ECB Watch

AIB Treasury Economic Research Unit

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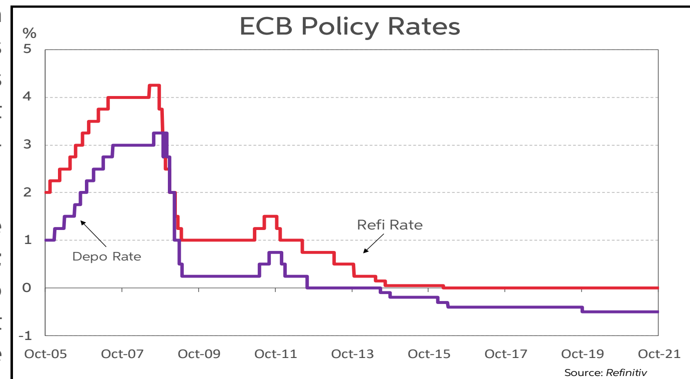
ECB pushes back on market rate expectations

As expected, the October meeting of the ECB's Governing Council was largely uneventful. The ECB left its deposit rate and refi rate unchanged, at –0.5% and 0%, respectively, in line with market expectations. The most recent policy change from the ECB came at its previous meeting in September, when it announced a recalibration of its Pandemic Emergency Programme (PEPP), stating its intention to reduce the pace of monthly asset purchases to a moderately lower pace in Q4 compared to Q2/Q3.



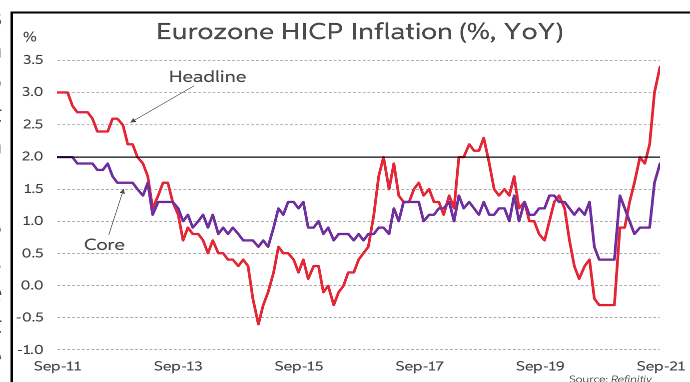
Today's meeting statement noted that the Eurozone economy continued to recover strongly, although it did acknowledge that "momentum had moderated to some extent". In this regard, the ECB stated that shortages of raw materials, equipment and labour are acting as a headwind to production in some sectors as well as "clouding the outlook" for the next few quarters.

The most recent update to the ECB's macro forecasts were released in September. These projections showed an upward revision to 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 at today's meeting is that the risks to the economic outlook for the Eurozone remain broadly balanced.

Meanwhile, in terms of the key topic of inflation, the ECB commented that they expect inflation will rise further in the near term, but that it anticipates it will fall over the course of next year. However, it did acknowledge that the recent spike higher in prices will last for longer than they had originally expected.

President Lagarde elaborated further on this, discussing that the recent move higher in inflation is mainly due to three factors. Firstly, sharp rises in energy prices, which accounted for nearly half of overall inflation in September**.** The second factor related to the fact that the recovery in demand was outstripping supply. Thirdly, base effects related to the expiry of the German VAT cut. The President emphasised the ECB's assessment was that all three factors would "ease over the course of 2022" and/or fall out of the year-on-year calculation.

The ECB revised higher its inflation projections during its most recent forecasting round in September. It is anticipating 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.



The market is now expecting the ECB to raise interest rates sooner than previously envisaged. Futures contracts suggest that it is pricing in the possibility that the ECB could start to hike rates, albeit gradually, during the second half of next year. At the time of the last Governing Council meeting in September, the market was not discounting a rate hike until late 2023/early 2024.

During the press conference, President Lagarde was asked a number of times about the hawkish shift in market expectations for Eurozone interest rates. She pushed back strongly against them. The President stated that the ECB's analysis of the conditions set out by its forward guidance are not satisfied at the time of "lift off" as priced in by markets "nor anytime soon thereafter". Despite President Lagarde's remarks, Eurozone yields rose by 3-5bps, while the euro was modestly higher in the immediate aftermath of the meeting, although part of this currency move was to do with some dollar weakness.

