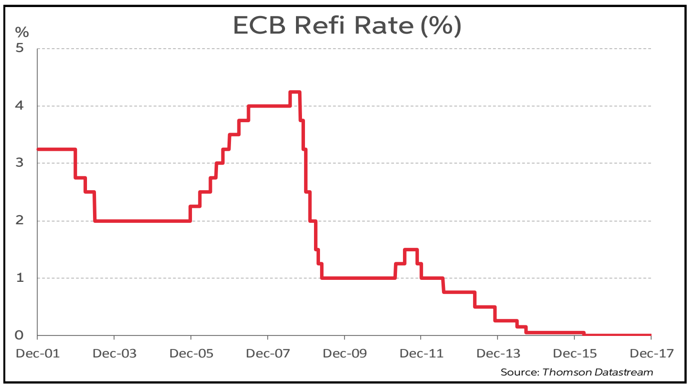
ECB Watch

AIB Treasury Economic Research Unit

15th December 2017

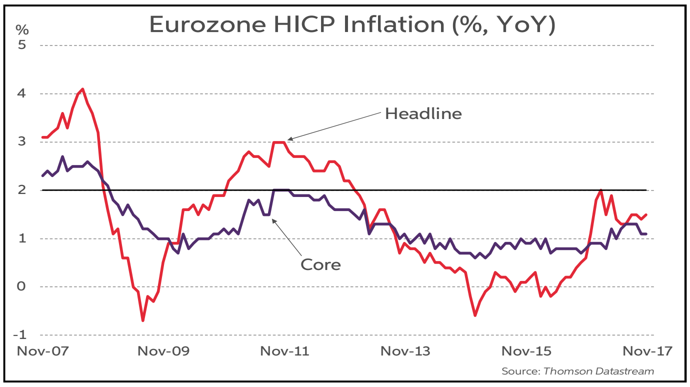
ECB content with current policy stance

The December ECB Governing Council meeting concluded in line with market expectations for no change to monetary policy. Rates were left at –0.4% for the deposit rate and 0% for the refi rate. At its previous meeting in October, the ECB announced an extension to its asset purchase programme which had been due to run until the end of this year. The purchases will last until at least September 2018, but at a reduced rate of €30 billion per month (currently at €60bn). The ECB re-affirmed its commitment, that if necessary, the programme could be extended beyond this date or it could increase the size of purchases.



The meeting statement illustrated an upbeat assessment by the ECB of the economic backdrop and outlook. The Governing Council commented that the incoming data "indicates a strong pace of economic expansion and a significant improvement in the growth outlook". It also noted that the "strong cyclical momentum" combined with a "significant reduction of economic slack" gave it confidence that it can achieve its inflation objective (i.e. close to, but below 2%).

The latest ECB staff forecasts reflect the Central Bank's more upbeat view of the economic outlook with its real GDP growth projections revised substantially higher. The ECB now expects GDP to grow by 2.4% this year (from 2.2%). Its GDP forecast for 2018 was upgraded to 2.3% (from 1.8%) and for 2019 it revised up its growth projection to 1.9% (from 1.7%). The first release of the ECB's 2020 forecast was also published, with growth of 1.7% being pencilled in. **The Central Bank remains of the view that the risks to the economic outlook remain "broadly balanced".**



Meanwhile, the ECB expects inflation to average 1.4% in 2018 (from 1.2%), and 1.5% in 2019 (no change). It is projecting inflation will average 1.7% in 2020. These upward revisions mainly reflect higher oil and food prices. Thus, inflation is **expected to only start moving towards its medium-term target of just under 2% in 2020, justifying the ECB's continuing very loose monetary stance despite the strengthening in activity**. In the press conference, President Draghi was asked if '1.7%' met the ECB's target. He responded by saying that it depends on what the underlying drivers of the increase in inflation are, making specific reference to "nominal wages" as a key variable for the ECB.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2017	2018	2019	2020
HICP	1.5	1.4	1.5	1.7
Real GDP	2.4	2.3	1.9	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $54.3 in 2017, $61.6 in 2018, $58.9 in 2019 and $57.3 in 2020. *Source: ECB December 2017*

In summary, the December meeting shows that the ECB is comfortable with its current policy stance. It expects to keep interest rates at their current very low levels well past the point that it concludes doing net asset purchases. This suggests that rates are unlikely to be hiked in the Eurozone before 2019 at the earliest. This is reflected in interest rate futures contracts, with **markets anticipating 3-month Eurozone rates remaining negative until end-2019 and staying low for an extended period beyond that, only reaching 1% by mid 2023.**

