RESEARCH

ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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The ECB has no choice but to act in June

- **An unanimous GC "is comfortable with acting" next month**
- **An unanimous GC is now "not resigned to have too low inflation for too long a time"**
- **The ECB expressed growing concerns about the euro**

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. In an unprecedented step, Mr Draghi hinted an easing by the central bank as soon as June. Mr. Draghi reiterated the unanimity within the Governing Council (GC) to use unconventional monetary policy to handle a prolonged period of low inflation. On the economic outlook, medium-term inflation risks remain "broadly balanced" and risks to the economic outlook continue to be to the downside.

During the Q&A, Mr Draghi hinted that the central bank would ease its monetary policy at June´s meeting. He said there is consensus about acting: the GC "is comfortable with acting" next month, but only after learning about the staff projections in early June. He highlighted that there was consensus among GC members not "to resign to low inflation for a too long time." This seems a bit at odds with the wording of the statement in which inflation risks are considered to be "broadly balanced," but certainly more in line with the staff forecast of inflation remaining clearly below 2% well in 2015. Considering April´s unexpectedly low inflation outturn (0.7% vs. BBVA´s expected 0.8% and a probably higher expected value implicit in the staff outlook) together with the persistent strength of the euro (the staff forecasts currently assume an exchange rate of 1.36), the ECB will probably revise down its inflation projections for 2014 by a couple of decimal points (together with a smaller revision to the 2015 forecasts). Nonetheless, Mr Draghi was not explicit on what measures they might implement. As in other meetings, he clarified that they discussed all the range of instruments available. At this conference the QE was not explicitly mentioned.

The ECB expressed growing concern about the euro. Apart from clarifying its importance for both price stability and growth (adding, as always, that it is not a policy target of the bank), Mr Draghi said, for first time, that the strength of the euro in a context of low inflation "is cause for serious concern" within the GC. He seemed to downplay the recent tightening of the money market, as it has only occurred in the very short-term part of the curve. Moreover, the amount of liquidity on the EONIA market has increased quite significantly, raising the rate to more-meaningful market values.

Regarding inflation, in response to a question about the definition of "too prolonged period of low inflation" which would prompt the central bank to act, he said that it is when the risk of de-anchoring medium-term inflation increases, reiterating that "the longer the period, the bigger the risk of a de-anchoring of inflation expectations."

Listening today to Draghi, we expect the ECB to act in June. It is difficult to foresee a change in either the inflation or the exchange rate outlook that would change their mind. However, Draghi gave no clear hints on the choice of any particular measure. In our view, considering that the euro is currently the ECB´s main source of concern, the GC is more likely to start by exhausting the more conventional measures that remain available (i.e. lowering refi and depo rates, and narrowing the interest rate corridor).

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 ARE THERE ON PURPOSE)

Mario Draghi, President of the ECB, ~~Frankfurt am Main, 3 April~~Brussels, 8 May 2014

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. I would like to thank Governor Coene 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~~ of the Eurogroup, Finance Minister Dijsselbloem.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. Incoming information ~~confirms~~continues to indicate that the moderate recovery of the euro area economy is proceeding in line with our previous assessment. At the same time, recent information remains consistent with our expectation of a prolonged period of low inflation followed by only a gradual upward movement in HICP inflation rates. The signals from the monetary analysis confirm the picture of subdued underlying price pressures in the euro area over the medium term. Inflation expectations for the euro area over the medium to long term ~~continue to be~~ remain firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%.

Looking ahead, we will monitor economic developments and money markets very closely ~~and~~. We will ~~consider all instruments available to us. We are resolute in our determination to~~ maintain a high degree of monetary accommodation and ~~to~~ act swiftly, if required~~. Hence, we do not exclude~~, with further monetary policy easing ~~and we~~. We firmly reiterate that we continue to expect the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness of the economy, the high degree of unutilised capacity, and subdued money and credit creation. ~~At the same time, we are closely following developments on money markets.~~ The Governing Council is unanimous in its commitment to using also unconventional instruments within its mandate in order to cope effectively with risks of a too prolonged period of low inflation. Further information and analysis concerning the outlook for inflation and the availability of bank loans to the private sector will be available in early June.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Real GDP in the euro area rose by 0.2%, quarter on quarter, in the last quarter of 2013, ~~after 0.1% and 0.3% in the previous two~~thereby increasing for three consecutive quarters ~~respectively. Survey data that encompass the first quarter of this year are consistent with continued moderate growth, confirming previous expectations that the ongoing recovery is increasingly supported by firmer domestic demand.~~. Recent data and survey indicators confirm that the ongoing moderate recovery continued in the first quarter of 2014 and at the beginning of the second quarter. Looking ahead, ~~some further improvement in~~ domestic demand should ~~materialise,~~continue to be supported by a number of factors, including the accommodative monetary policy stance, ongoing improvements in financing conditions working their way through to the real economy, ~~and~~ the progress made in fiscal consolidation and structural reforms~~. In addition, real incomes are supported by moderate price~~, and developments~~,~~ in ~~particular lower~~ energy prices. ~~Economic activity is also expected to benefit from a gradual strengthening of demand for euro area exports.~~ At the same time, although labour markets have stabilised and shown the first signs of improvement, unemployment ~~in the euro area~~ remains high in the euro area and, overall, unutilised capacity ~~is~~continues to be sizeable. Moreover, the annual rate of change of MFI loans to the private sector remained negative in March and the necessary balance sheet adjustments in the public and private sectors ~~will~~ continue to weigh on the pace of the economic recovery.

