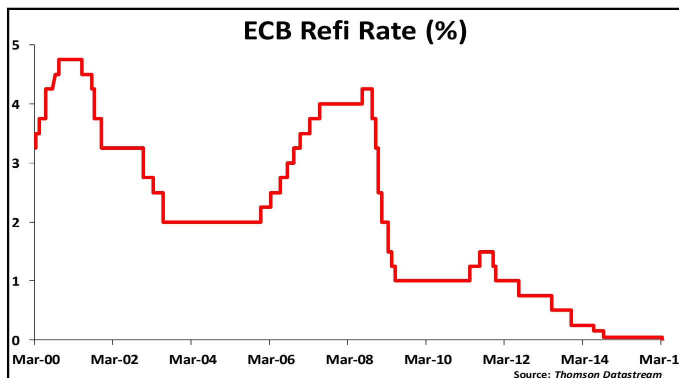
ECB Watch

10th March 2016

AIB Treasury Economic Research Unit

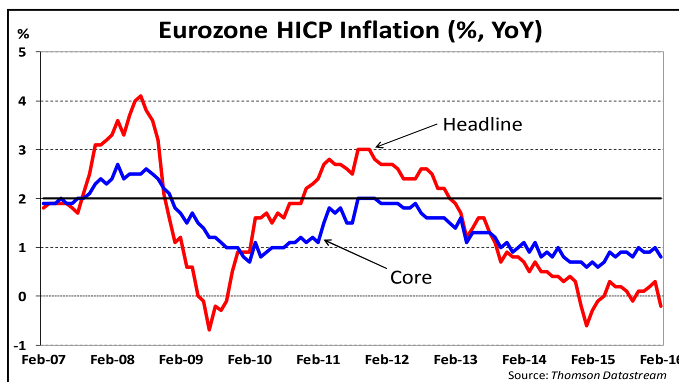
ECB easing more extensive than expected

The ECB announced a number of further policy easing measures at today's meeting that exceeded market expectations. It **cut the deposit rate by a further 10bps,** moving it deeper into negative territory to -0.4%. In an unexpected move, the ECB also cut the refi rate by 5bps to 0%.



In addition to the more dovish than expected rate announcements, the ECB also stated that it was **increasing the volume of its asset purchases to €80bn per month, from €60bn.** This was more than expected. There was no change to the length of the QE programme, which the ECB still expects to run until at least the end of March 2017. However, the Governing Council also expanded the basket of QE eligible assets, with euro denominated **investment grade bonds issued by corporations now eligible.**

The ECB also indicated that it would launch **four new four-year TLTROs** over the course of next twelve months, starting in June 2016. The funds would be at the prevailing refi rate but the rate could be lowered to as far as the deposit rate for banks whose net lending exceeds a "benchmark".



The Governing Council decided to provide this additional monetary stimulus in order to **counteract heightened risks to the ECB's price stability objective** and help secure a return of inflation towards levels that are below, but close to, 2%. The decision to loosen policy further was not unanimous but Mr Draghi indicated the majority in favour of the new measures was "overwhelming".

Today's meeting also saw the publication of the latest set of ECB staff macro-economic projections. Compared to the December version, the **ECB slashed its inflation forecast for 2016 from 1% to 0.1%.** This is the main reason for todays' further easing measures. It also lowered this year's GDP growth forecast to 1.4% from 1.7% previously. The ECB sees growth and inflation picking up in 2017 and 2018.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2015	2016	2017	2018
HICP	0.0	0.1	1.3	1.6
Real GDP	1.5	1.4	1.7	1.9

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $34.9 in 2016, $41.2 in 2017 and $44.9 in 2018. Source: ECB March 2016

The market reaction to today's ECB decisions has been quite volatile. There was a very positive market reaction when the policy changes were initially announced at 12.45pm. The euro fell by over a cent against the dollar, yields moved lower and stocks rallied strongly. However, when Mr Draghi indicated at his press conference that there was a limit to how far the ECB could go with negative interest rates without having consequences for the banking system, and that **he did not anticipate any further rate cuts** with any further easing likely to comprise non-standard measures, **the market mood changed.** The euro soared by more than two cents versus the dollar after Draghi's comments, stocks markets fell back from their highs and bond yields are actually up on the day. Trading remains volatile as we wait to see where markets will settle, especially FX and equities. Overall, the euro is up on the day, trading above $1.11 and at 78p v sterling.

