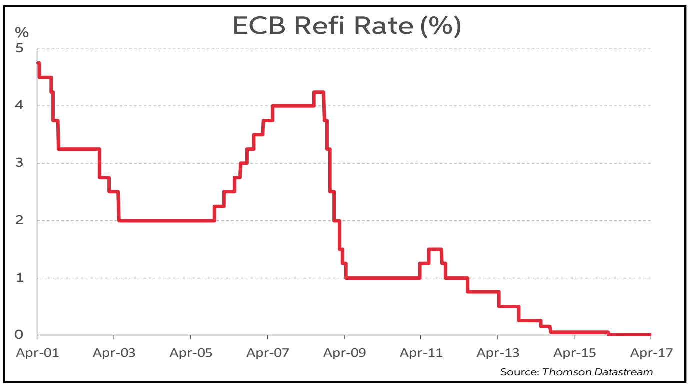
ECB Watch

AIB Treasury Economic Research Unit

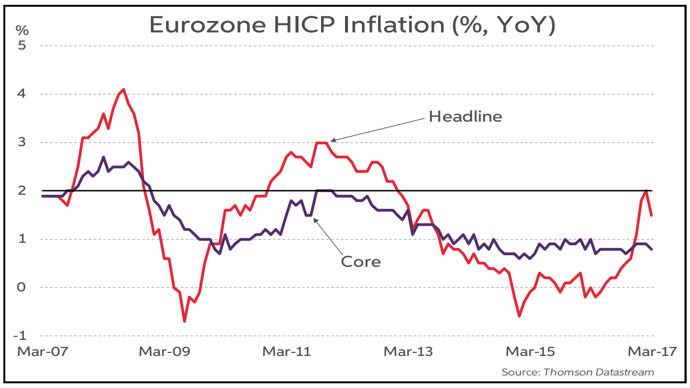
27th April 2017

ECB reiterates policy needs to remain very accommodative

Today's ECB meeting concluded with its key interest rates remaining unchanged at −0.4% for the deposit rate and 0% for the refi rate, as expected. **There was also no change to the plans for its asset purchase programme**. The ECB had previously announced that it would reduce its rate of purchases from €80bn per month back to the original rate of €60bn per month from this month. The QE programme will run until end December 2017, or beyond, if necessary.



The tone and content of today's meeting statement indicate that the ECB is becoming increasingly optimistic about the economic outlook. The statement noted that that the incoming macro data since the Council's last meeting in early March confirm that the economic recovery is becoming increasingly solid. The data have also bolstered the ECB's confidence that the economic expansion will continue to firm and broaden. Furthermore, both the meeting statement and President Draghi, in his press conference, noted that the **risks surrounding the euro area growth outlook have "further diminished",** although they still remain "tilted to the downside".



The optimistic assessment of the economic outlook is in line with the latest staff macro projections published last month. The ECB expects GDP to grow by a solid 1.8% this year, 1.7% in 2018 and 1.6% in 2019.

The ECB is looking for inflation to average 1.7% in 2017, up from 0.2% in 2016, reflecting the recovery in oil prices. However, despite this marked rise, the **ECB has been keen to emphasise that underlying inflation remains low and is expected to rise only gradually over the medium term.** Core inflation has remained very subdued in a 0.7-0.9% range over the past year. The ECB is forecasting that inflation will average 1.6% in 2018 and 1.7% in 2019, thus remaining below target.

Overall, ECB policy is set to remain very loose for a considerable period of time, with the on-going large asset purchase programme continuing this year and its key discount rate being maintained at −0.4%. The ECB remains concerned that underlying inflation pressures are very subdued and thus it continues to emphasise that a very substantial degree of monetary accommodation is still needed to achieve a sustained upward move in inflation, "without undue delay".

Market reaction to today's meeting and policy statement was muted enough, with the euro and bond yields both slightly lower given that there was little sign the ECB is considering changing its easing bias just yet. **There has been some speculation that the ECB could row back on its easing biases at its next policy meeting in early June.** In this regard, it could indicate that the risks to economic growth are no longer tilted to the downside and have become balanced, and also drop the reference to its willingness to loosen policy further if required.

However, any moves towards monetary tightening are still a long way off. The ECB would first have to taper or run down its asset purchase programme, probably over the first half of next year at the earliest. The ECB expects to keep rates at their current very low levels for an extended period of time beyond that. Not surprisingly then, markets do not see 3-month Eurozone rates turning positive until mid-2019 or reaching 1% until end of 2022.

