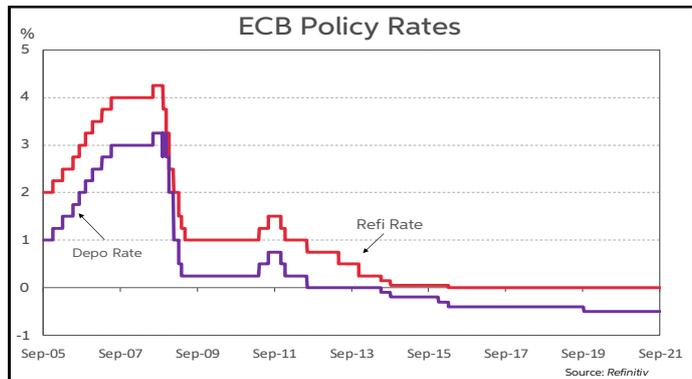


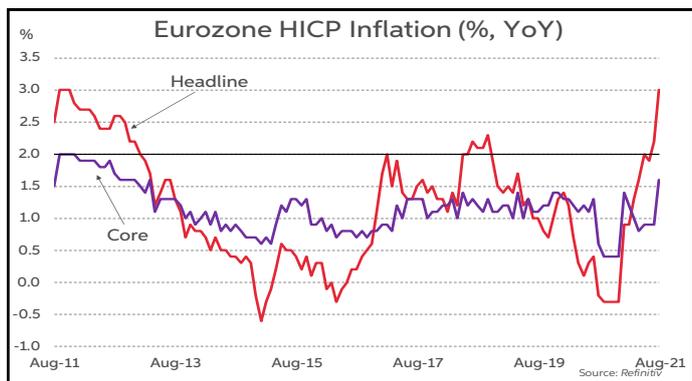
## ECB lowers pace of asset purchases under PEPP

The September meeting of the ECB's Governing Council saw the central bank announce a reduction in the pace of monthly asset purchases under its Pandemic Emergency Purchase Programme (PEPP). There was unanimity within the Governing Council on this decision. The announcement had been anticipated by the market following a raft of hawkish comments from key ECB officials in the lead up to today's meeting. However, President Lagarde was keen to not use the word 'taper' to describe the "moderately lower pace" of monthly PEPP purchases. Instead she emphasised it was a "recalibration" of policy. She stated that the decision to lower the monthly rate of purchases was based on a joint assessment of financing conditions and the inflation outlook. The ECB assessed that favourable financing conditions could be maintained despite the changes to its PEPP purchases, while the inflation outlook has been upgraded.



The ECB's characterisation of the Eurozone economy was generally upbeat in tone. It noted that the economic rebound is "increasingly advanced" with output expected to exceed its pre-Covid level by the end of the year. The meeting statement also referenced the successful vaccine rollouts, allowing economies to largely reopen. Although, it remained cognisant of the risk from the Delta variant to the full reopening of the economy.

The increased level of optimism within the ECB regarding the economic outlook was reflected in the ECB's updated macro projections which were released today. It revised higher its growth expectations for 2021 to 5.0%, from 4.6%. For 2022 and 2023 its growth projections were left broadly unchanged at 4.6% and 2.1% respectively. The central bank's assessment is that the risks to the economic outlook for the Eurozone remain broadly balanced.



The ECB also revised higher its inflation outlook. However, while it expects inflation to rise further this autumn, it continues to be of the view that the recent upswing will prove temporary and inflation will start to fall back next year. It is now forecasting headline inflation to average 2.2% (from 1.9%) this year, and is projecting it at 1.7% (from 1.5%) in 2022 and 1.5% (from 1.4%) in 2023. Core inflation is now forecast at 1.3% in 2021, 1.4% in 2022 and 1.5% in 2023, which represent slight upward revisions compared to June. The ECB's view is that while underlying price pressures have "edged up", over the medium term, inflation is envisaged to remain well below its 2% target.

With the ECB continuing to foresee inflation undershooting its 2% target until at least 2023, the central bank is unlikely to contemplate rate increases anytime soon. Futures contracts suggest that the market does not envisage official ECB interest rates will rise from their current levels until the end of 2023 or in early 2024. Instead, the focus in the near term will be on PEPP and when it will end. At the press conference, President Lagarde commented that no discussion on this took place at the September meeting, but that the issue will be addressed comprehensively at its December meeting. The cautious approach taken from the ECB today caused peripheral bond yields to decline, but it had a limited impact on the single currency.

