

ECB Watch

Europe

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Economic Analysis

Financial Scenarios

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Refi rate to record-low of 0.75% as recession spreads to core eurozone

- **The corridor unchanged (at +/-75bp) thus leaving the deposit facility at 0.0%**
- **Draghi says that downside risks to the euro area economic outlook are now materializing**
- **No further steps on non-standard measures**

As expected, the ECB decided to cut the main policy rate by 0.25% to 0.75%, to historic low at today's monetary policy meeting. It also cut the deposit rate and marginal lending rate by 25bp, thus leaving unrevised the interest rate corridor (at +/-75bp).

The decision was "unanimous in all grounds" and "this by itself carries a special strength to this decision". The ECB justified the rate cut because the "downside risks to the euro area economic outlook are now materializing and this would damp the price behaviour". In the statement, a reference to "renewed" weakening of economic growth in Q2 was added, and "prevailing uncertainty" was changed by "heightened uncertainty". In the Q&A Draghi added that now the ECB sees growth weakening in the whole euro area. However, for the time being, he emphasized that its "baseline scenario has not changed" and they still see a gradual and slow recovery near the year-end". In this context, Mr Dragui did not hint any additional cut in the short-term.

Regarding the effect of the rate cut, Mr. Draghi emphasizes that "the reason why this price signal has a more powerful effect than before is that it has been accompanied by a reduction in the rate on the deposit facility", although he said that "doesn't see changes in bank behaviour". We consider that the effect on lending would be small as the credit channel of monetary policy is not functioning properly. We also think that the users of the deposit facility probably will not change their liquidity hoarding behaviour. In any case, the refi rate cut is positive as it reduces the banks' funding costs, especially in peripheral countries where banks rely much more on ECB liquidity.

With respect to non-standard measures, the ECB did not announce any extra measures today, although Mr Dragui said that the collateral framework will have to be revised. In this context, he wanted to emphasize that the ECB will keep all liquidity lines open to solvent banks.

Regarding these collateral rules, since the last ECB meeting the ECB has acted in both directions: easing and tightening rules. On the one hand, on 22 June the ECB took further measures to increase collateral availability for counterparties by lowering the rating thresholds for certain asset-backed securities. On the other, the ECB tightened its lending rules on banks, by announcing early this week that it would not accept higher levels of government-guaranteed bank bonds as collateral for refinancing operations. However the central bank left the door open to exceptions if the request is accompanied by a funding plan.

To sum up, we do not see further immediate actions in both standard and non-standard measures, beyond some fine tuning in collateral rules. However, new actions cannot be discarded if financial crisis escalate again in coming months.

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,
Vitor Constâncio, Vice-President of the ECB,
Frankfurt am Main, ~~6 June~~5 July 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~~cut the **key ECB interest rates** ~~unchanged~~. ~~While inflation rates are likely to stay above 2% for the remainder of 2012, over the policy-relevant horizon we expect price developments to remain in line with price stability by 25 basis points.~~ Inflationary pressure over the policy-relevant horizon has been dampened further as some of the previously identified downside risks to the euro area growth outlook have materialised. Consistent with this picture, the underlying pace of monetary expansion remains subdued. Inflation expectations for the euro area economy continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. At the same time, economic growth in the euro area ~~remains continues to remain~~ weak, with heightened uncertainty weighing on confidence and sentiment, ~~giving rise to increased downside risks to the economic outlook.~~

~~In previous months we~~We have implemented both standard and non-standard monetary policy measures. This combination of measures has supported the transmission of our monetary policy. ~~Today, we have decided to continue conducting our main refinancing operations (MROs) as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the 12th maintenance period of 2012 on 15 January 2013. This procedure will also remain in use for the Eurosystem's special term refinancing operations with a maturity of one maintenance period, which will continue to be conducted for as long as needed. The fixed rate in these special term refinancing operations will be the same as the MRO rate prevailing at the time. Furthermore, the Governing Council has decided to conduct the three-month longer-term refinancing operations (LTROs) to be allotted until the end of 2012 as fixed rate tender procedures with full allotment. The rates in these three-month operations will be fixed at the average rate of the MROs over the life of the respective LTRO. Keeping in mind that all our non-standard monetary policy measures are temporary in nature, we will monitor further developments closely and ensure medium term price stability for the euro area by acting in a firm and timely manner.~~All our non-standard monetary policy measures are temporary in nature and we maintain our full capacity to ensure medium-term price stability by acting in a firm and timely manner. Let me also remind you of the decision taken by the Governing Council on 22 June 2012 concerning further measures to increase collateral availability for counterparties.

Let me now explain our assessment in greater detail, starting with the **economic analysis**. On a quarterly basis, euro area real GDP growth was flat in the first quarter of 2012. ~~Available indicators~~, following a decline of 0.3% in the previous quarter. Indicators for the second quarter of ~~the year~~2012 point to a renewed weakening of economic growth and ~~highlight prevailing~~heightened uncertainty. Looking beyond the short term, we ~~continue to~~ expect the euro area economy to recover gradually. ~~However, ongoing~~, although with momentum dampened by a number of factors. In particular, tensions in some euro area sovereign debt markets and their impact on credit conditions, the process of balance sheet adjustment in the financial and non-financial sectors and high unemployment are expected to ~~continue to dampen~~weigh on the underlying growth momentum.

