ECB Watch

AIB Treasury Economic Research Unit

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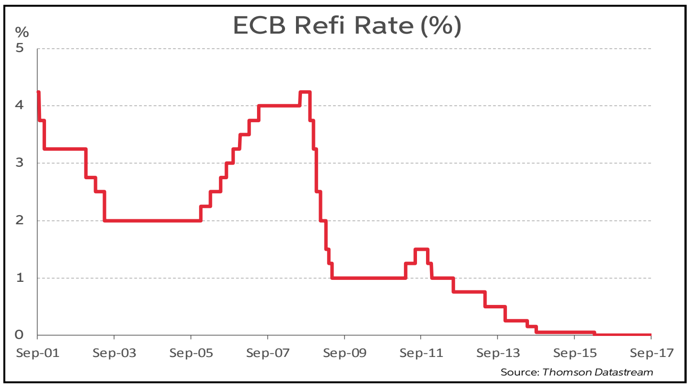
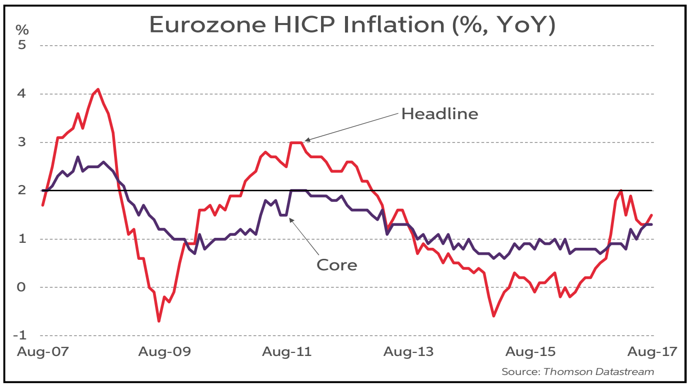
ECB signals QE tapering decision likely in October

As expected, today's meeting of the ECB's Governing Council concluded with its key interest rates remaining unchanged at −0.4% for the deposit rate and 0% for the refi rate. There was also no change to its asset purchase programme. The ECB once again emphasised its QE programme will run until end December 2017, or beyond, if necessary.



However, we did get further clarity on when the ECB may announce a tapering of its asset purchase programme. President Draghi stated during the press conference that it was likely that the "bulk of decisions will be taken in October".



The other key point of interest in the lead up to today's meeting was what the ECB would say about recent euro strength. The statement noted that "recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium term outlook for price stability". However, despite numerous questions on the matter, not surprisingly, and true to form, the ECB President did not comment on specific levels.

Meantime, the latest ECB staff forecasts have taken into account the "stronger growth momentum" in the Eurozone economy year to date, with its near term growth expectations revised higher. The ECB now expects GDP to grow by 2.2% this year (from 1.9%). 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 acknowledged the impact of recent euro strength by lowering its inflation projections for 2018 to 1.2% (from 1.3%) and in 2019 to 1.5% (from 1.6%). Its inflation forecast for this year remains at 1.5%.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2016	2017	2018	2019
HICP	0.2	1.5	1.2	1.5
Real GDP	1.8	2.2	1.8	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $51.8 in 2017 , $52.6 in 2018 and $53.1 in 2019.
Source: ECB September 2017

In summary, today's meeting statement/press conference show that the ECB continues to proceed cautiously as it gradually moves away from an easing policy bias towards a more neutral policy stance. Indeed, President Draghi emphasised that "patience is needed" and that the "recovery remains dependent" on accommodative monetary policy .

Therefore, it is likely that the tapering of its QE programme in 2018 and withdrawal of monetary stimulus is likely to be very gradual in pace. **This is reflected in rate expectations, where markets envisage 3-month Eurozone remaining negative till end-2019, staying low for an extended period beyond that, and only reaching towards 1% towards by end-2023.** In terms of market reaction, the euro traded higher during the press conference on the back of the strong signals that a QE tapering announcement was on the cards for October, while at the same time President Draghi refrained from trying to 'talk down' the currency. In level terms, this was reflected in EUR/USD retesting the $1.20 level, trading as high as $1.206 before moving back down to $1.20.

