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ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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ECB on a wait-and-see stance

- **The less dovish tone further lowers the probability of another rate cut**
- **The two 3y LTROs were labelled by Draghi as an "unquestionable success". Still downside risks on activity persist**
- **We now expect the ECB to remain on hold both on monetary policy and non-standard measures for a protracted period**

As widely expected, the ECB left the key policy rate unchanged at 1.0% at today's monetary policy meeting. At the press conference, ECB president Draghi hinted that the Governing Council is not currently leaning to neither lowering interest rates further nor launching additional LTROs auctions. The tone was a bit more upbeat, and the wording less dovish. Medium-term inflation risks are characterised as "still broadly balanced" (the "still" was added and might signal a potential revision in coming months) but notably a reference to "upside risks prevailing" to the upwardly revised 2012 inflation outlook was added. Inflation is now expected to stay above 2% in 2012. On activity the reference to downside risks remains but the one to "high uncertainty" has been dropped.

The ECB staff mid point projection for 2012 HICP inflation was upwardly revised to 2.4% from 2.0%, while the 2013 projection was raised from 1.5% to 1.6%. How does this compare to our forecasts? Recent increases in energy prices combined with slight upward innovations lead us to see annual inflation slightly above our previous forecast (2.3% average in 2012, reverting to 2% by year-end, and averaging 1.5% in 2013). The 2012 and 2013 ECB`s GDP projections were revised down (mid-point forecasts: from 0.3% in December to -0.1% for 2012 and from 1.3% to 1.1% for 2013), yet the growth assessment contained no significant changes as economic activity is "still subject to downside risks" (the "still" is also a new addition, but it was only used in the first paragraph). We think that the limited available data for Q1 2012 point to a somewhat more optimistic outlook, as confidence improved in January more than expected. Yet, February's data has been somewhat disappointing. As regards BBVA Research view´s, our updated MICA-BBVA model estimates' point to zero or slightly negative growth in Q1 12, which is somewhat better than a month ago. If confirmed, it could imply a lower contraction in 2012 (-0.3% vs our current -0.5% forecast).

Much of the Q&A was dominated by 3y LTROs related questions. Mr Draghui strongly emphasized that the impact of both auctions has been very positive; an "unquestionable success" and very effective in removing the tail risks. He stressed that the risk environment has "improved enormously", markets have reopened and even the interbank market has improved slightly in comparison when they decided to carry out these auctions. Yet, he remarked that these operations are very complex and the overall impact is yet to be assessed. In this regard, when asked about the possibility of another 3y LTRO auction he said that the ECB never "pre-committs" but very clearly expressed that they have already done what is in their hands to solve the crisis, emphasizing that the ECB addressed liquidity but "monetary policy can´t do everything, and the ball is now back in Goverments' court". Today's Q&A confirms our view that further ECB policy steps on non-standard measures are unlikely unless the conditions deteriorate a lot.

Mr Draghi downplayed both the risks stemming from the relaxation of collateral rules (which can be "much looser" as the haircuts on the additional claims are "very high) and of divisions within the Governing Council ("nobody is isolated"; it is normal to have target II imbalances).

Overall, the slightly more positive activity data in early 2012, together with somewhat higher price pressures due to oil prices and the disappearance of the tail risk of a fallout due to liquidity injections make us no longer think that rates will be cut further unless conditions worsen again markedly.

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, ~~9 February~~ 8 March 2012

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 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 ~~mid-January broadly confirms~~the beginning of February has confirmed our previous assessment~~. Inflation is likely to stay above 2%~~ of the outlook for ~~several months to come, before declining to below 2%.~~economic activity. Available survey indicators confirm ~~some tentative~~ signs of a stabilisation in ~~economic activity at a low level around the turn of the year, but~~ the euro area economy. However, the economic outlook ~~remains~~ is still subject to ~~high uncertainty and~~ downside risks. Owing to rises in energy prices and indirect taxes, inflation rates are now likely to stay above 2% in 2012, with upside risks prevailing. Nevertheless, we expect price developments to remain in line with price stability over the policy-relevant horizon. The underlying pace of monetary expansion remains subdued~~ –~~, consistent with contained inflationary pressures over the medium term.