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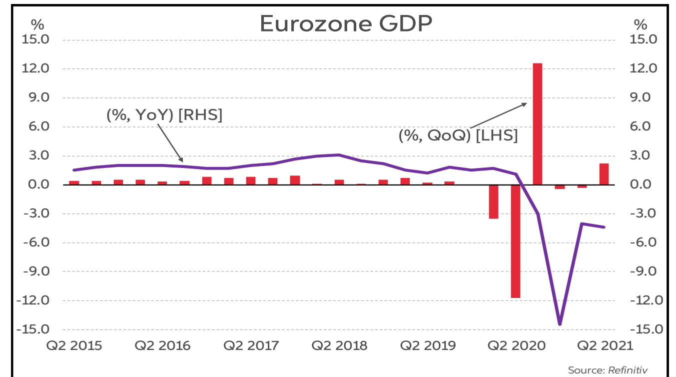
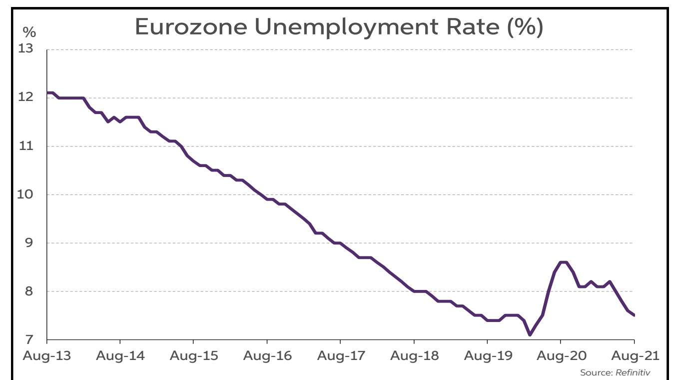
Eurozone recovery intact, but challenges ahead

So far in 2021, the Eurozone economy has performed better than had been anticipated. Although GDP contracted by 0.3% in the first quarter, this was much less than had been feared, and subsequently, output rose by more than expected in the second quarter, rebounding by 2.2%. However, this meant that Eurozone GDP remained 2.5% below its pre-pandemic level in Q2, while in the US, the economy was 0.8% larger than before the pandemic struck.



Survey data suggest the Eurozone recovery stayed intact throughout the third quarter. The composite PMI averaged 58.4 in the Eurozone in Q3, up from 56.7 in Q2. In contrast, although they stayed well in expansion mode, both the UK and US composite PMIs fell in Q3 compared to Q2. This is partly because Eurozone economies re-opened later than elsewhere, but it also reflects the fact that the bloc experienced a much smaller rise in Covid-19 cases in the third quarter. However, both the monthly readings of the services and manufacturing PMIs moved lower in September. The EC sentiment indices were at higher levels in Q3 than in Q2, but they also moved off their peaks as the quarter progressed. **In October, lead indicators such as the PMIs and the EC sentiment indices have been relatively unchanged compared to their September levels, consistent with a slightly slower pace of growth more recently.**

However, the available hard data for Q3 has been much more mixed. Retail sales fell by 2.6% in July, before rebounding by 0.3% in August. This may reflect a change in consumption patterns, back towards services (not captured in retail sales data) and away from goods, due to the re-opening of the hospitality and leisure sector more fully. Nonetheless, retail sales were 3.1% above their pre-pandemic level in August. Industrial production though, is still 1.3% below its pre-Covid level. In August, output fell by 1.6% as supply shortages continued to weigh on manufacturing. German auto production for example, was more than 40% below it pre-pandemic level as firms struggled to get parts. Supply shortages are likely to persist in the months ahead, indicating that the rebound in production may continue to face challenges.



In terms of the labour market, the impact from the pandemic has been limited. The jobless rate continued to trend lower in August, falling to 7.5% down from a 'Covid' peak of 8.7% last summer. It is 0.4% above its pre-pandemic level. This reflects the success of labour support schemes in shielding the jobs market, although, these programmes will soon be wound down. These schemes have in part been funded by the EU SURE initiative, which has disbursed nearly €90bn to member states.

Turning to inflation, headline HICP rose to 3.4% in September, up from 3.0% in August and 2.2% in July. The increase in inflation this year has been largely due to a rise in energy prices, which are 17.6% higher year-on-year. The ex-food & energy reading rose to 1.9% from 1.6%, suggesting that underlying price pressures are gaining some momentum as well. Inflation is likely to increase further in the months ahead, as rising input costs and the recent surge in energy prices place additional upward pressure on consumer prices. The latest ECB staff projections from September show inflation averaging 2.2% this year. Today though, the ECB acknowledged that inflation will remain higher than it had previously envisaged, before falling back over the course of next year.

Despite a weak start to 2021, a strong economic recovery has taken root in Q2, and appears to have continued in Q3. Personal consumption though, was 6% below its pre-pandemic level at the end of Q2. As restrictions continue to ease, there is scope for this gap to be eliminated, 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 in Q4 and into next year. 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 IMF expects a strong rebound of 5% in GDP this year and 4.3% next year.**

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