ECB Watch

AIB Treasury Economic Research Unit

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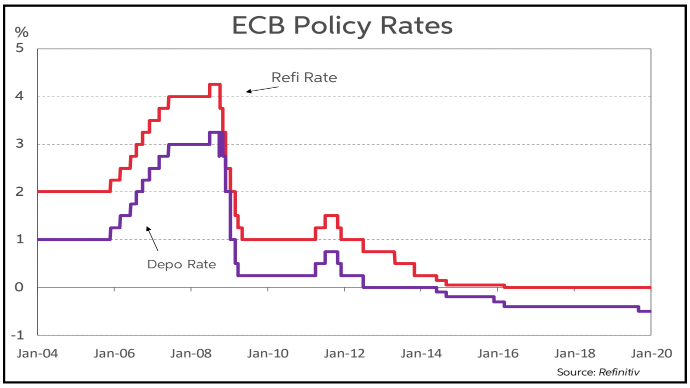
ECB very much on hold

The January meeting of the ECB's Governing Council concluded, as expected, with no changes to monetary policy. The ECB is viewed as being very much on hold as regards to future policy action.

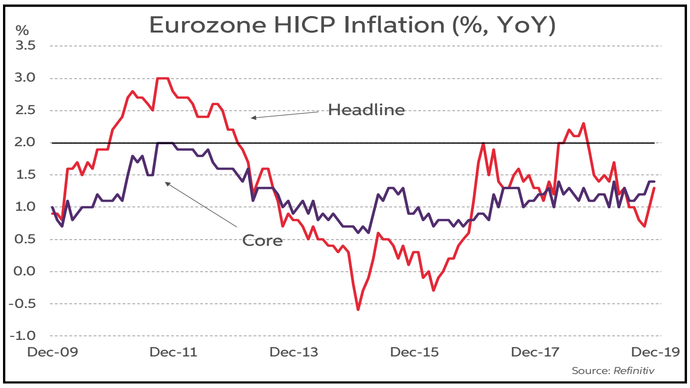


Instead, the central bank is in monitoring mode, assessing the impact of the easing measures it announced back in September. These initiatives included a 10bps reduction in the deposit rate to –0.5%, as well as restarting its QE programme.

Notwithstanding this, the ECB still does retain an easing bias. It continues to indicate that it would provide more monetary stimulus to the Eurozone economy, if required, to meet its policy objective of inflation close to, but below 2%. This bias was again evident in the meeting statement, which noted that official rates will remain at their present or lower levels until inflation converges towards its target. The ECB also continued to emphasise that its QE purchases programme would run for as long as necessary and only end shortly before it starts to raise rates.

The ECB's most recent set of staff macroeconomic projections were published back in December. The subdued growth and inflation outlook outlined in these forecasts provide the rationale as to why the central bank retains an easing bias. The ECB is expecting GDP growth of just 1.1% this year. For 2021, the central bank is envisaging a modest pick up in economic activity, with GDP growth of 1.4% being forecast. It is anticipating a similar growth rate for 2022.

One of the few tweaks in today's meeting statement saw the ECB change somewhat its assessment of the risks to its economic outlook. **While it continues to be of the view that the risks to its outlook remain "to the downside", it did state today that these risks have "become less pronounced".** In the post-meeting press conference, President Lagarde stated that this was due to receding uncertainty around international trade compared to the time of its last meeting in December.



On the inflation front, the December staff projections showed that the ECB is forecasting a very muted outlook. HICP inflation is forecast at 1.1% in 2020, rising to 1.4% in 2021. The central bank is projecting that inflation will average 1.6% in 2022. **In other words, the ECB is expecting inflation will remain well below its 2% target in the next couple of years.**

In terms of market expectations, the view is that further easing from the ECB is unlikely, with monetary policy staying on hold throughout this year. A key reason for the market's scepticism on further policy loosening is that the minutes of the September meeting showed significant opposition on the Governing Council to the easing package it announced back then. The ECB is also commencing this month a major review of its monetary policy framework that is expected to be concluded by the end of this year.

Futures contracts indicate that the market does not see ECB rates starting to rise until 2022 and then only very slowly. These contracts also show that the market is envisaging three month money market rates remaining negative until the end of 2024. Given the lack of surprises from today's meeting, market reaction has been muted, with both the euro and bond yields continuing to trade within very tight ranges.