Looking ahead, ~~it is essential for monetary policy~~we are firmly committed to ~~maintain~~maintaining price stability ~~for~~in the euro area~~ as a whole. This ensures a~~, in line with our mandate. To this end, the continued firm anchoring of inflation expectations – in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term~~. Such anchoring~~ – is ~~a prerequisite for monetary policy to make its contribution to supporting economic growth and job creation in the euro area. A very thorough analysis of all incoming data and developments over the period ahead is warranted.~~

~~Through our non-standard monetary policy measures we will continue to support the functioning~~ of the ~~euro area financial sector, and thus the financing of the real economy. Since the first three-year longer-term refinancing operation (LTRO) was conducted in December 2011 we have approved specific national eligibility criteria and risk control measures for the temporary acceptance in a number of countries of additional credit claims as collateral in Eurosystem credit operations, which should lead to an increase in available collateral. Further details will be provided in a press release to be published today at 3.30 p.m. At the start of the current reserve maintenance period on 18 January 2012 the reserve ratio was reduced, freeing up additional collateral. As stated on previous occasions, all our non-standard measures are temporary in nature~~essence.

Over recent months, a wide range of additional non-standard monetary policy measures has been implemented by the Eurosystem. These measures, including in particular two three-year longer-term refinancing operations, were decided upon against the background of exceptional circumstances in the last quarter of 2011. The first impact of these measures has been positive. Together with fiscal consolidation and stepped-up structural reforms in several euro area countries, as well as progress towards a stronger euro area economic governance framework, they have contributed to a significant improvement in the financial environment over recent months. We expect that the three-year longer-term refinancing operations will provide further support for the ongoing stabilisation in financial markets and, in particular, for lending activity in the euro area. All our non-standard monetary policy measures are temporary in nature. Furthermore, all the necessary tools to address potential upside risks to medium-term price stability are fully available.

Let me now explain our assessment in greater detail, starting with the economic analysis. Real GDP ~~growth~~contracted by 0.3% in the euro area in the fourth quarter of 2011 ~~is likely to have been very weak~~. According to ~~the~~recent survey data ~~for the last two months~~, there are ~~tentative~~ signs of a stabilisation in economic activity, albeit still at a low level. Looking ahead, we expect the euro area economy to recover ~~very~~ gradually in the course of ~~2012.~~this 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 financial sector ~~are lending support to the euro area economy. Moreover, stress in financial markets has diminished in response to our monetary policy measures, but also in response to the progress made towards a stronger euro area governance framework and intensified fiscal consolidation in several euro area countries~~. However~~, subdued global demand growth~~, the remaining tensions in 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, are expected to continue to dampen the underlying growth momentum.

This assessment is also reflected in the March 2012 ECB staff macroeconomic projections for the euro area, which foresee annual real GDP growth in a range between -0.5% and 0.3% in 2012 and between 0.0% and 2.2% in 2013. Compared with the December 2011 Eurosystem staff macroeconomic projections, the ranges have been shifted slightly downwards.

This outlook ~~is~~ remains subject to downside risks. They notably relate to a renewed intensification of tensions in euro area debt markets and their potential spillover to the euro area real economy. Downside risks also relate to ~~possible adverse developments in the global economy, higher than assumed~~ further increases in commodity prices~~, protectionist pressures and the potential for a disorderly correction of global imbalances~~.

Euro area annual HICP inflation was 2.7% in ~~January~~ February 2012, according to Eurostat's flash estimate, ~~unchanged~~slightly up from ~~December. The average inflation rate for 2011 was 2.7%, mainly driven by higher energy and other commodity prices.~~2.6% in January. Looking ahead, inflation is now likely to stay above 2% ~~for several months to come, before declining to below 2%. This pattern reflects the expectation that~~in 2012, mainly owing to recent increases in energy prices, as well as recently announced increases in indirect taxes. On the basis of current futures prices for commodities, annual inflation rates should fall again to below 2% in early 2013. Looking further ahead, in an environment of ~~weak~~modest growth in the euro area and ~~globally~~well-anchored long-term inflation expectations, underlying price pressures ~~in the euro area~~ should remain limited.

