

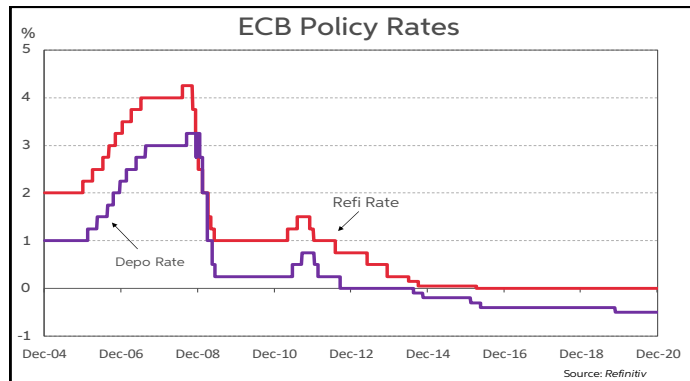
ECB on hold, will maintain favourable financing conditions

The January meeting of the ECB's Governing Council saw policy kept on hold. This was no surprise given that the central bank had announced a further easing of monetary policy at its December meeting. It both expanded and extended its Pandemic Emergency Purchase Programme (PEPP) and also enhanced its special liquidity programme, known as TLTRO 3, at last month's meeting.

Today, much interest was centred on the ECB's assessment of the near term economic outlook in the light of the tightening of restrictions on activity, owing to the recent sharp rise in new Covid cases.

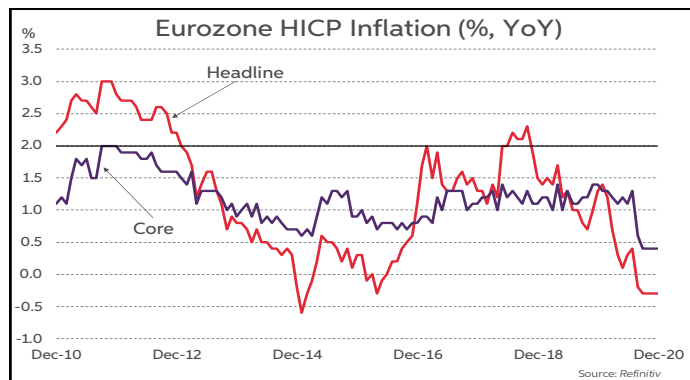
The ECB noted the negative impact that this was having on the services sector in particular. However, it also pointed to some recent positive developments, including agreement on an EU-UK trade deal. It acknowledged that the risks to GDP forecasts were still tilted to the downside in the short-term, although, they are less pronounced.

The ECB continues to expect the economy to recover as vaccines become more widely available.



The ECB's latest set of staff macroeconomic projections were published last month. After declining by an estimated 7.3% last year, the economy is forecast to grow by circa 4% in both 2021 and 2022. The ECB indicated today that these projections remain "broadly valid", though as before, the risks remain tilted to the downside.

The ECB sees the HICP rate averaging around 1% in the next two years before rising modestly to 1.4% in 2023. With inflation expected to remain well below its 2% target until at least 2023, the ECB is likely to have to maintain an ultra loose monetary policy for some time. Indeed, today, it emphasised that it would preserve favourable financing conditions until at least March 2022.



In this regard, the ECB indicated that policy remains flexible and it is prepared to do more easing if required.

It has been notable that the ECB has kept its two main interest rates unchanged during this pandemic suggesting they are at their lower bound, with the refi rate remaining at 0% and the deposit rate staying at -0.5%. This suggests that any further policy loosening will be through additional quantitative easing measures and enhanced liquidity operations.

However, interbank rates have fallen over the past year as a result of QE and the ECB's large liquidity operations. These measures have included a lowering of the interest rate on refinancing operations. Thus, short-term money market rates have fallen below the ECB deposit rate. Markets expect rates to remain at very low levels over the next number of years and are not pricing in an increase in the deposit rate until end 2024. Money market rates are seen as remaining negative until at least 2027.

ECB Macroeconomic Forecasts for the Euro Area				
(%)	2020	2021	2022	2023
HICP	0.2	1.0	1.1	1.4
Real GDP	-7.3	3.9	4.2	2.1

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$41.6 in 2020, \$44 in 2021, \$45.4 in 2022 and \$46.9 in 2023

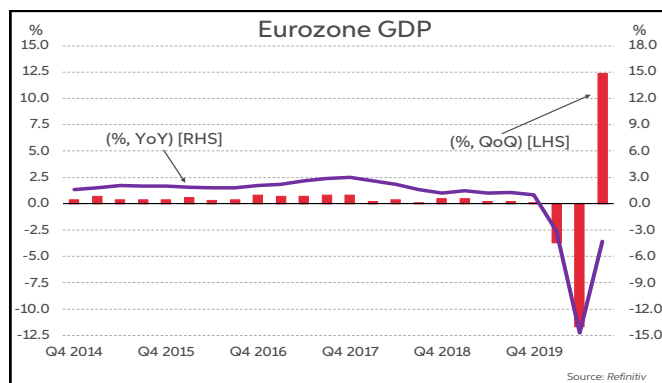
Source: ECB December 2020

The market reaction to the ECB meeting was muted, with the central bank back on hold after loosening policy last month. Indeed, there has been little movement in futures contracts or bond yields since last summer, with the message sinking in that low rates and ample liquidity are here to stay for years to come.

