ECB Watch

AIB Treasury Economic Research Unit

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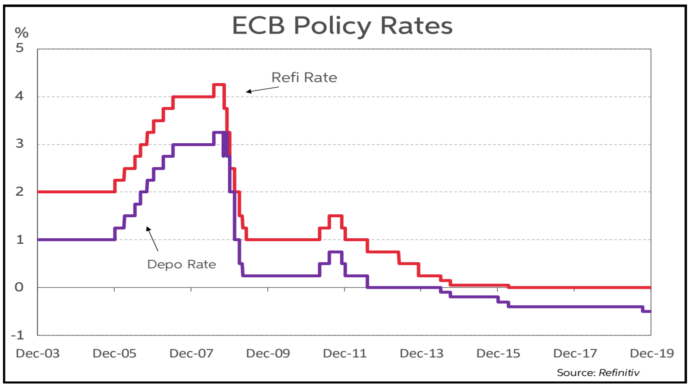
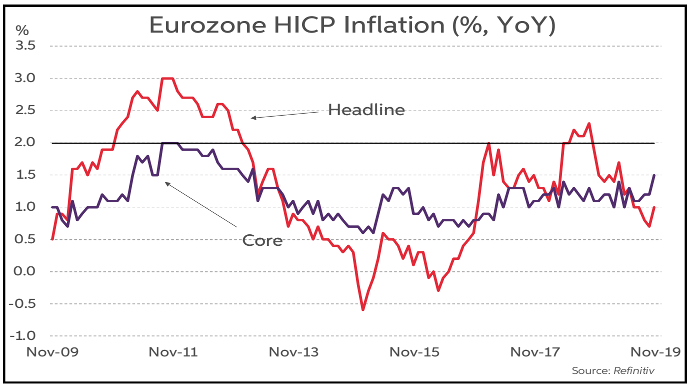
ECB to remain on the sidelines over the coming months

The last ECB meeting of 2019 and the first with Christine Lagarde as President saw the Governing Council keep policy unchanged. This was very much in line with market expectations. **The central bank is widely viewed to be on hold as regards to further policy action.** This is to allow time for the significant easing package it announced back in September to impact on the real economy. These measures included a cut of 10bps to the deposit rate from −0.4% to −0.5%, as well as restarting its QE asset purchase programme.



However, the ECB does continue to retain an easing bias. The meeting statement text once again stated that official rates will remain at their present or lower levels until inflation robustly converges with its 2% target. The ECB also continued to emphasise that its QE purchases programme would run for as long as necessary and only end shortly before it starts to raise rates.

Today also saw the release of the ECB's updated staff projections for December. The generally muted outlook for economic activity illustrates why the ECB retains an easing bias**.** Both the growth and inflation forecasts were only slightly altered from their subdued levels in the September edition.



The ECB is now projecting slightly higher GDP growth of 1.2% (from 1.1%) in 2019. Meantime it has revised lower its 2020 projection to 1.1% (from 1.2%). The central bank expects GDP growth to come in at 1.4% in 2021 (unchanged from September). In its first published GDP forecast for 2022, the ECB is projecting growth of 1.4%.

Meanwhile, inflation is expected to remain well below the 2% target in the next couple of years. HICP inflation is forecast at 1.2% in 2019, unchanged from September. The ECB did revise modestly higher its 2020 inflation forecast to 1.1% (from 1.0%), while marginally downgrading its 2021 projection to 1.4% (from 1.5%) in 2021. The ECB envisages inflation averaging 1.6% in 2022. Responding to a question in her inaugural press conference, on inflation remaining below its 2% target in 2022, President Lagarde commented that directionally it was "good" but was still unsatisfactory from an ECB price stability objective.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2019	2020	2021	2022
HICP	1.2	1.1	1.4	1.6
Real GDP	1.2	1.1	1.4	1.4

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $63.8 in 2019, $59.6 in 2020, $57.4 in 2021 and $56.8 in 2022

Source: ECB December 2019

The ECB continues to be of the view that the risks to its outlook remain "to the downside". However, in a change from the October statement, it added that these risks have become "somewhat less pronounced".

