ECB Watch

AIB Treasury Economic Research Unit

AIB

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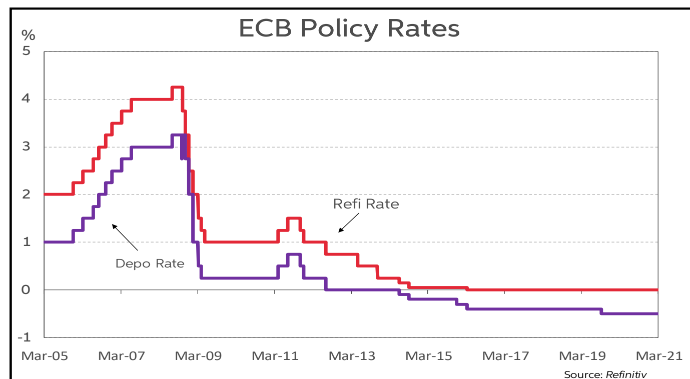
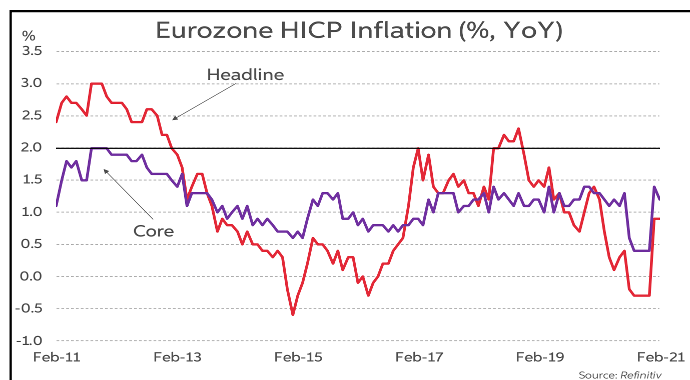
ECB to increase the pace of monthly QE asset purchases

The ECB's Governing Council meeting for March saw the central bank announce an increase to the pace of monthly asset purchases under its Pandemic Emergency Purchase Programme (PEPP). The meeting statement noted PEPP purchases in the second quarter would be "conducted at a significantly higher pace than during the first months of the year". **This alteration to monthly QE comes amid a backdrop of rising bond yields and interest rates over recent weeks, as markets react to the prospects for a stronger economic rebound and rising inflation.** The ECB decided to act to prevent a tightening of financial conditions that it views to be inconsistent with "countering the downward impact of the pandemic" on inflation. President Lagarde commented in the press conference that the decision to amend monthly purchases had "total consensus" within the Governing Council.



The envelop of PEPP was left unchanged at €1,850bn. However, President Lagarde did emphasise that the ECB retains flexibility and that the envelop can be "recalibrated" if required to maintain favourable financing conditions. At the same time, she stated that the central bank does not need to use the full envelop if it is not required.

Meanwhile, as expected, the ECB left its deposit rate and refi rate unchanged at –0.5% and 0%, respectively. The Governing Council once again guided that they expect rates to remain at their present or lower levels until the inflation outlook robustly converges close to, but below 2%.



The ECB also released its updated macro economic projections today. 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% this year, followed by an increase of 4.1% in 2022 and 2.1% in 2023. These forecasts are 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.

Meanwhile, the central bank revised higher its inflation outlook for 2021-22. 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%.

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

With the ECB anticipating that inflation will remain well below its 2% target till at least 2023, the central bank is likely to maintain an ultra loose monetary policy for quite some time. This is borne out in futures contracts, which suggest that the market does not envisage official ECB rates rising from their current levels until 2024. Market reaction to today's meeting saw bond yields fall, most notably in periphery markets, with ten year Italian yields declining by around 10bps on the day.

