ECB Watch

AIB Treasury Economic Research Unit

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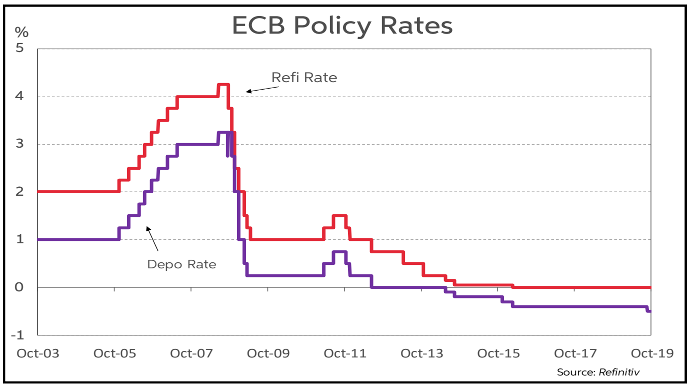
ECB content for now with current easing initiatives

President Draghi's last meeting as head of the ECB saw the Governing Council keep policy unchanged. This was very much in line with market expectations, as the central bank had announced a significant easing package at its previous meeting in September.

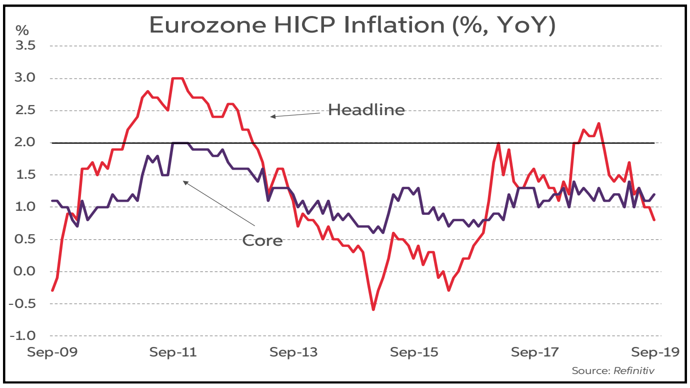


This included a cut of 10bps to the deposit rate, from –0.4% to –0.5%. The ECB also indicated that it would restart its QE asset purchase programme in November at a relatively modest pace of €20bn per month**.** It also announced more favourable terms for its TLTRO 3 programme, as well as a new two-tier system for reserve remuneration of banks holdings of excess liquidity, to exempt much of it from the negative deposit rate.

Today's meeting statement showed that the ECB retains a bias to ease policy further if required. The text stated that official rates will remain at their present or lower levels until inflation "robustly" converges with its 2% target. The ECB also continued to emphasise that its QE purchases would run for as long as necessary and only end shortly before it starts to raise rates.

However, the minutes from the September meeting showed that the Governing Council was quite divided over its easing package. A number of members made it clear that the they believed the package to be too dovish, especially in relation to restarting its QE programme. **Given these divisions and the fact that it has only recently announced a raft of easing measures, there is unlikely to be any further policy initiatives from the ECB in the near term.** Furthermore, a new head of the ECB, Christine Lagarde, takes the helm on November 1st.

The ECB's most recent set of staff macroeconomic projections were published back in September. The more subdued outlook implied by the forecasts shows why the ECB is back on an easing path. Both its inflation and growth forecasts were revised downwards. Inflation is expected to remain well below the 2% target in the next couple of years. HICP inflation is forecast at 1.2% in 2019, 1.0% in 2020 and 1.5% in 2021. It is projecting more moderate GDP growth of 1.1% in 2019 and 1.2% in 2020, with 2021 forecast at 1.4%. **In today's meeting statement, the ECB continues to be of the view that the risks to its outlook remain "to the downside".**



Interestingly, though, despite continuing weak data, the market has become less dovish on its view of the path of interest rates in the Eurozone. Indeed, futures contracts suggest that the market is expecting no more than another 10bps cut in interest rates. Previously, the expectation had been for as much as 20bps of further easing, taking the deposit rate down to –0.7%. This is in line with the trend in other markets, which may reflect some abatement of risks, with progress in US-China trade talks and on a Brexit deal.

Nonetheless, the market does not see ECB rates starting to rise until mid-2022 and then only very slowly. Futures contracts show three month money market rates remaining negative until the start of 2025. **The reaction in financial markets to today's ECB meeting was very muted, with little movement in fixed income or forex markets.** This reflects the fact that the commentary from the ECB today was very much in line with market expectations and the likelihood that the ECB will remain on the side-lines in the coming months as it assesses the impact of last month's round of easing measures.

