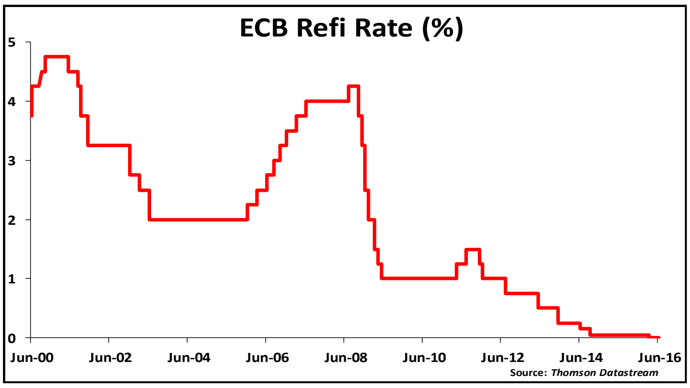
ECB Watch

2nd June 2016

AIB Treasury Economic Research Unit

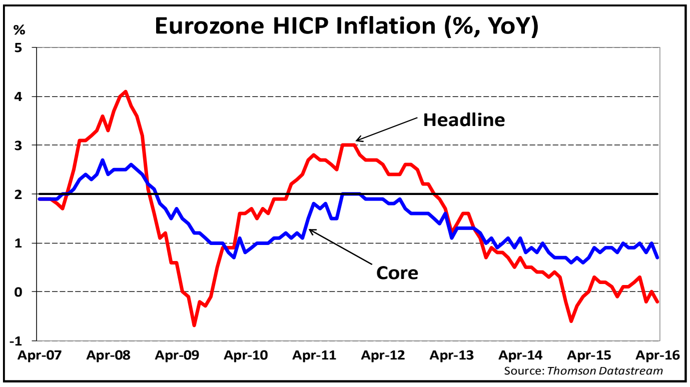
Little new from the ECB

Today's meeting of the ECB's Governing Council concluded with no changes to monetary policy. The lack of any policy changes was expected as the ECB is still in the process of implementing the easing measures announced at its March meeting.



These included cutting the deposit rate by a further 10bps, to -0.4% and reducing the refi rate by 5bps to 0%. In addition, the ECB increased the volume of its asset purchases to €80bn per month, from €60bn, as well as expanding the basket of QE eligible assets. It also announced the launch of four new four-year TLTROs over the course of next year, starting this month.

The statement released after this month's meeting and tone of the press conference showed that the Governing Council remains very much cognisant of the risks to the ECB's price stability objective. **The statement once again emphasised that the risks to the economic outlook "remain tilted to the downside".** The Governing Council noted that these risks continue to relate to developments in the global economy, the upcoming British referendum and to geopolitical factors.



The concerns about price stability continue to be reflected in the latest set of ECB staff quarterly economic forecasts, which were released after the meeting. The **2016 inflation forecast was revised up slightly to 0.2%, to take account of the recent rise in oil prices, but this is still a very low rate. Inflation is expected to pick up to 1.3% in 2017 and 1.6% in 2018, thus remaining below the ECB's 2% target.** The GDP growth forecast for this year was raised to 1.6% from 1.4% previously. The ECB envisages that growth will remain moderate but steady at 1.7% in both 2017 and 2018.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2015	2016	2017	2018
HICP	0.0	0.2	1.3	1.6
Real GDP	1.5	1.6	1.7	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $43.4 in 2016, $49.1 in 2017 and $51.3 in 2018. Source: ECB June 2016

The **ECB again emphasised its willingness to loosen policy further, if necessary,** by "using all the instruments available within its mandate". It said that **it expects "interest rates to remain at current or lower levels for an extended period of time".**

However, while the ECB has not ruled out cutting interest rates again, the scale of any further cuts is likely to be relatively modest. Indeed, with inflation expected to rise from the second half of the year onwards, we think it likely that rates have reached a trough, unless there is a major shock to the economy and financial markets. In this regard, Mr Draghi indicated that the ECB would be ready to act if there was any major dislocation in markets in the aftermath of the upcoming UK referendum vote. **Overall, today's ECB meeting had little enough impact on markets,** with the euro and bonds remaining broadly stable. With the ECB very much on hold, the focus for markets has moved to the upcoming Fed meeting as well as the UK referendum later this month. These are likely to be the two key events for markets in June.

