ECB Watch

AIB Treasury Economic Research Unit

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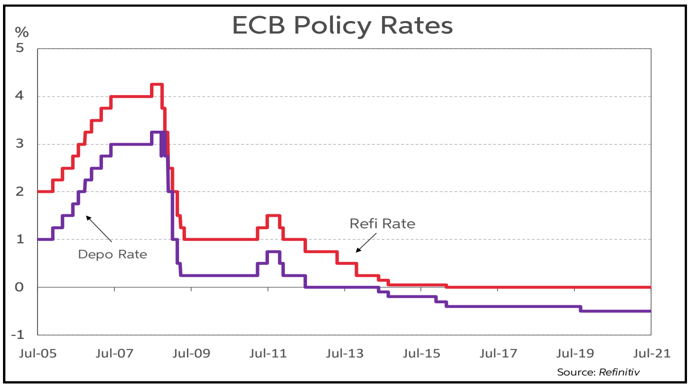
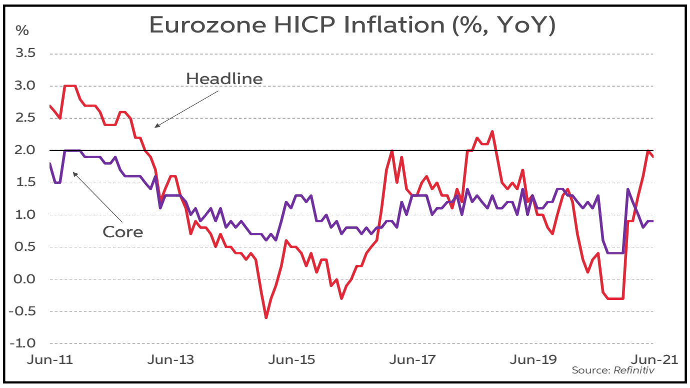
ECB adjusts its guidance in line with its new inflation target

The July meeting of the ECB's Governing Council was its first meeting to be held since it changed its inflation target following a strategic review of its policy deliberation framework and objectives. The new inflation objective is now a symmetric 2% target compared to its previous 'close to, but below 2%'. This implies that the ECB will allow inflation to run above its 2% target for a short period of time, if required. The strategic review also saw the ECB commit to a flexible and pragmatic approach in relation to non-conventional tools, such as quantitative easing.



As a result, today's meeting saw it alter its forward guidance on interest rates to be consistent with its new strategy. The ECB now states that it expects its key interest rates to remain at their present, or lower levels until three key criteria are met. **Firstly, and most significantly, that inflation is viewed by the Governing Council to be reaching its 2% target well ahead of its projection horizon,** which is three years (currently out to end 2023). President Lagarde stated that "well ahead" could be interpreted as meaning the midpoint of this horizon. Secondly, inflation is durable for the remainder of its projection horizon and thirdly, that its judges realised underlying inflation to be "consistent with inflation stabilising" at its 2% target over the medium term. In response to a question in the press conference, President Lagarde stated that the change to its forward guidance was not unanimous, but that there was an "overwhelming majority" in favour.

Aside from leaving its key interest rates unchanged, the ECB also maintained the envelop of its Pandemic Emergency Purchase Programme (PEPP) at €1,850bn. President Lagarde commented that there was no discussion or debate on any changes to PEPP. It maintained its guidance that it expects purchases to continue "until at least the end of March 2022, and in case, until it judges that the coronavirus crisis phase is over".



The ECB's most recent update to its macro projections were released at its previous meeting in June. It expects the continued progress in the vaccination campaigns will allow for a further easing of containment measures, helping to underpin a rebound in activity over the course of the year. It revised higher its growth expectations for 2021-22, while leaving its projection for 2023 unchanged. For 2021, it is forecasting GDP growth of 4.6% (from 4%), followed by growth of 4.7% (from 4.1%) in 2022 and 2.1% in 2023. **The ECB maintained its view at its July meeting that it assesses the risks to the economic outlook for the Eurozone to be "broadly balanced".** In terms of its outlook for inflation, it is forecasting the headline rate to average 1.9% (from 1.5%) this year and is projecting it at 1.5% (from 1.2%) in 2022. Its 2023 inflation forecast is 1.4%. Core inflation is forecast at 1.1% in 2021, 1.3% in 2022 and 1.4% in 2023. The ECB commented today that the outlook for inflation over the medium term remains subdued.

Taking account of these inflation forecasts in line with its new forward guidance, would suggest that the ECB does not envisage hiking interest rates during its current forecast horizon. Indeed, President Lagarde was asked in the press conference based on its new criteria as to why the ECB is not providing additional stimulus to help it achieve its new 2% target. **In terms of market expectations, futures contracts suggest that the market does not envisage official ECB rates rising from their current levels until 2024.** Market reaction to today's meeting saw peripheral bond yields move slightly lower, with little movement in the euro.

