ECB Watch

AIB Treasury Economic Research Unit

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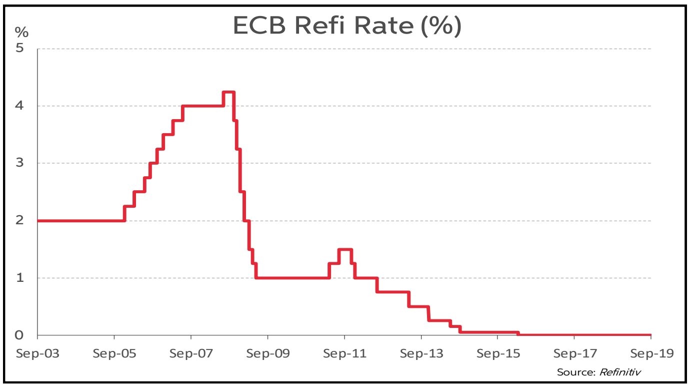
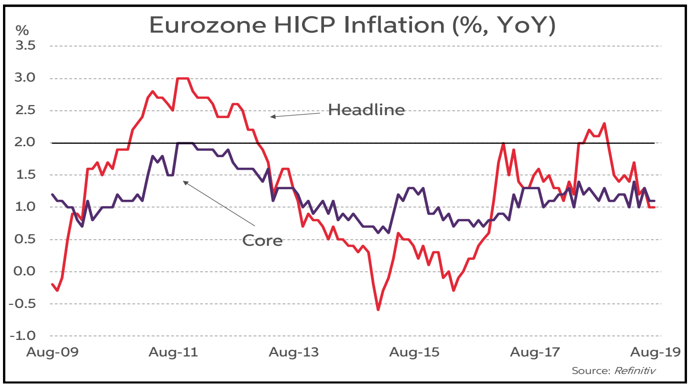
ECB back on easing path; cuts rates & restarts QE

The September meeting of the ECB Governing Council saw the **central bank move back on to a clear policy loosening path,** as had been signalled at its last meeting in late July. The **deposit rate was cut by 10bps from −0.4% to −0.5%,** in line with market expectations. The ECB **signalled that a further easing in rates is possible,** saying official rates will remain at their present or lower levels until inflation "robustly" converges with its 2% target. It is thus maintaining an easing bias. The market is pricing in another 10bps cut by mid-2020—it had two priced in before today's meeting.



Meantime, the ECB also indicated that it would **restart it QE asset purchase programme in November.** In this regard, recent soundings suggested a reluctance amongst some members of the Governing Council to this move. Thus, total purchases will be **relatively modest at €20bn per month.** However, the ECB indicated that the purchases would run for as long as necessary and only end shortly before it starts to raise rates.



Meanwhile, the interest rate on **the new long-term refi (TLTRO 3) will now be set at the level of the average refi rate** over the life of the TLTRO, rather than 10bps above. The maturity of the operations is being extended from two to three years. A **new two-tier system for reserve remuneration is being introduced** that will see part of banks holdings of excess liquidity exempted from the negative deposit rate.

Today also saw the release of the ECB's **updated staff macroeconomic projections.** These show why the ECB has moved back on to an easing path, with **inflation and growth forecasts revised downwards.** Furthermore, **inflation is expected to remain well below the 2% target** in the next couple of years. HICP inflation is forecast at 1.2% in 2019 (from 1.3%), 1.0% in 2020 (from 1.4%) and 1.5% in 2021 (from 1.6%). It is now also projecting more moderate GDP growth of 1.1% in 2019 (from 1.2%) and 1.2% in 2020 (from 1.4%), with 2021 forecast at 1.4% (from 1.5%). The ECB also remains of the view that the **risks to the outlook remain "tilted to the downside".**

ECB Macroeconomic Forecasts for the Euro Area

(%)	2018	2019	2020	2021
HICP	1.7	1.2	1.0	1.5
Real GDP	1.9	1.1	1.2	1.4

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $62.5 in 2019, $57.0 in 2020 and $56.3 in 2021.

Source: ECB September 2019

Markets were relieved in particular to see the resumption of an open-ended QE asset purchase programme from November. Thus, **the initial reaction to today's ECB actions saw the euro lose ground and bond markets rally, though these moves later reversed with upward pressure on short-dated bond yields in particular.** Meantime, the market expectation now is that the deposit rate will be cut by a further 10bps in total to −0.6%. The markets do not see rates starting to rise until late 2023 and then only very slowly. Futures contracts show rates rising by just 30bps in total by early 2025, pointing to the deposit rate still being negative at −0.3% by then.

