ECB Watch

AIB Treasury Economic Research Unit

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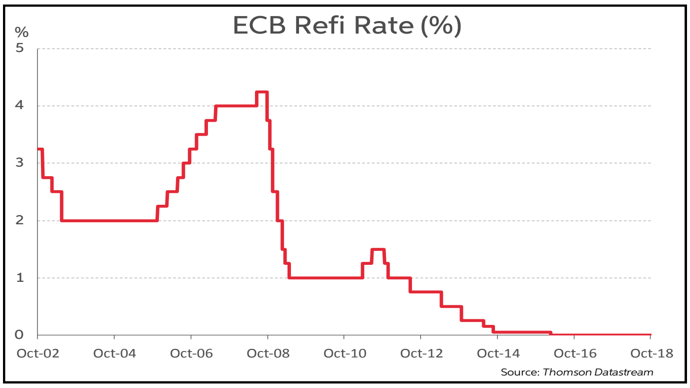
ECB rates on hold until at least Autumn 2019

As expected, the October meeting of the ECB Governing Council concluded with no changes to monetary policy. The ECB had previously announced back in June that it would reduce monthly net asset purchases to €15bn (from €30bn) this month and then cease net purchases at the end of 2018.



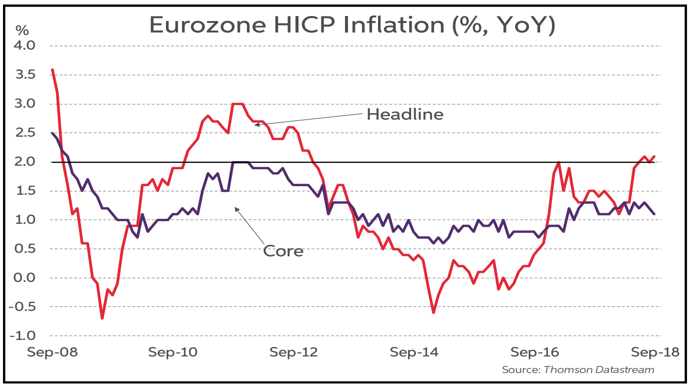
The meeting statement contained minimal changes from its September version. The ECB continued to state that it will keep interest rates at their current very low levels "at least through the summer of 2019".

In terms of the economic outlook, the statement did note the softer data from the Eurozone recently. However, while commenting that incoming data was "somewhat weaker than expected", the ECB was keen to emphasise that overall the macro updates remained consistent with its view of "broad-based economic growth".

In the Q&A, President Draghi elaborated further on why the ECB was not overly concerned about recent disappointing data and that the risks to its outlook remain broadly balanced. He commented on (1) country specific issues and the likely temporary impact from these (e.g. German car sector), (2) export performance returning to normal after a very strong 2017, (3) global trade uncertainties and (4) Eurozone growth returning to its potential rate after the above trend performance in 2017.

President Draghi also outlined in detail why the ECB remain confident that inflation is on an upward trajectory, gradually converging towards the 2% target. He stated that 'negotiated' wages in the region are "going up", the labour market continues to tighten and that capacity utilisation in most countries is "very high".

The central bank's most recent set of macro forecasts, released at the September meeting, showed that it expects inflation will remain below its 2% target over the next three years. The ECB is forecasting HICP inflation to average 1.7% in 2018, 2019 and 2020. The ECB is expecting GDP growth of 2.0% in 2018, 1.8% in 2019 and 1.7% in 2020.



In summary, today's ECB meeting was very much a non-event. With inflation expected to remain below its 2% target over the next three years, the Central Bank continues to emphasise a very cautious approach to tightening policy.

Interest rates in the Eurozone are unlikely to start to be hiked until the autumn of 2019 at the earliest, from their present levels of 0% for the refi rate and –0.4% for the deposit rate. It is likely that when the ECB does eventually start to raise rates, its first few initial moves may see the gap between the deposit rate and refi rate narrow to around 25bps from 40bps at present.

Futures contracts suggest that rates may rise by close to 20bps by end-2019 and will have risen by 50bps in total by end-2020. Market pricing **indicates that 3-month Eurozone rates are not expected to turn positive until mid-2020.** Further out, the market envisages rates remaining low for an extended period. Indeed, three month rates are not expected to get to 1% until around mid-2023.

