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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Wait-and-see stance

- **ECB seems more worried about the downside risks to economic activity**
- **Still warning about upside inflation risks but less hawkish**
- **Unanimity about the fact that an exit strategy is premature**

As expected, the ECB left the key policy rate unchanged at 1.0% at today's monetary policy meeting and took no additional steps on non-standard liquidity measures. A rate cut was not discussed; however, the governing council discussed extensively its policy stance as economic outlook has become more uncertain. Mr Draghi emphasized that the monetary stance is accommodative .The overall tone was dovish (but less dovish than previously anticipated) albeit there are no hints that there will be a rate cut.

The ECB seems more worried about the downside risks to economic activity. Mr Dragui said clearly that "we have to put growth back at the centre of the agenda", although he tried to temper the expectations created last week, at the European Parliament, when he called for a "growth compact" showing concerns on growth prospects. He also emphasized that indications are not enough to change its baseline scenario, which foresees a gradual recovery in the second part of the year. At next ECB meeting, when they will release its revised projections, they will have more data for assessment. When he was asked about the "growth compact" he reaffirmed in the need of a growth path in Europe and he remarked that there is no contradiction between growth and fiscal compact. When talking about fiscal policy, he also remarked that more clarity is needed as to what will be the eurozone in ten year's time, in what may sound as a call for a roadmap for the fiscal union. On inflation, the more hawkish tone in the last ECB meeting was eliminated, showing traces of less concerns about potential inflation risks. Particularly, the risk assessment was unchanged (risks are "broadly balanced") but dropped the "upside risks in the near term" and "upside risk prevailing" used in 4 April statement. All in all, these shifts on the wording reflect the ECB is a bit more relaxed about risks of pass-through and more concerned about eurozone growth prospects.

Concerning the exit strategy, unlike the previous ECB meeting Mr Dragui emphasized that there is unanimity about the fact that an exit strategy is premature, but they never pre-committed.

Part of the Q&A was dominated by the ECB's non-standard policies of liquidity provision, as the 3-month full allotment tender operation were planned to end on June 27. On this issue, Mr Dragui was extremely clear: "we will announce it at the ECB's June meeting". On the 3y LTROs and the possibility that their effects are vanishing, Mr. Draghi took a defensive position on the effects of these liquidity policies, repeating once more that "they have helped to avoid a major credit constrain" and also signalling that now "the credit supply is much less tight than before", "deposits are flowing back into banking systems" and "M3 has recovered". However, he emphasized that some more time is needed to eventually see how this liquidity propagates to the real economy. Regarding the SMP, in line with other press conferences, Mr Dragui said that the programme is "still there" but neither infinite nor eternal. He emphasized that it is up to governments to bring their own financing costs under control by implementing structural reforms. It seems clear that the ECB will not re-activate the SMP unless Spanish and/or Italian yields were to move significantly higher.

Annex 1. Introductory statement, tracking the changes: in black, wording common to both the current and previous statements, in brown 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, 4 April~~Barcelona, 3 May 2012

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. I would like to thank Governor Fernández Ordóñez for his kind hospitality and express our special gratitude to his staff for the excellent organisation of today's meeting of the Governing Council. We 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.

Based on our regular economic and monetary analyses, we decided to keep the key ECB interest rates unchanged. ~~The information that has become available since the beginning of March broadly confirms our previous assessment.~~ Inflation rates are likely to stay above 2% in 2012~~, with upside risks prevailing. Over~~. However, over the policy-relevant horizon, we expect price developments to remain in line with price stability. Consistent with this picture, the underlying pace of monetary expansion remains subdued. ~~Survey indicators for economic growth have broadly stabilised at low levels in the early months of 2012, and a moderate recovery in~~Available indicators for the first quarter remain consistent with a stabilisation in economic activity at a low level. Latest survey indicators for the euro area highlight prevailing uncertainty. Looking ahead, economic activity is expected ~~in~~to recover gradually over the course of the year. ~~The~~ At the same time, as we said previously, the economic outlook ~~remains~~ continues to be subject to downside risks.