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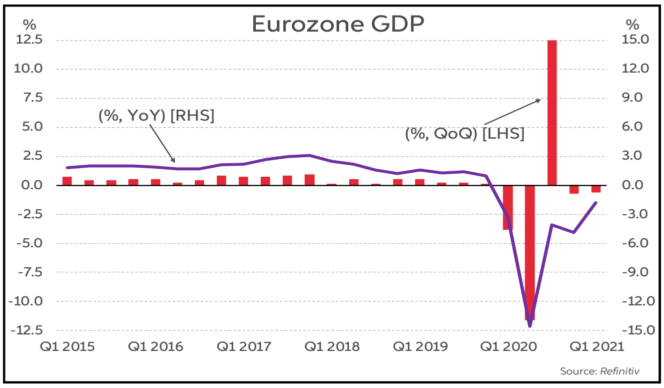
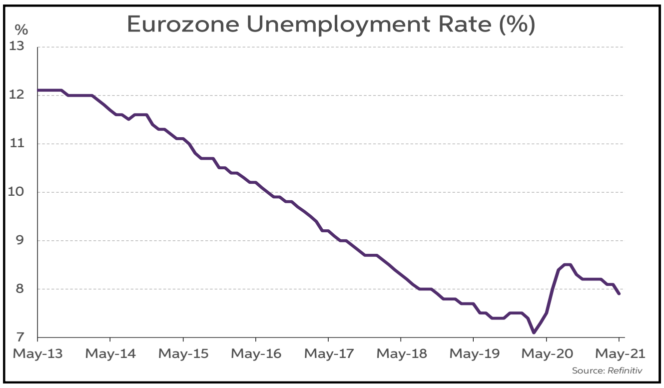
Strong economic recovery taking hold in Eurozone

The latest update to Eurozone GDP data for Q1 showed that the pace of quarterly contraction was revised from 0.6% to just 0.3%. This is an encouraging result given that most of the region was in some form of a lockdown over the period, and reflects businesses ability to adapt to the restrictions. The fall in Q1 GDP was driven by continued weak consumer spending. Household consumption fell by 2.3%, subtracting 1.2 percentage points (p.p.) off GDP. Meanwhile, investment, government expenditure and net trade were broadly flat in the quarter and therefore had a negligible impact on GDP. However, inventories added 0.7 p.p.



Survey data for Q2 suggest a strong recovery has taken hold in the Eurozone. The manufacturing PMI, which was already pointing towards a strong rebound in the sector in Q1, improved further in Q2. Having averaged 58.4 in the opening months of the year, the index averaged 63.1 in the second quarter. However, it must be noted that supply chains remain under severe pressure, which may act as a headwind to growth in the months ahead. The services PMI suggests that the sector is experiencing a strong rebound in activity, as restrictions are gradually eased across the bloc. The services PMI averaged 46.9 in Q1, but printed above the key 50 threshold throughout Q2, averaging 54.7. Similarly, the EC sentiment indices have all improved throughout the second quarter, with the services index most notably regaining its pre-Covid level.

However, the available 'hard data' for Q2 have remained somewhat mixed owing to a variety of pandemic related factors. While retail sales rose by 4% in March, lifting them back above their pre-Covid level, they fell back again in April. Indeed, there were sharp falls in retail sales in all of the big Eurozone economies in April, as consumer demand remained muted in Germany, and shops were forced to shut for a period in parts of France and Italy. In May though, this reversed again, with retail sales jumping by 4.6%, the strongest monthly rise since June 2020 as restrictions were eased further. In terms of industrial production, output has been constrained by shortages of raw materials in key sectors. In May for example, industrial production fell by 1%, owing largely to a decline in autos production, which has fallen 15% since November.



In terms of the labour market, the impact from the pandemic has been limited to date. The jobless rate inched lower to 7.9% in May, down from a 'Covid' peak of 8.7% last summer, and just 0.6% above its pre-pandemic level. This reflects the success of labour support schemes in shielding the job's market, with many of them likely to stay in place for most of 2021. These schemes have in part been funded by the EU SURE programme. To date, €94.3bn in support has been approved, of which nearly €90bn has been disbursed to member states.

Turning to inflation, headline HICP edged lower to 1.9% in June, having spiked to 2.0% in May. The increase in the headline rate this year has been largely due to rises in energy prices. The core rate has remained at just 0.9%, as underlying price pressures remain subdued. Inflation will likely rise further over the coming months, but the increase will be much smaller than in the US. Eurozone inflation fell less than in the US last year, and there has been less fiscal stimulus provided also. The latest ECB staff projections show the HICP rate averaging 1.9% this year, before falling back to 1.5% in 2022, and 1.4% in 2023. The core rate is seen averaging 1.1% in 2021.

Despite a weak start to 2021, a strong economic recovery is now underway, as restrictions are gradually eased. The strong rebound in growth in the third quarter of last year highlights that when economies re-open, activity can recover quickly. Furthermore, monetary policy will remain accommodative, and national governments are continuing to provide fiscal support. Grants and loans from the EU recovery fund are also due to come on stream this year, with the worst affected countries set to benefit the most from the fund. In its latest update, the OECD expects GDP to grow by 4.3% in 2021, and 4.4% in 2022 in the Eurozone. Similarly, the ECB expects GDP to grow by circa 4.6% this year and 4.7% in 2022.