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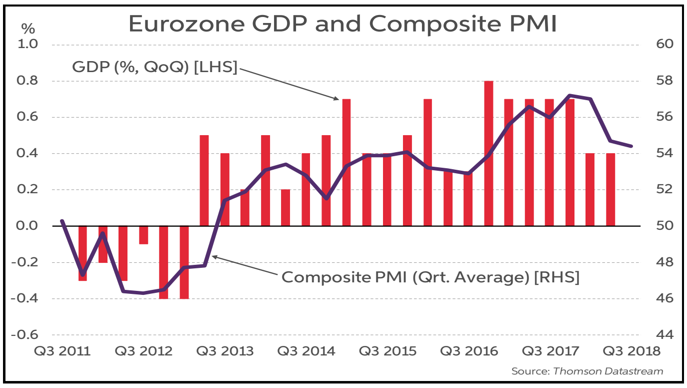
Eurozone growing at a moderate pace

The Eurozone economy recorded a second consecutive 0.4% quarterly increase in GDP in Q2 2018. This is down on the 0.7% quarterly growth rates recorded right through 2017. The underlying data shows investment was the primary driver of growth in Q2, contributing 0.3 percentage points (p.p.). Consumer and government expenditure each added 0.1 p.p.

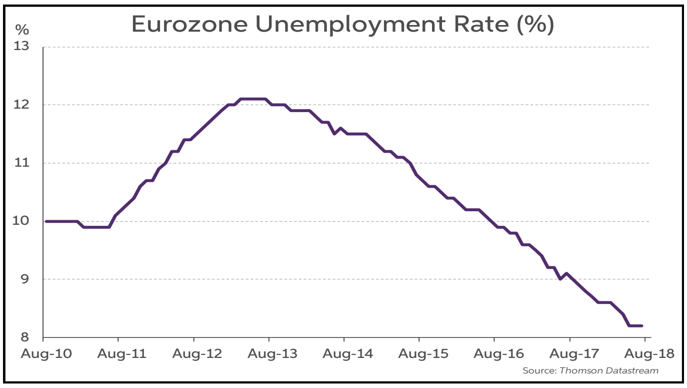


Survey data suggest that the Eurozone economy continued to grow at a similar pace in Q3. The Markit composite PMI average of 54.3 for the period was broadly in line with Q2's 54.7 performance. Likewise, while the EC measure of Eurozone economic sentiment edged down in Q3, it remains at an elevated level.

The available hard data for Q3, though, have been somewhat tepid. Retail sales declined by 0.3% in July/ August against Q2, driven by a fall in food and fuel expenditures. On the supply side of the economy, industrial production has remained broadly flat in July/August when compared with Q2. Meantime, the goods trade surplus narrowed in July/August, suggesting that trade may act as a net drag on growth in Q3.

In terms of the labour market, recent data have been positive. The Eurozone jobless rate fell to a near 10-year low of 8.1% in August. This compares to 9.0% a year previous. **Employment in the Eurozone grew by 0.4% in the second quarter, representing a 1.5% increase on an annual basis.** The timelier composite PMI employment sub-component averaged 55.1 in Q3, up from 54.8 in Q2, indicative of a continuing good pace of job creation. The tightening labour market is reflected in annual wage growth rising from 1.9% in Q1 to 2.3% in Q2.

With regard to inflation, higher energy prices resulted in the headline rate hovering around the 2% level in Q3. However, core inflation remains quite subdued. At 1.1% in September, it is well under the ECB's HICP target rate of close to, but just below 2%.



Meanwhile, the limited survey data available for October suggests growth may have lost some momentum at the beginning of Q4. **The composite PMI fell to 52.7, from 54.1 in September.** This was in large part due to a steep fall in the German index. Likewise, the French INSEE and German Ifo surveys both recorded falls. Although, consumer confidence did pick up in the month.

The Eurozone economy continues to face some significant challenges. Unemployment remains very high in some countries, while productivity growth is weak. On the political front, tensions between the Italian government and the European Commission is a source of worry, as is the continuing uncertainty over the nature of the UK's exit from the EU. Meanwhile, weaker external demand owing to global trade tensions and emerging market difficulties seems to be acting as a dampener on activity.

Nonetheless, it is still envisaged that the economy will keep continuing growing at a moderate rate. The latest IMF forecasts show that it expects growth of 2.0% in 2018, followed by a rise of 1.9% in 2019. There are a number of tailwinds for the economy. Positive real earnings as wage growth picks up, a low inflation environment, mildly expansionary budgetary measures and ultra-loose monetary policy are providing an accommodative backdrop for domestic demand, with both consumer spending and business investment expected to continue growing at a solid pace.

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