case in Q109. Looking ahead into next year, after a phase of stabilization, a gradual recovery with positive quarterly growth rates is expected by mid-2010.	Looking ahead into next year, after a phase of stabilization, a gradual recovery with positive quarterly growth rates is expected by mid-2010.	Recent data are consistent with the expectation that the significant contraction in economic activity has come to an end and is now followed by a period of stabilization and very gradual recovery.	Cautious sentiment. Risks are balanced
Inflation	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.	The fall of annual inflation rates into negative territory in June is in line with previous expectations and they are projected to remain temporarily in negative territory over the coming months, before turning positives again.	The fall of annual inflation rates into negative territory in July is in line with expectations and they are projected to remain temporarily in negative territory over the coming months, before turning positive again. later this year	Owing to base effects, annual inflation rates are projected to turn positive again within coming months. Inflation forecasts from ECB Staff have been revised slightly upwards.	Inflation rates will remain 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. Cautious interpretation of available information.	Broadly balanced
Monetary analysis	Continued deceleration in the pace of underlying monetary expansion and thus support the assessment of moderate inflationary pressures.	Continued deceleration in monetary dynamics, supporting the assessment of a slower underlying pace of monetary expansion and low inflationary pressures over the medium term.	Continued deceleration in monetary dynamics, supporting the assessment of a slower underlying pace of monetary expansion and low inflationary pressures over the medium term.	Continued deceleration in both broad money and credit growth. Gradual improvement in financing conditions and lower market interest rates should support the demand for credit in the period ahead.	Continued deceleration in the underlying pace of monetary expansion. Low inflationary pressures
Movement	0.00	0.00	0.00	0.00	
“Refi” rate	1.00	1.00	1.00	1.00	

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

Relevant events before the next ECB meeting (October 8th)

September, 14	Euro Area industrial production, July
September, 14	Euro Area employment, Q2/09
September, 14	Euro Area labour cost, Q2/09
September, 16	Euro Area inflation, August
September, 17	Euro Area trade balance, July
September, 17	Euro Area construction output, July
September, 23	Euro Area industrial new orders, July
September, 29	Euro Area monetary aggregates, August
September, 29	Euro Area business and consumer survey, September
September, 30	Euro Area flash estimate, September
October, 1	Euro Area unemployment, August
October, 2	Euro Area industrial producer prices, August
October, 5	Euro Area retail trade, August
October, 5	Euro Area PMI, September
October, 7	Euro Area national accounts, Q2/09 second release