ECB Watch

AIB Treasury Economic Research Unit

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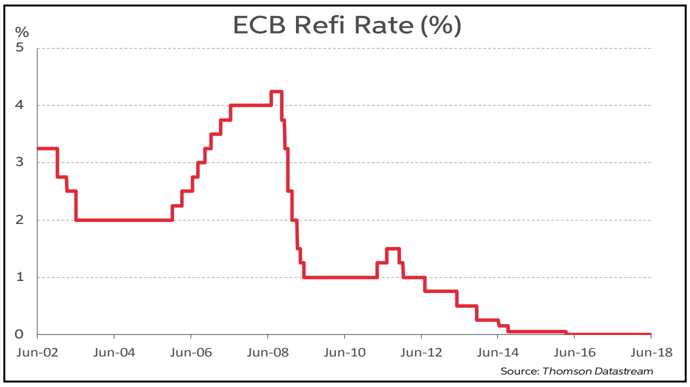
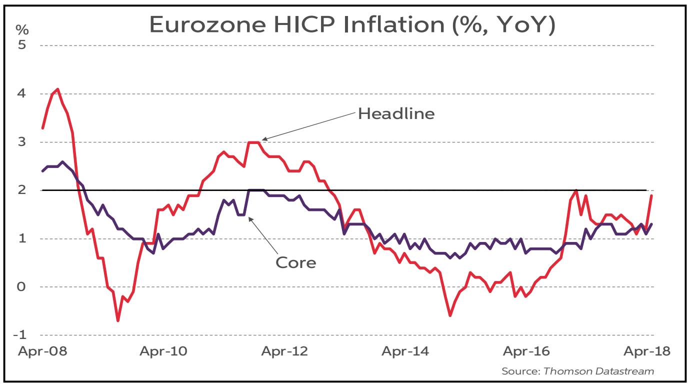
A dovish end announced to ECB net asset purchases

Market attention at today's meeting of the ECB Governing Council was mainly centred on whether it would provide guidance on the precise date that it will end net asset purchases under its QE programme.

Expectations on this front had been heightened by recent comments from some Council members that the matter would be discussed at today's meeting. The ECB had been guiding that net asset purchases would continue "until the end of September 2018, or beyond, if necessary". At present, the ECB is purchasing €30bn of assets each month under its QE programme.



Today, the ECB announced that it would reduce monthly net asset purchases to €15bn in the final quarter of the year and then cease these purchases altogether at the end of 2018. However, it will still continue to replace bonds as they mature, thereby maintaining a large stock of assets on its balance sheet. Ending net purchases will mark a significant change in monetary policy. However, the impact is muted by the fact that **the ECB also indicated today that it will keep interest rates at their current very low levels "at least through the summer of 2019".**



Thus, the ECB is taking a very cautious approach to tightening policy. Interest rates in the Eurozone are unlikely to start to be hiked until the end of Q3 2019 at the earliest, from their present levels of 0% for the refi rate and –0.4% for the deposit rate. Futures contracts softened slightly after the ECB announcement **and are now anticipating that 3-month Eurozone rates will remain negative into the opening quarter of 2020.** They see rates staying low for an extended period beyond that, only reaching 1% at end 2022.

The reason for the cautious approach to monetary tightening is the expectation that inflation will remain below the ECB's 2% target over the next couple of years. HICP inflation is forecast at 1.7% for each of the next three years through to 2020. These are slightly above the March forecasts for 2018 and 2019, reflecting higher oil prices. Meanwhile, the ECB's lowered its GDP growth forecast for 2018 from 2.4% to 2.1%, after slower growth in Q1. The ECB continues to anticipate growth of 1.9% in 2019 and 1.7% in 2020.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2017	2018	2019	2020
HICP	1.5	1.7	1.7	1.7
Real GDP	2.3	2.1	1.9	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $74.5 in 2018, $73.5 in 2019 and $68.7 in 2020.

Source: ECB June 2018

Markets were not expecting the dovish guidance today from the ECB on interest rates. Thus, despite the announcement that the ECB would cease net asset purchases at end year, the euro fell and bonds rallied on its guidance that there would be no hike in rates until after next summer. The shift in market rate expectations was not that significant, with futures contracts rallying by 5bps. However, the marked fall in the EUR/USD rate from above $1.18 to around $1.1650, suggests that FX market was not positioned for the guidance on rates.

