

Europe

ECB Watch

Madrid, 4 November 2010

Economic Analysis

Europe

Miguel Jiménez González-Anleo
mjimenez@grupobbva.com
+34 91 537 37 76

Agustín García Serrador
agustin.garcia@grupobbva.com
+34 91 537 79 38

Financial Scenarios
Sonsoles Castillo
s.castillo@grupobbva.com
+34 91 374 44 323

María Martínez Álvarez
maria.martinez.alvarez@grupobbva.com
+34 91 537 66 83

Javier Amador
javier.amador@grupobbva.com
+34 91 537 3161

Cristina Varela Donoso
cvarela@grupobbva.com
+34 91 537 7825

Victoria de Zuriarrain
victoria.zuriarrain@grupobbva.com
+34 91 537 7584

Leanne Ryan
leanne.ryan@grupobbva.com
+34 91 537 8432

Focus on Economic Governance

- The main novelty in the statement was an added paragraph on the reform of the EU's economic governance which "does not go as far" as the Governing Council has been calling for. In the Q&A session Trichet's tone on this subject was tough
- The ECB chairman deferred any decision on liquidity at least until the next meeting
- In contrast with last month's Q&A, Mr. Trichet placed less focus on and showed less concern about euro appreciation pressures

Bottom line: The ECB announced that the monetary policy stance had been left unchanged. Despite the Fed's announcement of a new round of quantitative easing (QE2) and the possibility of taking more action by adjusting the pace and overall size of QE2 if needed, with the euro at \$1.42 for the first time since January, and in a context of renewed tensions in peripheral spreads, the language of the ECB released statement does not show any shift in a dovish direction.

Although Mr. Trichet did not comment on the impact of the extra liquidity from QE2 on the ECB policy decisions –he only referred to the subject with a hawkish bias by stating in the Q&A session that the additional monetary stimulus would raise commodity prices–, the Fed's stance is causing further declines in the dollar. Our view is that cumulative appreciation of the euro could be damaging for growth prospects, and thus, the Governing Council will likely be increasingly concerned with the downside risks to the economic outlook. Another factor that will become progressively more important is sovereign risk. In that context, they should be cautious and perhaps in coming meetings start to make some wording changes.

The ECB chairman put less emphasis on the phasing-out of non-standard measures and delayed any decision on liquidity at least until the next meeting. Our view is that the impact from QE2's extent and timing –ie, monthly purchases until the end of 2Q11– might influence the ECB and force them to announce the extension of the full-allotment in December to a similar time horizon.

Liquidity: The ECB chairman deferred any decision on liquidity at least until the next meeting. Trichet put less emphasis on the phasing-out of non-standard measures –other than insisting that they are transitory by nature. In our view they will announce the extension of the full allotment in the next meeting in the December. The liquidity normalization is occurring at a slow pace, the use of deposit facility by EMU banks is decreasing, however the provision of liquidity in LTRO and MROS has remained at high levels in the last month (since the decline in September when after 12M, 6M and 3M LTROs matured). Specifically the last LTRO auction had both a relatively high demand and a large amount of bidders; 42.5 bn and 132 institutions bidding, in contrast the same week another 23 bn LTRO maturity took place, and demand was 20 bn higher. Taking this into account and the fact that on average demand is higher this month at MROs auctions than last month's, we can state that the ECB is the only mean to get liquidity for certain financial institutions and that of course the situation is still far from normalising.

Money markets: Regarding money markets, Mr. Trichet's comments on the recent rise in EONIA rates suggest that the Governing Council is neutral (he said that "it shows we are in a normalising process" and observed that volumes were now much higher when he pointed out that movements depend "on the decisions of the banks themselves"), confirming our view that the ECB seems comfortable with this environment.

Government bond purchases program: Mr Trichet remarked that they launched the program in May to help restore a normal functioning of the monetary transmission mechanism. When he was asked about their intention to finish the program (this is the third week in a row in which the ECB has made no bond purchases) he did not rule out the end of the program and he implicitly signalled that they are buying bonds this week (to a specific question he answered “you will see that the program exists” with the publication of data next Monday). This is not surprising considering the upturn in some peripheral spreads.