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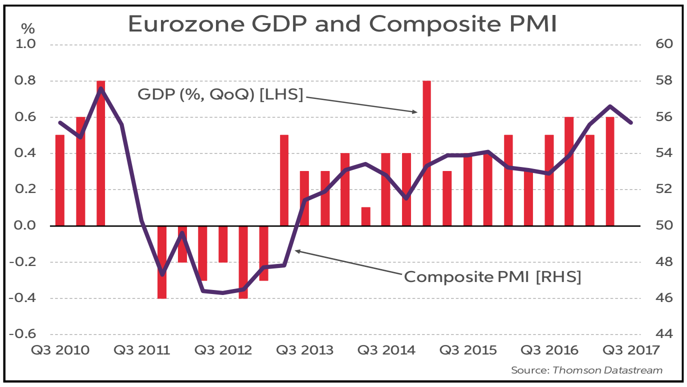
Eurozone growth remains very encouraging

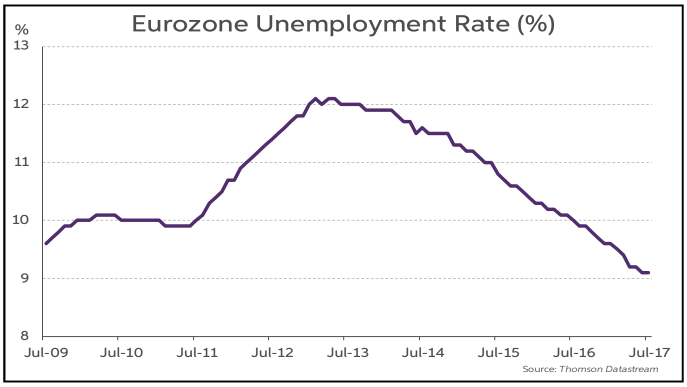
The Eurozone economy grew by an impressive 0.6% in Q2, a slight improvement on Q1's encouraging 0.5% rise. The economy grew by 2.2% on a year-on-year basis, up from 1.9%. The underlying Q2 data show that household consumption was the main source of growth, adding 0.3 percentage points (p.p.). Investment (0.2 p.p.), net exports (0.1 p.p.) and Government spending (0.1 p.p.) also boosted growth. Inventories deducted 0.1 p.p. for the second quarter in a row.



Recent survey data have suggested that the Eurozone economy has continued to grow at a solid pace in Q3. The Markit Composite PMI averaged 55.7 in July/August, compared to 56.6 in Q2. This looks to be consistent with a healthy quarterly increase of around 0.5% in GDP. The EC measure of Eurozone economic sentiment also suggests that the economy has continued to expand solidly in Q3.

The little available 'hard' data which we have for Q3 have been soft, though there are a lot of data for the quarter yet to come. For example, Eurozone retail sales declined by 0.3% in July. Although, this did follow on from June's solid 0.6% increase, while the pace of year-on-year growth remained strong at +2.6%. Meantime, German industrial output was flat in July, after recording strong growth of 1.8% in the second quarter.

In terms of the labour market, recent data have continued to show further improvement. The unemployment rate fell to 9.1% in June/July, an eight year low. This compares to 10% a year earlier. The 'dichotomy' of the unemployment rates in the major Eurozone economies remains stark. German unemployment has fallen further in recent months to just 3.7%, while the rate in France has picked back up to 9.8%, having edged down to 9.5% in April. Elsewhere, there is little downward direction in the unemployment rate in Italy (stuck above 11%), while it remains very high in Spain at over 17%.



Employment in the currency bloc has grown at a healthy pace in recent quarters. Year-on-year growth picked up to 1.5% in Q1, its strongest performance since Q1 2008. **The employment component of the Eurozone composite PMI averaged a solid 54.1 in July/August.** This is broadly unchanged compared to Q2's 10-year high quarterly average of 54.4. This suggests that employment has continued to grow at a firm pace.

The Eurozone economy, though, still faces some challenges, including high levels of unemployment in many countries, a lack of structural and financial sector reforms in some economies and modest wage growth. Meanwhile, despite victory for pro-EU groups in French and Dutch elections, some political uncertainty still remains in the Eurozone, with German, Austrian and Italian legislative elections all due in the next 8 months. The currency has also moved higher this year.

However, there are also tailwinds for the economy, including low underlying inflation and the positive impact of loose monetary policy, with interest rates likely to remain at very low levels for the next few years. An improvement in global growth is also providing support to the economy, while fiscal policy has become more expansionary in many countries. The ECB is forecasting GDP growth of 2.2% for this year and 1.8% in 2018.

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