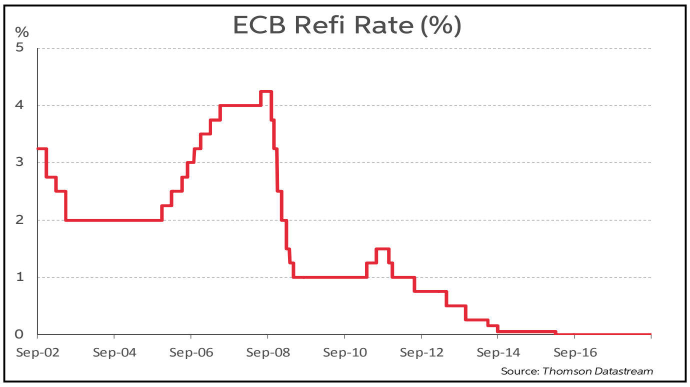
ECB Watch

AIB Treasury Economic Research Unit

13th September 2018

ECB remains very cautious on the policy outlook

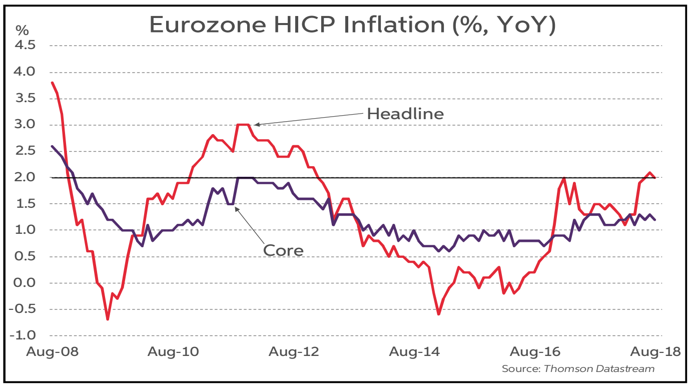
The September meeting of the ECB Governing Council proved to be a non-event, with no changes to monetary policy, as expected. The most recent policy change from the ECB came back in June, when it announced that it would reduce monthly net asset purchases to €15bn from October and then cease net purchases at the end of 2018**.**



The meeting statement showed very little change from its July 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 noted that that recent macro data remain consistent with its view of an on-going broad-based expansion and gradually rising inflation in the Eurozone. However, it did state that uncertainties involving rising protectionism, emerging market risks and financial market volatility had "gained more prominence recently". Overall though, the ECB continues to view the risks to the economic outlook as being "broadly balanced".

Its latest set of macro forecasts, released today, provide additional insight into the ECB's cautious attitude to monetary tightening. They show that the Central Bank expects inflation will remain below its 2% target over the next three years. The ECB expects HICP inflation to average 1.7% in 2018, 2019 and 2020 (no change from the June projections). Meanwhile, the ECB slightly revised lower its GDP growth forecasts for 2018 to 2.0% (from 2.1%) and for 2019 to 1.8% (1.9%), mainly due to factoring in a modestly weaker contribution from foreign demand. It continues to anticipate growth of 1.7% in 2020.



In summary, today's update from the ECB provided no surprises as the Central Bank continued 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.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2017	2018	2019	2020
HICP	1.5	1.7	1.7	1.7
Real GDP	2.4	2.0	1.8	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $71.5 in 2018, $71.7 in 2019 and $69 in 2020.

Source: ECB September 2018

In terms of market expectations, futures contracts suggest that rates may rise by around 20bps by end-2019. Futures contracts **indicate that 3-month Eurozone rates are expected to remain negative 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. The market view that rates will remain below 1% in the coming five years suggests it expects inflation to remain very subdued and growth quite modest over the period.