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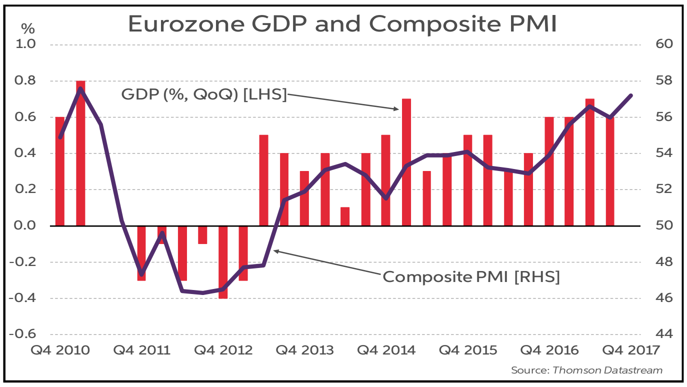
Eurozone economy growing strongly

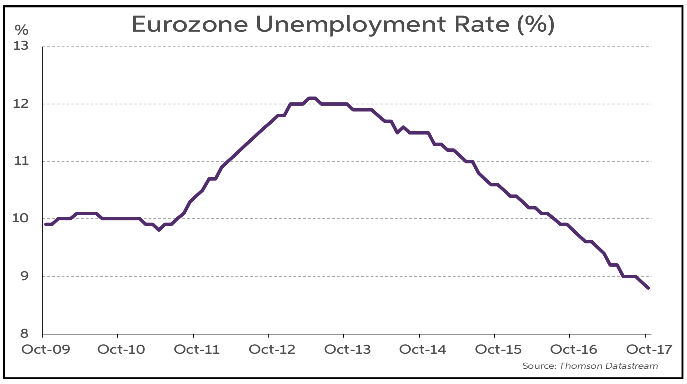
The Eurozone economy grew by a strong 0.6% in Q3, broadly in line with Q2's very impressive 0.7% rise. Year-on-year growth picked up to 2.6%, from 2.4%, its strongest rate since Q1 2011. **The underlying data show that consumer spending wasn't quite as firm as in Q2, adding 0.2 percentage points (p.p.) to GDP, versus 0.3.** Investment was also softer, 0.2 p.p. compared to 0.4. Inventories added another 0.1 p.p. in Q3. Meantime, net trade was neutral, after deducting 0.2 p.p. from growth in Q2.



Survey data for Q4 suggest that the economy recorded another strong quarter of growth. The Markit composite PMI averaged 57.2 in Q4, its best performance since Q1 2011. Such a result is consistent with quarterly growth of around 0.7%. Meanwhile, the EC measure of Eurozone economic sentiment picked up to its highest level in 17 years in November. National level indicators, such as the German Ifo, French INSEE and Italian ISTAT indices also suggest that the economy continues to grow at a strong pace.

The available 'hard' data for Q4 have been somewhat mixed, though. For example, retail sales fell by 1.1% in October, after recording a modest 0.5% increase in Q2. However, it must be noted that the EC measure of Eurozone consumer confidence did jump to a 17-year high in November, indicating that spending growth may pick-up pace in the coming months. On the output side, industrial production recorded a modest 0.2% rise in October, after growing by 1.2% in Q3.

In terms of the labour market, recent data have been positive. Employment grew by a solid 0.4% in Q3, with the year-on-year rate edging up to 1.7%, from 1.6%. This is its firmest rate since Q1 2008. The timelier composite PMI employment sub-component averaged 55.5 in Q4, above Q3's 54.2 average and its best performance since Q3 2000. This indicates that employment growth may have picked up further pace in the final quarter.



In terms of unemployment rate, it fell to its lowest level in October (8.8%) since January 2009. This partly reflects a steady pace of decline in unemployment in France, which fell to a 6-year low of 9.4% in October. Unemployment in countries with very high jobless numbers, such as Italy (11.1%) and Spain (16.7%) is also continuing to decline, as economic growth picks up pace. The unemployment rate in Germany, the Eurozone's largest labour market, has remained very low at just 3.6% in recent months.

The Eurozone economy still faces some problems, including marked regional disparities in unemployment as well as very high youth unemployment in some countries, slow productivity growth, weak wage growth and a continuing aversion to structural reforms in some countries. **Nonetheless, the economic prospects in the Eurozone look brighter now than at any time in the past decade.** The OECD is forecasting Eurozone GDP growth of 2.4% this year, followed by 2.1% in 2018 and 1.9% in 2019. This is broadly in line with the view of the European Commission.

This positive outlook for the economy is based on a number of factors, including the fact that ECB policy looks set to remain very loose in the coming years, fiscal policy is generally becoming more expansionary, while the global economy is picking up momentum. Inflation is also expected to remain low, helping to maintain growth in real spending power. The EC also points out that given the recovery in the Eurozone is less advanced than elsewhere, it has the capacity to continue growing strongly for quite some time.