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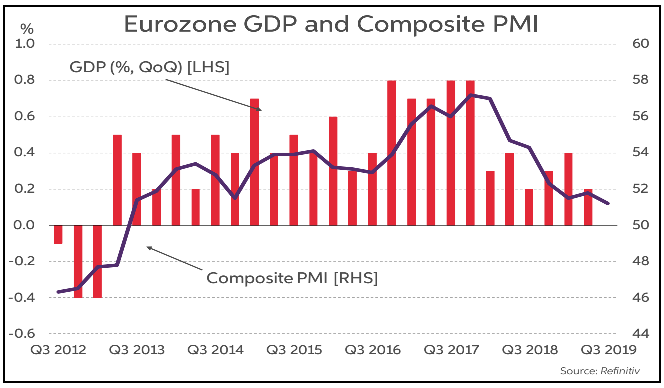
Outlook for Eurozone economy remains gloomy

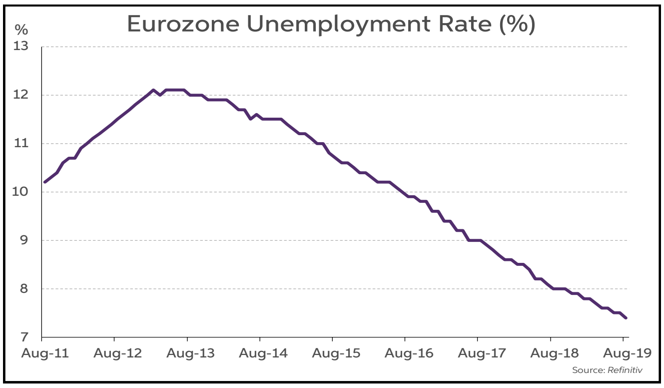
Eurozone GDP growth moderated to 0.2% in Q2, from 0.4% in the opening quarter of the year. The breakdown shows that domestic demand drove growth in the quarter. Consumption, government expenditure and fixed investment all added 0.1 percentage points (p.p.). In contrast, net trade acted as a drag, subtracting 0.1 p.p.. On a national level, activity has slowed notably in Germany and Italy, with the former on the cusp of a technical recession. In contrast, most of the other economies are performing relatively well.



Leading indicators suggest that Eurozone growth eased further in Q3. There has been little evidence of a recovery in manufacturing. The sector's PMI dropped to 45.7 in September, leaving the Q3 average at 46.4, compared to 47.7 in Q2. This is well below the key 50 level that separates growth from contraction. Worryingly, the services index fell sharply to 51.6 in September, from 53.5. The sector's PMI averaged 52.8 in the quarter, versus 53.1 in Q2. Overall, this meant the composite index averaged 51.2 in Q3, down from 51.8 in the second quarter. Nationally, the Italian ISTAT is trending downwards, while the German Ifo remained at a level consistent with economic contraction in Q3. The French INSEE was also broadly unchanged in the quarter.

The available 'hard' data were generally weak in Q3. Retail sales volumes increased by just 0.1% in July/August on Q2 levels, indicating that consumer spending likely moderated in the quarter. Meanwhile, the industrial sector remains mired in recession. Despite a small increase in production in August, output fell by 1% in July/August versus Q2, with the year-on-year growth rate now at –2.8%.

In spite of the weakening of economic activity, the labour market has been holding up reasonably well, though cracks have begun to emerge. Employment growth eased to 0.2% in Q2, while wage inflation decelerated to 2.1%. More positively, the jobless rate edged down to 7.4% in August, close to a multi-decade low. Looking ahead, the employment subcomponent of the composite PMI suggests that the pace of new jobs creation may have moderated further in Q3.



On the inflation front, price pressures in the region remain very subdued. Lower oil prices saw headline HICP fall below the 1% level to 0.8% in September. Meantime, the core measure continues to hover around the 1% level. This is well below the ECB's target of close to, but just below, 2%.

The October PMIs suggest that activity got off to a weak start in the final quarter of the year. The composite index edged slightly higher to 50.2, pointing to continued economic stagnation. There was a slight improvement in the services PMI to 51.8, while the manufacturing index was unchanged at 45.7

Overall, near term downside risks continue to cloud the outlook for the Eurozone economy. The reliance of the region on export led growth, especially in Germany, means it remains vulnerable to deteriorating external demand. On that note, the considerable loss of momentum in the world economy and the weakening of international trade, partly linked to protectionist policies adopted by the Trump administration, represent significant ongoing threats to growth. Meanwhile, on the domestic front, the challenges in the auto industry are posing particular problems for Germany.

Despite this, there are a number of positives. The solid labour market and subdued inflation will support the key consumer side of the economy. At the same time, a somewhat more expansive outlook for fiscal policy should also help stimulate domestic demand, while the ECB's dovish policy stance will also aid activity. However, the near-term assessment remains downbeat. The latest ECB projections are for GDP to expand by 1.1% this year and 1.2% in 2020, broadly in line with the IMF's forecast for growth of 1.2% and 1.4%.

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