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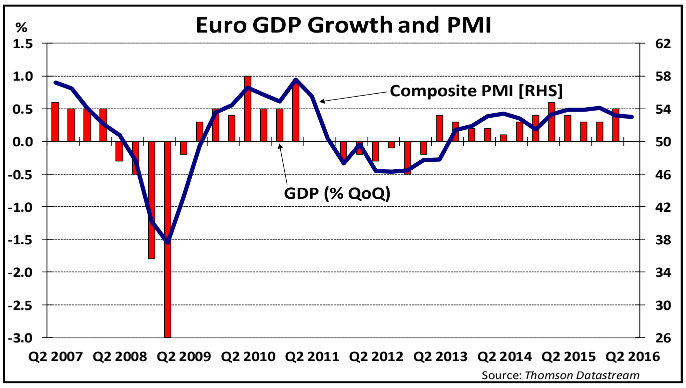
Some encouraging economic signs in 2016

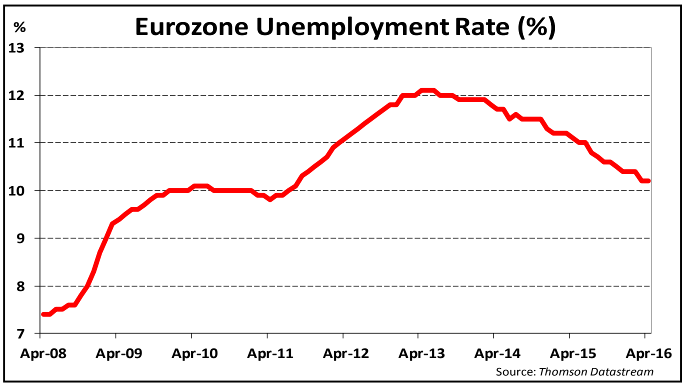
The preliminary estimate of Eurozone Q1 GDP showed that quarterly growth rose to 0.5%, from 0.3% in Q4 last year. However, year-on-year growth slowed slightly to 1.5%, from 1.6%. While we do not yet have a detailed breakdown of GDP, other data for the quarter suggest the economy was boosted by stronger consumer spending and industrial production, amongst other factors, though international trade may have remained a slight drag on growth.



Retail sales grew by 0.7% in Q1, up from 0.2% in Q4 last year. The underlying data point to a relatively broad based improvement in the quarter. Industrial production rose by 0.9% in Q1, compared to Q4's 0.4% pickup. All the main sectors improved, with the exception of durable goods, which recorded a slight decline. Meantime, monthly data suggest that external trade may have had a modestly negative impact on growth in the first quarter.

In terms of the performance of the economy so far in Q2, leading indicators of activity have generally pointed to continued modest growth. The Markit composite PMI averaged 53 in April/May, virtually unchanged from Q1's 53.2. Likewise, the EC economic sentiment index averaged 104.4 in April/May, compared to 104 in Q1. Meantime, national level indicators, such as the German Ifo, French INSEE and Italian ISTAT indices, have also suggested broadly stable growth in the last couple of months.

Improvements in the overall economy are being reflected in the labour market. The unemployment fell to 10.2% in April, a 4½-year low. While this figure does hide a significant dichotomy—German unemployment rate at 4.2%, versus 9.9% in France and 20.1% in Spain—the gap between Eurozone countries has narrowed somewhat in recent months.



Meantime, year-on-year growth in employment continued to accelerate in 2015, reaching a 7½-year high of 1.2% in Q4. In terms of 2016, the Eurozone composite employment PMI index has been broadly stable so far this year, holding at around end 2015 levels. **This suggests that employment should have continued to grow at a moderate pace in H1 2016.**

Meanwhile, **monetary aggregates were much improved last year and in Q1 2016.** However, year-on-year growth in M3 money supply slipped to 4.6% in April, from 5% in Q1. Meantime, the pace of growth in lending to the private sector edged up to 1.1% year-on-year in April, although there are little enough signs of any real upward momentum in credit expansion.

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 and related global risk aversion, as well as the potential for negative geo-political developments and the still present uncertainty over the UK's EU referendum. **However, there are also positives for the economy,** including the favourable impact from lower commodity prices, a weaker euro and the impact of monetary policy easing, with interest rates likely to remain at very accommodative levels for the next few years. The ECB expects the Eurozone to grow by 1.6% this year and 1.7% in 2017. This is broadly in line with the forecasts of the IMF, OECD and European Commission.

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