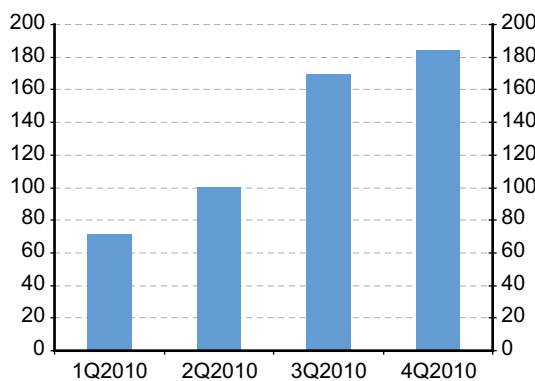
European Union’s Economic Governance: The main novelty in the statement was an added paragraph on the reform of the EU’s economic governance. In the Q&A, his tone was tough on this subject. The statement expressed that the ECB is concerned about “insufficient automaticity in the implementation of fiscal surveillance.” This reflects recent tensions between the Franco-German position on the issue, which favours a political decision on fiscal sanctions to individual countries but a tough crisis resolution mechanism, against the position of the Commission (supported by Mr Trichet) which prefers to give more weight to early intervention and automatic sanctions, with no political interference.

Exchange rates: In contrast with last month’s Q&A, he placed less focus and showed less concern on euro appreciation pressures.

On activity: Regarding economic activity and credit growth, the tone remains cautious but slightly more positive, with no reference to weak money and credit growth in the summary paragraph (in contrast to previous months). The wording to the key issue of loans to non-financial corporations is more positive, with a reference to a turning point that was not there in previous statements.

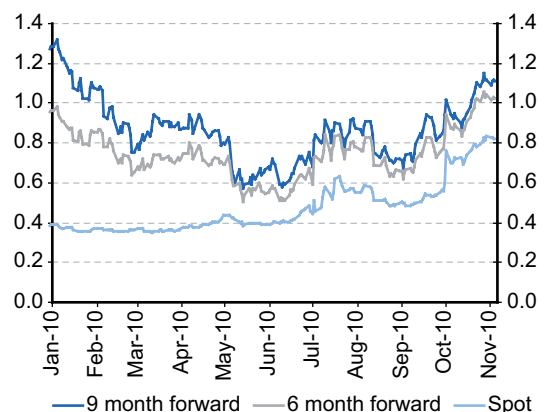
Market reaction: The market reaction was muted. Stocks, bonds and the euro did not appear to respond to the statement and the Q&A session. The euro is close –slightly below– to \$1.42.

Chart 1
MROs: Average weekly allotment



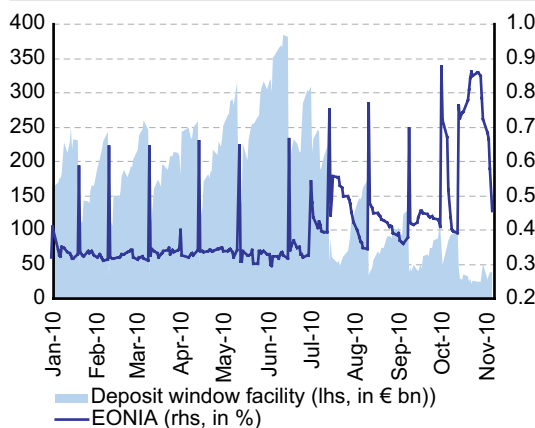
Source: BBVA Research

Chart 2
OIS 3 month rates implicit in OIS swaps



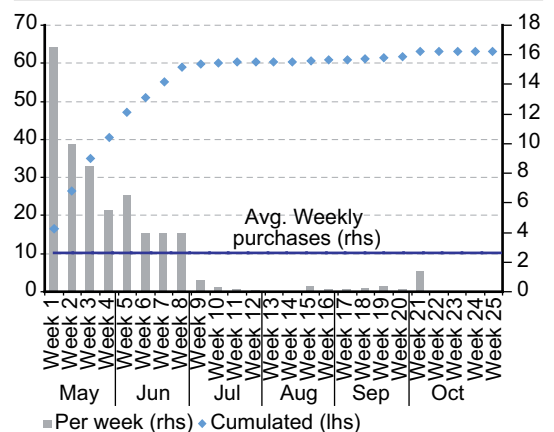
Source: Datatream and BBVA Research

Chart 3
ECB deposit window facility and Eonia



Source: Bloomberg and BBVA Research

Chart 4
ECB: sovereign bond purchase program



Source: ECB

Annex 1: Tracking the changes...

