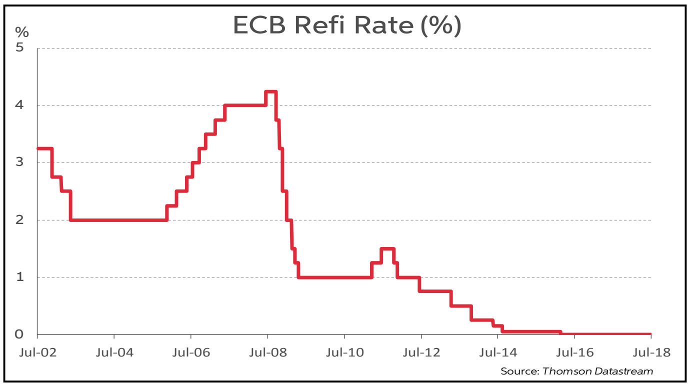
ECB Watch

AIB Treasury Economic Research Unit

26th July 2018

ECB retains cautious tone on its rate outlook

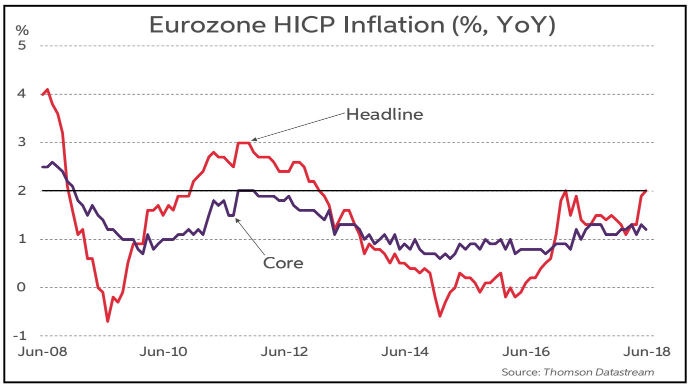
As expected, today's meeting of the ECB Governing Council for July concluded with no changes to monetary policy. At its previous meeting in June, the ECB announced that it would reduce monthly net asset purchases to €15bn in the final quarter of this year and then cease net purchases at the end of 2018**.** However, it will still continue to replace bonds as they mature, thereby maintaining a large stock of assets on its balance sheet.



The July edition of the meeting statement was broadly unchanged from the June version. At its meeting in June, the ECB indicated that it will keep interest rates at their current very low levels "at least through the summer of 2019". This guidance was repeated in today's meeting statement and reaffirmed by ECB President, Mario Draghi, in the post-meeting press conference. He stated that the ECB does not currently "see the need to modify or add new language" to its forward guidance on rates.

In terms of the economic outlook, the statement noted that the Eurozone economy is "proceeding along a solid and broad-based growth path". The text also stated that the "underlying strength of the economy" provides the ECB with confidence that the "sustained convergence of inflation" towards its 2% target will "continue in the period ahead". However, the ECB once again emphasised that "significant monetary stimulus" is still required to achieve its inflation aim.

The most recent set of ECB macro forecasts, which were released last month, provide some additional insight/ rationale as to why the Central Bank is taking such a cautious approach to monetary tightening. These forecasts show that the Governing Council is anticipating that inflation will remain below its 2% target over the next couple of years.



HICP inflation is forecast at 1.7% for each of the next three years, through to 2020. The projections for 2018 and 2019 were slightly above their March forecasts, reflecting higher oil prices.

Meanwhile, the ECB in its June forecasts lowered its GDP growth expectation for 2018 from 2.4% to 2.1%, after slower growth in the first quarter of the year. The ECB continues to anticipate growth of 1.9% in 2019 and 1.7% in 2020. Today's meeting statement noted that recent economic data, which have indicated continued solid growth in the Eurozone economy, have been in line with its June projections.

Overall, it is clear from today's meeting/press conference that the ECB remains content to take a very cautious approach to tightening policy. Interest rates in the Eurozone are unlikely to start to be hiked until the autumn of 2019 at the earliest, from their present levels of 0% for the refi rate and –0.4% for the deposit rate.

Markets are expecting rates to rise by around 20bps by end-2019. Futures contracts **indicate that 3-month Eurozone rates are expected to remain negative until mid-2020.** They see rates staying low for an extended period beyond that, and are not expected to get to 1% until around mid-2023. However, this seems rather modest, especially if the Eurozone economy continues to grow at a solid pace.

