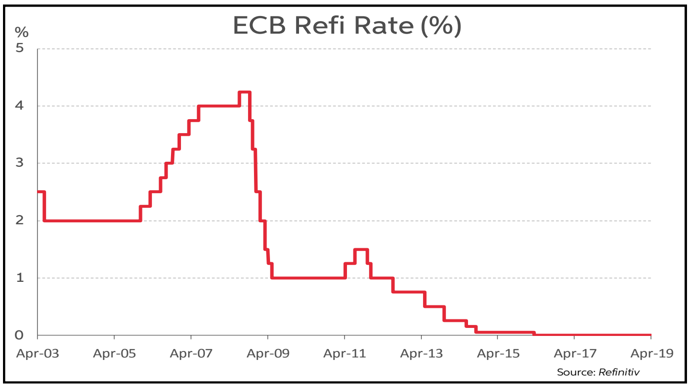
ECB Watch

AIB Treasury Economic Research Unit

10th April 2019

ECB content with current very cautious policy stance

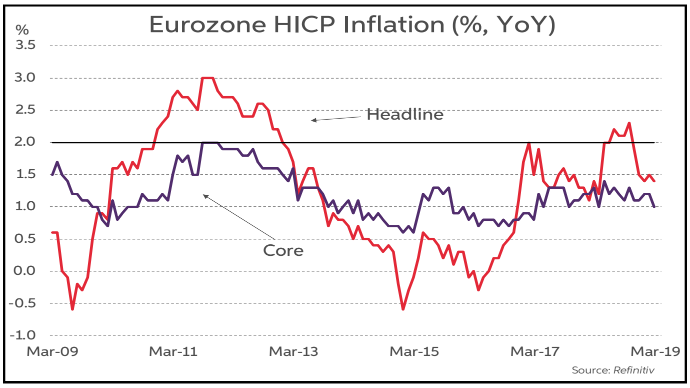
The April meeting of the ECB Governing Council concluded as expected with no changes to interest rates from their present levels of 0% for the refi rate and −0.4% for the deposit rate. Overall, today's meeting was relatively uneventful.



At its previous meeting in March, the ECB pushed out the timing of its guidance on when interest rates may start to rise. Its guidance now states that rates are on hold until at least through the end of 2019. At the same meeting, the ECB also announced the launch of another targeted longer-term refinancing operation, TLTRO III, to provide continued cheap funding for banks. This will start in September of this year and end in March 2021.

Today's meeting statement contained few surprises. The text stated that incoming macro data have confirmed that the slower growth momentum has extended into the current year. It also noted that global headwinds continue to have an impact on the Eurozone economy. Meanwhile, the ECB remains of the view that the risks to the economic outlook are still "tilted to the downside".

These concerns regarding the economic outlook were reflected in the downward revisions in its most recent set of macro forecasts, which were released in March. It is now projecting GDP growth of 1.1% in 2019 and 1.6% in 2020. Meanwhile, the 2021 GDP forecast was left unchanged at 1.5%.



The March update saw its inflation forecasts also revised lower. HICP inflation is now forecast at 1.2% in 2019, 1.5% in 2020 and 1.6% in 2021. These projections show that the ECB expects inflation to remain well below its 2% target over the next 3 years. Hence, it is under no pressure to start to hike interest rates.

Today's post-meeting press conference did not contain much in the way of new insight into the ECB's mindset on the monetary policy outlook. Given recent comments from some ECB members, the focus of questions was centred on the possibility of a tiered deposit rate facility for banks and the potential for the central bank's forward guidance to be pushed out even further. In reply to questions about a tiered deposit rate, President Draghi stated that the Governing Council did not discuss the pros and cons of any such mitigating measures. He also noted that this month's meeting did not feature a discussion on extending the time period of its forward guidance.

The market expectation now is that rates will not start to be raised until end-2020. Futures contracts suggest the market is factoring in around 10bps of tightening by end 2020. Over the medium term horizon, futures contracts show rates remaining low for an extended period. Three month rates, which currently stand at −0.35%, are only expected to get back into positive territory around mid 2022.

Looking further out, three month rates are not seen rising to 0.5% until 2024. This represents a marked change in interest rate expectations since last autumn when markets believed the ECB could start raising rates by end 2019, with three month rates getting to 0.5% by around mid-2021. Given the lack of news, there was very little market reaction to today's meeting.