Jean-Claude Trichet, President of the ECB,
Vitor Constâncio, Vice-President of the ECB
Frankfurt am Main, ~~10 October~~ 4 November 2010

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.

Based on its regular economic and monetary analyses, the Governing Council continues to view the current **key ECB interest rates** as appropriate. It therefore decided to leave them unchanged. ~~Considering~~ Taking into account all the new information and analyses which have become available since our meeting on ~~2 September~~ 7 October 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon. Recent economic data are consistent with our ~~expectation~~ assessment that the underlying momentum of the recovery ~~should proceed at a moderate pace in the second half of this year, with the underlying momentum remaining~~ remains positive. At the same time, uncertainty is ~~still~~ still prevailing. Our monetary analysis confirms that inflationary pressures over the medium term remain contained, ~~as suggested by weak money and credit growth~~. We expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations remains of the essence.

Overall, the current monetary policy stance remains accommodative. The stance, the provision of liquidity and the allotment modes will be adjusted as appropriate, taking into account the fact that all the non-standard measures taken during the period of acute financial market tensions are fully consistent with our mandate and, by construction, temporary in nature. Accordingly, the Governing Council will continue to monitor all developments over the period ahead very closely.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. ~~Euro area real GDP grew strongly on a quarterly basis, increasing by 1.0% in the second quarter of 2010, supported mainly by domestic demand, but partly reflecting temporary factors.~~ Recent statistical data releases and survey evidence generally confirm our ~~expectation of a moderation in the second half of this year in the euro area and elsewhere.~~ Nevertheless, view that the positive underlying momentum of the economic recovery in the euro area remains in place. In line with previous expectations, this implies ongoing real GDP growth in the second half of this year. The global recovery is expected to ~~go on~~ proceed, and this should imply a continued positive impact on the demand for euro area exports. At the same time, private sector domestic demand should ~~gradually strengthen further~~ contribute to growth, supported by the accommodative monetary policy stance and the measures adopted to restore the functioning of the financial system. However, the recovery in activity is expected to be dampened by the process of balance sheet adjustment in various sectors.

In the Governing Council's assessment, the risks to this economic outlook are still slightly tilted to the downside, with uncertainty ~~still~~ still prevailing. On the one hand, global trade may continue to grow more rapidly than expected, thereby supporting euro area exports. On the other hand, some concerns remain relating to the re-emergence of ~~renewed~~ tensions in financial markets. In addition, downside risks relate to renewed increases in oil and other commodity prices, ~~and~~ and protectionist pressures, ~~as well as~~ and the possibility of a disorderly correction of global imbalances.

With regard to price developments, as anticipated, euro area annual HICP inflation ~~was~~ rose to 1.89% in ~~September~~ October, according to Eurostat's flash estimate, compared with 1.68% in August. ~~The increase in inflation was anticipated and reflects base effects mainly stemming from the energy component.~~ September. In the next few months HICP inflation rates will hover around current levels before moderating again in the course of next year. Overall, in 2011 inflation rates should remain moderate, ~~benefiting from low domestic price pressures~~. Inflation expectations over the medium to longer term continue to be firmly anchored in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.

Risks to the outlook for price developments are slightly tilted to the upside. They relate, in particular, to the evolution of energy and non-oil commodity prices. Furthermore, increases in indirect taxation and administered prices may be greater than currently expected, owing to the need for fiscal consolidation in the coming years. At the same time, risks to domestic price and cost developments are still expected to be contained.

Turning to the **monetary analysis**, the annual growth rate of M3 ~~rose to 1.1% in August 2010, from 0.2% in July.~~ was broadly unchanged, at 1.0% in September 2010, after 1.1% in August 2010, from 0.2% in July. The annual growth rate of loans to the private sector ~~also rose, standing, at 1.2%, after 0.8% in the previous month.~~ also rose, standing, at 1.2%, after 0.8% in the previous month. In both cases, the rise reflects relatively strong monthly flows. The still low growth rates continue remained unchanged from August. Looking beyond developments in individual months, broad money and loan growth remains low and continues to support the assessment that the underlying pace of monetary expansion is moderate and that inflationary pressures over the medium term are contained.