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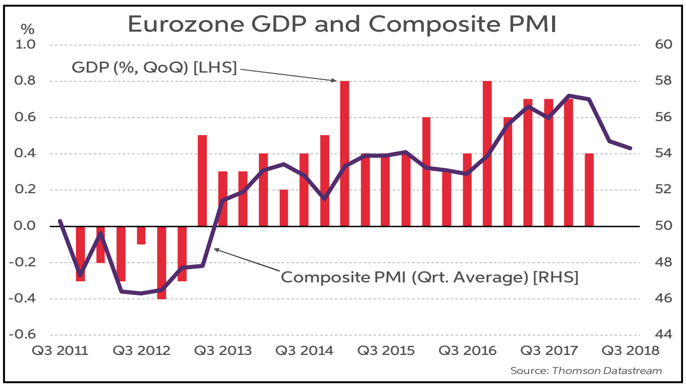
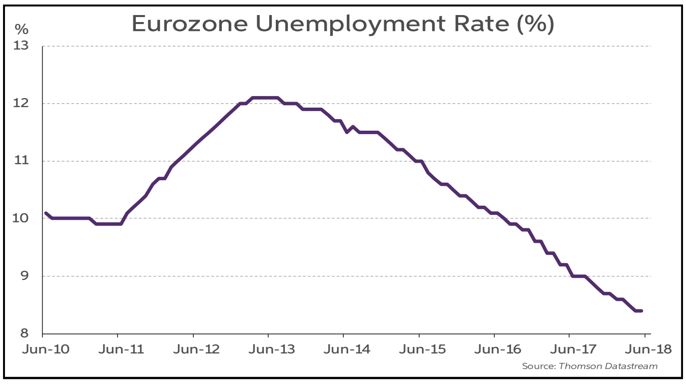
Eurozone growth continues at a reasonable pace



The Eurozone economy registered softer, but still solid, 0.4% growth in Q1 2018. This followed three quarters of 0.7% rises. The underlying data show inventories and consumer spending were the main sources of growth, accounting for 0.4 percentage points (p.p.) and 0.3 p.p. respectively. Net trade was a drag, deducting 0.3 p.p. in the Q1, as exports fell.

Leading indicators of activity for Q2 indicated that growth may have peaked, while maintaining a reasonable pace. The Eurozone Composite PMI averaged 54.7 in Q2, down from Q1's 57 average (which overestimated growth in the quarter). EC Eurozone economic sentiment also slowed in Q2, averaging 112.5 compared to 114 in Q1. National indicators such as the German Ifo and French INSEE indices also pointed to a more moderate pace of growth in the second quarter.

The limited hard data that we have for Q2 have been somewhat more positive. Retail sales increased by a modest 0.4% in April/May versus Q1, in which they were flat. Meantime, industrial production, which has been volatile in recent months, partly due to abnormal weather conditions, declined by 0.2% in April/May after falling by 0.6% in Q1. Meantime, the goods trade data for April/May have been encouraging, suggesting net trade could make a positive contribution to growth in the second quarter.



The labour market has continued to improve. The Eurozone jobless rate fell to 8.4% in April, and held there in May. This represents its lowest rate since December 2008. Meanwhile, **employment in the Eurozone grew by 0.4% in the first quarter, representing a 1.4% increase on an annual basis.** The employment component of the Composite PMI averaged 54.8 in Q2, little changed from Q1's 55.2. This suggests that the jobs market continued to expand at a solid pace in the quarter. The PMI came in at 54.7 in July.

On the inflation front, underlying price pressures in the currency bloc remain subdued. Headline CPI inflation jumped from 1.3% to 2% between April and June (largely due to higher energy prices). However, the core rate (excludes food & energy) has been broadly unchanged. At 1.2% in June, it is well below the ECB's 2% target.

The July survey data released so far have supported the view that growth continues at a healthy pace at the start of Q3. **The Composite PMI edged lower to 54.9, from June' 54.3.** The French INSEE fell back, while the German Ifo and Italian ISTAT indices were stable.

The Eurozone economy still faces some challenges and risks. Unemployment remains high in many countries, productivity growth is weak, while there are a host of legacy issues from the global downturn a decade ago, including high debt levels in many countries. Political developments also remain a concern, with 'anti-establishment' parties enjoying success in a number of countries and Brexit related uncertainty increasing. The protectionist trade policies of the US are also a cause for concern.

Overall though, the economy is expected to continue expanding at a solid pace, despite the fact that growth looks to have peaked in 2017. The latest IMF forecasts show that it anticipates growth of 2.2% in 2018, followed by a 1.9% rise in 2019. This is partly due to the fact that ECB monetary policy should remain very accommodative. In addition, fiscal policy has turned more expansionary, while consumer spending is being supported by solid jobs growth, positive real earnings and still elevated consumer confidence.