ECB Watch

AIB Treasury Economic Research Unit

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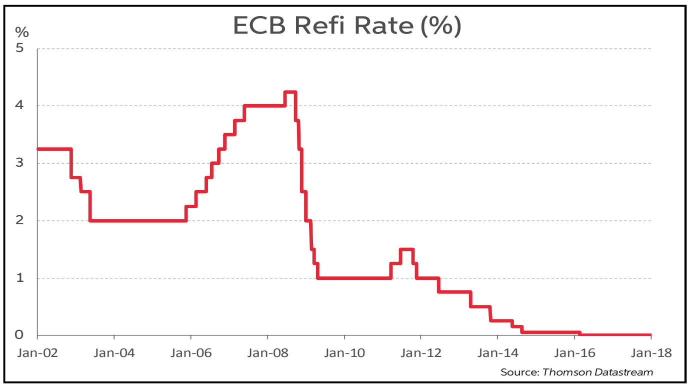
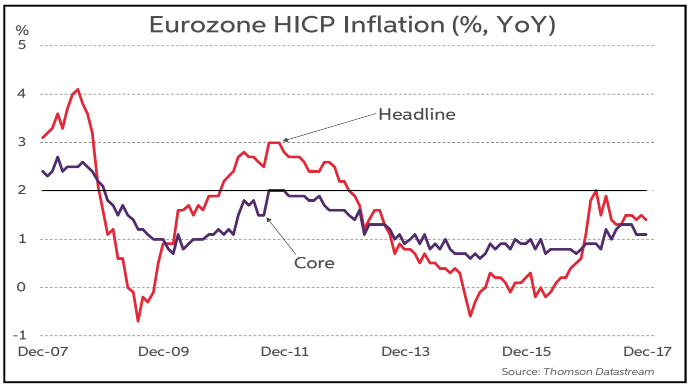
ECB dovish in tone, but euro continues to soar

Today's meeting of the ECB Governing Council saw the Central Bank make no changes to monetary policy. This was in line with market expectations. Rates were left at –0.4% for the deposit rate and 0% for the refi rate. The ECB's monthly asset purchases were cut from €60bn to €30bn per month at the start of the year. The programme is to run until at least September. Today, the ECB once again re-affirmed its commitment, that if necessary, the QE programme could be extended beyond this date and/or increased in size.



The minutes or 'account' of the ECB's December meeting released earlier this month appeared to be more hawkish in tone than the actual meeting statement and press conference. The account referenced that the ECB could soon revisit its forward guidance as it would need to evolve gradually over the coming months if the economy's strong performance was maintained. **As a result, expectations had been heightened that the ECB might adopt a more hawkish tone in today's meeting statement and press conference.**

However, this did not materialise. Indeed, as outlined above, the ECB retained its easing bias in relation to QE. Meantime, in the press conference, President Draghi stated that the discussion "hasn't really started" in relation to changing its forward guidance.



Overall, the January meeting suggests that the ECB is still inclined to take a very cautious approach to withdrawing its monetary stimulus. President Draghi once again emphasised today that the ECB expects to keep interest rates at their current very low levels well past the end of net asset purchases and that this was of "fundamental importance". Indeed, he went as far as saying that he sees "very few chances at all" that interest rates will be raised this year. This is reflected in interest rate futures contracts, with **markets seeing unchanged rates in 2018 and anticipating that 3-month Eurozone rates will remain negative until around Q3 2019. They see rates staying low for an extended period beyond that, only reaching 1% in early 2022.**

Despite the very dovish sounds from the ECB today, the market reaction was to take the euro decidedly higher, most notably against the weak dollar. This may in part be due to President Draghi refraining from directly talking down the euro's recent strength, instead saying that the ECB does not target exchange rates. This is in marked contrast to the remarks by US Treasury Secretary Mnuchin at the World Economic Forum in Davos, yesterday, when he welcomed the weakening trend in the dollar saying that it was good for US trade.

These comments seem to have irked the ECB somewhat, which noted that part of the euro's rise may be down to language used in discussing exchange rates which was not in line with agreed protocols. **The EUR/USD pair moved sharply higher from just over $1.24 to above $1.25 in the aftermath of the ECB meeting. It also climbed from 87p to above 87.5p against sterling.** Euro strength will make it harder for the ECB to get inflation back up to near its 2% target. Mr Draghi noted that if currency strength leads to an unwarranted tightening of monetary conditions, then the ECB would have to think about its monetary policy strategy.