~~The yield curve has remained fairly steep, but the downward impact of this on monetary growth is gradually waning. Moreover, while spreads~~ The annual growth rate of M1 has continued to moderate, standing at 5.9% in September 2010, while the annual growth rate of other short-term deposits has become less negative. This reflects the widening spread between ~~different short-term interest rates are still generally narrow, they have been widening somewhat between rates~~ paid on short-term time deposits and those paid on overnight deposits. ~~As a result, the annual growth rate of M1 has continued to moderate from high levels, and stood at 7.7% in August 2010, while the annual growth rate of other short term deposits has become less negative.~~

~~The rise in the annual growth rate of bank loans to the non-financial private sector reflects both a further slight increase in the positive growth of loans to households and a gradually less negative annual growth rate in loans to~~ is increasingly supported by the flow of loans to non-financial corporations. The ~~latest annual growth rate of these loans is still slightly negative, but developments are in recent months suggest that a turning point was reached earlier in 2010. This would be~~ consistent with the lagged response of loan developments to economic activity over the business cycle that was also observed in past cycles. The annual growth rate of loans to households stood at 2.8% in September and thereby remained at levels seen in previous months.

Banks have continued to gradually ~~increased~~ increase the weight of credit to the private sector in the overall size of their balance sheets ~~recently~~, but the challenge remains ~~for banks to expand the availability of such credit to the non-financial sector~~ when demand picks up further. Where necessary, to address this challenge, banks should retain earnings, turn to the market to strengthen further their capital bases or take full advantage of government support measures for recapitalisation.

To sum up, the current key ECB interest rates remain appropriate. We therefore decided to leave them unchanged. ~~Considering~~ Taking into account all the new information and analyses which have become available since our meeting on ~~2 September~~ 7 October 2010, we continue to expect price developments to remain moderate over the policy-relevant medium-term horizon. Recent economic data are consistent with our ~~expectation~~ assessment that the underlying momentum of the recovery ~~should proceed at a moderate pace in the second half of this year, with the underlying momentum remaining~~ remains positive. At the same time, uncertainty is ~~still~~ prevailing. A **cross-check** of the outcome of our economic analysis with that of the monetary analysis confirms that inflationary pressures over the medium term remain contained, ~~as suggested by weak money and credit growth~~. We expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households. Inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations remains of the essence.

Turning to **fiscal policies**, ~~we take note of the recent announcements made in some euro area countries with regard to measures to tackle the existing fiscal imbalances. Indeed, there is a number of countries have to meet major challenges, and immediate, ambitious and convincing corrective action is required. Credible multi-year consolidation plans are needed and will~~ clear need to strengthen public confidence in the capacity of governments to return to sustainable public finances, reduce risk premia in interest rates and thus support sustainable growth over the medium term. ~~For all euro area countries, the 2011 budgets need to reflect the commitment to ambitious fiscal consolidation in line with countries' pledges under the excessive deficit procedures. To this end, it is essential that countries pursue credible multi-year consolidation plans and fully implement the planned consolidation measures. In their 2011 budgets, they need to specify credible fiscal adjustment measures, focusing on the expenditure side.~~ Any positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected environment, should be exploited to make faster progress with fiscal consolidation.

The urgent implementation of far-reaching **structural reforms** is essential to enhance the prospects for higher sustainable growth. Major reforms are particularly ~~needed~~ necessary in those countries that have experienced a loss of competitiveness in the past or that are suffering from high fiscal and external deficits. The removal of labour market rigidities and the strengthening of productivity growth would further support the adjustment process of these economies. Increasing product market competition, particularly in the services sectors, would also facilitate ~~industrial~~ the restructuring of the economy and encourage innovation and the adoption of new technologies.

At their meeting on 28-29 October 2010 the EU Heads of State and Government agreed on the reform of the European Union's economic governance. The proposals put forward by President Van Rompuy represent a strengthening of the existing framework for fiscal and macroeconomic surveillance in the European Union. However, the Governing Council considers that they do not go as far as the quantum leap in the economic governance of Monetary Union that it has been calling for.

In particular, the Governing Council is concerned that there would be insufficient automaticity in the implementation of fiscal surveillance, that there is no specification of the rule to reduce the government debt ratio, and that financial sanctions have not been explicitly retained under the macroeconomic surveillance procedure.

With regard to the macroeconomic surveillance procedure in particular, the new system of mutual surveillance would need to concentrate firmly on euro area countries experiencing sustained losses of competitiveness and large current account deficits. It should be determined by transparent and effective trigger mechanisms. It would be essential that the assessments of macroeconomic imbalances and recommendations for corrective action be given broad publicity at all stages of the surveillance process.

