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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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ECB maintains a cautious stance

- **Monetary stance remains accommodative**
- **The exchange rate blinks on ECB´s radar screen**
- **Early LTRO´s repayments signal improvement of financial conditions**

As expected, at today´s monetary policy meeting the ECB kept rates unchanged at 0.75% and took no additional steps on non-standard liquidity measures. The decision was unanimous but there were talks on "how to improve financial conditions." Mr Draghi emphasized that the monetary stance continues to be accommodative, medium-term inflation risks remain "broadly balanced." and risks for the economic outlook continue to be on the downside.

The recent appreciation of the euro exchange rate has triggered a response from ECB´s Governing Council: "the outlook for price developments continue as broadly balanced over the medium term… with… downside risks stemming from a weaker economic activity and, more recently, the appreciation of the euro exchange rate." But this latest appreciation should not prompt any action. Mr. Draghi explained that an appreciation is a sign of confidence as long as it also reflects fundamentals (which was in his view the case for the euro, with both nominal and real exchange rates close to their long-term averages), discarding any type of exchange rate targeting, With regard to "currency wars", Mr. Draghi referred again to the G20´s consensus, which rejects competitive devaluations. In his view, recent exchange rate movements have been the unintended consequence of cyclical expansionary monetary policies pursued in some countries, rather than the result of permanent and deliberate devaluation policies.

The ECB´s statement included an explicit reference to banks´ liquidity as, for the first 3Y LTRO, counterparties have so far repaid €140.6 billion, representing 29% of the funds allotted to 523 banks on December 21st, 201. The ECB "will closely monitor conditions in the money market and their potential impact on the stance of monetary policy." On the Q&A Mr. Draghi emphasized that early repayment of LTRO´s should be seen as a sign of increasing confidence. He explained that many banks had acquired LTRO´s for precautionary reasons, but such uncertainty is vanishing, which "is certainly a positive sign." He added that, based on internal estimations for the second LTRO repayment, the ECB is "quite persuaded that the excess liquidity will be well over EUR 200 billion" (level at which Eonia stars to react), i.e. monetary conditions will remain accommodative.

Mr Draghi also stressed that over the last 6 months there has been significant improvement of financial conditions. However, like in previous meetings, he adopted a cautious tone by emphasizing that "the situation remains fragile" as credit availability remains challenging for smaller companies.

In our view the ECB would maintain interest rates on hold, while over the coming months both conditions in money markets and the evolution of exchange rate added to the factors to be monitored.

Annex 1. Introductory statement, tracking the changes:

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.

Mario Draghi, President of the ECB,
Vítor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~10 January~~7 February 2013

~~Jump to the transcript of the questions and answers~~

Ladies and gentlemen, the Vice-President and I are very pleased to welcome you to our press conference. ~~Let me wish you all a Happy New Year.~~ We will now report on the outcome of today's meeting of the Governing Council.

Based on our regular economic and monetary analyses, we decided to keep the **key ECB interest rates** unchanged. HICP inflation rates have declined ~~over recent months~~further, as anticipated, and are expected to fall below 2% ~~this year.~~in the coming months. Over the policy-relevant horizon, inflationary pressures should remain contained. The underlying pace of monetary expansion continues to be subdued. ~~Inflation~~ Medium to longer-term inflation expectations for the euro area remain firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2~~% over the medium term.~~%. Overall, this allows our monetary policy stance to remain accommodative. The economic weakness in the euro area is expected to ~~extend into~~prevail in the early part of 2013. In particular, necessary balance sheet adjustments in ~~financial and non-financial~~ the public and private sectors ~~and persistent uncertainty~~ will continue to weigh on economic activity. Later in 2013 economic activity should gradually recover~~. In particular,~~, supported by our accommodative monetary policy stance, ~~together with significantly improved~~the improvement in financial market confidence and reduced fragmentation, ~~should work its way through to the economy, and~~ as well as a strengthening of global demand ~~should strengthen~~. In order to sustain confidence, it is essential for governments to reduce further both fiscal and structural imbalances and to proceed with financial sector restructuring.

~~Let me now explain our assessment in greater detail, starting with the **economic analysis**. Following a contraction of 0.2%, quarter on quarter, in the second quarter of 2012, euro area real GDP declined by 0.1% in the third quarter. Available statistics and survey indicators continue to signal further weakness in activity, which is expected to extend into this year, reflecting the adverse impact on domestic expenditure of weak consumer and investor sentiment and subdued foreign demand. However, more recently several conjunctural indicators have broadly stabilised, albeit at low levels, and financial market confidence has improved significantly.~~With regard to the liquidity situation of banks, counterparties have so far repaid €140.6 billion of the €489.2 billion obtained in the first of the two three-year longer-term refinancing operations (LTROs) settled in December 2011 and March 2012. This reflects the improvement in financial market confidence. Repayments are provided for in the modalities of the three-year LTROs and are at the discretion of the counterparties, who must appropriately assess their funding situation, their ability to provide new loans to the economy and their resilience to shocks. We will closely monitor conditions in the money market and their potential impact on the stance of monetary policy, which will remain accommodative with the full allotment mode of liquidity provision.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. Euro area real GDP declined by 0.1%, quarter on quarter, in the third quarter of 2012, following a contraction of 0.2% in the second quarter. Available data continue to signal further weakness in activity in the fourth quarter and at the beginning of 2013. This weakness reflects the adverse impact of low consumer and investor sentiment on domestic expenditure, as well as subdued foreign demand. However, financial market sentiment has improved and the latest survey indicators confirm earlier evidence of a stabilisation in business and consumer confidence, albeit at low levels. Later in 2013 a gradual recovery should start, ~~as~~ with domestic demand being supported by our accommodative monetary policy stance, the ~~significant~~ improvement in financial market confidence and reduced fragmentation ~~work their way through to private domestic expenditure, and~~, and export growth benefiting from a strengthening of ~~foreign~~global demand ~~should support export growth~~.