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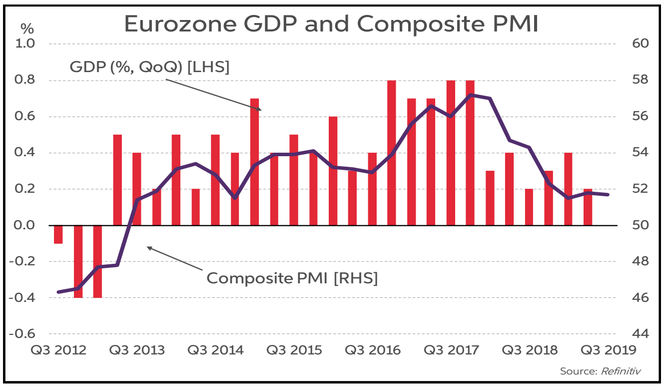
Slower growth path for Eurozone economy

Eurozone GDP eased to 0.2% in Q2, having expanded by 0.4% in the opening quarter of the year. Germany, the region's largest economy, has been source of much of the slowdown in the past year. The deterioration in the global trading environment has weighed heavily on its export oriented economy. Growth has also slowed to a crawl in Italy, as domestic demand has faltered amidst budget uncertainty. Elsewhere, though, activity has held up reasonably well.

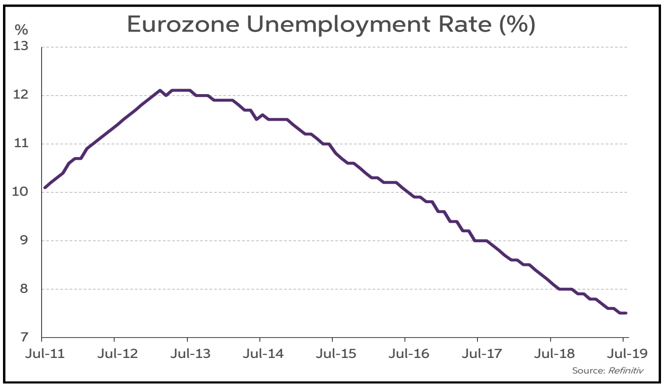


The breakdown shows that in the Eurozone as a whole, domestic demand drove growth in Q2. Consumption, government expenditure and fixed investment all added 0.1 percentage points (p.p.) to the quarterly total. In contrast, net external trade acted as a drag, subtracting 0.1 p.p..

Leading indicators of activity suggest that growth remained at a subdued level in Q3, but did not lose further momentum. The Composite PMI has averaged 51.7 in July/August, broadly unchanged from 51.8 in Q2. However, the contrast between the performance of the manufacturing and services sectors has become starker. The slowdown in the global economy has seen the manufacturing index remain deep in contractionary territory, at 46.8 in July/August, down from 47.7 in Q2. Meantime, the services PMI has averaged 53.4 in the same period, a level consistent with good growth in the sector. On the demand side of the economy, the EC measure of consumer confidence also continues to hold near Q2 levels.

Meanwhile, the available 'hard' data have been weak in the quarter-to-date. Retail sales contracted by 0.6% in July, having increased by 0.6% in Q2. Although, the year-on-year growth rate remained strong at 2.2%. At the same time, July's industrial production figures showed that the sector remains mired in recession. Output fell by 0.4%, with the year-on-year growth rate now standing at –2.0%.

In spite of the weaker outlook for economic activity, the labour market has been holding up reasonably well. Jobs growth held at 0.3% in Q2, while the jobless rate remained at 7.5% in July, close to multi-decade lows. Looking ahead, however, the employment subcomponent of the Composite PMI suggests that employment growth may have moderated in Q3.



On the inflation front, price pressures in the region remain very subdued. As oil prices have fallen over the course of the year, headline inflation has fallen back to just 1%. Meantime, the core measure (ex-food & energy) continues to hover around the 1% level. This is well below the ECB's target of close to, but just below, 2%.

Overall, near term downside risks continue to cloud the outlook for the Eurozone economy. The reliance of the region on export orientated growth, especially in Germany, means it is vulnerable to a deterioration in external demand. On that note, the considerable loss of momentum in the world economy and the weakening of international trade, partly linked to protectionist policies adopted by the Trump administration, represent significant threats to growth. Meanwhile, on the domestic front, continued uncertainty around the final outcome of Brexit and the particular challenges facing the German economy are both sources of worry.

Despite this, there are a number of positives. The solid labour market and subdued inflation will support the key consumer side of the economy. At the same time, a somewhat more expansive outlook for fiscal policy should also help support domestic demand, while today's policy easing package from the ECB will also help activity. However, the near-term assessment remains downbeat. Today's ECB projections are for GDP to expand by 1.1% this year and 1.2% in 2020, pointing to continuing subdued growth next year.