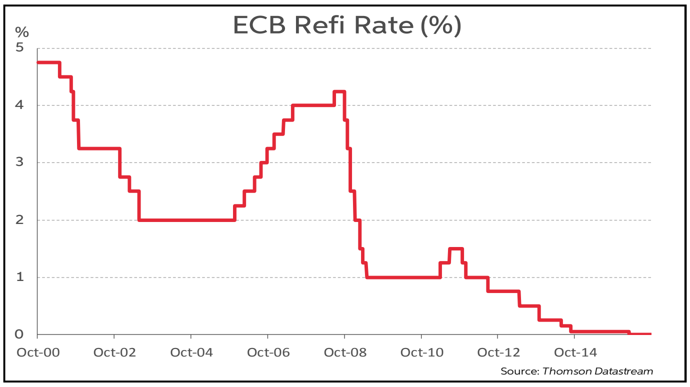
ECB Watch

AIB Treasury Economic Research Unit

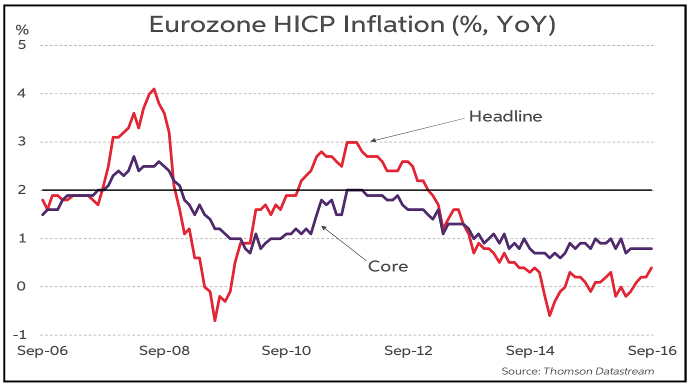
20th October 2016

No discussion on QE extension or tapering

The October meeting of the ECB's Governing Council concluded in line with market expectations for no change to the central banks current policy initiatives. The Central Bank kept the key interest rates unchanged at −0.4% for the deposit rate and at 0% for the refi rate. It also did not make any changes to its QE programme, stating that "the monthly asset purchases of €80 billion are intended to run until the end of March 2017, or beyond, if necessary".



However, in response to numerous questions in relation to the future of the QE programme beyond March next year, ECB President Mario Draghi stressed that "no discussion" had taken place on this issue. He said that the much of the discussion this month was "about how to overcome scarcity" of eligible bonds for its QE programme, while at the same time noting that "it's not a problem now". President Draghi also stated that there was no "tapering discussion". **In an answer to further questions on the tapering issue he said that "an abrupt ending" to QE would be "unlikely".**



In terms of the economic outook, the ECB continues to expect the "economic expansion to proceed at a moderate but steady pace while inflation is anticipated to "pick up over the next couple of months" and increase further in 2017 and 2018. The most recent ECB staff projections, which were released at its September meeting showed a GDP growth forecast of 1.7% for this year and 1.6% in 2017 and 2018. Meanwhile, on the inflation front, a rate of just 0.2% is forecast for this year, increasing to 1.2% and 1.6% in 2017 and 2018 respectively. **The ECB continues to view the risks to this baseline scenario as being to the "downside", with the risks relating "mainly to the external environment".**

Once again, the meeting statement emphasised the need for structural reforms and fiscal policy to compliment and "reap the full benefits" from the current accommodative stance of monetary policy. The statement noted that structural reforms need to be "substantially stepped up" to reduce structural unemployment and "boost potential output growth". At the same time, fiscal policy should also be used to "support the economic recovery".

Overall, the ECB retains a bias to ease monetary policy further if required to meet its price stability objective over the medium term. This bias is reflected in the fact that the ECB continues to assess the risks to its economic outlook as remaining "tilted to the downside". It is also evident in its explicit commitment "to act, if warranted, by using all the instruments available" to it.

However, there was a lack of any guidance as to what will happen to its QE programme post March-2017, and the fact that it was not even discussed was somewhat surprising given the end date is only months away. It is likely we will have to wait till December for a decision on this. The ECB stated that in December, its assessment will "benefit from the new staff projections" and work being undertaken by various Eurosystem committees on the "options available" to "ensure smooth implementation" of the QE programme. Market reaction to today's meeting was overall limited, although EUR/USD did briefly trade back above $1.10 and EUR/GBP above 90p on the "no discussion" comment before both pairs moved back to trade close to their pre-press conference levels.

