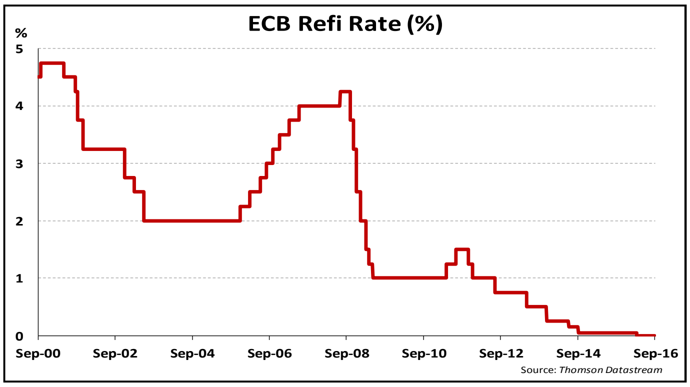
ECB Watch

8th September 2016

AIB Treasury Economic Research Unit

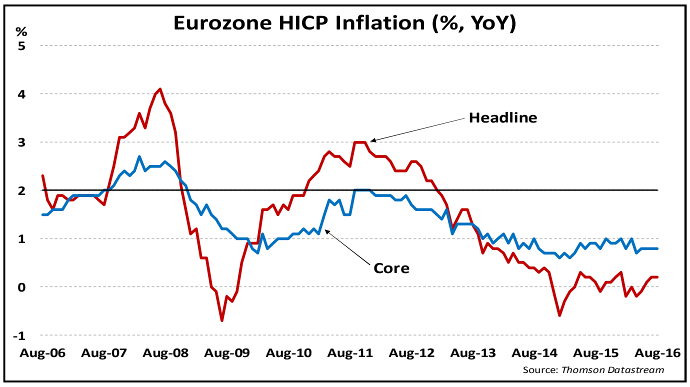
No signal that further easing is imminent

Today's meeting of the ECB's Governing Council concluded with no changes to monetary policy. 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".



The updated staff projections showed a slight downward revision to the ECB's growth outlook over the forecast horizon. While GDP was upgraded marginally to 1.7% this year (from 1.6%), there was a small downgrading of estimates for 2017 and 2018 from 1.7% to 1.6% for both years. Meanwhile, the inflation outlook was left broadly unchanged.

There had been some speculation in the lead up to today's meeting that the Governing Council may have announced an extension to its asset purchase programme, or at the very least provided an indication that such an extension was in the offing. However, in the post-meeting press conference, President Mario Draghi commented that they "didn't discuss" an extension of QE.



Given that the current QE end date is just six months away and combined with the downgrading of growth forecasts, President Draghi was questioned as to why the ECB did not act. He responded by saying that the Governing Council's assessment was that "for the time being, the changes are not substantial to warrant a decision to act". Instead, he emphasised that the current policy initiatives were "fully effective".

However, the ECB is undertaking background work to "evaluate the options that ensure a smooth implementation" of its purchase programme. This work is in the context of the constraints that are emerging on the eligible supply of bonds that the ECB can buy. Under the current purchase programme rules the ECB cannot buy bonds whose yield is below the deposit rate (-0.4%).

ECB Macroeconomic Forecasts for the Euro Area

(%)	2015	2016	2017	2018
HICP	0.0	0.2	1.2	1.6
Real GDP	1.9	1.7	1.6	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $42.8 in 2016, $47.4 in 2017 and $50.6 in 2018. Source: ECB September 2016

Furthermore, the ECB retains a clear bias to ease monetary policy further if economic conditions require such action. This bias is evident in the fact that the ECB continues to assess the risks to its economic outlook as remaining "tilted to the downside". It is also apparent in its explicit commitment to "act using all the instruments available" within its mandate "if warranted". Market reaction to today's meeting was relatively muted. The lack of any definitive signal that a QE extension was imminent, and the fact that it was not even discussed was somewhat surprising. As a result, the euro was modestly firmer following the meeting, with EUR/USD edging back up into $1.13 territory and EUR/GBP changing hands back up near 85p. Bond yields also moved somewhat higher.

