ECB Watch

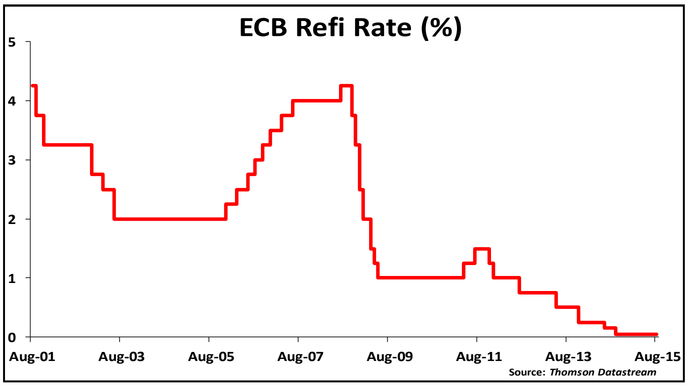
3rd September 2015

AIB Treasury Economic Research Unit

Dovish ECB to loosen policy further if needed

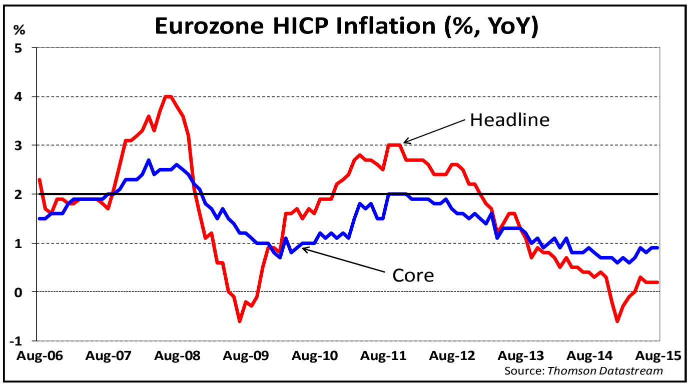
The outcome of today's meeting of the ECB Governing Council was in line with market expectations, with no changes to monetary policy. Thus, purchases under its QE programme will continue to run at a rate of €60 billion per month until at least September 2016.

However, the Governing Council statement and tone of Mr Draghi's press conference were more dovish than expected. The ECB also cut its inflation and growth forecasts and highlighted the downside risks to both from recent events.



The ECB emphasised its willingness to act further if warranted by using all the instruments available within its mandate, in particular by adjusting the size and duration of its QE programme. **Thus, it is clear that the ECB has a bias towards further easing and is prepared to take additional action if required to meet its price stability objective.** It indicated that it was too early to conclude whether recent developments would have a lasting impact on inflation, but vowed that it will closely monitor all relevant incoming information.

In terms of its assessment of the macro backdrop, the ECB noted that the economic recovery is continuing, though at a somewhat weaker pace than expected. Meanwhile, inflation is also a bit lower than anticipated. Furthermore, the ECB highlighted that renewed downside risks to the outlook for growth and inflation have emerged recently.



The latest set of ECB staff quarterly economic projections published today contained **downward revisions to both the inflation and growth forecasts.** ECB staff now see inflation averaging 0.1% in 2015 and 1.1% in 2016. These are significantly lower than the previous estimates of 0.3% and 1.5%, largely due to the large fall in oil prices since early in the summer. Inflation is seen averaging 1.7% in 2017.

GDP is now forecast to rise by 1.7% and 1.8% in 2016 and 2017 respectively, a cut of 0.2% for both years compared to the previous forecasts. Growth in 2015 is forecast at 1.4%. Thus, the ECB does not see the recovery gaining much further momentum.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2014	2015	2016	2017
HICP	0.3	0.1	1.1	1.7
Real GDP	0.9	1.4	1.7	1.8

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $55.3 in 2015, $56.1 in 2016 and $60.9 in 2017. Source: ECB September 2015

There was a **reaction in markets** to the more dovish than expected ECB comments, especially on the scope for expanding the QE programme and the emergence of fresh downside risks to growth and inflation. **The euro dipped, Eurozone bond yields were lower, while European stock markets rose.** The euro fell to close on $1.11 versus the dollar and is trading back below the 73p level against sterling. Today's ECB comments also support market expectations that interest rates are set to remain around zero for a very long time in the Eurozone. Futures contracts are not pricing in any rate increase until the second half of 2018, and do not see official rates rising to 1% until 2021.