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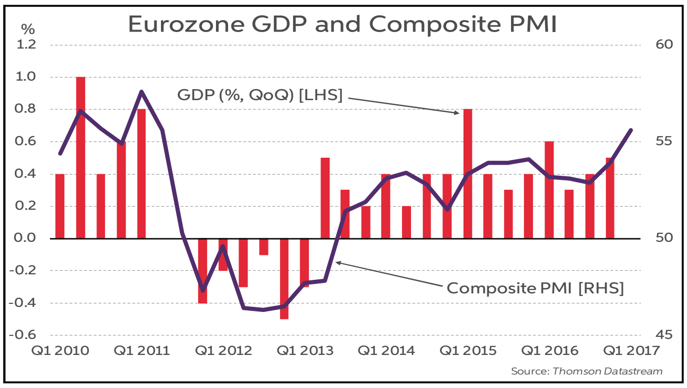
Eurozone data generally more upbeat

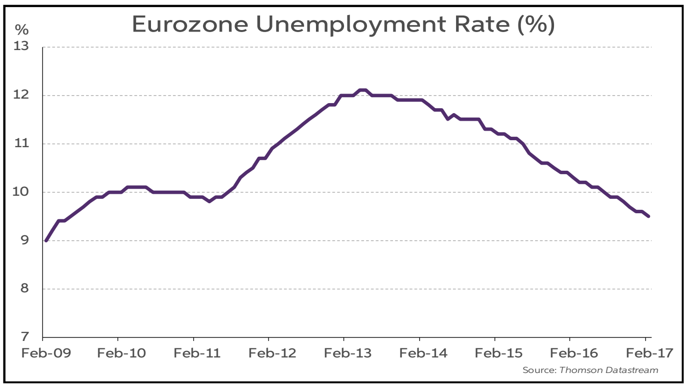


The Eurozone economy grew by an encouraging 0.5% in Q4, a slight improvement on Q3's 0.4% rise. The currency bloc grew by 1.8% on a year-on-year basis in Q4 and by 1.7% in 2016 as a whole.

Hard data for Q1 2017 have generally pointed to a slower pace of Eurozone growth. Industrial production fell by 0.1% in January/February following on from its solid 0.9% increase in Q4. Although, this partly reflects a fall in energy production due to mild weather conditions. **Retail sales rose by just 0.2% in Jan/Feb,** after Q4's +0.8%. Meanwhile, a pick-up in imports has seen the Eurozone goods trade surplus decline in Jan/Feb.

However, the tone of the hard data is in stark contrast to buoyant survey indicators of activity. For example, the Eurozone composite PMI averaged 55.6 in Q1 (up from 53.9 in Q4 2016), its best quarterly performance since Q2 2011. Both the manufacturing and services indices rose in Q1. Likewise, the EC Eurozone economic sentiment index averaged 107.9 in Q1, its strongest quarterly result since Q1 2011.

Furthermore, **timelier survey indicators for April painted a continuing very positive picture of the economy at the start of Q2. The composite PMI increased further to 56.7, a 6-year high,** while the EC economic sentiment index jumped to 109.6, a near 10-year high. National level indicators such as the German Ifo, French INSEE and Italian ISTAT indices are also around multi-year highs in April, pointing to firming economic growth.



In terms of the labour market, the recent signs have been generally positive. The Eurozone unemployment rate fell to 9.5% in February, its lowest level in eight years. Although, the 'dichotomy' of the unemployment rates in the major Eurozone economies remains very wide. German unemployment came in at 3.9% in February, while the level in France, Italy and Spain remained at or above 10%.

Employment has grown at a healthy pace in recent quarters. Year-on-year growth did slow slightly in H2 2016, though, to 1.2%. **The employment component of the Eurozone composite PMI increased in Q1 and rose further in April to 54.8, its highest level in nearly 10 years.** This suggests that employment growth may have accelerated again.

The Eurozone economy continues to face some challenges, including high levels of unemployment in many countries, a lack of structural and financial sector reforms in some economies, weak levels of business investment and only modest wage growth. Meanwhile, despite the likely election of a pro-EU President in France, political risks still remain in the Eurozone, with German and possibly Italian elections later this year.

However, there are also tailwinds for the economy, including relatively low underlying inflation, the generally weak euro and the positive impact of loose monetary policy, with interest rates likely to remain at very low levels for the next few years. A modest improvement in global growth should also help to provide some support to the economy. Fiscal policy has also become more expansionary in many countries. The ECB is forecasting GDP growth of 1.8% for this year and 1.7% in 2018. The recent forecasts from the IMF are for growth of 1.7% this year and 1.6% in 2018. **Overall then, the expectation is that the Eurozone economy will continue to grow at a steady pace in the next couple of years.**

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