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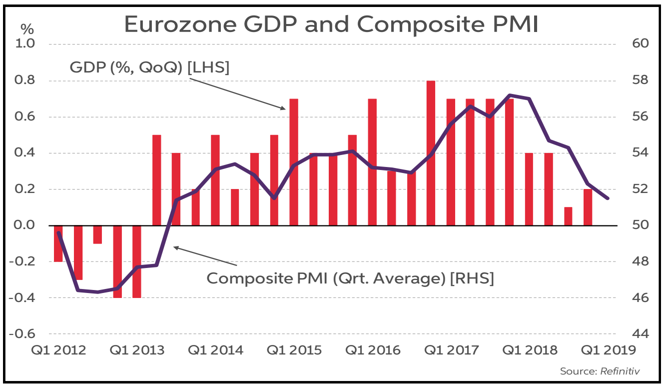
Eurozone growth remains sluggish

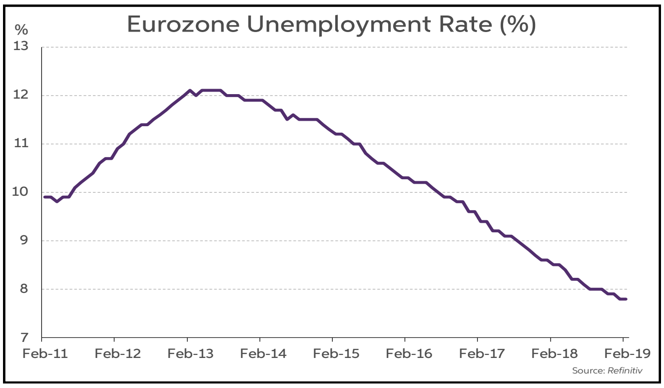
Economic growth in the Eurozone slowed notably in the second half of 2018. GDP expanded by just 0.2% in Q4 2018. The economy grew by 1.8% in 2018, down from 2.4% in 2017. The slowdown has been concentrated in Italy and Germany. The former entered into a recession in Q4, while the latter narrowly avoided the same fate. Growth elsewhere remained solid enough.



Leading indicators of activity suggest that the Eurozone economy may have lost further momentum in the opening quarter of 2019. The composite PMI averaged 51.5 in Q1, its worst quarterly performance since Q4 2014. The breakdown shows that the manufacturing sector has been responsible for this decline. The manufacturing PMI averaged 49.1 in the quarter, below the 50.0 level that separates growth from contraction, and is trending downward. The sector has been adversely impacted by factors such as new car emissions standards and the slowdown in global trade. In contrast, the services index improved in both February and March, leaving the quarterly average at 52.4. Meanwhile, similar to the composite PMI, the EC Eurozone Economic Sentiment index also moved down in the quarter to 106, from 108.9 in Q4. At a national level, the German Ifo and the French INSEE also suggest that the pace of economic activity slowed in the quarter.

However, the hard data available for Q1 have been more upbeat. Retail sales have increased by 0.5% above Q4 levels in January/February, suggesting that household spending has picked up slightly at the beginning of 2019. Meanwhile, despite the dismal readings of the manufacturing PMI, Eurozone industrial output rose by a very strong 1.4% in January. Meanwhile, there was a good rise in German industrial production in February, thanks to a strong increase in construction output.

Meantime, labour market data have been mixed. The unemployment rate edged down to 7.8%, an over 10-year low, in January and held there in February. However, the composite PMI employment sub-component suggests that employment growth, which weakened in H2 2018, may have slowed further in the first quarter of 2019.



On the inflation front, price pressures in the region remain very subdued. Lower oil prices have seen HICP inflation moderate in recent months, with the headline rate standing at just 1.4% in March. At the same time, the core measure fell to 1.0%, in part due to the timing of Easter this year. This is well below the ECB's target rate of close to, but below 2%.

Overall, the Eurozone economy has returned to a period of much slower economic growth. External demand has softened as the pace of global economy activity has slowed. On this note, weaker growth in China, the protectionist policies pursued by the Trump administration and ongoing Brexit-related uncertainty are all a source of worry. Meanwhile, country specific factors such as the delays to car production in Germany, as well as higher borrowing costs and increased uncertainty in Italy, are also weighing on activity.

However, falling inflation, continuing very low interest rates and an easing of some current headwinds to growth should see activity pick up pace again as the year progresses. Nevertheless, growth forecasts for the Eurozone have been slashed. Yesterday, the IMF cut its 2019 GDP forecast from 1.6% to 1.3%, while the 2020 forecast was reduced from 1.5%, to 1.7%. These are broadly in-line with the ECB's most recent projections for growth of 1.1% and 1.6% in 2018 and 2019 respectively.

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