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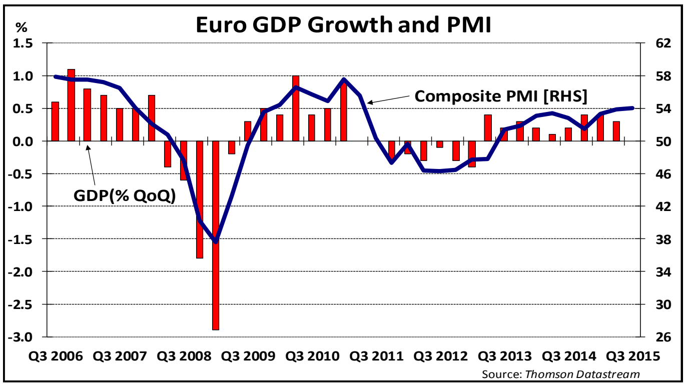
Moderate Upswing Continuing

The pace of GDP growth in the Eurozone moderated slightly in Q2 to 0.3%, after registering growth of 0.4% in Q1 and Q4 2014. Growth edged up to 1.2% from 1% on a year-on-year basis.

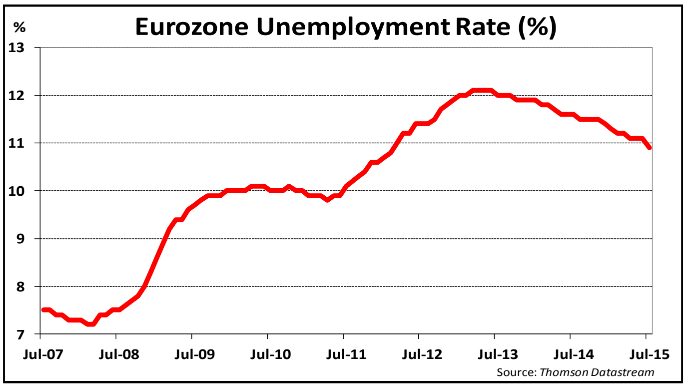


At a national level, growth in the big three economies—Germany, France and Italy—which account for c.65% of Eurozone GDP, was modest to flat. German growth was slightly improved at 0.4% (from 0.3%), the French economy was disappointingly flat (grew by 0.7% in Q1), while Italy grew by 0.3% (third consecutive quarter of growth). **The performance of the peripheral economies was generally strong,** with Spain (+1%) and Greece (+0.9%) seeing encouraging growth.

While we do not yet have the breakdown of Q2 GDP, 'hard' data releases during the quarter suggest that industrial production may have acted as a drag on growth (fell by 0.2% in Q2). Although, **the retail sector continued to grow and thus, consumer spending is likely to have made another positive contribution to GDP.** Retail sales rose by 0.4% in July, maintaining their positive trend at the start of Q3.

In terms of survey data for Q3, leading indicators of activity suggest that the economy has maintained a modest pace of growth. The key composite PMI averaged 54.1 in July/August, in line with Q2's 53.9 average. Meanwhile, the EC economic sentiment index averaged 104.1 in July/August versus 103.7 in Q2. At a national level, important indicators such as the German Ifo, French INSEE and Italian ISTAT indices have also shown little change in Q3 to date compared to Q2.

The steady pace of improvement in the Eurozone economy has had a positive impact on the labour market. The Eurozone unemployment rate fell to 10.9% in July, it lowest level since February 2012. Although, this still represents a very high level. The headline figure also hides a dichotomy between Eurozone countries, with the unemployment rate in Germany currently at just 4.7%, compared to 10.4% in France and 22.2% in Spain. Employment has been rising at slightly below 1% year-on-year in recent quarters. **The employment component of recent Eurozone PMI surveys suggests that employment is continuing to grow at a modest pace.**



Meantime, monetary aggregates have continued to improve. **Annual growth in M3 money supply rose further in July to 5.3%.** Growth has averaged 4.7% in 2015 so far, after averaging just 1.9% in 2014. Meantime, underlying growth in loans to the private sector also continued to pick up in July, rising by 1.4% year-on-year, its best rate since the end of 2011.

Overall, growth in the Eurozone is expected to remain moderate as it still faces some significant headwinds. These include the continuation of tight fiscal policy, high levels of unemployment in many countries, a lack of structural reforms in some economies, as well as the risks posed by a slowdown in growth in emerging markets (especially China). However, there are also some tailwinds for the economy including the favourable impact from lower oil prices, a weaker euro and the impact of monetary policy easing measures, with interest rates likely to remain at very low levels for the next few years. The ECB is forecasting moderate GDP growth of 1.7% in 2016 and 1.8% in 2017, up from 1.4% this year.