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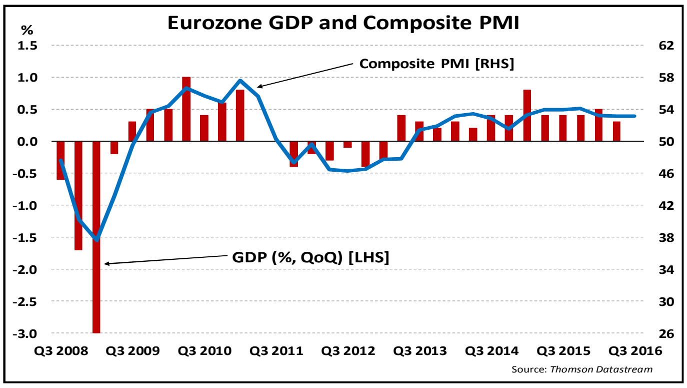
Eurozone still growing at moderate pace

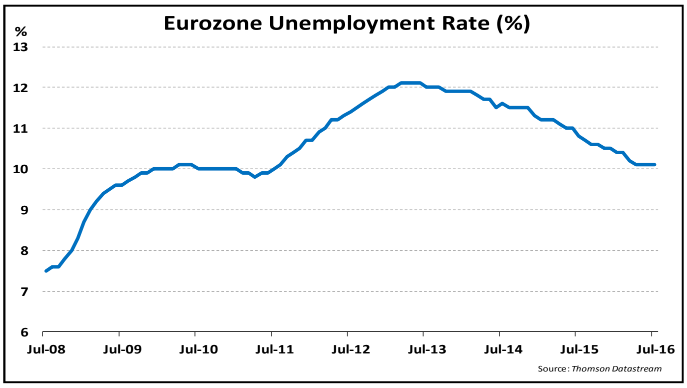
The Eurozone economy grew by 0.3% in Q2, after picking up by 0.5% in Q1. Year-on-year growth edged down slightly to 1.6% in the second quarter, from 1.7%. The underlying data show that net trade made the largest contribution to growth in Q2, adding 0.4 percentage points. The primary reason for the slower 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 have pointed to a stable, but modest, pace of growth. The key Eurozone composite PMI averaged 53.1 in July/ August, which on past form is consistent with a 0.3/0.4% pace of quarterly growth. The EC measure of Eurozone economic sentiment averaged 104, similar to Q2's 104.3 reading. National level PMIs, as well as other indicators such as the German Ifo, French INSEE and Italian ISTAT surveys have also pointed to on-going modest growth.

The limited hard data available so far for Q3 have been mixed. Eurozone retail sales recorded strong growth of 1.1% in July, following on from Q2's weak 0.2% increase. Meantime, German industrial production fell by 1.5% in July, also slipping back into negative territory on a year-on-year basis. Although, this may reflect seasonal factors related to earlier than usual summer factor shutdowns.

In terms of the labour market, year-on-year growth in employment has continued to accelerate, reaching an 8-year high of 1.4% in Q1 (from 1.3% in Q4'15). Employment has risen by 0.3% on a quarterly basis since Q3'15. The Eurozone composite employment PMI averaged 52.7 in July/August, slightly firmer than Q2's 52.3 performance. This suggests that employment is continuing to grow at a steady pace in the current quarter.



Meantime, **the unemployment rate held at 10.1% for a fourth consecutive month in July.** Underlying data show that the dichotomy between countries remains large and, in some instances, is even widening. For example, unemployment in Germany fell to 4.2% in July, while it rose to 10.3% in France. Unemployment in the other two largest Eurozone economies, Italy and Spain, came in at 11.4% and 19.6%, respectively.

The Eurozone economy continues to face some significant challenges, including 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. Meantime, while the early signs are that the initial 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 consumer spending.

However, there are also some tailwinds for the economy, including the favourable impact from lower commodity prices, the relatively weaker euro and the impact of monetary policy easing, with interest rates likely to remain at very accommodative levels for the next few years. Today's updated ECB staff forecasts show the Central Bank expects growth of 1.7% in 2016 and 1.6% in 2017. This is broadly in line with the recent IMF economic projections of a steady, but moderate, pace of growth.

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