ECB Watch

AIB Treasury Economic Research Unit

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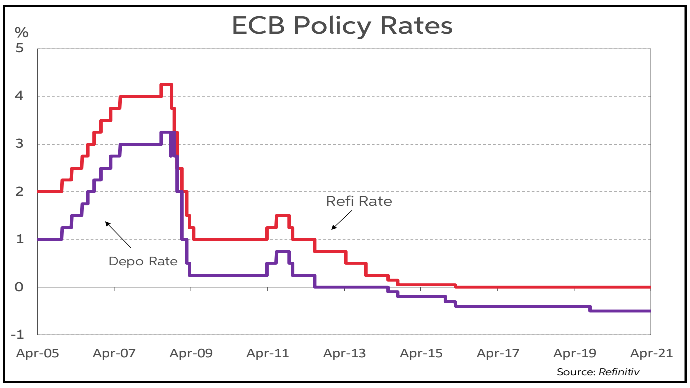
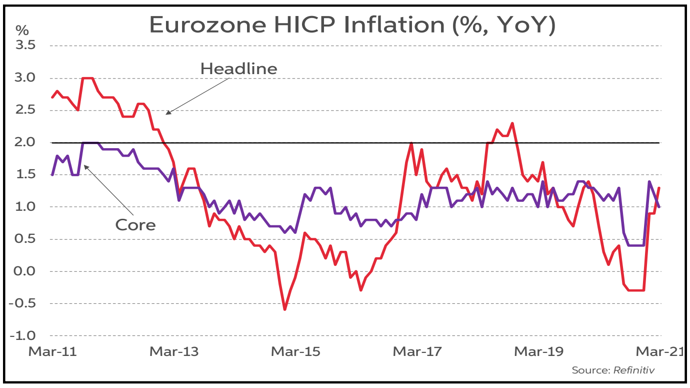
ECB content with current policy settings

The April meeting of the ECB's Governing Council concluded very much in line with expectations for no changes to monetary policy. As expected, the ECB left its deposit rate and refi rate unchanged at –0.5% and 0%, respectively. Meanwhile, the envelop of its Pandemic Emergency Purchase Programme (PEPP) was left unaltered at €1,850bn.



The last policy change from the ECB was at its previous meeting in March when it announced an increase to the pace of monthly asset purchases under its PEPP. This change was designed to prevent a tightening of financial conditions as upward pressure emerged on bond yields. **ECB President Lagarde commented today of a "significantly increased" pace of monthly purchases in the current quarter.**

The meeting statement continued to espouse a generally cautious tone. It noted that while the economy is expected to improve over the course of this year, there remains "uncertainty surrounding the near term" macro outlook, due to the challenges arising from the pandemic and the speed of vaccination programmes.



The last detailed update we got from the ECB on its view of the economic outlook was in the release of its staff macro projections last month. It expects the on-going vaccination programmes combined with the gradual easing of restrictions to underpin a rebound in activity over the course of this year. It is forecasting GDP growth of 4%, followed by an increase of 4.1% in 2022 and 2.1% in 2023.

These forecasts were broadly similar to their December projections. **The ECB's assessment is that the risks to the medium term economic outlook have become more balanced, but downside risks remain in the near term.**

The central bank did revise higher its inflation outlook for 2021-22 back in March. It is now forecasting inflation to average 1.5% (from 1.0%) this year and is projecting it at 1.2% (from 1.1%) in 2022. However, it stressed that these upward revisions were largely due to temporary factors and higher energy price inflation. Its 2023 inflation forecast was left unchanged at 1.4%. President Lagarde noted in today's press conference that while inflation has picked up over recent months, this was mainly due to some idiosyncratic and temporary factors, and an increase in energy inflation. Indeed, the meeting statement noted that underlying price pressures remain subdued amid weak demand and significant slack in labour and product markets.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2020	2021	2022	2023
HICP	0.3	1.5	1.2	1.4
Real GDP	-6.9	4.0	4.1	2.1

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $59.3 in 2021, $55.7 in 2022, $53.7 in 2023

Source: ECB March 2021

Market reaction was muted to today's meeting. Given that the ECB is anticipating that inflation will remain well below its 2% target until at least 2023, the central bank is likely to maintain an ultra loose monetary policy for quite some time. Market expectations are consistent with this outlook. Futures contracts suggest that the market does not envisage official ECB rates rising from their current levels until 2024.