~~The June 2012 Eurosystem staff macroeconomic projections for the euro area foresee annual real GDP growth in a range between 0.5% and 0.3% for 2012 and between 0.0% and 2.0% for 2013. Compared with the March 2012 ECB staff macroeconomic projections, the range for 2012 remains unchanged, while there is a slight narrowing of the range for 2013.~~

~~In the Governing Council's assessment~~The risks surrounding the economic outlook for the euro area ~~is subject to increased~~continue to be on the downside ~~risks relating~~. They ~~relate~~, in particular, to a ~~further renewed~~ increase in the tensions in several euro area financial markets and their potential spillover to the euro area real economy. Downside risks also relate to possibly renewed increases in ~~commodity~~energy prices over the medium term.

Euro area annual HICP inflation was 2.4% in ~~May~~ June 2012, according to Eurostat's flash estimate, ~~after 2.6% in unchanged from~~ the previous month. ~~Inflation is likely to stay above 2% for the remainder of the year, mainly owing to developments in energy prices and indirect taxes. However, on~~ On the basis of current futures prices for ~~commodities, annual~~ oil, inflation rates should ~~fall~~ decline further in the course of 2012 and ~~be again below 2% again in early 2013. Looking ahead~~ Over the policy-relevant horizon, in an environment of modest growth in the euro area and well-anchored long-term inflation expectations, underlying price pressures should remain ~~subdued~~ moderate.

~~The June 2012 Eurosystem staff macroeconomic projections for the euro area foresee annual HICP inflation in a range between 2.3% and 2.5% for 2012 and between 1.0% and 2.2% for 2013. In comparison with the March 2012 ECB staff macroeconomic projections, there is a narrowing of the projection ranges for 2012 and 2013.~~

~~The Governing Council continues to view the~~ Taking into account today's decisions, risks to the ~~medium term~~ outlook for price developments ~~as~~ continue to be broadly balanced over the medium term. The main downside risks relate to the impact of weaker than expected growth in the euro area. Upside risks pertain to further increases in indirect taxes, owing to the need for fiscal consolidation, and higher than expected ~~commodity~~ energy prices over the medium term. ~~The main downside risks relate to the impact of weaker than expected growth in the euro area.~~

~~The~~ Turning to the ~~monetary analysis indicates that~~, the underlying pace of monetary expansion has remained subdued, with short-term developments displaying some volatility. The increase in the ~~first four months of 2012. The annual growth rate of M3 fell to 2.9% in May, up from 2.5% in April, down from 3.1% in March, following strong inflows into money in the first quarter of the year. The moderation in annual M3 growth~~ and close to the 3.0% observed in March, mainly reflected a reversal of the outflows in April ~~was mainly driven by outflows~~ from overnight deposits belonging to non-monetary financial intermediaries (which includes entities like central counterparties, particularly investment funds and securitisation vehicles)). In addition to an increased preference for deposits with shorter maturities, these factors have also shaped M1 developments, with the annual growth rate increasing from 1.8% in April to 3.3% in May.

The annual growth rate of loans to the private sector (adjusted for loan sales and securitisation) declined to 0.8% in April (from 1.2% in March), ~~owing to negative loan flows to non-monetary financial intermediaries. At the same time, monthly flows of 4% in May (from 0.8% in April). Annual growth rates for loans to both non-financial corporations and households were moderately positive in April and the annual rates of growth (adjusted for loan sales and securitisation) stood at~~ also decreased in May, to 0.72% and 1.53% respectively ~~in April, broadly unchanged from March.~~

~~Money and credit data up to April provide evidence that, as intended by our policy measures, an abrupt and disorderly adjustment in the balance sheets of credit institutions has not materialised. Given, with negative monthly loan flows to non-financial corporations. To a large extent, subdued loan growth reflects the current cyclical situation, heightened risk aversion, and the ongoing adjustment in the balance sheets of households and enterprises, subdued~~ which weigh on credit demand ~~is likely to prevail in the period ahead.~~

Looking ahead, it is essential for banks to continue to strengthen their resilience ~~further~~ where it is 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.

To sum up, ~~taking into account today's decisions~~, 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.

Let me now make a few remarks relating to ~~fiscal and economic~~ other policies. Significant progress has been achieved with fiscal consolidation over recent years. It is of crucial importance to continue with the efforts to restore sound fiscal positions and to regain competitiveness. These are pre-conditions for stable economic growth. As a natural complement, the implementation of the new macroeconomic surveillance framework under the EU semester is necessary. In several euro area countries, excessive imbalances exist and need to be corrected. To this end, comprehensive product, labour and financial sector reforms will help foster sustainable growth. Competition should be strengthened in product markets, not least by the completion of the Single Market, and wages should adjust in a flexible manner, reflecting labour market conditions and productivity. These growth-enhancing reforms would accelerate the necessary adjustment process and enhance job creation. We welcome the European Council conclusions of 29 June 2012 to take action to address financial market tensions, restore confidence and revive growth. We agree that Economic and Monetary Union needs to be put on a more solid basis for the future and that sustainable growth, sound public finances and structural reforms to boost competitiveness remain key economic priorities. We welcome the decision to develop a specific and time-bound road map for the achievement of a genuine

Economic and Monetary Union. We also welcome the euro area summit initiative towards a single supervisory mechanism, the possibility - with appropriate conditionality - to recapitalise banks directly, and the use of existing EFSF/ESM instruments in a flexible and efficient manner in order to stabilise markets. Finally, the ECB is ready to serve as an agent to the EFSF/ESM in conducting market operations.

~~Finally, the Governing Council very much welcomes leaders at the last European Council meeting agreeing to step up their reflections on the long-term vision for Economic and Monetary Union. The Governing Council considers this a highly important step.~~

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