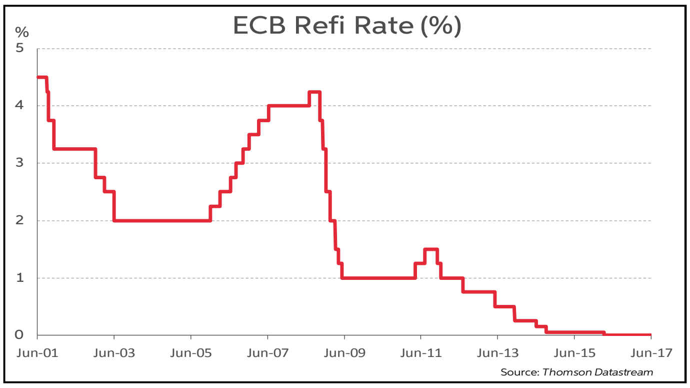
ECB Watch

AIB Treasury Economic Research Unit

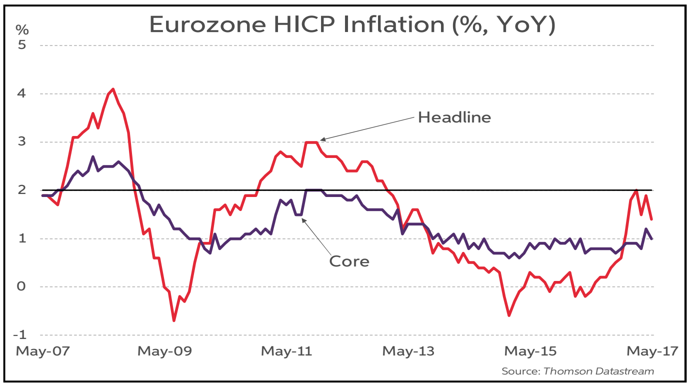
8th June 2017

ECB retains its overall dovish stance

As expected, today's meeting of the ECB's Governing Council concluded 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.



However, there were some changes to the meeting statement that indicate that the ECB has rowed back somewhat on its easing bias. Firstly, the meeting statement no longer refers to the possibility that interest rates could be lowered, instead it states that the ECB expects rates to "remain at present levels for an extended period of time and well past the horizon" of the QE programme. In the post meeting press conference, President Draghi commented that the easing bias regarding interest rates was removed because the "tail risk" to the inflation outlook had "disappeared". The second change was in relation to the ECB's characterisation of the risks facing the Eurozone's economic outlook. Whereas previously, the ECB described the risks as being tilted to the downside, the **Central Bank is now of the view that the "risks to the growth outlook are now broadly balanced".**



This more upbeat assessment of the economic outlook is reflected in upward (albeit modest) revisions to the June edition of the staff macro projections. The ECB now expects GDP to grow by 1.9% this year (from 1.8%). It's 2018 forecast was also upgraded slightly to 1.8% (from 1.7%) , while its 2019 projection was left unchanged at 1.7%. The Governing Council commented that recent data "confirms a stronger momentum" in the economy. **However, despite its upgrading of its growth forecasts, the ECB downgraded its inflation outlook.** President Draghi stated that this mainly reflected "lower oil prices". In terms of specifics, inflation is now expected to average 1.5% this year (was 1.7%), 1.3% next year (from 1.6%) and for 2019, inflation is forecast to average 1.6% (1.7%).

ECB Macroeconomic Forecasts for the Euro Area

(%)	2016	2017	2018	2019
HICP	0.2	1.5	1.3	1.6
Real GDP	1.7	1.9	1.8	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $51.6 in 2017 , $51.4 in 2018 and $51.5 in 2019.
Source: ECB June 2017

Overall, while the ECB did remove one aspect of its easing bias (in relation to interest rates), the general tone was still on the dovish side. President Draghi continued to emphasise that underlying inflation remains subdued and that a "very substantial degree of monetary accommodation is still needed". Indeed, he reaffirmed that the ECB remains willing to further expand its asset purchase if required. He further reinforced this point by stating that the "ECB will be in the market for a long time" and commented that policy "normalisation was not discussed". Markets have taken a dovish interpretation of today's meeting. This is reflected in a slightly weaker euro, with EUR/USD down near $1.12, while bond yields are also marginally lower. In terms of rate expectations, markets do not see 3-month Eurozone rates turning positive until end-2019 and still being below 1% by end 2022.

