ECB Watch

AIB Treasury Economic Research Unit

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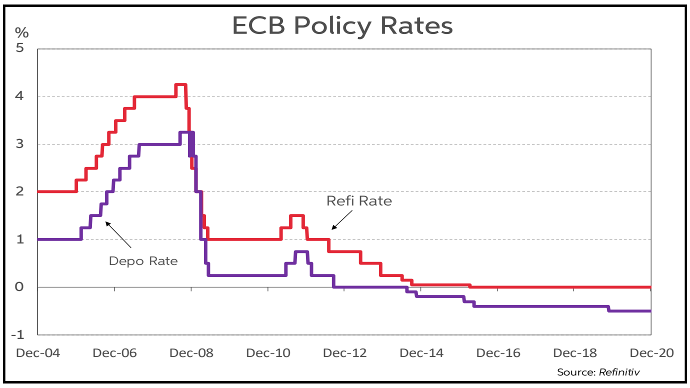
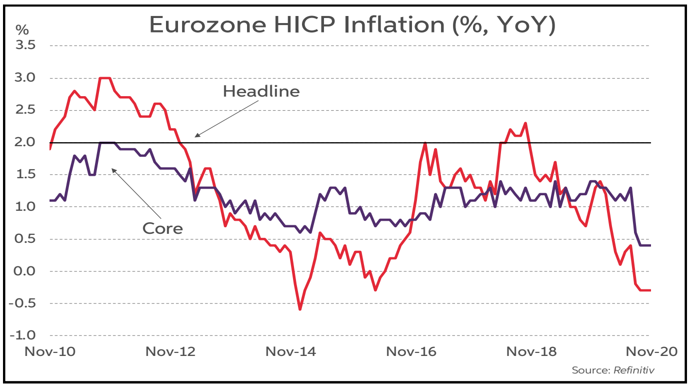
ECB delivers on stimulus promise

The December meeting of the ECB's Governing Council saw the central bank announce a further easing in monetary policy. This was very much in line with expectations as the ECB had given a clear commitment at its last meeting in October that more stimulus would be delivered this month. ECB President Lagarde stated that the rationale for further policy easing was the near term economic impact of the pandemic becoming more pronounced and weakness in inflation lasting longer than it had previously anticipated.



In terms of the key highlights of its new package of measures, the ECB both expanded and extended its Pandemic Emergency Purchase Programme (PEPP). The envelop of purchases was increased by €500bn, bringing the total size if the programme to €1,850bn, while monthly purchases will now continue to at least March 2022.

The ECB also enhanced its special liquidity programme, known as TLTRO 3. This included extending the period that "favourable terms" apply by a further 12 months to June 2022. It raised the borrowing limit from 50% to 55% of a banks stock of eligible loans as well stating it would conduct three additional operations during the second half of 2021. On top of these policy actions, it is going to maintain its easier collateral measures until June 2022. It is also offering four additional longer term refinancing operations (PELTROs) next year and a time extension to its repo and swap lines.



As expected, the ECB once again left its key interest rates unchanged. The ECB retains a bias to ease rates if needed, reflected in its guidance of rates remaining at their "present or lower levels". **However, given that the central bank refrained from cutting rates at the height of the pandemic crisis in the first half of the year, including maintaining the deposit rate at –0.5%, it appears that official rates are at their lower bound.**

Today also saw the release of the ECB's latest set of staff macroeconomic projections. The central projection is for a contraction of 7.3% this year. This represents an upward revision from the September forecast of -8%. The ECB is forecasting growth of 3.9% next year, which is less optimistic than its previous forecast of 5%. However, it revised upwards its 2022 GDP forecast to 4.2% (was 3.2%). Meanwhile, in its first published view for 2023, it is projecting growth of 2.1%. **It once again emphasised that the risks surrounding the Eurozone's economic outlook remain "tilted to the downside", although it did note that they have become "less pronounced".**

ECB Macroeconomic Forecasts for the Euro Area

(%)	2020	2021	2022	2023
HICP	0.2	1.0	1.1	1.4
Real GDP	-7.3	3.9	4.2	2.1

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $41.6 in 2020, $44 in 2021, $45.4 in 2022 and $46.9 in 2023

Source: ECB December 2020

With inflation set to remain well below its 2% target till at least 2023, the ECB is likely to have to maintain an ultra loose monetary policy for some time. Indeed, futures contracts suggest that the market does not envisage official ECB rates rising from their current levels until the second half of 2024.