The risks surrounding the economic outlook for the euro area continue to be on the downside. ~~Developments~~Geopolitical risks, as well as developments in global financial markets and ~~in~~ emerging market economies, ~~as well as geopolitical risks,~~ may have the potential to affect economic conditions negatively. Other downside risks include weaker than expected domestic demand and insufficient implementation of structural reforms in euro area countries, as well as weaker export growth.

According to Eurostat's flash estimate, euro area annual HICP inflation was 0.7% in April 2014, up from 0.5% in March~~ 2014, down from 0.7% in February. The decrease reflects falls in the annual rates of change of the food, goods and services components, partly offset by a more moderate decline in energy prices.~~. As expected, given the timing of Easter, the increase was mainly due to a rise in services prices. On the basis of current ~~exchange rates and prevailing futures prices for energy, annual HICP inflation is expected to pick up somewhat in April, partly related to the volatility of service prices in the months around Easter. Over the following months~~information, annual HICP inflation is expected to remain around present low levels over the coming months, before only gradually increasing during 2015 to reach levels closer to 2% towards the end of 2016. ~~At the same time, medium~~New macroeconomic projections by Eurosystem staff will become available in early June. Medium to long-term inflation expectations remain firmly anchored in line with price stability.

The Governing Council sees both upside and downside risks to the outlook for price developments as limited and broadly balanced over the medium term. In this context, the possible repercussions of both geopolitical risks and exchange rate developments will be monitored closely.

Turning to the **monetary analysis**, data for ~~February~~March 2014 continue to point to subdued underlying growth in broad money (M3). Annual growth in M3 ~~was broadly stable~~moderated to 1.1% in ~~February at~~ March, from 1.3~~%, compared with 1.2~~% in ~~January.~~February. The growth of the narrow monetary aggregate M1 remained robust ~~at~~ but decreased to 5.6~~.2~~ % in ~~February~~March, after 6.~~1~~2% in ~~January.~~February. The ~~main factor supporting annual M3 growth continued to be the~~ increase in the MFI net external asset position, reflecting in part the ~~keen~~ continued interest of international investors in euro area assets, remains the main factor supporting annual M3 growth.

~~MFI loans to the private sector continued to decline in February.~~ The annual rate of change of loans to non-financial corporations (adjusted for loan sales and securitisation) was ~~-~~-3.1~~%, compared with -2.8~~% in ~~January.~~March, unchanged from February. 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. The annual growth rate of loans to households (adjusted for loan sales and securitisation) stood at 0.4% in ~~February~~March 2014, ~~still~~ broadly unchanged since the beginning of 2013.

The April 2014 bank lending survey confirmed the stabilisation of credit conditions for loans to enterprises and households. Credit standards over the previous three months remained broadly unchanged for loans to enterprises but were eased in net terms for households. Broadly in line with these results, in the survey on the access to finance of small and medium-sized enterprises (SMEs) for the period October 2013-March 2014, SMEs reported that bank loan availability had become less negative and had actually improved in some euro area countries. According to both surveys, the general economic outlook contributed less negatively or even positively to these developments. At the same time, banks still reported tight levels of credit standards when seen in a historical perspective.

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. ~~This is the objective of~~In this context, the ongoing comprehensive assessment ~~by~~of banks' balance sheets is of key importance. Banks should take full advantage of this exercise to improve their capital and solvency position, thereby contributing to overcome any existing credit supply restriction that could hamper the ~~ECB~~recovery.

To sum up, the economic analysis confirms our expectation of a prolonged period of low inflation followed by only a gradual upward movement in HICP inflation rates towards levels closer to 2%. A **cross-check** with the signals from the monetary analysis confirms the picture of subdued underlying price pressures in the euro area over the medium term.

~~As regards **fiscal policies**, euro area countries have made important progress in correcting fiscal imbalances. They should not unravel past consolidation achievements and should put high government debt ratios on a downward trajectory over the medium term, in line with the Stability and Growth Pact. Fiscal strategies should ensure a growth-friendly composition of consolidation to achieve better quality and more efficient public services, while minimising the distortionary effects of taxation. Further decisive steps are needed to **reform product and labour markets** with a view to improving competitiveness, raising potential growth, generating employment opportunities and making euro area economies more flexible.~~

Regarding **fiscal policies**, according to the European Commission's spring forecast, the general government deficit in the euro area is expected to decline further, from 3.0% of GDP in 2013 to 2.5% this year and to 2.3% in 2015. The government debt-to-GDP ratio is expected to stabilise at 96.0% in 2014 and to decline to 95.4% in 2015. In view of still rather high debt ratios and to improve fiscal sustainability, euro area countries should not unravel progress made with fiscal consolidation and should comply with their commitments under the Stability and Growth Pact. At the same time, comprehensive and ambitious **structural reforms** in product and labour markets are warranted to lift the euro area's growth potential, improve its adjustment capacity and reduce the high unemployment facing many euro area countries today. To this end, the Governing Council concurs with Tuesday's ECOFIN Council communication that decisive policy action is needed in countries where macroeconomic imbalances hinder the smooth functioning of Economic and Monetary Union.

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