### ECB Macroeconomic Forecasts for the Euro Area

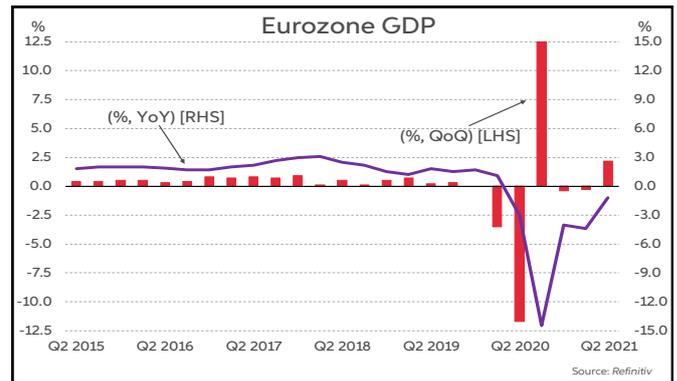
(%)	2020	2021	2022	2023
HICP	0.3	2.2	1.7	1.5
Real GDP	-6.5	5.0	4.6	2.1

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average \$67.8 in 2021, \$67.3 in 2022, \$64.1 in 2023

Source: ECB September 2021

# Strong recovery continues in the third quarter

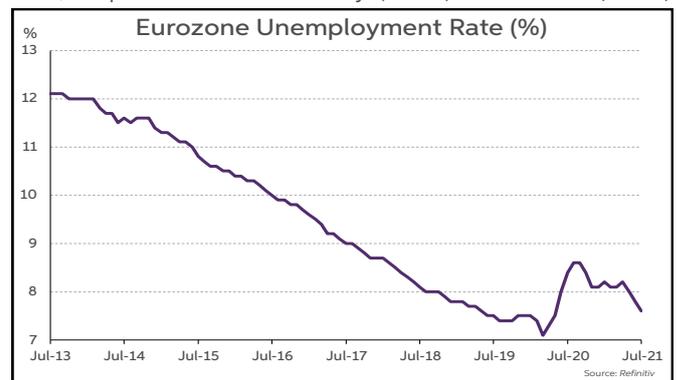
Having contracted by a modest 0.3% in the opening three months of the year, Eurozone GDP staged a strong rebound in the second quarter, expanding by 2.2%. The rebound was led by consumer spending as restrictions were eased across the bloc. Household expenditure grew by 3.7%, adding 1.9 percentage points (p.p.) to the total. Investment and government expenditure both increased contributing 0.5 p.p. to growth. Imports (+2.3%) slightly outpaced exports (+2.2%), clipping 0.1 p.p from the quarterly total. A small rundown in inventories knocked another 0.1 p.p. from GDP.



Survey data suggest the Eurozone economy has continued to grow at a healthy pace so far in the third quarter. Although the manufacturing PMI has inched lower over the past few months, the index remains elevated, at 62.8 in July and 61.4 in August. Indeed, the index has printed in expansion mode for the past 13 months, and above 60 since March of this year. However, supply chains remain under severe pressure, which may act as a headwind to growth in the months ahead. The services PMI indicates the sector is experiencing a very strong rebound in activity also. The index has averaged to 59.4 so far in Q3, up from 54.7 in Q2, with the PMI printing at its highest levels since mid-2006 in July and August. The sector is benefitting from the return of tourism and the loosening of restrictions, which were particularly harmful to firms in the leisure and hospitality industry.

However, retail sales for July, the only Eurozone wide hard data point currently available for Q3 were very disappointing. Sales declined by 2.3% in the month, as the impact from the re-opening of the retail sector went into reverse. Household spending may also have switched back towards services and away from goods due to the return of hospitality and leisure. In any case, despite the fall in July, retail sales were 0.1% higher than in Q2, and remain 2.6% above their pre-pandemic level. However, the latest industrial production data shows that output is still circa 1.6% below its pre-Covid level in the Eurozone, as production in Germany (-5.5%) and France (-5.3%) remains well below their February 2020 peak.

In terms of the labour market, the impact from the pandemic has been limited to date. The jobless rate continued to trend lower in July, falling to 7.6% down from a 'Covid' peak of 8.7% last summer, and just 0.5% above its pre-pandemic level. This reflects the success of labour support schemes in shielding the jobs market, although, these schemes will soon be wound down. These schemes have in part been funded by the EU SURE programme, which has disbursed nearly €90bn to member states.



Turning to inflation, headline HICP jumped to 3.0% in August, up from 2.2% in July. The increase in the headline rate this year has been largely due to a rise in energy prices, which are 15.4% higher year-on-year. Base effects owing to changes in the German VAT rate are also pushing inflation higher. However, the ex-food & energy reading almost doubled in August, rising to 1.6% from 0.9%, suggesting that underlying price pressures are gaining momentum. Inflation is likely to increase further as the year progresses as rising input prices and supply chain issues put more upward pressure on consumer prices. The latest forecasts from the ECB released today show inflation averaging 2.1% this year, before falling back to 1.7% in 2022, and 1.5% in 2023.

Despite a weak start to 2021, a strong economic recovery has taken root in Q2, and appears to have continued in Q3. Although, consumer spending rose by 3.7% in Q2, it remained 6% below its pre-pandemic level. As restrictions continue to ease personal consumption should rise further, as households run down some of the large amounts of precautionary and forced savings they built up over the last 18 months. Funding from the EU Recovery Fund has also started to come on stream, with the countries worst impacted by the pandemic due to receive the most support. However, there are risks to the Eurozone economy that will need to be carefully navigated. Inflation may prove stickier than the ECB currently anticipates if supply chains continue to remain under severe pressure. A resurgence in Covid-19 during the winter could also negatively impact the recovery. The latest staff projections show that the ECB expects GDP to grow by 5.0% this year, 4.6% in 2022, and by 2.1% in 2023.

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