Rebound to follow difficult start to 2021

Eurozone GDP rebounded strongly by 12.5% in Q3. However, GDP was still 4.3% below its Q4 2019 level. The national data showed that the rebound was greatest in the countries hit hardest by the pandemic. France (+18.7%), Spain (+16.7%) and Italy (+15.9%) recorded the largest quarter-on-quarter increases in Q3, having been the three hardest hit economies in the Eurozone in H1 2020. Elsewhere, the first reading of fully year GDP for Germany showed the economy contracted by 5% in 2020, much less than was initially feared.

Survey data suggest that restrictions across the Eurozone continued to have a more adverse impact on the services sector than the manufacturing sector. In Q4, the manufacturing PMI remained in expansion mode averaging 54.6 vs. 52.4 in Q3. In contrast, the services PMI printed below the 50 threshold during Q4. Overall, the services index averaged 45 in Q4, down from 51.1 in Q3. However, the fall in the service PMI was not as sharp as in the spring. Likewise, the EC sentiment indices have held up much better in Q4 than they did earlier in the year. The headline index actually improved in Q4

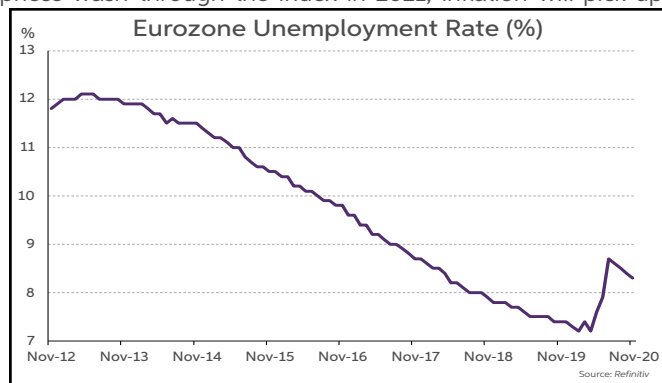


when compared to Q3 (89.6 vs. 87.0), although, here too the divergence between the services and manufacturing sectors is evident. While the industrial sentiment index rose from -11.1 in September to -7.2 in December, the services sentiment index which was also at -11.1 in September, has moved in the opposite direction, falling to -17.4.

The available “hard data” for Q4 also indicate that the fall in activity was nowhere near as severe as in H1 2020. Retail sales fell by 6.1% in November, which brings them back to 3.2% below their February level. However, during the first lockdown, retail sales were 21% below their pre-pandemic level. Output has also fared far better than earlier in the year. Industrial production has remained on an upward trend in Q4, and was just 0.8% below its pre-Covid level in November. Thus, while the Eurozone economy likely contracted again in Q4, the data suggest that the fall was far more modest than earlier in the year.

The impact on the labour market has been limited to date, given the scale of the crisis and decline in GDP. The unemployment rate was at 8.3% in November, up from 7.3% at the start of 2020, and, indeed has been on a downward trend since it peaked at 8.7% in July. This reflects the success of furlough schemes in protecting the job’s market, with many of these schemes likely to remain in place in 2021. The European Council has also approved circa €90bn under its SURE (labour market) scheme to allow governments to continue to provide such supports.

In relation to inflation, the headline rate of HICP remained at -0.3% in December, while core inflation stayed at 0.2%. VAT cuts in a number of countries, as well as restrictions on activity are keeping inflation very low. However, once these temporary measures and lower energy prices wash through the index in 2021, inflation will pick up. Despite this, the ECB forecasts that inflation will remain subdued, rising to 1%, in 2021, still far below its 2% inflation target.



The Eurozone economy is set to remain weak in early 2021, with service industries such as travel, hospitality and leisure much more affected by Covid restrictions than manufacturing and construction. Disruptions to trade following the narrow FTA signed with the UK may also act as a bit of a drag for the export led Eurozone economy, as would a continued appreciation of the euro.

However, there are grounds for optimism. Vaccines have started to be rolled out, and more will become available as 2021 progresses. This should allow for a robust economic recovery to take root. The rebound seen in Q3 shows that when businesses re-open, the economy can bounce back quickly. Monetary policy will remain very accommodative also, and national governments will continue to provide fiscal support. Grants and loans from the EU recovery fund will also come on stream this year, with the worst affected countries set to benefit the most from the fund. In its December forecasts, the ECB sees Eurozone GDP falling by 7.3% in 2020, before rebounding by circa 4% in 2021, with similar growth expected in 2022. Obviously, though, risks remain for the expected recovery.

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