~~Medium-term inflation~~ Inflation expectations for the euro area economy ~~must~~ continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. Over the last few months we have implemented both standard and non-standard monetary policy measures. This combination of measures has ~~contributed to a stabilisation in~~ helped both the financial environment and ~~an improvement in~~ the transmission of our monetary policy. ~~We need to carefully monitor further~~Further developments~~. It is also important to keep~~ will be closely monitored, keeping in mind that all our non-standard monetary policy measures are temporary in nature and that ~~all the necessary tools are available~~we maintain our full capacity to ~~address upside risks to~~ensure medium-term price stability by acting in a firm and timely manner.

Let me now explain our assessment in greater detail, starting with the economic analysis. ~~Real GDP contracted by 0.3% in the euro area in the fourth quarter of 2011. Survey data confirm~~ Available indicators for the first quarter remain consistent with a stabilisation in economic activity at a low level~~ in early 2012. We~~. Latest signals from euro area survey data highlight prevailing uncertainty. At the same time, there are indications that the global recovery is proceeding. Looking beyond the short term, we continue to expect the euro area economy to recover gradually in the course of the year~~. The outlook for economic activity should be~~, supported by foreign demand, the very low short-term interest rates in the euro area, and all the measures taken to foster the proper functioning of the euro area economy. However, ~~the~~ remaining tensions in some euro area sovereign debt markets and their impact on credit conditions, as well as the process of balance sheet adjustment in the financial and non-financial sectors and high unemployment~~ in parts of the euro area~~, are expected to continue to dampen the underlying growth momentum.

~~Downside risks to the~~ As we said previously, this economic outlook ~~prevail. They relate~~ continues to be subject to downside risks, relating in particular to ~~a renewed~~ an intensification of tensions in euro area debt markets and their potential spillover to the euro area real economy~~. Downside risks also relate~~ , as well as to further increases in commodity prices.

Euro area annual HICP inflation was 2.6% in ~~March~~April 2012, according to Eurostat's flash estimate, after 2.7% in the previous ~~three~~four months. Inflation is likely to stay above 2% in 2012, mainly owing to ~~recent~~ increases in energy prices, as well as ~~recently announced~~ to rises in indirect taxes. On the basis of current futures prices for commodities, annual inflation rates should fall below 2% again in early 2013. In this context, we will pay particular attention to any signs of pass-through from higher energy prices to wages, profits and general price-setting. However, looking ahead, in an environment of modest growth in the euro area and well-anchored long-term inflation expectations, underlying price pressures should remain limited.

Risks to the outlook for HICP inflation rates in the coming years are still seen to be broadly balanced~~, with upside risks in the near term mainly stemming from~~. Upside risks pertain to higher than expected ~~oil~~commodity prices and indirect tax increases~~. Downside risks continue to exist owing to~~, while downside risks relate to weaker than expected developments in economic activity.

The monetary analysis indicates that the underlying pace of monetary expansion has remained subdued, with somewhat higher growth rates in the past few months. The annual growth rate of M3 was 3.2% in March 2012, compared with 2.8% in February~~ 2012, compared with 2.5% in~~. Since January~~. In both January and February~~ we have observed a strengthening in the deposit base of banks.~~ Annual loan growth to the private sector has remained subdued, with the rate (adjusted for loan sales and securitisation) moderating in February to 1.1% year on year, from 1.5% in January.~~

The annual growth rates of loans to non-financial corporations and loans to households (adjusted for loan sales and securitisation) stood at 0.~~6~~5% and 1.~~8~~7% respectively in March, both slightly lower than in February. The volume of MFI loans to non-financial corporations and households remained practically unchanged compared with the previous month.