The public and the markets can be confident that the Governing Council remains firmly committed to delivering on its mandate of maintaining price stability over the medium term.

DISCLAIMER

This document and the information, opinions, estimates and recommendations expressed herein, have been prepared by Banco Bilbao Vizcaya Argentaria, S.A. (hereinafter called "BBVA") to provide its customers with general information regarding the date of issue of the report and are subject to changes without prior notice. BBVA is not liable for giving notice of such changes or for updating the contents hereof.

This document and its contents do not constitute an offer, invitation or solicitation to purchase or subscribe to any securities or other instruments, or to undertake or divest investments. Neither shall this document nor its contents form the basis of any contract, commitment or decision of any kind.

Investors who have access to this document should be aware that the securities, instruments or investments to which it refers may not be appropriate for them due to their specific investment goals, financial positions or risk profiles, as these have not been taken into account to prepare this report. Therefore, investors should make their own investment decisions considering the said circumstances and obtaining such specialized advice as may be necessary. The contents of this document is based upon information available to the public that has been obtained from sources considered to be reliable. However, such information has not been independently verified by BBVA and therefore no warranty, either express or implicit, is given regarding its accuracy, integrity or correctness. BBVA accepts no liability of any type for any direct or indirect losses arising from the use of the document or its contents. Investors should note that the past performance of securities or instruments or the historical results of investments do not guarantee future performance.

The market prices of securities or instruments or the results of investments could fluctuate against the interests of investors. Investors should be aware that they could even face a loss of their investment. Transactions in futures, options and securities or high-yield securities can involve high risks and are not appropriate for every investor. Indeed, in the case of some investments, the potential losses may exceed the amount of initial investment and, in such circumstances, investors may be required to pay more money to support those losses. Thus, before undertaking any transaction with these instruments, investors should be aware of their operation, as well as the rights, liabilities and risks implied by the same and the underlying stocks. Investors should also be aware that secondary markets for the said instruments may be limited or even not exist.

BBVA or any of its affiliates, as well as their respective executives and employees, may have a position in any of the securities or instruments referred to, directly or indirectly, in this document, or in any other related thereto; they may trade for their own account or for third-party account in those securities, provide consulting or other services to the issuer of the aforementioned securities or instruments or to companies related thereto or to their shareholders, executives or employees, or may have interests or perform transactions in those securities or instruments or related investments before or after the publication of this report, to the extent permitted by the applicable law.

BBVA or any of its affiliates' salespeople, traders, and other professionals may provide oral or written market commentary or trading strategies to its clients that reflect opinions that are contrary to the opinions expressed herein. Furthermore, BBVA or any of its affiliates' proprietary trading and investing businesses may make investment decisions that are inconsistent with the recommendations expressed herein. No part of this document may be (i) copied, photocopied or duplicated by any other form or means (ii) redistributed or (iii) quoted, without the prior written consent of BBVA. No part of this report may be copied, conveyed, distributed or furnished to any person or entity in any country (or persons or entities in the same) in which its distribution is prohibited by law. Failure to comply with these restrictions may breach the laws of the relevant jurisdiction.

This document is provided in the United Kingdom solely to those persons to whom it may be addressed according to the Financial Services and Markets Act 2000 (Financial Promotion) Order 2001 and it is not to be directly or indirectly delivered to or distributed among any other type of persons or entities. In particular, this document is only aimed at and can be delivered to the following persons or entities (i) those outside the United Kingdom (ii) those with expertise regarding investments as mentioned under Section 19(5) of Order 2001, (iii) high net worth entities and any other person or entity under Section 49(1) of Order 2001 to whom the contents hereof can be legally revealed.

The remuneration system concerning the analyst/s author/s of this report is based on multiple criteria, including the revenues obtained by BBVA and, indirectly, the results of BBVA Group in the fiscal year, which, in turn, include the results generated by the investment banking business; nevertheless, they do not receive any remuneration based on revenues from any specific transaction in investment banking.

BBVA and the rest of entities in the BBVA Group which are not members of the New York Stock Exchange or the National Association of Securities Dealers, Inc., are not subject to the rules of disclosure affecting such members.

"BBVA is subject to the BBVA Group Code of Conduct for Security Market Operations which, among other regulations, includes rules to prevent and avoid conflicts of interests with the ratings given, including information barriers. The BBVA Group Code of Conduct for Security Market Operations is available for reference at the following web site: www.bbva.com / Corporate Governance".