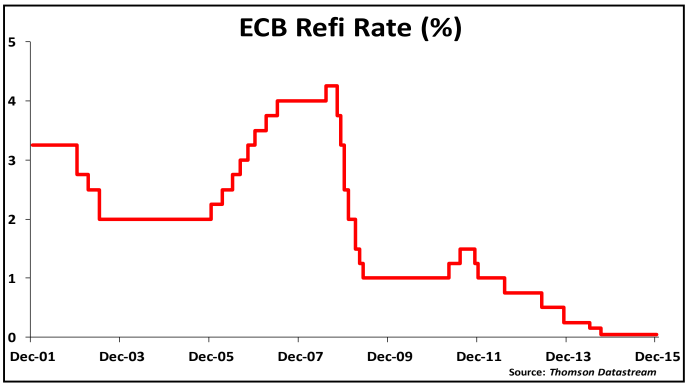
ECB Watch

3rd December 2015

AIB Treasury Economic Research Unit

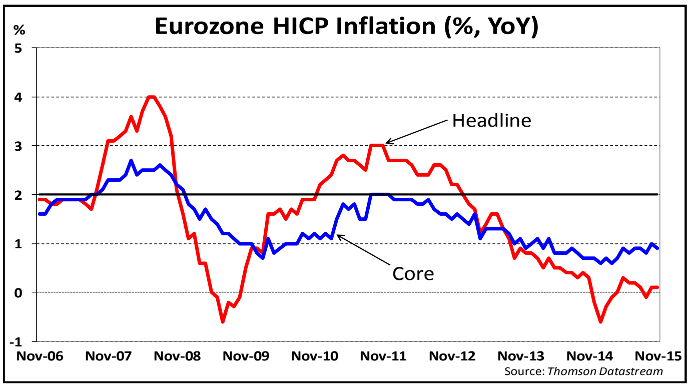
ECB easing underwhelms versus expectations

As widely expected and signalled, the ECB announced a raft of new easing measures at today's Governing Council meeting. It cut the deposit rate by another 10bps, moving it deeper into negative territory at −0.3%. Rates were last cut in September 2014.



The ECB announced an extension of its QE programme. The monthly purchases of €60bn per month are "now intended to run until the end of March 2017, or beyond, if necessary" from the original proposed end date of September 2016. It also stated that it would reinvest the principal payments on the securities purchased as well as broadening the spectrum of bonds it can purchase as part of its public sector bond buying to include euro denominated debt issued by regional and local governments in the Eurozone. Finally, the ECB stated that it would continue to conduct its "main refinancing operations as fixed rate tender procedures with full allotment for as long as necessary".

The Governing Council decided to provide this additional monetary stimulus "in order to secure a return of inflation towards levels that are below, but close to, 2%". In the post meeting press conference, ECB President, Mario Draghi, stated the Central Bank decided that its current policy initiatives, while being "successful", were "not enough" to ensure that the ECB achieves its inflation objective. He said that these latest announcements will help to consolidate "something that has been successful".



Today's meeting also saw the publication of the latest set of ECB staff macro-economic projections. Compared to the September version, the GDP forecasts are broadly unchanged. Meanwhile, the outlook for inflation has been revised down slightly.

The policy announcements today from the Governing Council were not unanimous, indicating that there was some opposition within the ECB to more aggressive easing. President Draghi emphasised though, that the "measures need time to be fully appreciated" and that there is still a willingness within the ECB to do more, if required. **However, it is quite clear, judging by the market reaction, that the ECB has under-delivered compared to market expectations.** The market had been expecting a 15-20bps cut in the deposit rate and a sizeable expansion in the quantity of monthly asset purchases.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2014	2015	2016	2017
HICP	0.3	0.1	1.0	1.6
Real GDP	0.9	1.5	1.7	1.9

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $53.8 in 2015, $52.2 in 2016 and $57.5 in 2017. Source: ECB December 2015

This disappointment was evident across financial markets. Eurozone yields rose, with ten year German bund yields increasing by 15bps to over 0.60%. Meanwhile, European equity markets sold off, with the Euro Stoxx down nearly 3%. On currency markets, the euro rose sharply. After starting the day just below $1.06, the euro bolted higher, to within touching distance of $1.09, before settling near $1.085, while EUR/GBP traded up close to 72p.