Oliver Mangan	John Fahey	Conor Beakey
Chief Economist	Senior Economist	Economist
oliver.n.mangan@aib.ie	john.j.fahey@aib.ie	conor.x.beakey@aib.ie

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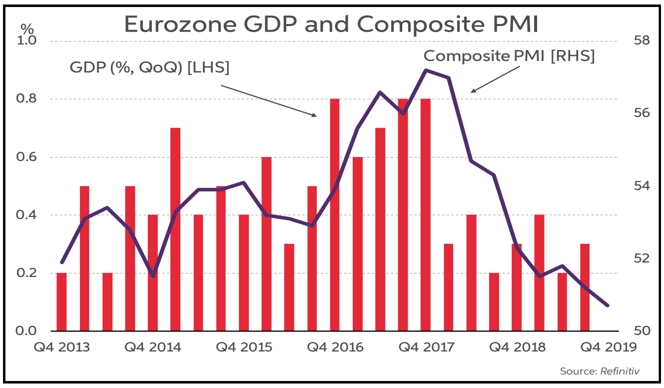
Eurozone growth slow but steady

Eurozone GDP growth edged up from 0.2% to 0.3% in Q3, which left the year-on-year growth rate at 1.2%. GDP growth has now been confined to a narrow 0.2-0.4% range for seven consecutive quarters since the start of 2018. Consumer spending drove activity in Q3 2019, contributing 0.3 percentage points (p.p.). Government expenditure added a further 0.1 p.p.. Meanwhile, changes in inventories acted as a drag, subtracting 0.1 p.p.. With regard to the national breakdown, Germany and Italy continued to underperform and activity there is virtually stagnant, with GDP rising by 0.5% and 0.3% year-on-year in Q3. Growth elsewhere, such as in France (+1.4% YoY) and Spain (+1.9% YoY), has held up comparatively well.

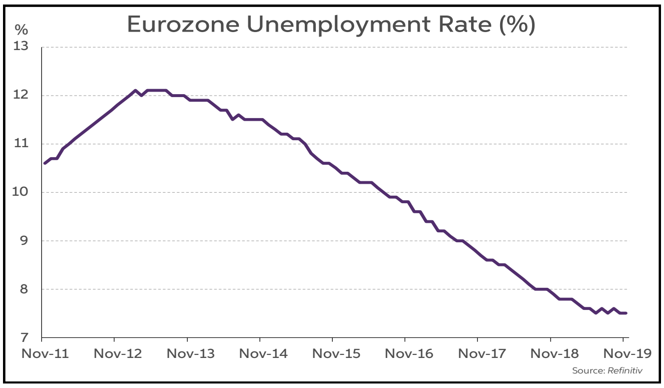


Survey data indicate that the economy may have expanded at a marginally slower rate in the final quarter of the year. The composite PMI was a touch weaker in Q4, averaging 50.7 vs 51.1 in Q3. This reflected a decline in the service sector's index, which came in at 52.3 against 52.8 in the preceding quarter. In contrast, the manufacturing PMI held at 46.4, but is still in contractionary territory. Meanwhile, the EC sentiment index fell back to 101.2 in Q4, from 102.5, but it did pick up in the final two months of the year.

The available 'hard' data generally remained soft in Q4. In October/November, retail sales increased by just 0.4% on Q3 levels. The industrial sector also remains mired in recession, with output falling by 0.6% in October/November versus Q3. More positively, the boost provided by Brexit related stockpiling to the goods trade balance in October, which was not fully offset in November, should help to prop up growth in Q4.

The moderation in economic activity in 2018/19 has begun to weigh on the labour market. Employment growth has lost considerable momentum, rising by just 0.1% in Q3. The employment sub-component of the composite index suggests that jobs growth remained weak in the final quarter of the year. In time, this may see the unemployment rate tick upwards, but for the moment it remains at a multi-decade low of 7.5%. Wage inflation also looks to have peaked and has moderated since the summer.

On the inflation front, a combination of technical factors and base effects have seen the headline and core rates of HICP pick-up. However, at 1.3% and 1.4%, respectively, in December, they remain well below the ECB's 2% target.



There are a number of supportive factors at work for the Eurozone economy. The global manufacturing downturn appears to be bottoming out, while the US and China 'phase-one' trade deal may help world trade volumes recover somewhat. The IMF expects that growth in emerging economies will pick up this year. This should be supportive of Eurozone activity, given the reliance of the region on export-led growth. Meanwhile, relatively low unemployment and subdued inflation will offer support to the consumer side of the economy. Additionally, the ECB's dovish stance should continue to aid growth, while fiscal policy looks set to be mildly expansionary.

However, despite these positives, the near-term outlook for the Eurozone remains downbeat and a sustained pick up in activity does not appear close to hand. Uncertainty regarding the future trading relationship between the UK and the EU will likely persist this year as difficult talks get underway. The protectionist regime in the US also remains a distinct risk factor, despite the recent partial trade deal with China. On the domestic front, the challenges facing the auto sector represent a particular problem for Germany, while the outlook for Italy remains challenging. **The latest ECB projections are for GDP to expand by 1.1% in 2020 and 1.4% in 2021. These are broadly in-line with the IMF's forecasts for growth of 1.3% in 2020 and 1.4% in 2021.**

AIB, 10 Molesworth Street, Dublin 2 Tel: 353-1-6600311 https://aib.ie/investorrelations/economic-research-unit