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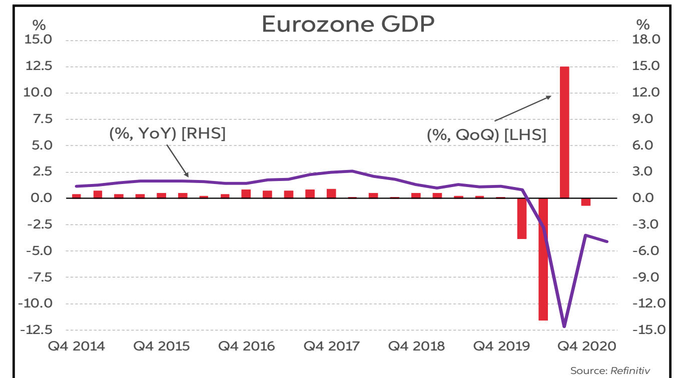
Weak start to 2021, but rebound expected in H2

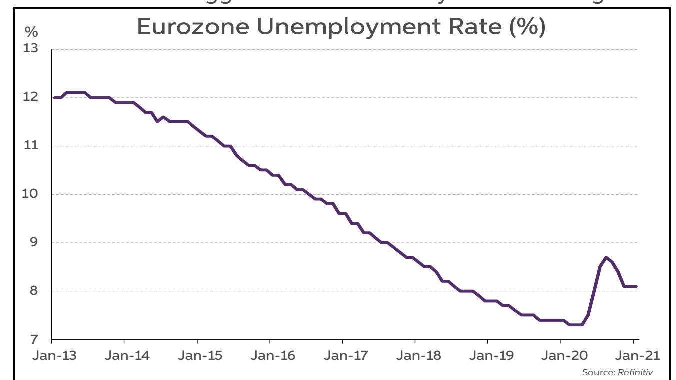
Eurozone GDP contracted by 0.7% in Q4 2020, as tighter restrictions were put in place to counter the winter wave of Covid-19. In the year as a whole, the economy contracted by 6.6%, slightly less than was initially feared. National data highlights that the German economy fared better than most. German GDP fell by 5.3% in 2020, much less than in France (-8.2%), Italy (-8.9%) or Spain (-11.0%), as these countries were harder hit during the first wave of the pandemic, and they depend more on international travel and tourism, which was severely disrupted.



Regarding the underlying breakdown, 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 in Q4, 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..

Survey data suggest that restrictions continue to more adversely impact the services sector than the manufacturing. The services PMI averaged 45 in Q4, and has been almost unchanged in January (45.4) and February (45.7). Indeed, the services sector has been in contraction mode since September. In contrast, the manufacturing PMI has printed above 50 since July. In February, the manufacturing index rose to 57.9, its highest level in three years. The EC sentiment indices highlight the widening divergence between the sectors also. While the industrial sentiment index rose form –11.3 in September to –3.3 in February, the services index which was at –11.1 in September fell to circa –17 in November, and has remained at this level ever since.

The limited amount of 'hard data' for January suggest that the economy may contract again in Q1. Retail sales fell by 5.9% in January, as national lockdowns stymied economic activity. This left sales 6.7% below their pre-pandemic levels. Although, the Eurozone wide reading of industrial production for January has not yet been released, the German production figures point to a fall in output. German industrial production declined by 2.5% in January due to a slump in construction and semi-conductor shortages, which is effecting output globally. The poor early data in Q1, and the continuation of very tight restrictions across the Eurozone suggest that GDP is likely to contract again.



However, the impact on the labour market remains limited to date. The jobless rate was unchanged at 8.1% in January having peaked at 8.6% in July. This reflects the success of furlough schemes in protecting the job's market, with many of these schemes likely to remain in place for most of 2021.

Regarding inflation, the headline HICP rate was unchanged at 0.9% in February, having jumped sharply higher in January. This was in large part due to the German VAT cut ending and businesses postponing winter sales. As the year progresses, inflation is likely to rise further due to base effects, particularly in relation to energy prices. The release of forced savings and potential margin widening in the second half of the year could also see inflation rise further. However, these effects are likely to prove transitory, with inflation expected to remain subdued over the medium term.

The Eurozone economy is set to remain weak in early 2021, as the extension of containment measures designed to keep a lid on new Covid-19 cases, hold down economic activity also. The slower pace of vaccine rollouts risk pushing the economic recovery back to the later part of Q2.

Yet, there are grounds for optimism. Highly effective vaccines have begun to be rolled out, with supply set to ramp up as the year progresses. Monetary policy will remain accommodative also, and national governments will continue to provide fiscal support. Grants and loans from the EU recovery fund will also come on stream this year, with the worst affected countries set to benefit the most from the fund. In its latest update, the OECD has revised its growth forecasts for the Euro-area upwards to 3.9% in 2021 and 3.8% 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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