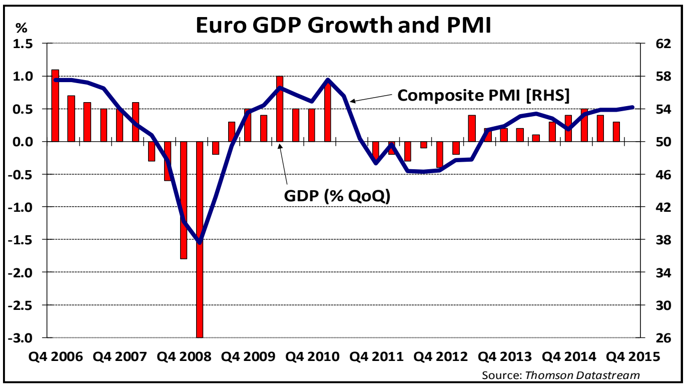
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Eurozone economy remains subdued

The pace of GDP growth in the Eurozone slowed in Q3, coming in at 0.3%. This was after gains of 0.4% in Q2 and 0.5% in Q1. Year-on-year growth did pick up further, though, to 1.6%. This is its fastest pace of expansion in over four years.

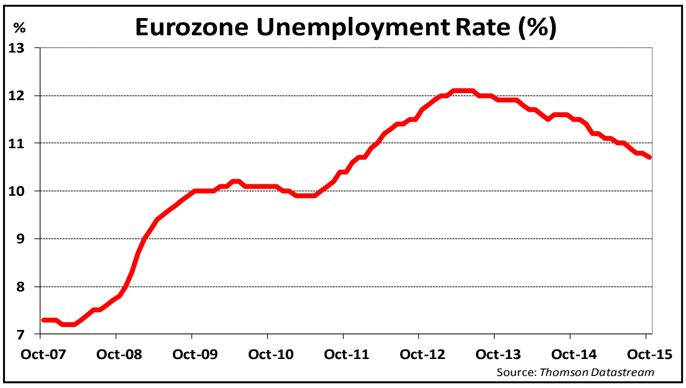


At a national level, unlike in recent quarters, growth was generally soft in both core and peripheral countries in Q3. The latter bloc of economies had generally outperformed in H1. Growth in the Eurozone's three biggest economies—Germany, France and Italy—remained very modest, coming in at 0.2-0.3%. Given that they account for c.65% of the Eurozone economy, even continued strong performances elsewhere would have had only limited impact on headline Eurozone growth.

While we do not yet have the breakdown of Q3 GDP, 'hard' data releases during the quarter suggested that the contribution from industrial production remained negligible (output rose by 0.1% in Q3). **Meantime, retail sales continued to grow (+0.7%) and thus, consumer spending is likely to have remained a key driver of growth in the quarter.** Retail sales, though, declined slightly at the start of Q4.

Leading survey indicators of activity suggest that the economy continued to grow at a subdued pace in Q4. The key Eurozone composite PMI averaged 54.1 in October/November, broadly matching its 53.9 average from the previous two quarters. The EC economic sentiment index also points to on-going moderate growth in the Eurozone in the final quarter of the year.

The modest pace of improvement in the Eurozone economy has had some beneficial impact on the labour market. The Eurozone unemployment rate fell to 10.7% in October, its lowest rate in nearly four years. The headline figure hides a worrying dichotomy, though, with the unemployment rate in Germany currently at just 4.5%, compared to 10.8% in France and 21.6% in Spain. Meanwhile, year-on-year growth in employment has been just below 1% since mid-2014. In terms of the near term outlook, the Eurozone composite employment PMI averaged just 52.1 in October/November versus a similarly 'soft' 51.8 in Q3. This suggests that employment growth will remain muted.



However, **monetary aggregates have been much improved in 2015.** While the pick-up in the pace of annual growth in M3 money supply has levelled off in recent months, at 5.3% in October, it is significantly stronger than a year ago. Furthermore, underlying growth in loans to the private sector has also improved, with year-on-year growth of 1% in October, its best rate since the end of 2011.

Overall, growth in the Eurozone is expected to remain moderate as it still faces some significant challenges. These include high levels of unemployment in many countries, a lack of structural reforms in some economies, the negative impact from a slowdown in growth in emerging markets (especially China), as well as the risks from geo-political factors.

However, there are also some positives for the economy, including the favourable impact from lower commodity 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 GDP growth of 1.7% in 2016 and 1.9% in 2017, up from 1.5% this year.

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomicresearch.com