ECB Watch

AIB Treasury Economic Research Unit

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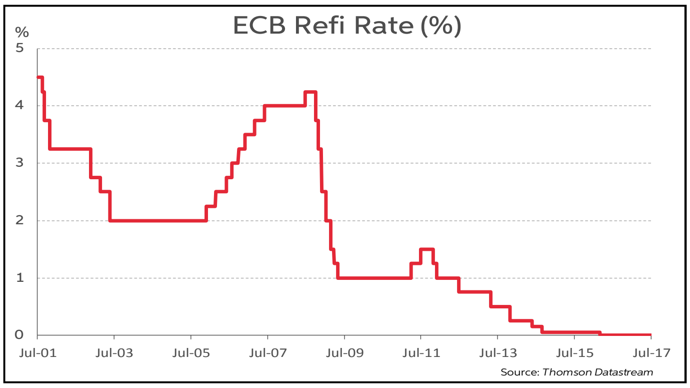
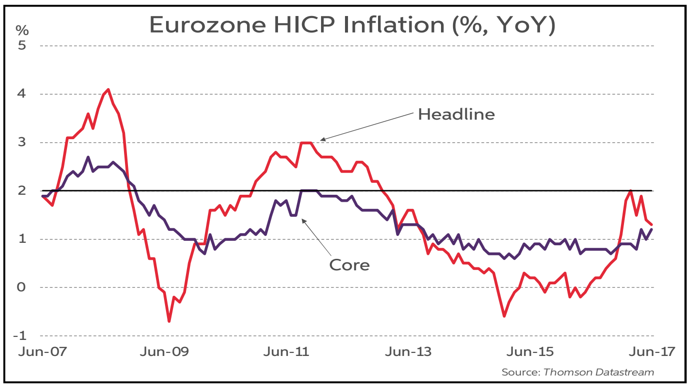
ECB patient and prudent, retaining QE easing bias

Today's ECB meeting concluded, as expected, with its key interest rates remaining unchanged at –0.4% for the deposit rate and 0% for the refi rate. There was also no change to the plans for its asset purchase programme. The ECB once again emphasised its QE programme will run until end December 2017, or beyond, if necessary.



There had been a lot of speculation in the lead up to today's meeting that the ECB may remove or row back on its easing bias in relation to its asset purchase programme. **However, the text stating that the ECB stands "ready to increase our asset purchase programme in terms of size and/or duration" was left unchanged.** In the accompanying press conference, President Draghi outlined the rationale behind this decision.

He stated that the "last thing the Governing Council want is actually an unwanted tightening of the financing conditions" that "either slows down or may even jeopardise" the progress of reaching a sustained path towards its 2% inflation target. The decision for no change to its forward guidance was unanimous. He also emphasised that inflation is "not where" the ECB wants it to be or "where it should be". Meanwhile, the meeting statement referenced the fact that "measures of underlying inflation remain overall at subdued levels". **Therefore, based on this analysis, the ECB remains of the view that a "very substantial degree of monetary accommodation is still needed" for its to achieve its price stability objective.**



The ECB continues to take confidence from recent macro data regarding the performance of, and outlook for, economic growth in the Eurozone. President Draghi commented that "we are finally experiencing a robust recovery" and that "incoming information confirms a continued strengthening of the economic expansion" in the region. This generally upbeat assessment that the ECB has on the economic outlook is in line with the latest staff macro projections published at the time of its June meeting. The ECB expects GDP to grow by 1.9% this year, 1.8% in 2018 and by 1.7% in 2019. Meanwhile, in terms of the inflationary outlook, the ECB is expecting headline inflation to average 1.5% this year, 1.3% next year and for 2019, inflation is forecast to average 1.6%.

Overall, it is clear from today's meeting statement and subsequent press conference that the ECB is erring on the side of caution and allowing itself flexibility as it assesses its move away from an easing policy bias towards a more neutral policy stance. Indeed, in the words of President Draghi, the ECB needs to be "persistent and patient" in its implementation of its monetary stimulus and repeated his assertion that the ECB will be in the "market for a long time" to achieve its price stability objective. It seems apparent then that any tapering of its QE programme, which may begin in 2018 and withdrawal of monetary stimulus is likely to be very pedestrian in pace. This is reflected in rate expectations, where markets do not envisage 3-month Eurozone rates turning positive till around mid-2019 and only reaching towards 1% towards the last quarter of 2022. In terms of market reaction, despite the ECB retaining its QE easing bias, the euro edged higher in the immediate aftermath, trading up from $1.15 to $1.16 (also reflects some dollar weakness), while EUR/GBP moved up into 89p territory (helped in part by softer sterling tone). Its appears that euro bulls may have taken some encouragement from the fact that President Draghi stated that the ECB would be having a discussion in the autumn on the outlook for its QE programme.