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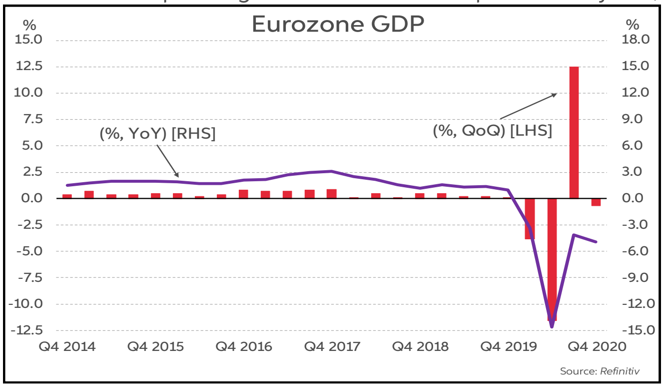
Eurozone GDP likely contracted again in Q1

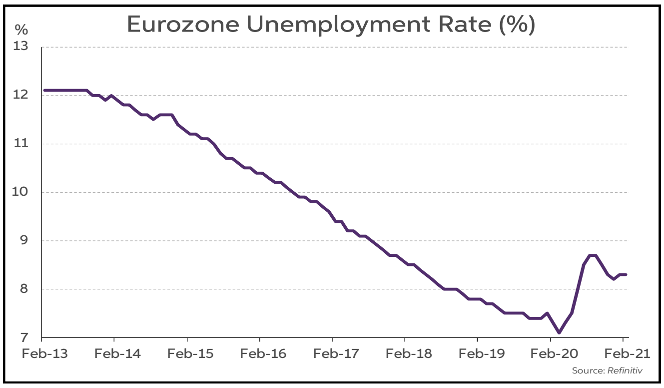
Eurozone GDP contracted by 0.7% in Q4 2020, as tighter restrictions were introduced to counter the second wave of Covid-19. The fall in Q4 GDP was driven by weaker consumer spending. Household consumption fell by 3%, clipping 1.6 percentage points (p.p.) off GDP. Investment and government expenditure both increased, although together, they added just 0.4 p.p. to growth. Meanwhile, imports (+4.1%) outpaced exports (+3.5%), knocking 0.1 p.p. from the quarterly total. Though, rising inventories added 0.6 p.p.. In the year as a whole, the economy contracted by 6.6%. However, amongst individual nations economic growth varied substantially. Of the large EU countries, Germany fared best. German GDP fell by 4.9% in 2020, much less than in France (-8.2%), Italy (-8.9%) or Spain (-11.0%).



According to survey data, manufacturing continued to outperform the services sector in Q1. This is not surprising given that restrictions, which have a more adverse effect on the services sector, remained in place throughout the quarter. The services PMI averaged 46.9 in Q1, slightly higher than in Q4, at 45. Meanwhile, the manufacturing PMI has soared, from already strong levels. The index averaged to 58.3 in Q1 versus 54.6 in Q4 2020. The manufacturing survey printed at an all-time high of 62.5 in March also, as output, new orders, exports and purchasing activity increased substantially in the month. The services PMI, though higher, remained below 50. Likewise, all of the EC sentiment indices moved higher in March, albeit, the services and consumer confidence measures still remain at subdued levels. Industrial sentiment though, jumped to its highest level since December 2018.

However, the available 'hard data' for Q1 remained soft given the uptick in survey data. Although retail sales rose by 3% in February, this only partially reversed the 5.2% decline in January, leaving sales 2.8% below their pre-pandemic level. Similarly, industrial production has also contracted in the opening two months of the year. Production fell by 1% in February, reversing the 0.8% increase in January, meaning output was 1.6% lower than in February of last year, before the pandemic hit. Thus, 'hard data' for the first two months of 2021 indicates that the Eurozone economy has likely contracted again in Q1. However, given the stronger survey data for March, the outlook for the region appears to be brightening.

In relation to the labour market, the impact from the pandemic has been limited to date. The jobless rate was unchanged at 8.3%, having risen from 7.3% a year earlier to a peak of 8.7% in August and September. This reflects the success of furlough 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 €75.5bn has been disbursed to member states under the initiative.



Regarding inflation, the headline HICP rate jumped to 1.3% in March, from 0.9% in February. This was largely due to a rise in energy prices. However, core inflation declined to 1% from 1.2%, suggesting that underlying price pressures remain subdued. As the year progresses inflation is likely to rise further due to base effects. These effects are expected to be transitory though, with inflation forecast to remain subdued over the medium term.

Despite a weak start to 2021, the near term outlook for the Eurozone economy is for a strong recovery to take root, starting in Q2 and accelerating in the second half of the year. Highly effective vaccines have started to be rolled out, with supply set to ramp up as Q2 progresses. 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 will continue 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 IMF has revised its growth forecasts for the Euro-area upwards to 4.4% in 2021 and 4.0% in 2022. Similarly, the ECB expects GDP to grow by circa 4% this year and in 2022. However, the economic rebound is highly contingent on the success of the vaccine roll out and Covid-19 subsiding.

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