ECB Watch

AIB Treasury Economic Research Unit

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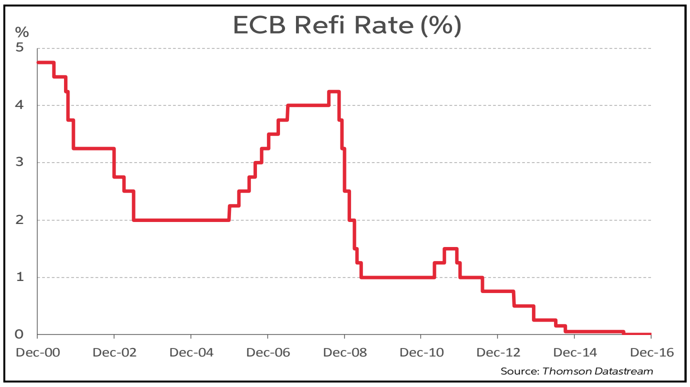
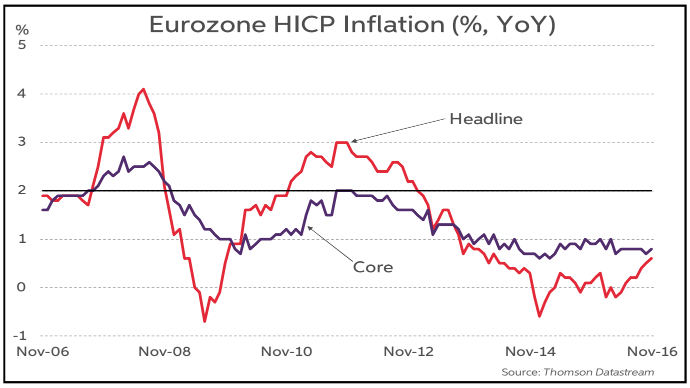
ECB extends, but reduces, the rate of asset purchases

Today's meeting of the Governing Council saw the ECB keep its key interest rates unchanged at -0.4% for the deposit rate and 0% for the refi rate. This was in line with market expectations. **However, the Central Bank did make a number of changes to its QE programme.** It decided, by "broad consensus", to extend its monthly asset purchase (from the current expiration date of end March 2017) "until the end of December 2017, or beyond, if necessary". However, **it reduced its rate of purchases from €80bn per month back to its original rate of €60bn per month.** The Central Bank **also adjusted the parameters of the QE programme.** Firstly, the maturity range is to be "broadened by decreasing the minimum remaining maturity for eligible securities from two years to one year". Secondly, the purchase of securities with a "yield to maturity below" the ECB's deposit rate "will be permitted".



In the post-meeting press conference, ECB President Mario Draghi was keen to stress that today's reduction in the monthly rate of QE purchases did not represent a 'tapering'. Indeed, he stated on a number of occasions that tapering was "not discussed" and there is "no question of tapering". To reinforce this point, he later commented that today's extension to QE and the willingness to do more shows that the "ECB is going to stay in the markets" and "continue to exert pressure on market prices".



In terms of the rationale for the changes to the QE programme, President Draghi noted that the 'risk of deflation has largely disappeared'. He also pointed out that the outlook for inflation and its sustained return to target is now 'not very different from the outlook at the beginning of the asset purchase programme' (i.e. when the rate of purchases was €60bn per month). The "calibration" of QE also "reflects the moderate but firming recovery of the euro area economy and still subdued underlying inflationary pressures".

ECB Macroeconomic Forecasts for the Euro Area

(%)	2016	2017	2018	2019
HICP	0.2	1.3	1.5	1.7
Real GDP	1.7	1.7	1.6	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $43.1 in 2016, $49.3in 2017 , $52.6 in 2018 and $54.6 in 2019. Source: ECB December 2016

The updated staff macro projections for December were broadly unchanged from the September edition. The ECB continues to expect GDP to grow by 1.7% this year. It marginally upgraded its forecast for 2017 to 1.7% (from 1.6%), while 2018 was unchanged at 1.6%. The ECB is also expecting growth of 1.6% in 2019. The outlook for inflation also showed only marginal changes compared to September.

Overall, the ECB retains a bias to ease policy further if required. The Central Bank continues to view the "risks surrounding the euro area growth outlook" as remaining "tilted to the downside". The meeting statement emphasised that if the outlook for inflation becomes "less favourable", the ECB "intends to increase the programme in terms of size and/or duration". Market reaction to today's meeting has seen the euro weaken somewhat, with EUR/USD back below $1.07 and EUR/GBP trading back down under the 85p mark.