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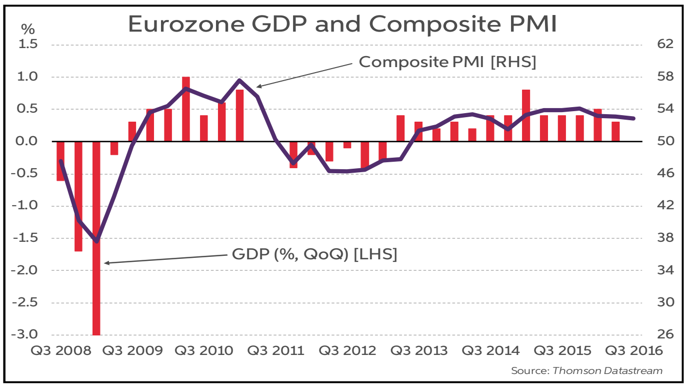
Eurozone growth remained modest in Q3

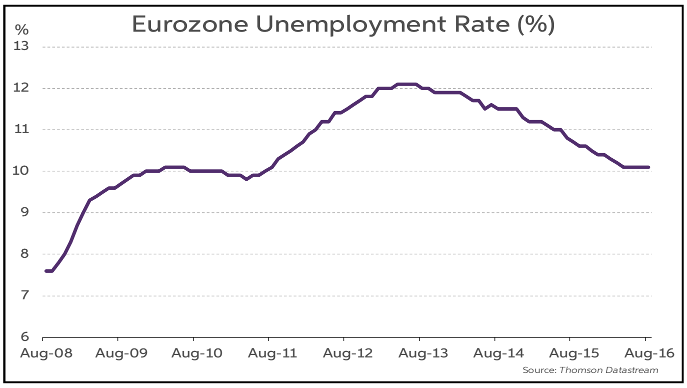
The Eurozone economy grew by 0.3% in Q2, after expanding by 0.5% in Q1. Year-on-year growth edged down slightly to 1.6% in the second quarter, from 1.7%. The underlying data show that net trade made the largest contribution to growth in Q2, adding 0.4 percentage points. The primary reason for the slower pace of growth in the quarter was weaker domestic demand. Household consumption growth slowed, adding just 0.1 p.p. in the quarter (vs. 0.3 p.p. in Q1)



In terms of the performance of the economy in Q3, leading indicators of activity point to a stable, but modest, pace of growth. The key Eurozone composite PMI averaged 52.9 in the third quarter, which on past form is consistent with a 0.3/0.4% pace of quarterly GDP growth. The EC measure of Eurozone economic sentiment averaged 104.3, unchanged from its performance in Q2. National level PMIs, as well as other indicators such as the German Ifo, French INSEE and Italian ISTAT surveys also suggest on-going modest growth.

The available 'hard' data for the quarter also point to a modest pace of growth. Retail sales rose by 0.4% in July/August versus Q2, in which they increased by 0.2%. On the output side of the economy, industrial production increased by a very modest 0.1% in July/August, after declining by 0.2% in Q2. **Although, the Eurozone's goods trade surplus narrowed in July/August,** suggesting that the positive impact from trade recorded in Q2 may not be repeated, or will have at least diminished, in Q3.

In terms of the labour market, employment growth has improved in 2016, coming in at 1.4% year-on-year in H1, versus 1.2% in H2 2015. **The Eurozone composite employment PMI averaged 52.5 in Q3, its best performance since Q2 2011.** This suggests employment continued to grow at a healthy pace in the quarter.



Meantime, **the unemployment rate held at 10.1% for a fifth consecutive month in August.** Underlying data show the dichotomy between countries remains large and, in some instances, is even widening. For example, unemployment in Germany held at 4.2% in August, while it rose further to 10.5% in France (from 10.3%). Unemployment in the other two largest Eurozone economies, Italy and Spain, came in at 11.4% and 19.5%, respectively.

The Eurozone economy continues to face some significant challenges, including the high levels of unemployment in many countries, a lack of structural reforms in some economies, the negative impact from a slowdown in in global growth in 2015/2016 (especially in China) and related global risk aversion. Meantime, while the early signs are that the initial Brexit impact on the Eurozone economy has been limited, the UK vote to leave the EU remains a significant downside risk. Brexit could weigh on investment and employment, particularly in countries and sectors with strong trade links with the UK. It could also have a negative impact on domestic spending.

However, there are also some tailwinds for the economy, including the favourable impact from low commodity prices, the relatively weak euro and the impact of monetary policy easing, with interest rates likely to remain at very accommodative levels for the next few years. Fiscal policy has also become more expansionary in many countries. **The ECB is forecasting GDP growth of 1.7% in 2016 and 1.6% in 2017.**

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