~~Risks to the medium-term outlook for price developments remain broadly balanced. On the upside, they relate to higher than assumed increases in indirect taxes and administered prices, as well as increases in commodity prices. The main downside risks relate to the impact of weaker than expected growth in the euro area and globally.~~

The March 2012 ECB staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 2.1% and 2.7% in 2012 and between 0.9% and 2.3% in 2013. In comparison with the December 2011 Eurosystem staff macroeconomic projections, the ranges for HICP inflation have been shifted upwards, notably the range for 2012.

Risks to projected HICP inflation rates in the coming years are seen to be still broadly balanced, with upside risks in the near term mainly stemming from higher than expected oil prices and indirect tax increases. However, downside risks continue to exist owing to weaker than expected developments in economic activity.

The monetary analysis indicates that the underlying pace of monetary expansion remains subdued. The annual growth rate of M3 ~~decreased to~~was 2.5% in January 2012, up from 1.~~6~~5%

in December 2011~~, after 2.0% in November, reflecting a further weakening of monetary dynamics towards the end of the year~~. Loan growth to the private sector also remains subdued. However, its annual rate (adjusted for loan sales and securitisation) picked up slightly in January to 1.5% year on year from 1.2% in December.

The annual growth rates of loans to non-financial corporations and loans to households~~,~~ (adjusted for loan sales and securitisation~~, also decreased further in December, and~~) stood at ~~1.2~~0.8% and 2.1~~.9~~% respectively~~. The volume of MFI loans to both sectors declined in December, and this was particularly pronounced in the case of the non-financial corporate sector. In addition, there are indications that bank lending conditions tightened further, affecting loan supply in several euro area countries in late 2011. It is not yet possible to draw firm conclusions from these developments, particularly given that the impact of the first three-year LTRO on bank funding is still unfolding and may not have been fully reflected in the most recent bank lending survey. In addition, other non-standard monetary policy measures announced in December are still to be implemented. Accordingly, close scrutiny of credit developments in the period ahead is essential~~ in January. The volume of MFI loans to non-financial corporations declined only slightly in January, following the pronounced decline in December. By contrast, the flow of loans to households in January was positive.

Following the signs of improvement in the financial environment, it is essential for banks to strengthen their resilience further, including by retaining earnings. The soundness of ~~bank~~ banks' balance sheets will be a key factor in facilitating an appropriate provision of credit to the economy~~ over time. It is essential that the implementation of banks' recapitalisation plans does not result in developments that are detrimental to the financing of economic activity in the euro area~~.

To sum up, the economic analysis indicates that ~~underlying price pressures~~ price developments should remain ~~limited and risks to the medium-term outlook for price developments remain broadly balanced.~~in line with price stability over the medium term. A cross-check with the signals from the monetary analysis confirms this picture.

~~A combination of structural reforms and fiscal discipline is essential for boosting confidence and delivering~~Looking ahead, in order to deliver a favourable environment for sustainable growth~~.~~ ~~Regarding~~ ~~fiscal policies~~~~, all euro area~~ and to support confidence and competitiveness, the Governing Council stresses the urgent need for governments ~~need to continue to do their utmost to ensure fiscal sustainability. It is essential that all countries adhere to the fiscal targets they announced for 2012. This should help to anchor expectations of~~to make further progress towards restoring sound fiscal ~~policies and strengthen confidence. The rules guiding the design and implementation of national fiscal policies are being strengthened at the EU level as well as in the legal frameworks of several Member States. These are~~ positions and implementing the structural reform agenda. Regarding fiscal consolidation, many governments in the euro area are making progress. Continuing with comprehensive fiscal consolidation and complying with all commitments remains essential. In this respect, the 2012 European Semester should be used to enforce rigorously the reinforced fiscal surveillance mechanism. Equally important ~~steps in the right direction. With regard to~~are structural reforms~~, these are key~~ to ~~increasing~~increase the adjustment capacity and competitiveness of euro area countries~~, thereby strengthening~~ and to strengthen growth prospects and job creation. ~~Notably, far-reaching and ambitious reforms should be implemented to foster competition in product markets, particularly in services sectors, while rigidities in labour markets should be reduced and wage flexibility should be enhanced~~In this area, more progress is desirable. The Governing Council strongly welcomes the European Commission's Alert Mechanism Report on macroeconomic imbalances and expects the proposed in-depth country reviews to actively support the reform processes under way in euro area countries.

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