ECB Watch

AIB Treasury Economic Research Unit

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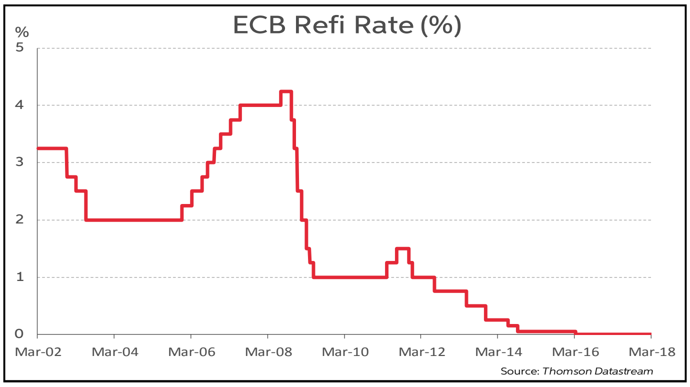
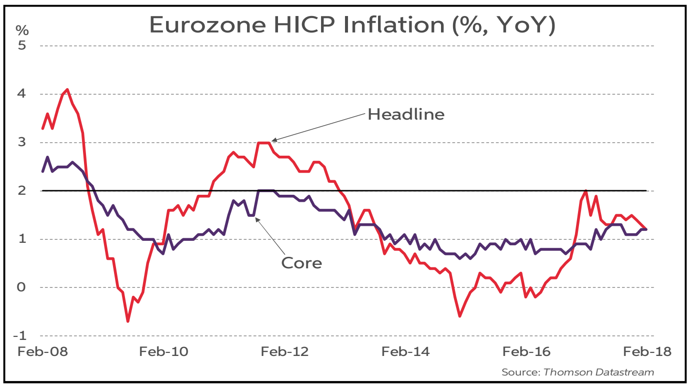
ECB removes its easing bias

Today's meeting of the ECB Governing Council saw no changes to monetary policy, but the Central Bank did drop its easing bias that it could increase the size of its monthly asset purchases. Rates were left at –0.4% for the deposit rate and 0% for the refi rate. Meantime, the ECB's monthly asset purchases were also left unchanged, having been cut from €60bn to €30bn per month at the start of the year. The QE programme is still scheduled to run until at least September.



Thus, the ECB has removed its easing bias in relation to its QE programme. While asset purchases will continue "until the end of September 2018, or beyond, if necessary", **the ECB is no longer indicating that the programme could increase in size.** The expectation is that the ECB will cease net asset purchases later this year.

In his press conference today, President Draghi played down the significance of today's move to drop its easing bias. He also indicated that there was not much discussion within the Governing Council about other possible changes.



The ECB is still taking a cautious approach to tightening policy. President Draghi once again emphasised that the ECB expects to keep interest rates at their current very low levels well past the end of net asset purchases. This suggests that interest rates in the Eurozone are unlikely to start to be hiked until 2019. This is reflected in futures contracts, with **markets seeing unchanged rates in 2018 and anticipating that 3-month Eurozone rates will remain negative until around end Q3 2019. They see rates staying low for an extended period beyond that, only reaching 1% at the end of 2021.**

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, as evidenced in the latest set of ECB staff economic forecasts. HICP inflation is forecast at 1.4% in both 2018 and 2019 and 1.7% in 2020, little changed from last December's forecasts. President Draghi noted that underlying measures of inflation remain "subdued". Meanwhile, the ECB's growth forecasts were upgraded slightly for 2018, with GDP now forecast to rise by 2.4% this year. It 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	1.4	1.4	1.7
Real GDP	2.3	2.4	1.9	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $65 in 2018, $61.2 in 2019 and $58.3 in 2020.

Source: ECB March 2018

The reaction in markets to today's ECB meeting was muted enough. The euro rose very briefly, before settling down to its pre-meeting levels, while there was no lasting impact on bond or interest rate markets. The subdued reaction of markets to the dropping of its easing bias by the ECB may reflect the fact that they had no expectation that the QE programme would be increased in size. Today's move then is largely symbolic especially with markets anticipating that net asset purchases will cease later this year.

