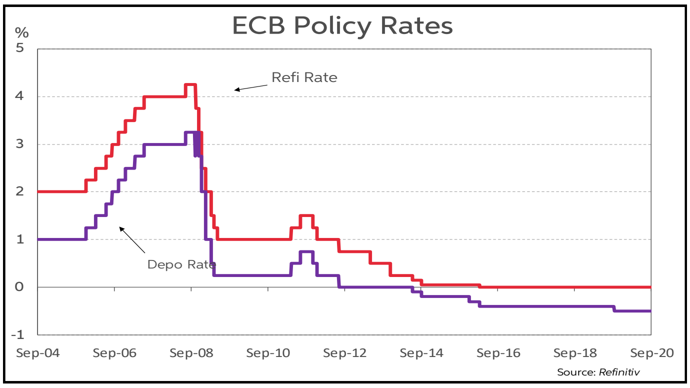
ECB Watch

AIB Treasury Economic Research Unit

10th September 2020

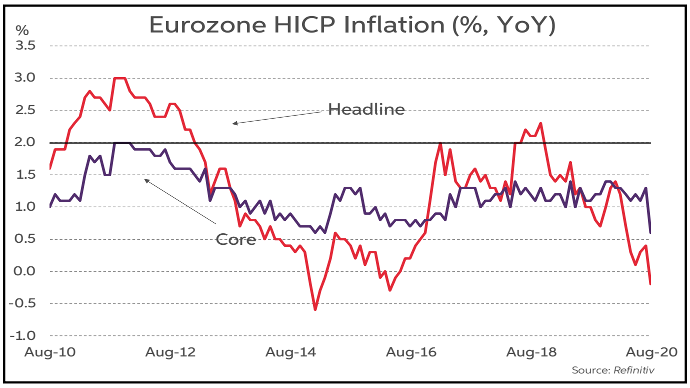
ECB satisfied with current policy settings

The September meeting of the ECB Governing Council concluded as expected with no changes to policy. The key refi and deposit rates were maintained at 0.0% and –0.5% respectively. Meanwhile, it maintained the total envelope of the purchases under its pandemic emergency purchase programme 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".



The ECB commented in its meeting statement that the incoming macro data suggest a strong rebound in activity in the third quarter. It mentioned the notable sign of recovery in consumption and a significant rebound in industrial production and services. However, it also acknowledged that the service sector appears to have lost some momentum recently.

We got the latest insight today into the ECB's expectations for the economic outlook with the releases of its updated economic forecasts. The ECB's central projection is for a contraction of 8% in Eurozone GDP this year. This represents a small upward revision from its June forecast of –8.7%. Meanwhile, the ECB is projecting growth of 5% in 2021 and 3.2% in 2022. These are largely unchanged from their June version. The updated GDP forecasts indicate that the ECB continues to be of the view that it is going to take the Eurozone economy some time to recover the fall in output that occurred in the first half of this year.



The ECB continues to emphasise that the balance of risk to the forecasts is to the downside. It emphasised that sustaining the recovery remains highly dependent on the evolution of the pandemic and the success of containment measures. Indeed, in in a more severe scenario, where tough coronavirus containment measures have to remain in place for a longer period of time, the ECB estimates that GDP could fall by as much as 12.6% in 2020 and increase by just 3.3% in 2021.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2019	2020	2021	2022
HICP	1.2	0.3	1.0	1.3
Real GDP	1.2	-8.0	5.0	3.2

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $42.8 in 2020, $47.5 in 2021 and $49.2 in 2022

Source: ECB September 2020

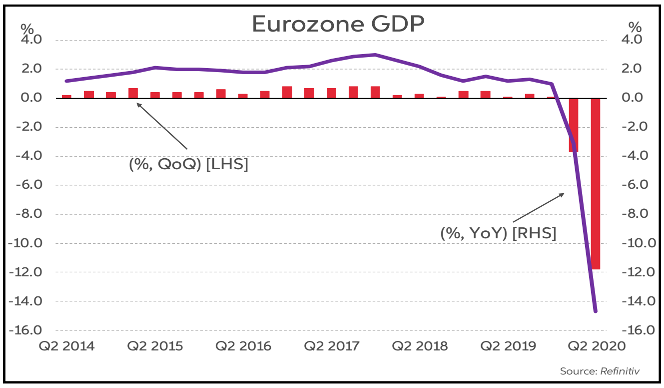
Meanwhile, the central back sees HICP inflation averaging 0.3% this year, before rising to 1% in 2021 and 1.3% in 2020. The forecasts are broadly similar to the June projections. **With inflation set to remain well below its 2% target for some years, the ECB is likely to have to maintain an ultra loose monetary policy for some time.** Indeed, given the heightened uncertainty regarding the outlook, the ECB retains a clear willingness to ease policy further if required. **Futures contracts suggest that the ECB's rate policy will probably stay unchanged, as they are only pricing in around 5bps of a rate cut.** Meanwhile, the first 10bps hike in the deposit rate is not priced in until end 2023. Looking further ahead, the contracts suggest the market anticipates that rates could be still at –0.2% by 2025. In terms of market reaction to today's meeting, the euro made some gains, and bond yields rose somewhat which suggests the market may have been expecting a more dovish tone.

Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

John Fahey
Senior Economist
john.j.fahey@aib.ie

Growth rebounding but risks remain

The impact of the pandemic on the Eurozone was really felt in Q2, as GDP contracted by 11.8%. The most severe lockdown measures were in place in April, while economies only partially rebounded in May and June as many restrictions remained in place. 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.

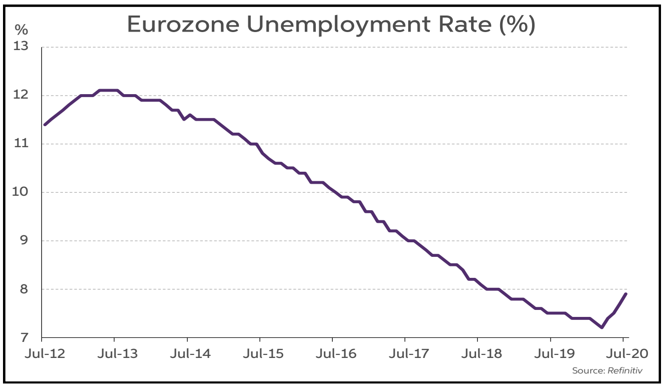


With regard to the underlying breakdown, Eurozone consumption plunged by 12.4% and gross capital formation collapsed by 17.0%. Surprisingly, government spending also fell by 2.6%, while net trade acted as a slight drag, as exports sank by 18.8% and imports declined by 18.0%.

As mentioned above, most of the damage was inflicted early in Q2. Although activity did rebound at the end of the quarter, with retail sales bouncing back strongly by 20.6% in May and 5.6% in June. Leading indicators suggest the economic recovery may be beginning to loose some momentum in Q3. While remaining expansionary, both the services and manufacturing PMI's for the euro area slipped backwards in August. The headline EC sentiment continues to rise, albeit at a slower pace than in prior months, reaching 87.7 in August. Retail sales fell by 1.3% in July, while industrial production remains well below February's level.

The labour market remains relatively unscathed given the scale of the crisis. The jobless rate edged up in July to 7.9% from 7.8% a month prior. This partially reflects technicalities surrounding the measurement of unemployment, but also the relative success of furloughing schemes in preventing mass lay-offs. Indeed, following its success, Germany has extended its short-time working scheme until the end of 2021. However, as government supports are removed, we would expect lay-offs to rise.

In relation to inflationary developments, the headline rate of HICP moved into negative territory in August for the first time since May 2016. Meanwhile, core inflation fell to 0.6%, as a VAT cut in Germany, and seasonal factors, such as later than normal summer sales impacted the data. More VAT cuts across a wider range of countries are likely to help keep inflation low as the year progresses. The ECB will be more worried about the structural pressures on inflation however, as labour market slack, excess capacity and a stronger euro hinder price growth.



A key aspect of the recovery being sustained is how the Covid-19 virus evolves, and how authorities deal with this. Over the past number of weeks we have seen spikes in cases lead to local containment efforts, while the virus continues to hamper key sectors of the economy such as tourism, leisure and travel. More broadly, exceptional uncertainty about the course of the virus continues to weigh on consumer sentiment and business investment. Continued outbreaks of the virus globally are also likely to delay the recovery in international trade volumes, another headwind for the Eurozone, which relies on export orientated growth. Taking these factors together, it is clear the economy will take a long time to recover, and that substantial ongoing fiscal and monetary support will be needed.

However, there are some grounds for optimism. The EU Recovery Fund was agreed upon in July, with €390bn of the €750bn fund to take the form of grants. This is important, as large fiscal transfers will help southern European countries, the worst hit by the crisis and perhaps the least able to borrow more, to provide further economic stimulus. Also, substantial QE and TLTRO programmes by the ECB have helped all governments to announce substantial budget deficits this year, while reducing the possibility of another debt crisis. **Overall though, the economic outlook remains very uncertain.** New ECB staff forecasts project a fall in output of 8% this year, followed by a partial recovery in 2021, with growth put at 5% and 3.2% in 2022. The projections show that euro area GDP is not expected to return its pre-pandemic level until at least the end of 2022.

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