ECB Watch

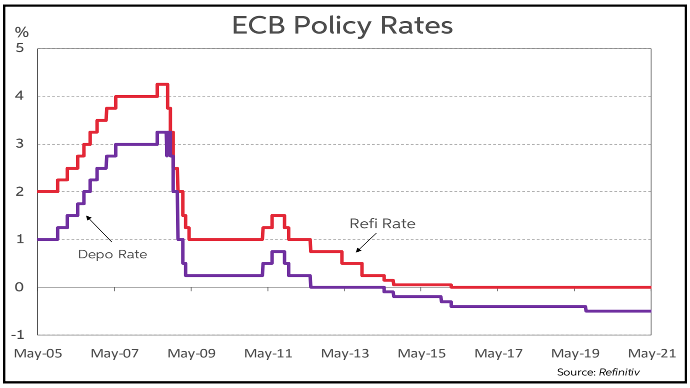
AIB Treasury Economic Research Unit

10th June 2021

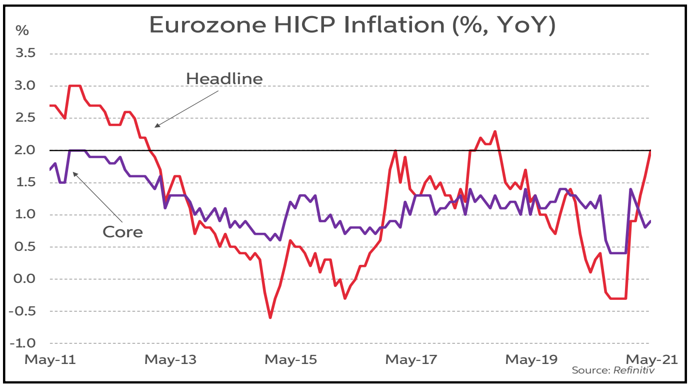
ECB confirms no changes to its accommodative stance

As expected, the June meeting of the ECB's Governing Council was largely uneventful. It concluded with no changes to monetary policy. 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 meeting statement's characterisation of the economy's performance and outlook was generally optimistic in tone, while at the same time noting that "uncertainties remain". It commented that survey data suggest a strong recovery in the services sector amid the gradual easing in restrictions, while manufacturing remains robust. It also noted that the strengthening in consumer sentiment should see a strong rebound in household spending over the coming months.



This cautiously upbeat assessment of the economic outlook was reflected in the ECB's updated macro projections which were released today. It expects the further 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 now 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's assessment is that the risks to the economic outlook for the Eurozone remain broadly balanced. Upside risk relate to the potential for a stronger rebound in the global economy and a faster than expected rundown of household savings. In terms of the downside risks, the ECB referenced the on-going pandemic and the spread of virus mutations as potential headwinds for both economic and financial conditions.

The central bank also revised higher its inflation outlook for 2021-22. It is now forecasting headline inflation to average 1.9% (from 1.5%) this year and is projecting it at 1.5% (from 1.2%) 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% as the ECB viewed that the expected increased in underlying inflation should be largely offset by an anticipated decline in energy price inflation. Core inflation is forecast at 1.1% in 2021, 1.3% in 2022 and 1.4% in 2023.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2020	2021	2022	2023
HICP	0.3	1.9	1.5	1.4
Real GDP	-6.8	4.6	4.7	2.1

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $65.8 in 2021, $64.6 in 2022, $61.9 in 2023

Source: ECB June 2021

Market reaction was muted to today's meeting given the lack of any policy changes or new guidance. With the ECB continuing to envisage inflation undershooting its 2% target until at least 2023, the central bank is likely to maintain an ultra loose monetary policy for quite some time.

Indeed, President Lagarde stated that it is "too early, premature and unnecessary" to discuss any exit from PEPP at this point in time. Market expectations remain broadly consistent with this outlook. **Futures contracts suggest that the market does not envisage official ECB rates rising from their current levels until the second half of 2023.**

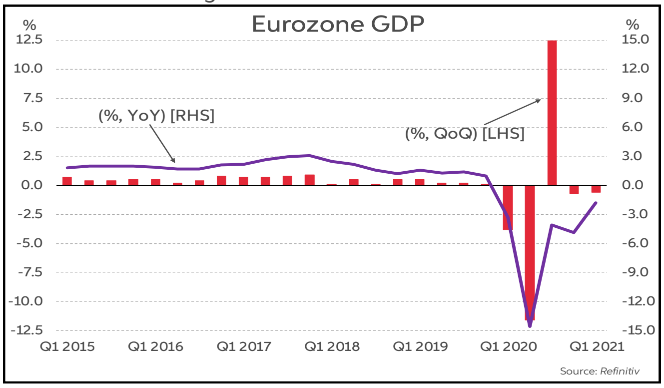
Oliver Mangan
Chief Economist
oliver.n.mangan@aib.ie

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

Daniel Noonan
Economist
daniel.x.noonan@aib.ie

Strong economic recovery starting to take root

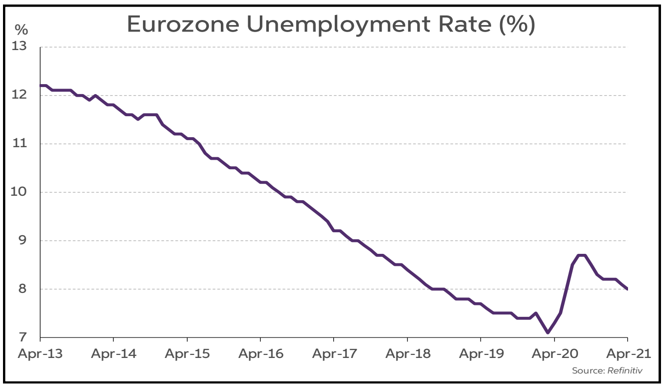
The latest update to Eurozone GDP data for Q1 showed that the pace of quarterly contraction was revised from 0.6% to just 0.3%. This is an encouraging result given that most of the region was in some form of a lockdown over the period. However, the currency bloc is technically in recession, having contracted by –0.6% in Q4'20. For the full year 2020, the economy shrank by 6.8%, although the pace of contraction varied significantly across member states. 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 that economic activity has started to pick up. The manufacturing PMI, which was already pointing towards strong growth in the sector in Q1 has improved further so far in Q2. Having averaged 58.4 in the opening months of the year, the index has jumped to 62.9 and 63.1 in April and May, respectively. However, it must be noted that supply chains remain under severe pressure, which may continue to act as a headwind to growth in the months ahead. The services PMI suggests that the sector is experiencing a 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, at 50.5 in April and 55.1 in May. Similarly, the EC sentiment indices have all improved in April and May, with the services index most notably regaining its pre-Covid level.

However, the available 'hard data' for Q2 have remained soft despite the improvement in survey data. Although retail sales rose by 3.3% 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 shut for a period in parts of France and Italy. Similarly, growth in industrial output has been meagre in April. However, given the stronger survey data for May, the outlook for the region appears to be brightening.

In terms of the labour market, the impact from the pandemic has been limited to date. The jobless rate was at 8.0% in April, having risen from 7.3% a year earlier to a peak of 8.7% in August and September. 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.



On the inflation front, the headline HICP rate jumped to 2.0% in May, from 1.6% in April. This means that inflation was now at its highest level since October 2018. However, the increase in the headline rate in May was largely due to a further rise in energy prices. The core rate was very subdued though, at just 0.9%, a underlying price pressures remain subdued. 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 appears to be taking root in Q2, 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. The digital green certificate should also allow travel to resume within the bloc, further boosting activity in southern regions, which were more impacted by the pandemic. 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.

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