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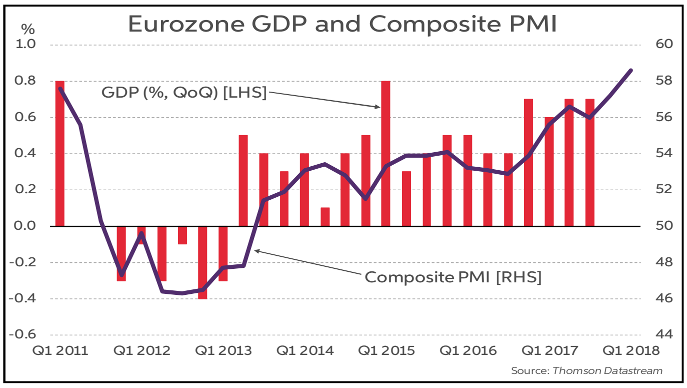
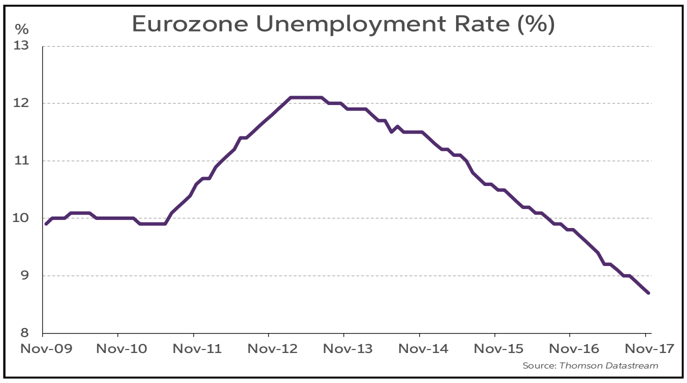
Eurozone growth may be gaining even more pace



The Eurozone economy grew by a strong 0.7% in Q3, matching its performance in Q2. Year-on-year growth picked up to 2.8%, from 2.4%, its strongest rate since Q1 2011. The underlying data show that net trade was the main source of growth in the third quarter, adding 0.5 percentage points (p.p.). Personal consumption and government spending added 0.2 p.p. and 0.1 p.p. respectively, while investment was a slight drag on growth (-0.1 p.p.).

Survey data for Q4 suggest that the pace of growth may have actually accelerated in the quarter. 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 0.7-0.8%. Meanwhile, the EC measure of Eurozone economic sentiment recorded its best quarterly performance since Q3 2000. National 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 generally positive. Industrial production grew by 1% in October/November versus Q3, in which it grew by a strong 1.2%. The underlying data show that the production of capital goods has been particularly robust in recent months, pointing to firmer levels of business investment. Meantime, retail sales were up by just 0.1% in Oct/Nov. Although, it must be noted that sales were also broadly flat in Q3, while overall consumer spending grew by a more encouraging 0.4% in the quarter.



In terms of the labour market, recent data have been very encouraging. Employment grew by a strong 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 (best since Q3 2000), suggesting employment growth should remain strong.

Meantime, the unemployment rate fell to its lowest level in November (8.7%) since January 2009. Noticeably, there has been a marked fall in French unemployment recently, which was at a 6½-year low of 9.2% in November. Unemployment in Italy (11%) and Spain (16.7%) remains high. The unemployment rate in Germany, the Eurozone's largest labour market, edged down to just 3.5% in November.

Early insights into the performance of the economy at the start of 2018 suggest a further pick-up in growth. The Composite PMI rose further to an 11½-year high of 58.6 in January, while the employment component edged up to a 17½-year high of 55.8. Meantime, the flash EC measure of Eurozone consumer confidence jumped to 1.3, its highest level since August 2000, close to its all-time high.

Overall, the economic prospects look brighter now than at any time in the past decade. The IMF is PUTTING Eurozone GDP growth at 2.4% for last year, followed by 2.2% in 2018 and 2% in 2019. This is broadly in line with the view of the OECD. **The positive outlook is based on a number of factors**, including the expectation that ECB policy is likely to remain loose for some time yet, generally more expansionary fiscal policy, while the global economy is picking up momentum. Inflation is also expected to remain low, helping to maintain growth in real spending power. The European Commission has noted that given the Eurozone recovery is less advanced than elsewhere, the economy has the capacity to continue growing strongly for quite some time.

Nonetheless, **the Eurozone economy still faces challenges,** including marked regional disparities in unemployment as well as very high youth unemployment in some countries, a need to boost productivity growth, low wage growth and a continuing aversion to structural reforms in some countries.

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