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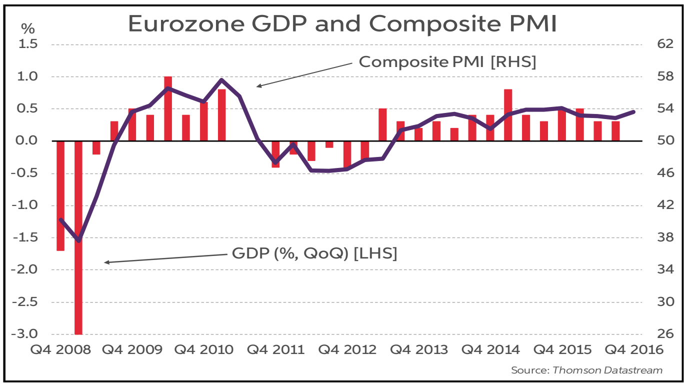
Pace of growth may improve slightly in Q4

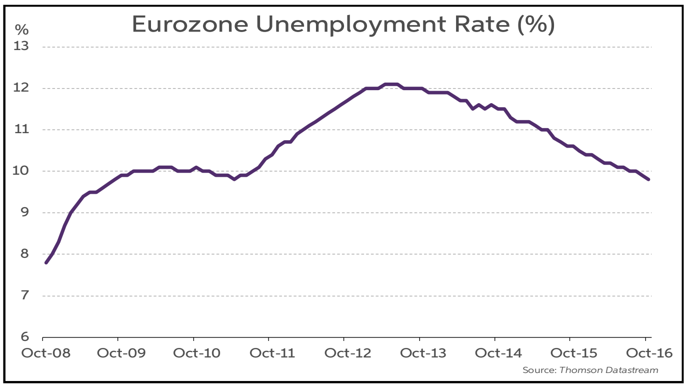
The Eurozone economy grew by a modest 0.3% in Q3, matching its performance in Q2. Year-on-year growth remained at 1.7% for a third consecutive quarter. The underlying data show that consumer spending was the main contributor to GDP, adding 0.2 percentage points (p.p.), while inventories and government spending added 0.1 p.p. each. Investment was flat, with net exports acting as a drag, deducting 0.1 p.p. from growth.



In terms of the performance of the economy in Q3, leading indicators of activity suggest growth may have picked up slightly. The key Eurozone composite PMI averaged 53.6 in the October/ November, which on past form is consistent with a 0.4/0.5% pace of quarterly GDP growth. The EC measure of Eurozone economic sentiment averaged 106.5 in Oct/Nov, compared to 104.3 in Q3. National level PMIs and other indicators such as the German Ifo, French INSEE and Italian ISTAT surveys also suggest that we could see some pick-up in growth in the fourth quarter.

However, there is still only limited 'hard' data available to validate the more positive view suggested by the survey data. Although, Eurozone retail sales did rise strongly in October, growing by 1.1% in the month. This result, combined with the marked improvement in the EC measure of Eurozone consumer confidence in November, suggests that sales could improve upon Q3's 0.4% increase in Q4.

In terms of the labour market, employment growth has improved in 2016, registering 1.4% year-on-year growth in H1, versus 1.1% in H2 2015. **The employment component of the Eurozone composite PMI averaged 52.7 in Oct/ Nov**. This is broadly unchanged from Q3's 52.5 result, which was its best quarterly performance since Q2 2011. Thus, it appears that employment growth may maintain a solid pace of improvement.



Meantime, **the unemployment rate has continued to show a steady pace of decline in recent months, while remaining at quite a high level.** It fell to 9.9% in September, its first time in single figures since August 2008, before moving down further to 9.8% in October. Furthermore, the large dichotomy in the unemployment rate between some countries has narrowed slightly.

The Eurozone economy continues to face some significant challenges, including high levels of unemployment in many countries, a lack of structural reforms in some economies, weak levels of business investment and only modest wage growth. The early signs are that the initial Brexit vote impact on the Eurozone economy has been limited, but the vote to leave the EU remains a significant downside risk. Meanwhile, Eurozone political uncertainty has also heightened in recent weeks with anti-establishment and euro-sceptic parties expected to do well in elections in France, Germany and the Netherlands in 2017. Early elections are also possible in Italy, given the outcome of the recent referendum.

However, there are also some tailwinds for the economy, including the favourable impact from low commodity prices, the relatively weak euro and the impact of monetary policy easing, with interest rates likely to remain at very accommodative levels for the next few years. A modest improvement in global growth should 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 1.7% for this year and next year.

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