ECB Watch

AIB Treasury Economic Research Unit

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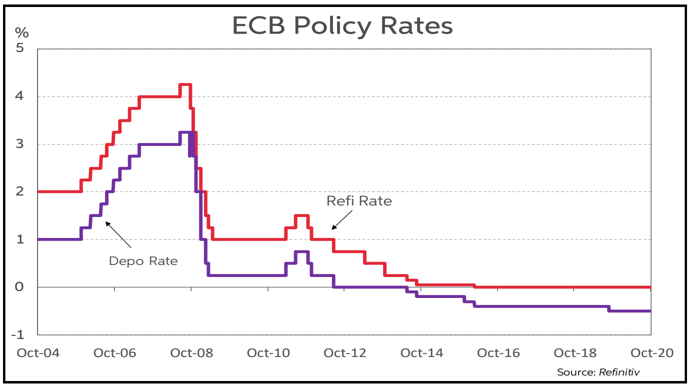
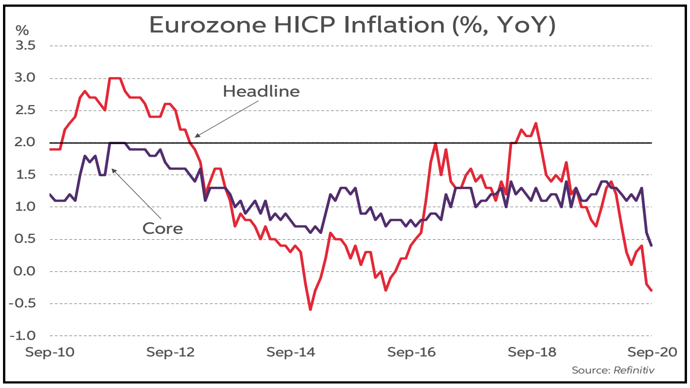
ECB promises more stimulus in December, if not before

The October meeting of the ECB's Governing Council concluded in line with market expectations, with no changes to policy. The key refi and deposit rates were maintained at 0.0% and –0.5% respectively. In terms of its quantitative easing policy, it maintained the total envelope of the purchases under its pandemic emergency purchase programme (PEPP) at €1,350bn. It also repeated its guidance that it would continue with net asset purchases under the programme until at least June 2021 and until the central bank "judges that the coronavirus crisis phase is over".



However, the Governing Council did give a clear signal that it would announce further stimulus measures at its next meeting in December. It said in its meeting statement that it will "recalibrate its instruments, as appropriate" to respond to the deterioration in the economic outlook. President Lagarde emphasised in the press conference that this recalibration will cover "all" its instruments, and that the ECB is in "little doubt" that the economic outlook will warrant these changes. This means that policy expansion is nailed on for December and that the ECB will look at all of its policy instruments and not just an extension to PEPP. In other words, even a rate cut cannot be ruled out in December.

In fact, the ECB did not rule out taking action before its December meeting. However, by waiting until December, the ECB will have the updated macro staff projections, allowing the central bank to carry out a thorough assessment of the economic outlook and the balance of risks. It should also have a better understanding of the severity of the second wave and its impact. The most recent set of economic forecasts from the ECB were for a contraction of 8% in Eurozone GDP this year and growth of 5% in 2021 and 3.2% in 2022. President Lagarde stated today that the ECB is confident that the 3.1% quarterly growth rate it had expected for Q4 will print to the downside of these expectations.



Indeed, once again today, it commented that the risks surrounding the Eurozone's economic outlook are "clearly tilted to the downside". This largely reflects the negative impact on the economy from the increase in Covid-19 numbers and the associated containment measures (including lockdowns in some key economies) being introduced to deal with this. In a more severe scenario outlined back in its September forecasts, where tough coronavirus containment measures have to remain in place for a longer period of time, the ECB estimated that GDP could increase by just 3.3% in 2021.

With inflation set to remain well below its 2% target for some years, the ECB is likely to have to maintain an ultra loose monetary policy for some time. In the near term, it envisages headline inflation remaining negative until early 2021. **Futures contracts suggest that the market is anticipating that the ECB's could reduce rates further, with around 10bps of a rate cut being priced in over the next twelve months.** Indeed, money market rates in the Eurozone are already well below the current deposit rate of –0.5%, owing to the very high level of excess liquidity in the system. Meanwhile, the first 10bps hike in the deposit rate is not priced in until end 2024. In terms of market reaction to today's meeting, the strongly dovish message from the ECB has seen the euro come under some downward pressure, with EUR/USD unable to hold onto the key $1.17 level. **In conclusion, after today's meeting is it clear that the ECB will be announcing further monetary stimulus in December, if not before, the only question is what policy mix this will take.**

