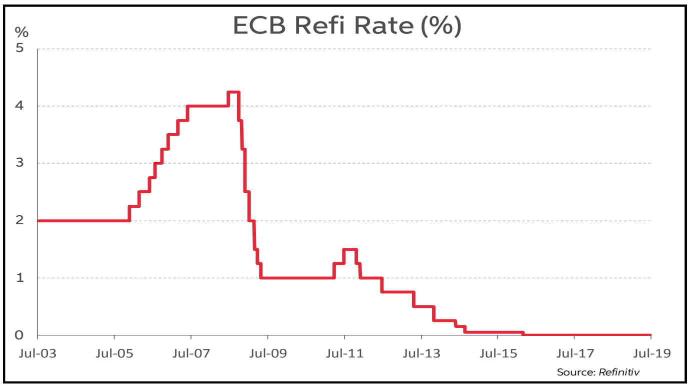
ECB Watch

AIB Treasury Economic Research Unit

25th July 2019

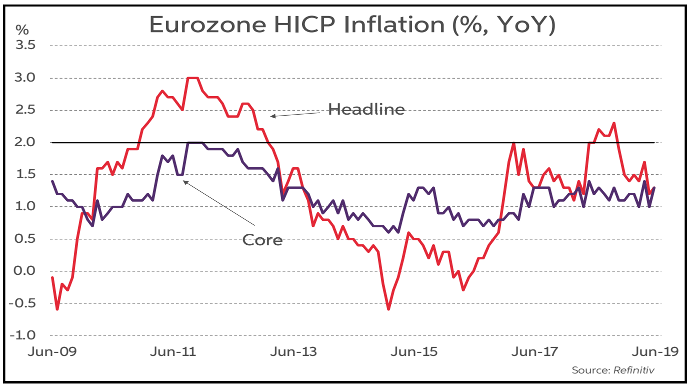
Policy easing on the cards for September

As expected, the July meeting of the ECB's Governing Council concluded with no changes to interest rates from their present levels of 0% for the refi rate and –0.4% for the deposit rate. However, the main focus on today's meeting was what indications the ECB would give regarding future policy easing.



In this regard, the ECB provided a clear signal today that policy easing is in the pipeline for its next meeting in September. The statement saw a reintroduction of its easing bias in relation to interest rates with the return of the reference to the possibility of "lower levels".

The ECB also emphasised that its "stands ready to adjust all of its instruments" and is "determined to act" to ensure that it achieves its inflation target (i.e. close to, but below 2%). In preparation for this, it has tasked the relevant ECB Committees to examine various options. These include changes to forward guidance, the design of a tiered interest rate system (to mitigate the risks to European banks profitability of further negative interest rates) and the size/composition of new asset purchases for its QE programme.



In the press conference, President Draghi stated that the "trigger" for action to ease policy will be if the medium term inflation outlook continues to fall short of its target. He also commented that the Governing Council decided to wait until it had its next macro projections (due in September) "before taking action" and that "all instruments are on the table".

The ECB's most recent set of macro forecasts were released in June. It is projecting GDP growth of 1.2% in 2019 and 1.4% in 2020 and 2021. On the inflation front, the ECB is expecting HICP inflation of 1.3% in 2019, 1.4% in 2020 and 1.6% in 2021. It is important to note these forecasts indicate that the ECB envisages that inflation will remain below its 2% target over the next 3 years. **It continued to state today that the risks to its macro outlook remain "tilted to the downside". However, President Draghi did comment that the risk of a recession are "pretty low".**

In summary, the ECB today gave a clear direction that it will ease policy at its next meeting in September. This could entail a package of measures, including cuts to interest rates with the introduction of a tiered system, changes to its forward guidance (as of today states that interest rates expected to remain at their present or lower levels until at least first half of 2020), as well as the potential for a restarting of new asset purchases under its QE programme.

In terms of market expectations, futures contracts suggest the market is factoring in 10bps of easing in the deposit rate by September and around another 10bps of easing by the end of the first half of 2020. Over the medium term horizon, futures contracts reflect an expectation of rates remaining very low for an extended period. Three month rates are only expected to get back into positive territory around September 2024. At the time of its previous meeting in June, this was expected to happen by Spring 2023. Market reaction to today's ECB meeting was generally muted.

