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Eurozone: ECB maintains status quo

ECB maintains status quo with dovish stance

As expected, the European Central Bank (ECB) decided to keep the key policy rate unchanged at 0.50%, broadly in line with market expectation. Accordingly, the ECB left the interest rate on its deposit facility and marginal lending facility unchanged at 0% and 1.0% respectively. Besides, the ECB President re-assured the market that the monetary policy will remain accommodative for as long as necessary and re-iterated that *"... The Governing Council confirms that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time…"*

Mr. Draghi, for the first time, also acknowledged that repayments of funds (which stood at close to EUR 320.6 bn as of end-August, as per our calculations) in the context of the three-year longer-term refinancing operations reflect improvements in financial market confidence, some reduction in financial market fragmentation and the ongoing deleveraging by euro zone (EZ) banks.

The key macro economic highlights

In the post policy press conference, ECB President Draghi delved into a detailed outlook on the macro economic variables in the Eurozone. The key highlights of the post policy conference are as follows: -

- On the **growth** front, the ECB acknowledges the fact that EA witnessed its first expansion in real GDP in Q2 2013, which came after six consecutive quarters of contraction. Nevertheless, in line with improving survey-based indicators, ECB revises its 2013 projections for real GDP upwards. It now expects real GDP to decline 0.4% in 2013, as against June projections of a decline of 0.6%. For 2014, though, it expects real GDP to grow 1.0%, slightly lower than 1.1% projected in June 2013. The ECB though recognizes that the risks surrounding the economic outlook for the euro zone continue to be on the downside.

- On **inflation**, ECB expects inflation rates to remain low in the coming months, owing in particular to the developments in energy price movements. However, it has revised its inflation projections for 2013 upwards by 0.1 percentage points to 1.5%. For 2014, inflation forecasts remain unchanged at 1.3%. The risks to the outlook for price developments are expected to be still broadly balanced over the medium term, with upside risks relating in particular to higher commodity prices as well as stronger than expected increases in administered prices and indirect taxes, and downside risks stemming from weaker than expected economic activity. As per the latest flash estimates, Eurozone annual HICP inflation was 1.3% YoY in August 2013, down from 1.6% in July. Core inflation, in fact, was unchanged at 1.1% YoY in August 2013.

- On the **monetary** indicators, ECB recognizes the subdued growth in broad money (M3) and credit growth, in particular. M3 growth moderated further to 2.2% YoY in July, as against 2.4% in June. While lending to households grew 0.3% YoY in July, broadly unchanged since the turn of the year, loans to non-financial corporations (NFCs) declined 2.8% YoY in July, as against 2.3% decline in June. Loans to NFCs declined at the fastest pace on record in July 2013.

- Finally, the ECB President re-emphasized the need to continue on the fiscal consolidation path and not to unravel the efforts of the governments to reduce their deficits and debt. Mr. Draghi also stated that further decisive steps to establish a banking union will help to accomplish the reduction in the fragmentation of euro zone credit markets.

Conclusion: Another rate cut on hold but not completely off the table

To sum up, as expected, ECB maintained its dovish tone of keeping interest rate at present or lower level for an extended period of time. The President also acknowledged the high fragmentation of euro credit markets, reduction of which is necessary to ensure an adequate transmission of monetary policy.

In terms of the currency market reaction, Euro has weakened considerably from the intra-day high of close to 1.3220 levels to 1.3160.

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