ECB Watch

AIB Treasury Economic Research Unit

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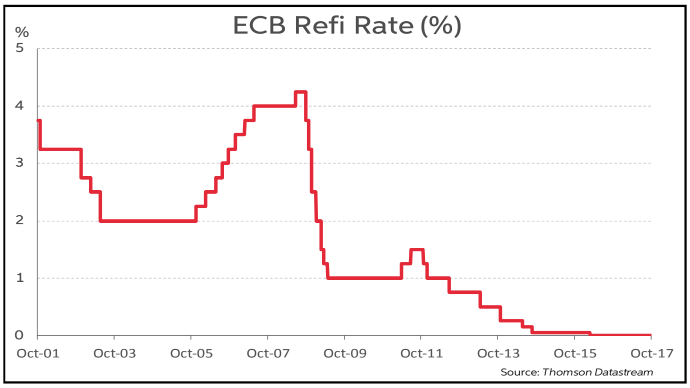
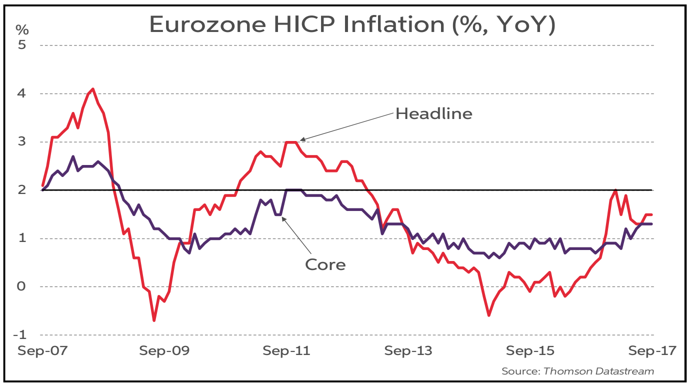
ECB to scale back QE in 2018, curbing monetary stimulus

Today's ECB's Governing Council meeting was keenly awaited by the markets as it would set monetary policy for much of the coming year. Rates were left unchanged as expected, at –0.4% for the deposit rate and 0% for the refi rate. All the **focus was on the ECB asset purchase programme.** The current phase, with asset purchases of €60 billion per month, runs until the end of this year.



It was widely expected that the ECB would today announce an extension of the programme to well into 2018, but with a significantly lower amount of monthly purchases. The ECB delivered on this belief, **announcing that the monthly purchases would be cut from €60 billion to €30 billion and that these would last until at least September 2018.** Furthermore, the ECB indicated that if necessary, the programme could be extended beyond this date or it could increase the size of monthly purchases, thus maintaining its easing bias.

The ECB observed that today's monetary policy decisions will help inflation return towards its medium term target of close to, but below, 2%. The strengthening in economic activity over the past year means that the **same degree of monetary accommodation is no longer required.** However, as inflation is expected to remain well below target for some time yet, the ECB obviously felt that it still needs to continue with some asset purchases for a further period of time.



The **ECB staff forecasts published last month took into account the stronger growth momentum in the Eurozone economy this year**, with its near term growth expectations revised higher. The ECB now expects GDP to grow by 2.2% this year (1.9% previously). Its GDP forecasts for 2018 and 2019 were left unchanged at 1.8% and 1.7% respectively. Meanwhile, in terms of the inflationary outlook, the ECB projections see **inflation at just 1.2% next year and in 1.5% in 2019,** still well below its medium-term target of just under 2%, **necessitating the continuing very loose monetary stance** despite the strengthening in activity.

In summary, today's meeting announcement shows that **the ECB is continuing to proceed cautiously as it gradually moves away from an easing policy bias towards a more neutral policy stance.** Indeed, President Draghi again emphasised that a continuing "ample degree of monetary stimulus" is required to meet its inflation target. A **key element of today's decision was to keep asset purchases "open ended"**, with a commitment to further extend the QE programme beyond next September or, indeed, increase purchases again, if this proves necessary.

Meantime, the ECB also repeated again today that it expects **to keep interest rates at their current very low levels well past the point that it concludes doing net asset purchases.** This suggests that rates are unlikely to be hiked in the Eurozone before 2019 at the earliest. This is reflected in interest rate futures contracts, with **markets envisaging 3-month Eurozone rates remaining negative until end-2019 and staying low for an extended period beyond that, only reaching 1% by the end of 2022.**

In terms of market reaction, **the euro and bond yields fell on the news that the ECB could extend its asset purchase programme beyond September 2018**. In level terms, this was reflected in the euro falling by almost a cent to near $1.1750, with EUR/GBP dropping back to 89p. Ten year bund yields fell by 5bps to 0.43%.