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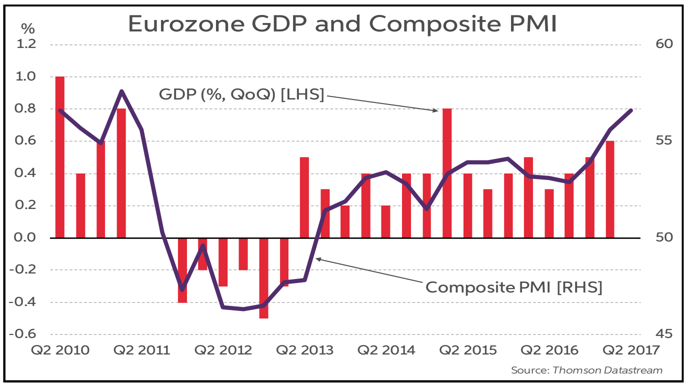
Eurozone growth continues to accelerate

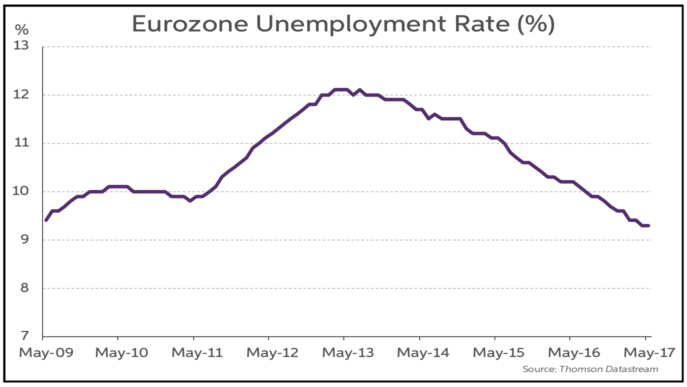
The Eurozone economy grew by an impressive 0.6% in Q1, an improvement on Q4's 0.5% rise and 0.4% in Q3. The economy grew by 1.9% on a year-on-year basis, up from 1.8%.



Leading indicators of activity have suggested that Eurozone growth continued to gather pace in Q2. The Markit Composite PMI averaged 56.6 in the quarter, its best performance since Q1 2011. Based on past form, **the PMI looks to be consistent with quarterly growth of around 0.7%/0.8%.** The EC measure of Eurozone economic sentiment also points to firmer growth in Q2. National level indicators, such as the German Ifo, French INSEE and Italian ISTAT indices are also consistent with a stronger pace of growth in the second quarter.

The available 'hard' data for Q2 have generally supported the view that growth firmed in the quarter. For example, Eurozone industrial production grew by 1.2% in April/May compared to Q1, in which it rose by just 0.1%. The underlying data show a broad based improvement in output. Meantime, retail sales picked up by 0.7% in April/May, an improvement on Q1's modest 0.3% rise. Although, the goods trade balance has shown little change from Q1, suggesting net exports impact on growth may remain muted.

In terms of the labour market, recent data indicate further improvement. The unemployment rate fell to 9.3% in April/May, an eight year low. This compares to 10.2% a year earlier. The 'dichotomy' of the unemployment rates in the major Eurozone economies remains wide, although it is narrowing. German unemployment has held at 3.9% since end 2016, while the rate in France has fallen from 9.9% to 9.6%. Italy (11.8% to 11.3%) and Spain (18.4% to 17.7%) have also seen some modest improvement.



Employment in the currency bloc has grown at a healthy pace in recent quarters. Year-on-year growth picked up to 1.5% in Q1, its strongest performance since Q1 2008. **The employment component of the Eurozone composite PMI averaged 54.4 in Q2, its best performance since Q3 2007.** This suggests that the pace of employment growth is continuing on an upward trajectory.

The Eurozone economy, though, still faces some challenges, including high levels of unemployment in many countries, a lack of structural and financial sector reforms in some economies and modest wage growth. Meanwhile, despite victory for pro-EU groups in French and Dutch elections, some political uncertainty still remains in the Eurozone, with German, Austrian and possibly Italian legislative elections later this year.

However, there are also tailwinds for the economy, including low underlying inflation and the positive impact of loose monetary policy, with interest rates likely to remain at very low levels for the next few years. An improvement in global growth is also providing some support to the economy, while fiscal policy has become more expansionary in many countries. The ECB is forecasting GDP growth of 1.9% for this year and 1.8% in 2018. The recent forecasts from the OECD are broadly in line with this, with GDP growth of 1.8% expected in both years. **Given recent macro data trends, though, we would not be surprised to see growth hit 2% or above this year and next.**

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