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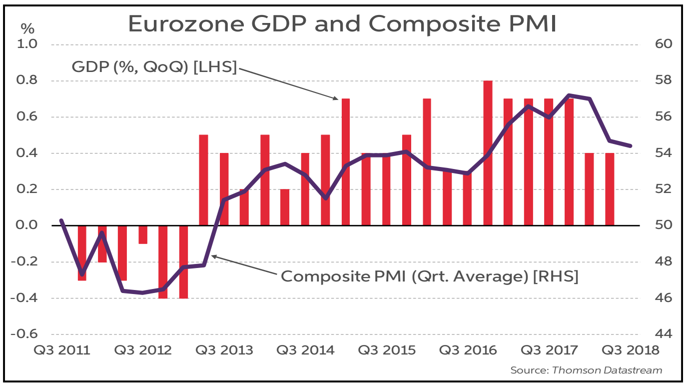
Eurozone growth continues at a solid pace

The Eurozone economy continued to grow solidly in Q2 2018, recording a second consecutive 0.4% quarterly increase in GDP. The economy grew by 2.1% on a year-on-year basis, down from 2.4% in Q1. The underlying data show investment and inventories were the primary drivers of growth, contributing 0.3 and 0.2 percentage points (p.p.) respectively. Consumer (0.1 p.p.) and government (0.1 p.p.) expenditure also helped boost growth. However, net trade was again a drag, deducting 0.2 p.p. in Q2 as an increase in exports could not compensate for a larger rise in imports.

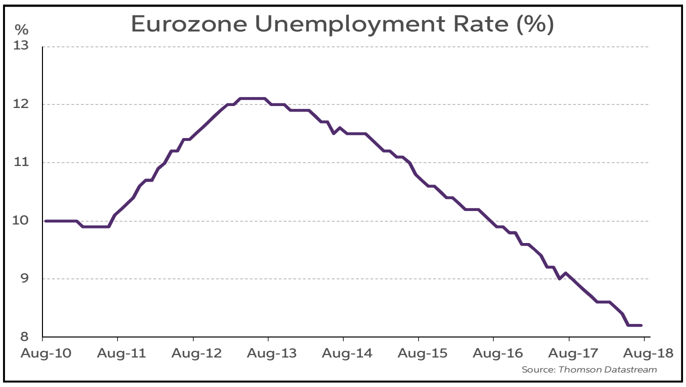


Leading indicators of activity for Q3 2018 suggest that economic growth is continuing at a solid pace of around 0.4%. The Eurozone Composite PMI averaged 54.4 in July/August which is broadly in line with Q2's figure of 54.7. Meanwhile, EC Eurozone economic sentiment dipped slightly in July/August, averaging 111.9 compared to 112.5 in Q2.

The limited hard data that we have for Q3 has been somewhat disappointing. Retail sales dipped by 0.2% on a month-on-month basis in July, driven by falls in food and fuel expenditure. Elsewhere, industrial production continued its decline in July, falling by 0.8% on the month. This means year-on-year growth has now entered into negative territory for the first time in 18 months.

However, the labour market has continued to register improvements. The Eurozone jobless rate fell to a near 10-year low of 8.2% in June and remained at this level in July. **Employment in the Eurozone grew by 0.4% in the second quarter, representing a 1.5% increase on an annual basis.** The employment component of the Composite PMI also suggests that the jobs market is continuing to expand at a steady pace in Q3. The index averaged 55.1 in July/August, a slight improvement on Q2's 54.8.

There has been little movement on the inflation front. Headline inflation was relatively unchanged in August at 2.0%, down slightly from 2.1% in the preceding month. However, core inflation remains quite subdued, with a reading of 1.2%. This is below the ECB's target of close to, but below, 2%.



The Eurozone economy still faces some challenges and risks. Unemployment remains above long term average rates in many countries, productivity growth is weak, while there are a host of legacy issues from the global downturn a decade ago, including high debt levels in many countries. Political developments also remain a concern, with 'anti-establishment' parties enjoying success in a number of countries and Brexit related uncertainty increasing. The protectionist trade policies of the US are also a cause for concern.

Overall though, the economy is expected to continue expanding at a solid pace, despite the fact that growth looks to have peaked in 2017. The latest ECB forecasts show that it anticipates growth of 2.1% in 2018, followed by a 1.9% rise in 2019. This is partly due to the fact that ECB monetary policy should remain very accommodative, with inter-bank rates remaining negative until mid-2020. In addition, fiscal policy has turned more expansionary, while consumer spending is being supported by solid jobs growth, positive real earnings and still elevated consumer confidence.

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