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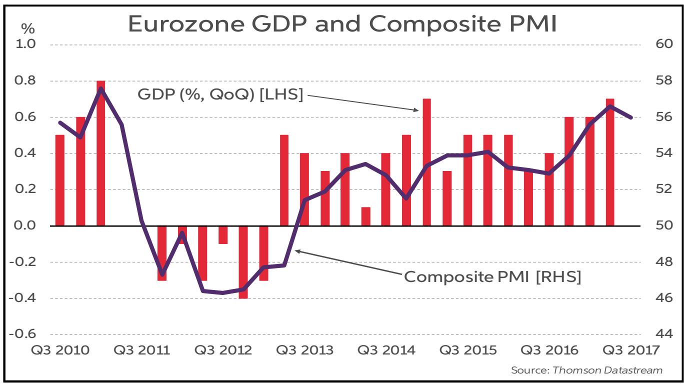
Economy growing at a strong pace

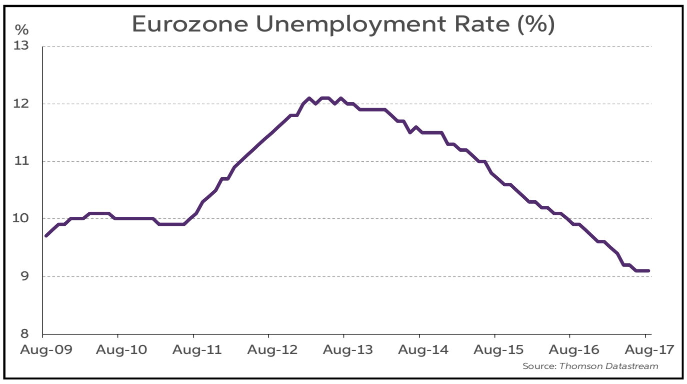
The Eurozone economy grew by a very impressive 0.7% in Q2, an improvement on Q1's +0.6%. The economy grew by 2.3% year-on-year in Q2, up from 2% in Q1. The underlying data show that investment was the main driver of growth in Q2, adding 0.4 percentage points.



Q3 survey data suggest that the Eurozone economy continued to grow at a strong pace in the quarter. The Markit Composite PMI averaged 56 over the three months, broadly in line with Q2's 56.6 performance. This looks to be consistent with a healthy quarterly increase of around 0.6% in GDP. The EC measure of Eurozone economic sentiment also suggested that the economy continued to expand solidly in Q3, averaging 112.1 in the quarter, its best performance since Q2 2007.

The available 'hard' data for Q3 have been somewhat mixed. For example, Eurozone retail sales were flat in July/August versus Q2, when they rose by 1%. Meantime, industrial production continued to grow at a very encouraging pace, rising by 1% in July/Aug versus Q2. 'Capital goods' output has risen particularly strongly, suggesting that investment is continuing to grow at an encouraging rate. Goods trade data have also been positive, indicating that external trade could make a positive contribution to GDP growth in Q3.

In terms of the labour market, recent data have been positive overall. Although, the unemployment rate has held at an 8-year low of 9.1% since June, having previously fallen at a steady pace since mid-2015. The country level breakdown shows that rising unemployment in France (9.8% in August vs 9.5% in May) is partly offsetting modest declines elsewhere. However, French unemployment is predicted to fall as new labour market reforms there start to bed down. Unemployment in Germany has fallen to just 3.6%, while it remains elevated in the Eurozone's other two major economies, Italy (11.2%) and Spain (17.1%).



Employment in the currency bloc has grown at a healthy pace in recent quarters, with year-on-year growth of 1.6% in H1 this year, its strongest performance since Q1 2008. **The employment component of the Eurozone composite PMI averaged a solid 54.2 in Q3.** This is broadly unchanged compared to Q2's 10-year high quarterly average of 54.4. This suggests continued good employment growth in Q3.

Eurozone survey data for October out earlier this week suggest the economy continued to grow at a strong pace at the start of Q4. The Composite PMI came in at 55.9, in line with its Q3 average. The flash EC measure of consumer confidence rose to a 16-year high, suggesting that consumer spending will continue to improve. The German IFO business sentiment index hit its highest level in October since the survey began in 1991.

The IMF is forecasting Eurozone GDP growth of 2.1% this year and 1.9% in 2018, with the ECB at 2.2% and 1.8%. We think that actual growth might prove somewhat stronger. The outlook for the economy remains favourable, with many positive factors at work. Monetary policy is set to stay very loose in 2018, with on-going QE and negative interest rates. Fiscal policy is becoming more expansionary in many countries. The global economy is also gaining momentum, while inflation is expected to remain low in the Eurozone, boosting real spending power. The prospects for key growth drivers like trade, investment and employment all remain positive. Thus, while there are concerns about long-term growth prospects because of adverse demographics, high debt levels and poor productivity, **the economy looks set to continue performing strongly near term.**

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