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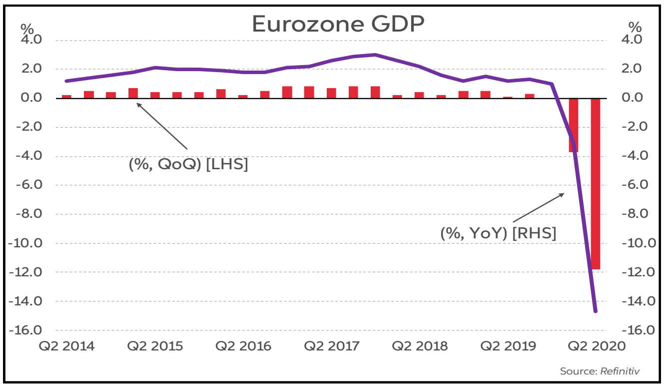
Second wave to disrupt the recovery in Q4

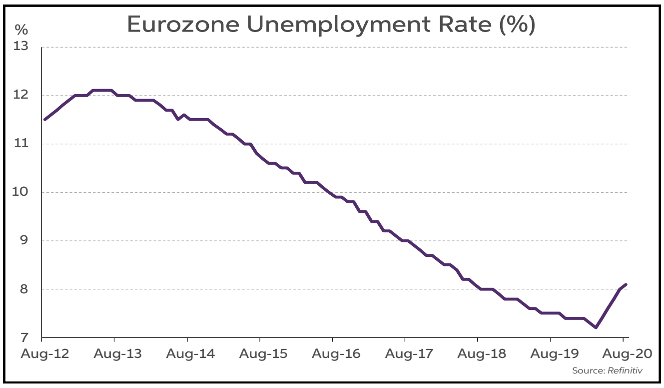
The impact of the pandemic on the Eurozone economy was really felt in Q2, when GDP contracted by 11.8%. Spain (-18.5%), France (-13.8%) and Italy (-12.8%), reported contractions in GDP greater than the Eurozone figure, as the severity of the outbreak in these countries resulted in more stringent lockdowns.



Leading indicators suggest that Eurozone GDP rebounded strongly in Q3. The manufacturing and services PMIs both printed above 50 in July and August as European economies opened up throughout the summer months. Nationally, business confidence measures such as the German Ifo and the French INSEE trended upwards throughout Q3. Although, while the manufacturing PMI continued to improve in September, reaching 53.7, the services PMI dropped below 50, to 48.0. This suggests that the recovery may have lost momentum near the end of the quarter. The divergence between the sectors largely reflects the more severe impact of restrictions and social distancing measures on the services sector.

The available 'hard' data generally show a strong rebound in Q3. Retail sales volumes increased by 3% in July/August on Q2 levels, indicating that consumer spending rose strongly in the quarter. Meanwhile, the industrial sector rebounded, with output up 5.7% in July/August versus Q2. However, industrial production was still 5.7% below its pre-Covid level. The third quarter reading of GDP will be released tomorrow, with the forecast for a 9.4% increase in output. However, this will still leave GDP close to 7% below its pre-Covid level.

The labour market remains relatively unscathed given the scale of the crisis. The jobless rate edged up in August to 8.1% from 8% a month prior, and 7.2% in February. This partially reflects the success of furlough schemes in preventing mass lay-offs. Many of these schemes have been extended until the end of the year, and even into next year. The European Council has also approved circa €90bn under its SURE (labour market) scheme to allow governments to continue to provide these supports, with the first €17bn already having been disbursed to hard hit countries such as Italy and Spain.



In relation to inflation, the headline rate of HICP remained in negative territory in September, at –0.3%. Meanwhile, core inflation fell to 0.4%, as a VAT cut in Germany and seasonal factors, such as later than normal summer sales continue to impact the data. More VAT cuts across a number of countries are likely to help keep inflation low during the fourth quarter.

The October PMIs suggest that activity got off to a weak start in Q4. The composite index fell to 49.4 pointing to a stalling of momentum. The divergence between the sectors has become even more stark, as the services index fell to 46.2, yet the manufacturing PMI rose to 54.4. This is in large part a reflection of the latest raft of containment measures introduced to try and stem the second wave of the virus. These measures continue to hamper key sectors of the services economy such as tourism, leisure, hospitality, and travel. As governments tighten restrictions, the Eurozone economy risks falling into a double-dip recession in Q4. Taking this on board, it is clear the economy will take a long time to recover fully, and that major ongoing fiscal and monetary support continue to be needed.

However, there are some grounds for optimism. National governments have continued for the most part, to provide substantial supports to businesses and households. The rebound seen in the third quarter also shows that when businesses re-open, the economy can bounce back quickly. The EU Recovery Fund was agreed upon in July, with €390bn of the €750bn fund to take the form of grants to provide further economic stimulus. Monetary policy will remain very accommodative also. **Overall though, the economic outlook remains very uncertain.** The IMF projects Eurozone GDP will fall by 8.3% this year, with growth rebounding by 5.2% in 2021. Thus, it could take until 2023 until output returns to its pre-pandemic level, with much depending on, if and when, a successful vaccine becomes widely available.

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