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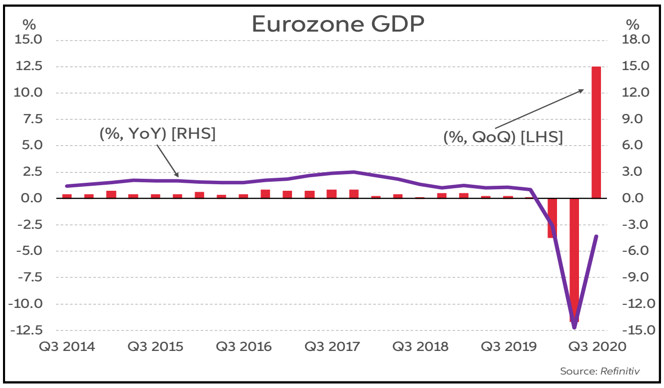
Second wave halts the economic recovery in Q4

Eurozone GDP rebounded strongly by 12.5% in Q3. A recovery in consumer spending contributed 7.3 percentage points (p.p.) to the total. Increased government expenditure added a further 1.1 p.p., while gross fixed capital formation added 2.8 p.p.. Meanwhile, net trade added 2.4 p.p., although, changes in inventories acted as a drag, subtracting 1.2 p.p.. However, GDP was still 4.3% below its Q4 2019 level, with a big shortfall in fixed investment in particular of over 10%.

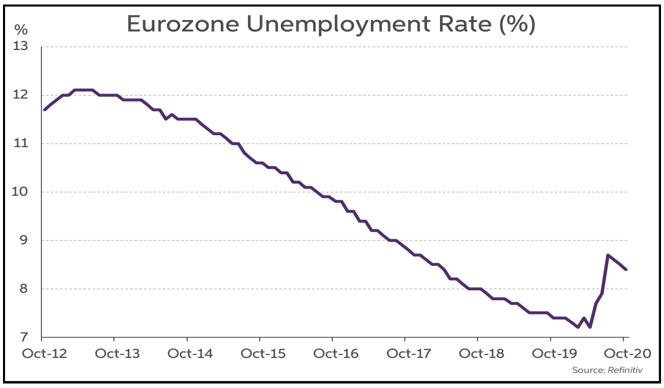


The national data showed that the rebound was greatest in the countries hit hardest by the pandemic. France (+18.7%), Spain (+16.7%) and Italy (+15.9%) recorded the largest quarter-on-quarter increases, having been the three hardest hit economies in the Eurozone in H1 2020. Elsewhere, the German economy grew by 8.5% in Q3 following a more modest fall in activity in the first half of 2020.

Leading indicators suggest the economic recovery came to a halt in the fourth quarter. The composite PMI fell back below 50 for the first time since July to 45.1 in November. This is due to the increased restrictions and re-imposition of national lockdowns to counteract the second wave of the pandemic. On this occasion, the lockdowns allowed for construction and manufacturing to remain open, unlike earlier in the year. Thus, the Eurozone manufacturing PMI has remained in expansion mode throughout Q4, printing at 53.8 in November. In contrast, the services PMI has moved downwards throughout the quarter, falling to 41.7 in November. However, it should be noted that the decline is nowhere near as sharp as the collapse seen in the spring. On a national level, the German Ifo, French INSEE and Italian ISTAT measures of business sentiment all moved lower in November. On the demand side, consumer confidence has edged lower also.

The only available "hard data" for Q4 so far are retail sales, which rose by 1.5% m/m in October. This lifted them 3.1% above their February level, with online sales remaining at an elevated level.

The labour market remains relatively protected given the scale of the crisis. The unemployment rate was at 8.4% in October, and has been on a downward trend for the past few months as the economy rebounded in Q3. However, large revisions to the data mean the jobless rate peaked at a higher rate than was previously thought, at 8.7% in July. Nonetheless, the labour market has been relatively unscathed, partially reflecting the success of furlough schemes. Many of these schemes have been extended into next year. The European Council has also approved circa €90bn under its SURE (labour market) scheme to allow governments to continue to provide these supports, with just under €40bn already disbursed amongst member states.



In relation to inflation, the headline rate of HICP remained in negative territory in November, at –0.3%, while core inflation stayed at 0.2%. VAT cuts in a number of countries is one factor keeping inflation very low. Restrictions are also impacting the data, putting downward pressure on prices.

The Eurozone economy seems likely to decline again in Q4, as a result of the re-imposition of national lockdowns to contain the spread of the virus. In order to ensure that a swift recovery can take place in 2021, the EU Council will seek to reach an agreement at this weeks summit on the EU Recovery Fund, worth €750bn. Brexit uncertainty remains though, with the possibility of a no-deal scenario still very much to the forefront.

However, there are other grounds for optimism. Vaccines should be rolled out in 2021, allowing for a robust economic recovery to take root. The rebound seen in the third quarter shows that when businesses re-open, the economy can bounce back quickly. Monetary policy will remain very accommodative also, and national governments for the most part will continue to provide fiscal support. **Overall though, the economic outlook remains uncertain.** In its latest forecasts provided today, the ECB sees Eurozone GDP falling by 7.3% this year, with growth rebounding by circa 4% in 2021, with similar growth expected in 2022.

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