ECB Watch

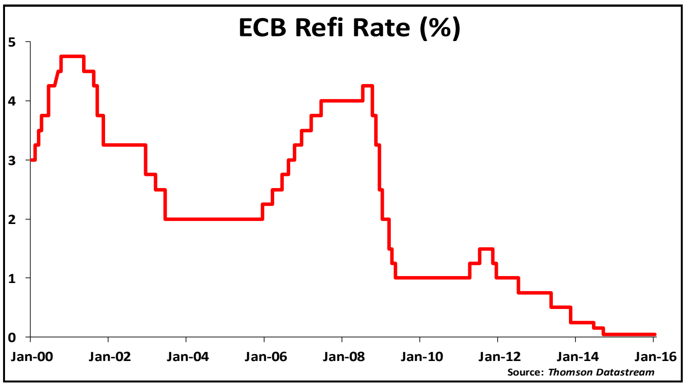
21st January 2016

AIB Treasury Economic Research Unit

ECB signals more easing is imminent

Today's meeting of the ECB's Governing Council concluded with no change to monetary policy. This was in line with market expectations given that the ECB had acted as recently as December, cutting the deposit rate by a further 10bps, moving it deeper into negative territory to -0.3%, while announcing an extension of its QE programme until at least the end of March 2017.

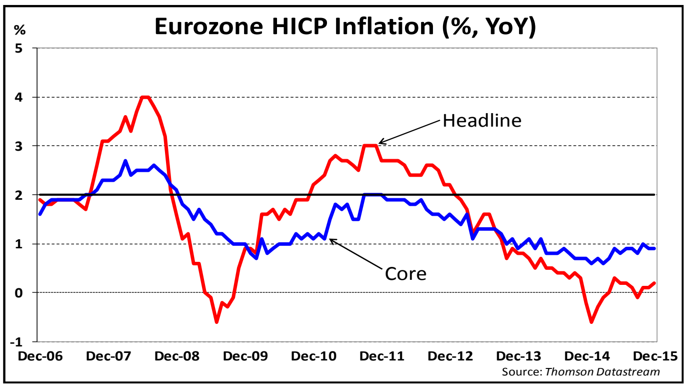
However, today's meeting was surprisingly dovish in tone. The ECB acknowledged that conditions on markets "have worsened" and "circumstances have changed" recently. The meeting statement noted that "downside risks have increased again amid heightened uncertainty about emerging market economies' growth prospects, volatility in financial and commodity markets, and geopolitical risks".



The meeting statement gave a strong signal that more easing was likely sooner rather than later. It noted that it will be "necessary to review and possibly reconsider our monetary policy stance at our next meeting", which takes place on March 10th.

The rational for this increased dovishness was that a further sharp decline in commodity prices meant that "the expected path of annual HICP inflation in 2016 is now significantly lower compared with the outlook in early December". At that time, oil prices had been forecast by the ECB to average $52 a barrel this year. Prices have fallen sharply since the start of the year, trading below $28 this week, with potential for further falls in prices. In his post-meeting press conference, the ECB President, Mario Draghi, said that given their persistence, size and potential for negative second round effects, the falls in commodity prices could not simply be 'looked through'.

President Draghi also stated that the Governing Council was "unanimous" in the view that there would be a need to "reconsider" policy in March. He emphasised that there were "no limits" regarding possible measures available to the ECB, acting within its mandate.



The market reaction to today's ECB updates has seen the euro weaken. Losses for the currency have seen it moving back down towards the $1.08 level against the dollar and below 77p against sterling. Equity markets have also seen some modest support. Meantime, the prospect of increased QE has seen sovereign bond yields fall. German 10-year yields are just below 0.45%, their lowest rate since October.

Overall then, the ECB seems to have teed markets up for further policy easing in March. It is of the view that given the "worsened" conditions, such actions may be necessary in order to achieve its mandate to ensure price inflation of close to, but below, 2% over the medium-term. While, the ECB did not specify what form these easing measures might take, it could include a further cut to the deposit rate. There is also likely to be an increase in the volume of monthly purchases under the QE programme. Markets have already priced in a further 10bps cut in the deposit rate.