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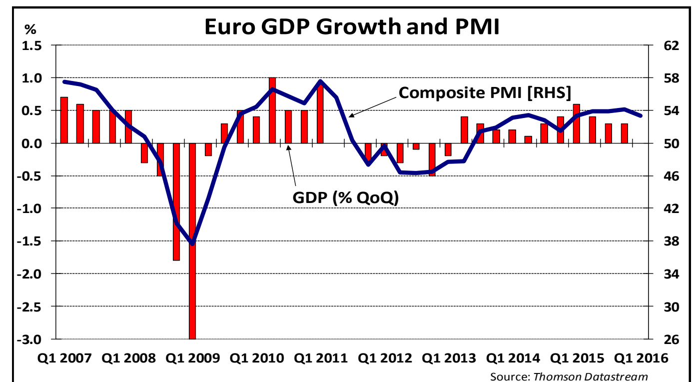
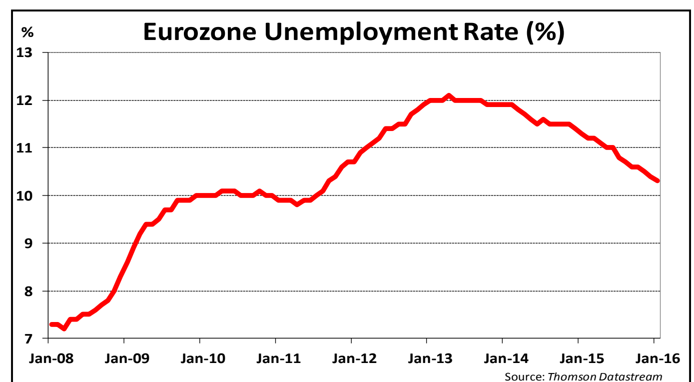
Mixed economic signals



Eurozone GDP rose by 0.3% in Q4, meaning the economy grew by 1.6% in 2015 overall. This follows on from 2014's 0.9% increase. The underlying data show that the improved performance last year largely reflected stronger growth in consumer spending and exports, though this softened towards the end of the year.

At a national level, growth was more 'balanced' last year. Germany, the Eurozone's largest economy, slowed slightly, recording growth of 1.4% versus 1.6% in 2014. The currency bloc's other major economies picked up, with France growing 1.1% (vs 0.2%), Italy 0.6% (-0.3%) and Spain showing a strong 3.2% increase (1.4%). **All Eurozone countries grew last year, with the exception of Greece (-0.2%).**

Leading indicators of activity for the first two months of this year have pointed to a weaker pace of growth. The Markit composite PMI averaged 53.3 in January/February, below its Q4 average of 54.1. The data breakdown suggests that the slowdown is broad based. Furthermore, the EC Eurozone economic sentiment index averaged 104.5 versus Q4's 106.3. National level survey data tell much the same story, with the German Ifo, French INSEE and Italian ISTAT indices all either down or flat compared to the fourth quarter.



We do not yet have much in the way of 'hard' Eurozone data for this year, though the figures published have generally been firmer. Eurozone retail sales rose by 0.4% in January. Meanwhile, German industrial output jumped by 3.3% in January, while French output picked up by 1.3%, suggesting Eurozone aggregate production started the year on a stronger footing.

Despite Eurozone growth remaining modest, improvement in the labour market has picked up pace. The unemployment rate fell to 10.3% in January, a 4½-year low. While this figure hides a worrying dichotomy—German unemployment is at just 4.3%, compared to 10.2% in France and 20.5% in Spain—the gap has narrowed.

Meantime, year-on-year growth in employment continued to accelerate in 2015, reaching a seven year high of 1.1% in Q3. In terms of the near term outlook, the Eurozone composite employment PMI averaged 52.2 in Jan/Feb, broadly unchanged from Q4's 52.3 average. **The PMIs suggest that we may see employment continue to grow at a moderate pace in H1 2016.**

While monetary aggregates were much improved last year, recent data have suggested that year-on-year growth may have peaked. M3 money supply growth looks to have levelled off at around 5%, though it is still much stronger than one year previous. The improvement in lending to the private sector has shown signs of slowing, with loan growth coming in at 0.8% year-on-year in January, below November's four year high of 1.2%.

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 (especially China) and related global risk aversion, as well as the potential for negative geo-political developments.

However, there are also some 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 low levels for the next few years. The ECB sees growth at around 1.5% this year, rising to 1.7% in 2017 and 1.9% in 2019, broadly in line with the recent projections from the OECD.

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