Money and credit data up to ~~February~~March confirm a broad stabilisation of financial conditions and thereby, as intended by our measures, the avoidance of an abrupt and disorderly adjustment in the balance sheets of credit institutions~~, as intended~~. In this context, the April bank lending survey indicates that the net tightening of credit standards by ~~our measures. Funding conditions for~~euro area banks ~~have generally improved,~~declined substantially in the first quarter of 2012 as compared with late 2011, for both loans to non-financial corporations and ~~there has been increased issuance activity and a re-opening of some segments of~~ loans to households, also on account of improvements in funding ~~markets. The~~ conditions for banks. As also indicated in the bank lending survey, the demand for credit ~~remains~~remained subdued in the first quarter of 2012, reflecting weak ~~in the light of still subdued~~ economic activity and the ongoing process of balance sheet adjustment in non-financial sectors. The full supportive impact of the Eurosystem's non-standard measures will need time to unfold and to have a positive effect on the growth of loans when demand recovers. In this context, it should be noted that the second three-year longer-term refinancing operation was only settled on ~~1 March~~ 1 March 2012.

~~Following the stabilisation in the financial environment~~Looking ahead, it is essential for banks to strengthen their resilience further, including by retaining earnings. The soundness of banks' balance sheets will be a key factor in facilitating both an appropriate provision of credit to the economy and the normalisation of all funding channels.

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.

~~In order to support confidence, sustainable growth and employment, the Governing Council calls upon governments to restore sound~~ fiscal positions ~~and implement strong~~structural reforms~~. Commitments under the Stability and Growth Pact need to be fully honoured and weaknesses in competitiveness forcefully addressed. National policy-makers need to fully meet their responsibilities to ensure fiscal sustainability, to increase the adjustment capacity of product and labour markets, to enhance productivity and competitiveness, and to ensure the soundness of their financial system. In particular, countries which have suffered losses in cost competitiveness need to ensure sufficient wage adjustment and foster productivity growth.~~

~~Let me conclude by recalling that the single monetary policy naturally focuses on maintaining medium-term price stability for the euro area as a whole. It is up to national policy-makers to foster domestic developments which support the competitiveness of their economies. Both prudent fiscal policies and competitive and flexible product and labour markets are of crucial importance for the functioning of the euro area economy.~~

It is of utmost importance to ensure fiscal sustainability and sustainable growth in the euro area. Most euro area countries made good progress in terms of fiscal consolidation in 2011. While the necessary comprehensive fiscal adjustment is weighing on near-term economic growth, its successful implementation will contribute to the sustainability of public finances and thereby to the lowering of sovereign risk premia. In an environment of enhanced confidence in fiscal balances, private sector activity should also be fostered, supporting private investment and medium-term growth.

At the same time, together with fiscal consolidation, growth and growth potential in the euro area need to be enhanced by decisive structural reforms. In this context, facilitating entrepreneurial activities, the start-up of new firms and job creation is crucial. Policies aimed at enhancing competition in product markets and increasing the wage and employment adjustment capacity of firms will foster innovation, promote job creation and boost longer-term growth prospects. Reforms in these areas are particularly important for countries which have suffered significant losses in cost competitiveness and need to stimulate productivity and improve trade performance.

In this context, let me make a few remarks on the adjustment process within the euro area. As we know from the experience of other large currency areas, regional divergences in economic developments are a normal feature. However, considerable imbalances have accumulated in the last decade in several euro area countries and they are now in the process of being corrected.

As concerns the monetary policy stance of the ECB, it has to be focused on the euro area. Our primary objective remains to maintain price stability over the medium term. This is the best contribution of monetary policy to fostering growth and job creation in the euro area.

Addressing divergences among individual euro area countries is the task of national governments. They must undertake determined policy actions to address major imbalances and vulnerabilities in the fiscal, financial and structural domains. We note that progress is being made in many countries, but several governments need to be more ambitious. Ensuring sound fiscal balances, financial stability and competitiveness in all euro area countries is in our common interest.