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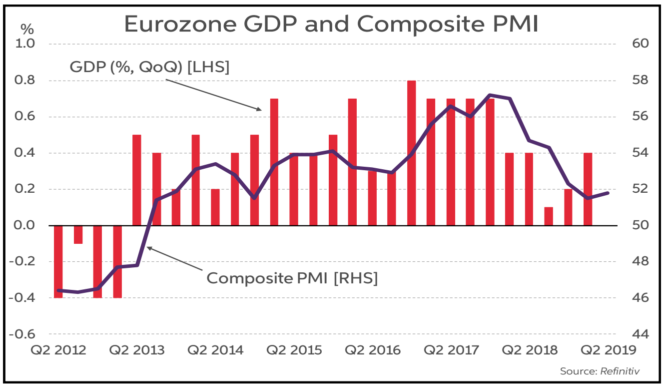
Eurozone growth to remain subdued

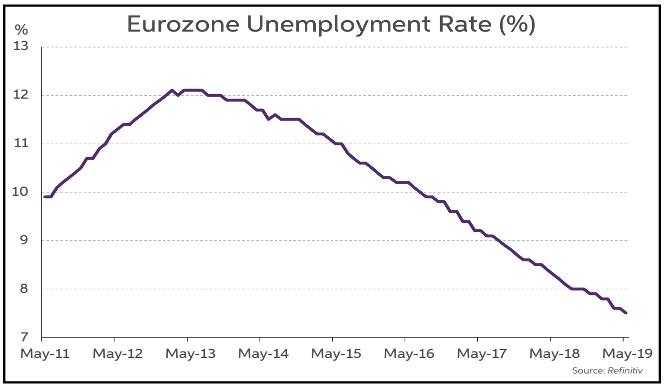
Eurozone GDP unexpectedly expanded by 0.4% in the opening quarter of 2019, following a weak performance in the second half of 2018. In terms of the underlying breakdown, personal consumption and investment drove growth in Q1, contributing 0.3 and 0.2 percentage points (p.p.) respectively. Meanwhile, net trade added 0.1 p.p., the impact of government expenditure was negligible, while changes in inventories subtracted 0.2 p.p. from the quarterly total.



However, the available 'hard' data indicate that growth may have moderated in Q2. For instance, retail sales volumes suggest that household expenditure was more subdued in the quarter. As of May, sales have been essentially flat, having risen by 0.8% in Q1. At the same time, industrial output has been slightly weaker in Q2 to-date, while it rose by 0.9% in the opening quarter of the year. More positively, the latest production figures showed that output did rise by a strong 0.9% in May, leaving the index at its highest level since October 2018. However, the manufacturing PMI remained very weak in Q2, mired below 48, deep into contraction territory.

Meanwhile, the labour market continues to show signs of improvement. Employment growth held at 0.3% in Q1, leaving the year-on-year rate at 1.3%. In terms of more timely indicators, the employment subcomponent of the composite PMI suggests that jobs growth should remain solid. This would allow the unemployment rate to continue to edge lower. It most recently fell to 7.5% in May, close to a multi-decade low. However, despite the positive developments, there has been little signs of an acceleration in the year-on-year growth rate of earnings, which remained at 2.2% in Q1.

On the inflation front, price pressures in the region remain very subdued. Partly reflecting lower oil prices, headline HICP was recorded at just 1.3% in June. The core measure did jump to 1.3%, from 1%, though this was largely due to temporary factors, such as higher transport costs owing to the timing of public holidays. Overall, inflation is running well below the ECB's target of close to, but just below, 2%.



With regard to Q3, the flash Markit PMIs for July suggest the Eurozone economy is continuing to struggle at the start of Q3. The composite PMI declined to 51.5, from 52.2, as both the manufacturing and the service sector indices moved lower. The former is now at an over 6-year low level. On a national level, the German Ifo for July suggested that activity had weakened further.

Overall, near term risks continue to cloud the outlook for the Eurozone economy. The reliance of the region on export orientated growth means it is vulnerable to a deterioration in external demand. On that note, the considerable loss of momentum in the world economy, as well as on-going global trade tensions linked to protectionist policies adopted by the Trump administration, represent significant threats to growth. Meanwhile, closer to home, continued uncertainty around the final outcome of Brexit is also a source of worry.

Despite this, there are a number of positives. Rising employment and subdued inflation will support the key consumer side of the economy. At the same time, the slightly more expansive outlook for fiscal policy should also help to stimulate domestic demand, while further policy easing by the ECB may also support activity. However, the near-term assessment does remain gloomy. The latest ECB projections are for GDP to expand by 1.2% this year and 1.4% in 2019, broadly in-line with the IMF's most recent forecast.

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