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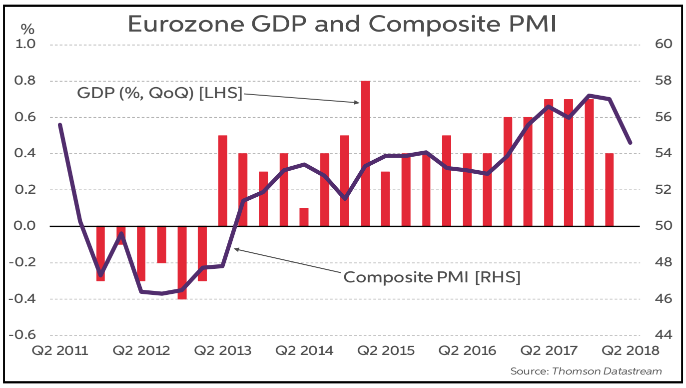
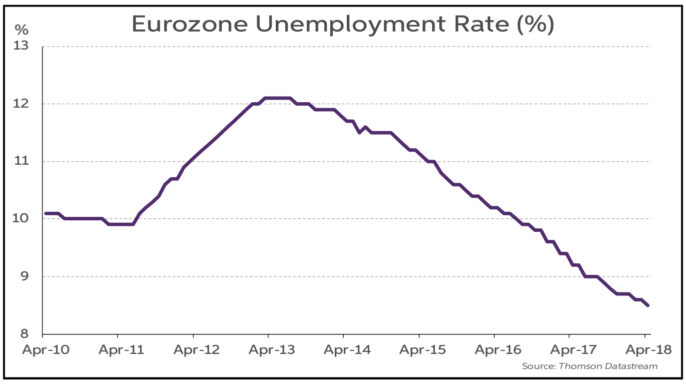
Eurozone growth appears to have peaked



The Eurozone economy registered a softer but still solid 0.4% pace of growth in Q1 2018. This followed four straight quarters of 0.7% increases in GDP during 2017. The underlying data show that consumer spending was the main source of growth, accounting for 0.3 percentage points, while the contribution from investment moderated to just 0.1 pp (vs. 0.3 in Q4'18). Meantime, after boosting growth by 0.4 pp in Q4'17, net trade was a slight drag (-0.1pp) in the opening quarter.

In terms of the more recent performance of the economy, leading indicators of activity for April and May provide further evidence that the pace of growth in the currency bloc has peaked. The key Eurozone Composite PMI moved down for a fourth consecutive month in May, to an 18-month low of 54.1. The index averaged 54.6 in April/May, well below Q1's 57 level. The EC measure of Eurozone economic sentiment has also slowed. It averaged 112.6 in April/May, compared to 114.1 in Q1. National level indicators such as the German Ifo, French INSEE and Italian ISTAT indices also point to a more moderate pace of growth.

The limited hard data that we have for Q2 have been somewhat disappointing. Retail sales in April increased by just 0.1% on a monthly basis, although the reading can be subject to revisions. Meantime, industrial production started the second quarter on a weak footing, falling by 0.9% in April. Thus, Q2 GDP growth could be lower than in Q1.



While the data indicate that growth has slowed, the labour market has continued to improve. The Eurozone jobless rate fell to 8.5% in April, down from 8.7% at the end of last year. This represents its lowest rate since December 2008.

Meanwhile, **employment in the Eurozone grew by 0.4% in the first quarter, representing a 1.4% increase on a yearly basis.** In terms of a more timely indicator, the employment component of the Composite PMI has been broadly stable. It averaged 54.7 in April/May, little changed from Q1's 55.2. This suggests that the jobs market continues to expand at a solid pace.

On the inflation front, underlying price pressures in the region remain subdued. While headline CPI inflation increased from 1.3% to 1.9% in May (largely due to a jump in energy prices), the core rate only rose from 1.1% to 1.3%, well below the ECB's 2% target.

The Eurozone economy still faces some challenges and risks. Unemployment remains high in many countries, though the European Commission has noted that the number of firms reporting labour shortages has "increased substantially". There are also external risks, in the form of potentially overvalued global financial assets, and thus the possibility of a market correction. The likely negative impact on the Eurozone economy and firms from protectionist trade policies in the US is also another risk.

Overall though, the economy is expected to continue expanding at a solid pace, albeit growth looks to have peaked in 2017. The latest European Commission forecasts show that it expects growth of 2.3% in 2018, followed by a 2% rise in 2019. This is partly due to the fact that ECB monetary policy should remain very accommodative. In addition, firmer global demand is providing a fillip to Eurozone exports. Consumer spending is being supported by good growth in real incomes and elevated consumer confidence.

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