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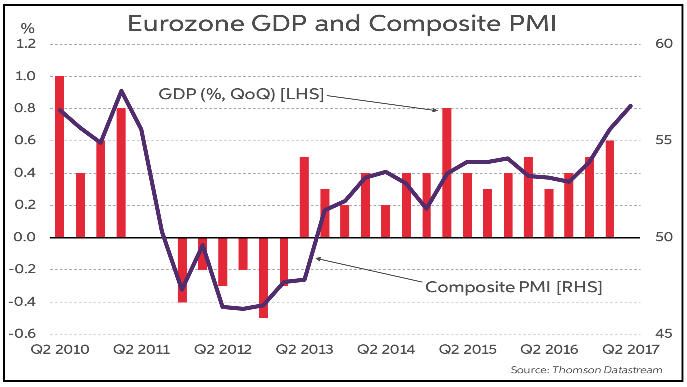
Eurozone data generally more upbeat

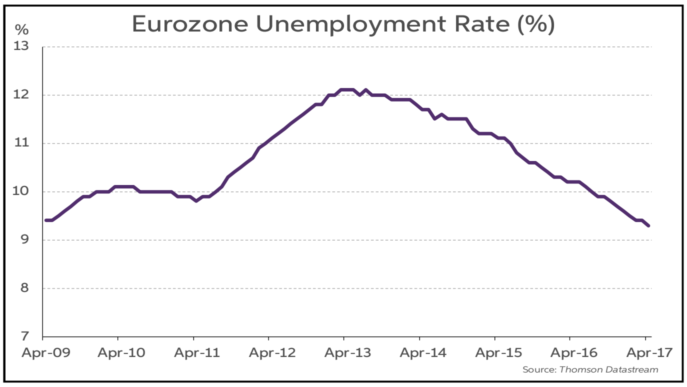


The Eurozone economy grew by an impressive 0.6% in Q1, an improvement on Q4's 0.5% rise and 0.4% in Q3. The currency bloc grew by 1.9% on a year-on-year basis in Q1, up from 1.8%.

Underlying GDP data show that investment was again the main source of growth, adding 0.3 percentage points (p.p.) in Q1. Consumer (0.2 p.p.) and Government spending (0.1 p.p.) also boosted GDP. Net exports were flat.

Leading indicators of activity for Q2 have suggested that the pace of growth has continued to accelerate. The key Eurozone Composite PMI averaged 56.8 in April/May. Based on past performance, this is consistent with quarterly growth of around 0.8%. Furthermore, the EC Economic Sentiment Index has risen to levels not seen since the middle of 2007. Meanwhile, national surveys such as the German Ifo, French INSEE and Italian ISTAT indices are also pointing to a firmer pace of growth.

There have been almost no 'hard' data releases for Q2 with which to back up the more positive picture being painted by the leading indicators. Retail sales grew by a very modest 0.1% in April, following on from Q1's 0.3% rise. However, the current run rate means that even if sales were flat in May and June, the pace of retail sales growth will still have picked up in Q2. Meantime, German industrial output recorded a strong 0.8% rise in April, boosted by a strong pick-up in energy production.



In terms of the labour market, recent signs have been positive. The Eurozone unemployment rate fell further to 9.3% in April, an eight year low. The 'dichotomy' of the unemployment rates in the major Eurozone economies remains very wide, though it is narrowing. German unemployment has held at 3.9% since end 2016, while the level in France has fallen from 9.9% to 9.5%. Italy (11.8% to 11.1%) and Spain (18.4% to 17.8%) have also improved.

Employment has grown at a healthy pace in recent quarters. Year-on-year growth did slow slightly in H2 2016, though, to 1.2%. **The employment component of the Eurozone composite PMI averaged 54.3 in April/May, putting it on course for its best performance since Q3 2007.** This suggests that employment growth may be accelerating again.

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 only modest wage growth. Meanwhile, despite victory for pro-EU groups in French and Dutch elections, political risks still remain in the Eurozone, with German and possibly Italian elections later this year.

However, there are also tailwinds for the economy, including relatively low underlying inflation, the relatively weak euro and the positive impact of loose monetary policy, with interest rates likely to remain at very low levels for the next few years. A modest improvement in global growth is also providing some support to the economy. Fiscal policy has also 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 for growth of 1.8% in both years. **Given recent trends, though, we would not be surprised to see growth hit 2% or above this year and next.**

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