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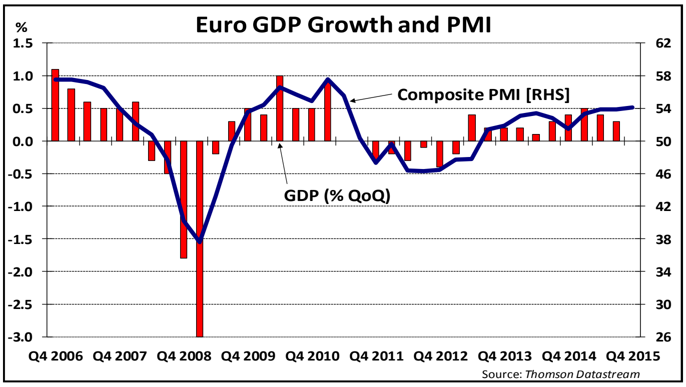
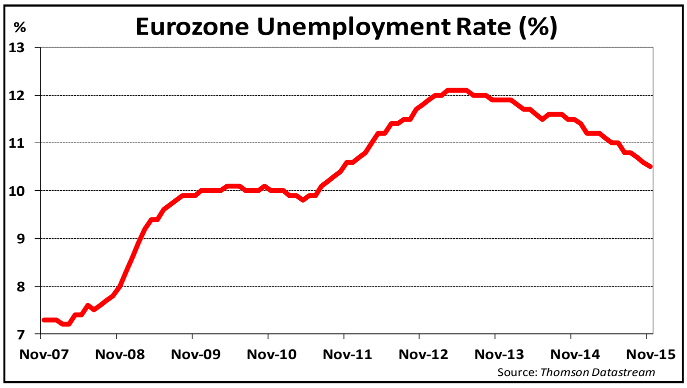
Modest recovery continuing



The Eurozone economy grew by a modest 0.3% in Q3, after a 0.4% pick-up in Q2. Year-on-year growth remained at 1.6%. Somewhat worryingly, exports, which had been the main source of growth for the economy in recent quarters, slowed in Q3. Exports contributed 0.1 percentage points (p.p.) to GDP, compared to an average of 0.6 p.p. in the previous three quarters. Personal consumption continued to grow at a solid pace, but investment remained weak. Changes in inventories added 0.2 p.p., a fillip which may not have been repeated in Q4.

Leading indicators of activity for Q4 have pointed to an improved pace of growth. The Markit composite PMI averaged 54.3 in Q4 after Q3's 53.6. This is consistent with growth of 0.4-0.5%. Furthermore, the EC Eurozone economic sentiment index averaged 106.3 versus Q3's 104.6. Although at a national level, indices such as the German Ifo and the French INSEE pointed to steady, or even slightly softer growth.

In contrast to the surveys, though, hard data for Q4 have suggested that growth may have slowed. Industrial production has remained very subdued, growing by just 0.1% in October/November compared to Q3. This primarily reflects a fall in energy production, due in part to lower energy prices and mild weather. Capital goods output has also been soft, which suggests that investment may have remained subdued. Meanwhile, retail sales declined by 0.4% in Oct/Nov versus Q4, with the underlying data showing a broad based decline.



Despite growth in the Eurozone remaining modest, the pace of improvement in the labour market has picked up. The unemployment rate fell to 10.5% in November, its lowest level since October 2011. While the headline figure does hide a dichotomy—unemployment in Germany is at just 4.5%, compared to 10.1% in France and 21.4% in Spain—this gap is starting to narrow.

Meantime, **year-on-year growth in employment has continued to accelerate, reaching a seven year high of 1.1% in Q3 last year.** In terms of the near term outlook, the Eurozone composite employment PMI rose to 52.8 at the end of last year, its strongest level since May 2011. This suggests that we may see further improvement in employment over the coming months.

Monetary aggregates were much improved during 2015. While the most recent M3 money supply data continued to show a levelling off in year-on-year growth, at 5.1% in November, it is much stronger than one year previous. Furthermore, underlying growth in loans to the private sector has also improved, with year-on-year growth of 1.3% in November, 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) and related global risk aversion, as well as the potential for negative geo-political developments.

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. In its latest World Economic Outlook, the IMF forecast that growth in the Eurozone would be 1.7% this year and again in 2017, following estimated growth of 1.5% in 2015.

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