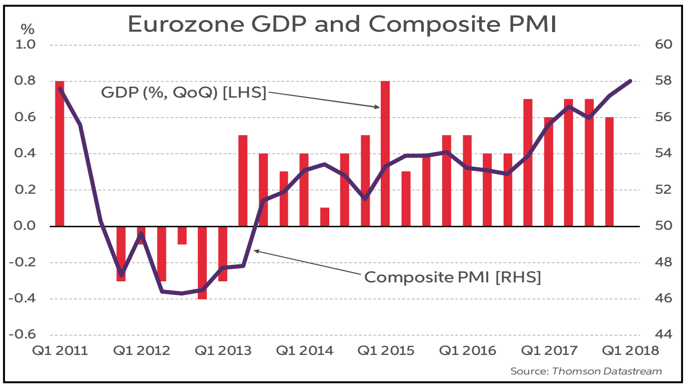
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Dara Turnbull
Economist
dara.c.turnbull@aib.ie

Eurozone growth continues at pace

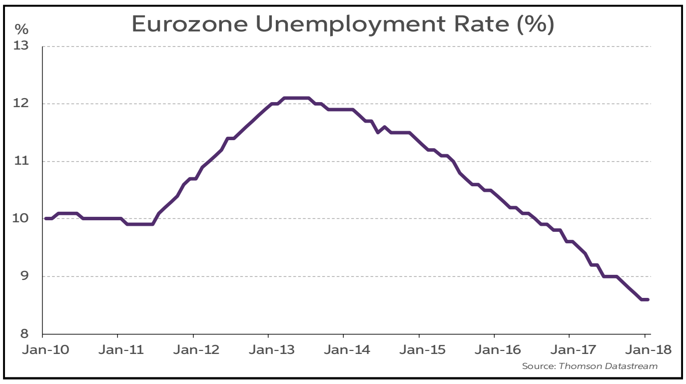
The Eurozone economy continued to perform very well in Q4, growing by 0.6% quarter-on-quarter. This meant that the economy grew by 2.3% in 2017, matching growth in the US and representing the currency bloc's best annual performance since 2007.



The breakdown of Q4 GDP showed that a exports remained the main driver of growth. Overall net trade added 0.4 percentage points (p.p.) to GDP in Q4, following on from 0.5 p.p. in Q3. Investment added 0.2 p.p., while consumption and government spending each added 0.1 p.p. Inventories were a 0.2 p.p. drag.

This strong economic performance has resulted in encouraging labour market developments. The Eurozone unemployment rate continues to decline, ending Q4 at 8.6%, down from 9.6% in the same month of 2016. The unemployment rate held at this 10-year low in January this year. An important factor in the more recent decline in unemployment has been the improved performance in France, the Eurozone's second largest economy, with unemployment there falling to 9% in December/January from 9.6% as recently as August.

While Eurozone employment figures for Q4 are not due for another few weeks, national level data suggest the jobs market continued to expand at a healthy pace in the quarter. Furthermore, the Eurozone composite employment PMI averaged a strong 55.5 in Q4, its best performance since Q3 2000. It also averaged 55.5 in the first two months of 2018. Thus, the signs from the labour market remain very promising.



In terms of the broader 'headline' PMI figures for Q1 2018, **the key composite index averaged 58 in Jan/Feb, improving on Q4 2017's already very strong 57.2 average.** Similarly, the EC measure of Eurozone economic sentiment averaged 114.5 in Jan/Feb, broadly in line with Q4's 114.3 print. Both indices suggest that the Eurozone economy continued to grow at a strong pace at the start of 2018. This view is also supported by national indicators such as the German Ifo, French INSEE and Italian ISTAT indices.

There have been limited 'hard' Eurozone data for 2018 out so far. Indeed, this week's retail sales release for January was the first major update in this regard. Sales were broadly flat on the month, though year-on-year growth did pick up to 2.3%, from an upwardly revised 2.1% in December. As in other major economies, sales have been volatile in recent months as the end November 'Black Friday' sales alter 'traditional' sales patterns.

Overall, the economic prospects for the Eurozone look brighter now than at any time in the past decade. The IMF is forecasting GDP growth of 2.2% in 2018 and 2% in 2019. Today's ECB forecasts are broadly similar. Positive factors including the likelihood that ECB policy will remain loose for some time yet, generally more expansionary fiscal policy and stronger momentum in the global economy should help to underpin growth in the economy. Inflation is also likely to remain low, helping to maintain growth in real spending power. The European Commission has noted that given the Eurozone recovery is less advanced than in many other major economies, the currency bloc has the capacity to continue to grow strongly for quite some time.

Nonetheless, the Eurozone economy still faces challenges, including marked regional disparities in unemployment including very high youth unemployment in some countries, a need to boost productivity growth, low wage growth and a continuing aversion to structural reforms in some countries. The outcome of the election in Italy (hung parliament, strong anti-establishment vote) also poses some uncertainty.

AIB Bankcentre, Ballsbridge, Dublin 4 Tel: 353-1-6600311 www.aibeconomics.com