The market is currently expecting no more than a small, 5bps, final rate cut next year. Futures contracts indicate that the market does not see ECB rates starting to rise until mid-2022 and then only very slowly**.** These contracts also show that the market is envisaging three month money market rates remaining negative until the end of 2024. **In conclusion, while the ECB retains an easing bias, the Central Bank is very likely to remain on the sidelines in the coming months as it assesses the impact of the easing measures it announced in September.**

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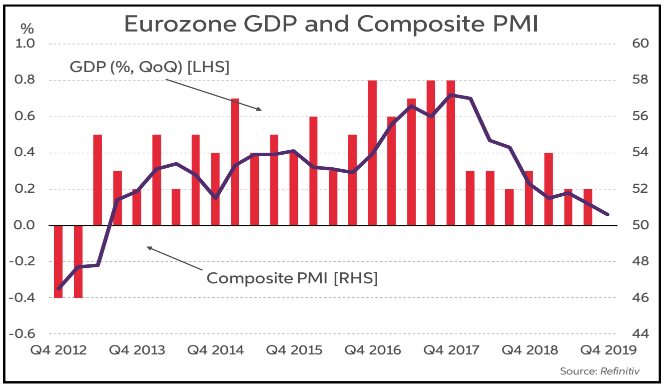
Eurozone economy runs out of steam

Eurozone GDP growth held at a weak 0.2% in Q3, leaving the year-on-year rate at 1.2%. Consumer spending drove growth in the quarter, contributing 0.3 percentage points (p.p.) to the total. Fiscal expenditure and fixed investment added a further 0.1 p.p.. Meanwhile, changes in inventories and net trade both acted as drags, subtracting 0.1 p.p. each.

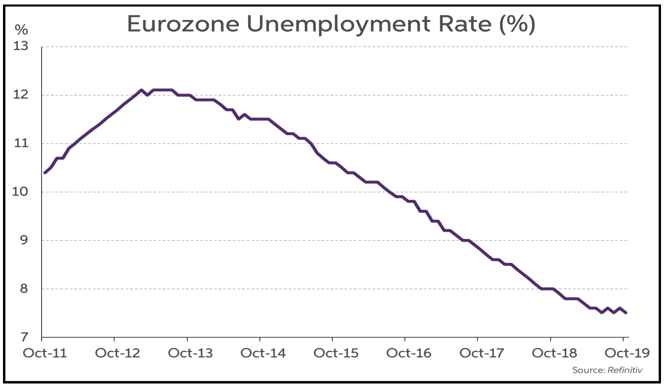


The national data showed that growth in the region remains very uneven. Germany narrowly avoided a recession in the quarter, but the economy has essentially stagnated. The same is true of Italy. In contrast, activity is holding up reasonably well elsewhere, with the French and Spanish economies, for instance, continuing to register solid GDP growth.

Leading indicators of activity suggest that the Eurozone economy may have lost further momentum in Q4. The composite PMI averaged just 50.6 in October/November, down from 51.2 in Q3, and is at a level consistent with practically stagnant activity. The decline has been driven by falls in the service's index, which came in at 52.1 in October/November versus 52.8 in Q3. However, on a positive note the manufacturing PMI appears to be bottoming out. Although, it remained deep in recessionary territory in October/November at 46.4. On the demand side of the economy, consumer confidence has also recovered some lost ground, but remains weak when compared to previous years.

The limited amount of 'hard data' available for the fourth quarter has been quite downbeat. Retail sales dropped by a sharp 0.6% in October, leaving the year-on-year growth rate at just 1.4%. Although, this may have been linked to consumers holding back spending ahead of 'Black Friday'. Meanwhile, industrial production fell by 0.5% in October, with the year-on-year growth rate put at –2.2%.

There are some signs that the labour market is beginning to feel the effect of the softening of economic activity. Employment growth eased to 0.1% in Q3, and has now expanded by just 0.9% on a year-on-year basis. Furthermore, the employment sub-component of the composite PMI suggests that jobs growth remained weak in the final quarter of the year. More positively, the jobless rate edged back down to its multi-decade low of 7.5% in October.



Meanwhile, price pressures remain relatively subdued. Although, strong services inflation lead to the core rate picking up to 1.5% in November. The headline measure also moved higher in the same month, but only to 1.0%.

Overall, the near-term outlook for the Eurozone economy remains gloomy. The prospects are for another year of weak global growth, amidst a sharp slowdown in international trade. Indeed, the OECD does not foresee a pick-up in the world economy in 2020 or 2021, with global growth to remain subdued at 3% or slightly below. Given that the Eurozone is heavily reliant on export-led growth, this suggests the region could be in for an extended period of muted activity. Brexit also looks set to remain a headwind in the near-term, with uncertainty likely to persist about the future trading relationship between the UK and EU even if the new UK Parliament ratifies the revised Withdrawal Agreement. On the domestic front, the challenges facing the auto sector represent a particular problem for Germany, while the outlook for Italy is downbeat.

Despite this, there are a number of positives. The solid labour market and still subdued inflation will offer support to the consumer side of the economy. At the same time, a somewhat more expansive outlook for fiscal policy should also help stimulate domestic demand, while the ECB's dovish policy stance will also aid activity. However, the near-term assessment remains downbeat. The latest ECB projections are for GDP to expand by 1.1% in 2020 and 1.4% in 2021, in line with the OECD's recent forecasts of 1.1% in 2020 and 1.2% in 2021.

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