The risks surrounding the economic outlook for the euro area ~~remain~~ continue to be on the downside. They ~~are mainly related to~~relate to the possibility of weaker than expected domestic demand and exports, slow implementation of structural reforms in the euro area, as well as geopolitical issues and imbalances in major industrialised countries which could both have an impact on developments in global commodities and financial markets. These factors have the potential to dampen ~~sentiment for longer than currently assumed and~~ the ongoing improvement in confidence and thereby delay ~~further~~ the recovery ~~of private investment, employment and consumption~~.

According to Eurostat's flash estimate, euro area annual HICP inflation was 2.~~2% in December 2012, unchanged from November and~~ 0% in January 2013, down from 2.~~5% in October and~~ 2.~~6% in August and September.~~% in November and December and from 2.5% in October. On the basis of current futures prices for oil, inflation rates are expected to decline further to below 2% ~~this year.~~in the coming months. Over the policy-relevant horizon, in an environment of weak economic activity in the euro area and well-anchored long-term inflation expectations, underlying price pressures should remain contained.

Risks to the outlook for price developments ~~are~~ continue to be seen as broadly balanced over the medium term, with ~~downside risks stemming from weaker economic activity and~~ upside risks relating to higher administered prices and indirect taxes, as well as higher oil prices, and downside risks stemming from weaker economic activity and, more recently, the appreciation of the euro exchange rate.

Turning to the **monetary analysis**, the underlying pace of monetary expansion continues to be subdued. The annual growth rate of M3 ~~remained broadly unchanged at~~ decreased to 3.3% in December 2012, from 3.8% in November ~~2012, after 3.9% in October. M3 growth continued to be driven by a preference for liquid assets, as M1 growth increased further to 6.7% in November, from 6.5% in October, reflecting inflows into overnight deposits from households and non-financial corporations. Following our non-standard monetary policy measures and action by other policy-makers, a broadly based~~. Shifts from overnight deposits to short-term time deposits led to a decrease in the annual rate of growth of M1, which declined to 6.2% in December, from 6.7% in November, and outflows from marketable instruments dampened overall M3 growth. A further strengthening in the deposit base of MFIs in a number of stressed countries ~~was observed. This allowed several MFIs to reduce~~ took place in December, in combination with further ~~their reliance on Eurosystem funding and helped to reduce segmentation in financial markets. M3 growth was also supported by an inflow of~~ capital inflows into the euro area, ~~as reflected in the strong increase in the net external asset position of MFIs~~both of which continued to reduce fragmentation.

~~There has been little change in credit~~ The annual growth~~, which remained weak in November. The annual~~ rate of ~~decline in~~ loans to the private sector (adjusted for loan sales and securitisation) remained ~~at -0.5% in November. This development reflects further net redemptions in loans to non-financial corporations. Net redemptions, however, were less pronounced than in previous months, amounting to €4 billion in November, after €7 billion in October and €21 billion in September. The annual rate of decline in loans to non-financial corporations was -1.4% in November, after -1.5% in October. The~~negative in December. This mainly reflected ongoing negative annual growth of loans to non-financial corporations, which was -1.3% in December after -1.5% in November. However, annual growth in MFI ~~lending~~loans to households ~~also~~ remained broadly unchanged at 0.7% in ~~November.~~December. To a large extent, subdued loan dynamics reflect the current stage of the business cycle, heightened credit risk and the ongoing adjustment in the balance sheets of ~~households and enterprises~~the financial and non-financial sectors. In line with these developments, the bank lending survey for the fourth quarter of 2012 confirms the weakness in credit demand and the continued effect of credit risk considerations on the tightening of credit standards. At the same time, the survey confirms the positive impact of Eurosystem measures on banks' overall funding and liquidity situation. In particular, banks reported improvements across all funding categories in the fourth quarter.

In order to ensure adequate transmission of monetary policy to the financing conditions in euro area countries, it is essential to continue strengthening the resilience of banks where needed. ~~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.~~ Decisive steps for establishing an integrated financial framework will help to accomplish this objective. The future single supervisory mechanism (SSM) is one of the main building blocks. It is a crucial move towards re-integrating the banking system.

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.

~~Other economic policy areas will need to make further contributions to ensure a firm stabilisation of financial markets and an improvement in the outlook for growth. Further **structural reforms** should be rapidly implemented to make the euro area a more flexible, dynamic and competitive economy. In particular, product market reforms to increase competition and competitiveness are essential, accompanied by measures to improve the functioning of labour markets. Such reforms will~~As regards other policy areas, **structural reforms** and **fiscal adjustment** can complement each other, thereby improving the outlook for job creation, economic growth and debt sustainability. Past policy action is bearing fruit, in terms of both the unwinding of existing fiscal imbalances and the reduction of current account deficits. In particular, in several countries with particular adjustment needs, contained growth in unit labour costs signals greater price competitiveness and exports are performing better. Governments should build on the progress achieved in fiscal consolidation, strengthen competition in product markets and continue with labour market reforms. This would boost the euro area's growth potential ~~and~~, reduce high structural unemployment and improve the adjustment capacities of the euro area countries. ~~They will also add further momentum to the progress being made with regard to unit labour costs and current account imbalances. As regards **fiscal policies**, the recent significant decline in sovereign bond yields should be bolstered by further progress in fiscal consolidation in line with the commitments under the Stability and Growth Pact.~~

We are now at your disposal for questions.

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