ECB Watch

AIB Treasury Economic Research Unit

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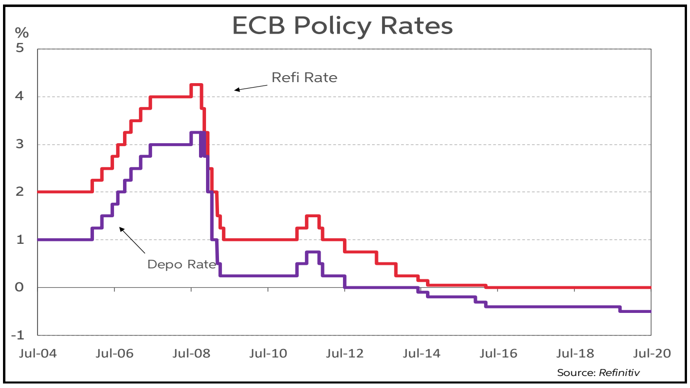
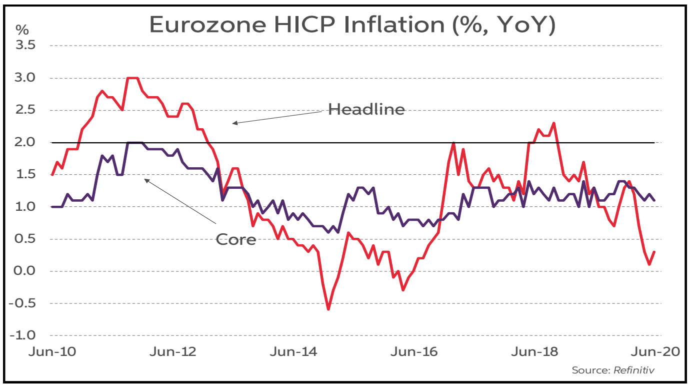
ECB content with current policy

Today's meeting of the ECB Governing Council concluded with no changes to policy. This was in line with market expectations, as the ECB had only last month announced an increase to its Pandemic Emergency Purchase Programme (PEPP). At this meeting, back in June, it expanded the size of the envelope from €750bn to €1,350bn. In today's meeting statement, the ECB, once again stated that it would **continue with net asset purchases under the programme until at least June 2021.** Meanwhile, its key interest rates also remain unchanged. The deposit rate was maintained at -0.5%. It has been at this level since September 2019.



The statement acknowledged some signs of improvement in the Eurozone economy. The Governing Council noted that over the last number of weeks incoming data has signalled a resumption of activity. It referenced the fact that both high frequency and survey indicators bottomed out in April, followed by signs of improvement in May and June, amid the easing of lockdown measures.

Overall though, the text showed that the ECB remains cautious about the economic outlook. It emphasised that the level of activity "remains well below" pre-Covid levels, the recovery has been "uneven and partial", while at the same time the "outlook remains highly uncertain". Given this backdrop, the ECB expects that "ample monetary stimulus" will continue to be required to support the recovery in the Eurozone economy.



In its most recent update to its economic forecasts, released at the June meeting, the ECB's central projection is for an unprecedented contraction of 8.7% in Eurozone GDP this year. The ECB staff forecasts see GDP growth rebounding by 5.2% next year and rising by 3.3% in 2022. This indicates that the central bank anticipates that it is going to take the Eurozone economy some time to recover the fall in output that occurred in the first half of this year. The ECB continues to emphasise that **the balance of risk to the forecasts is to the downside.** Indeed, in in a more severe scenario, where tough coronavirus containment measures have to remain in place for a longer period of time, the ECB estimates that GDP could fall by as much as 12.6% in 2020.

Given the deep recession, combined with the collapse in oil prices this year, there is already **severe downward pressure on inflation**. The HICP rate was registered at just 0.3% in June, down from 1.2% as recently as February before the COVID-19 pandemic took hold. **The ECB sees HICP inflation averaging 0.3% this year, before rising to 0.8% in 2021 and 1.3% in 2022.**

With inflation set to remain well below its 2% target for some years, the ECB is likely to have to maintain an ultra loose monetary policy for some time. In this regard, the central bank still retains a bias to ease policy further, if required. This includes its guidance that rates will remain at their "present or lower levels" until inflation converges to its 2% price stability objective, and will continue purchases under PEPP until at least the end of June 2021 or until the ECB judges the "coronavirus crisis phase is over".

In terms of market expectations, futures contracts are looking for the ECB to lower the deposit rate by close to 10bps. Meanwhile, the first 10bps hike in the deposit rate is not envisaged to happen till 2024. Looking further ahead, the contracts suggest the market anticipates that rates could be still at –0.2% by 2026.

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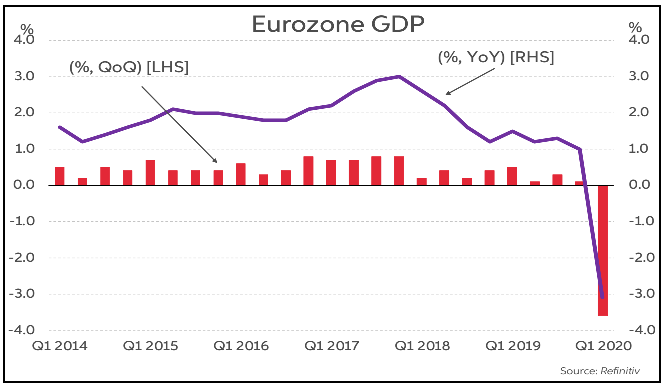
Growth rebounding after historic contraction

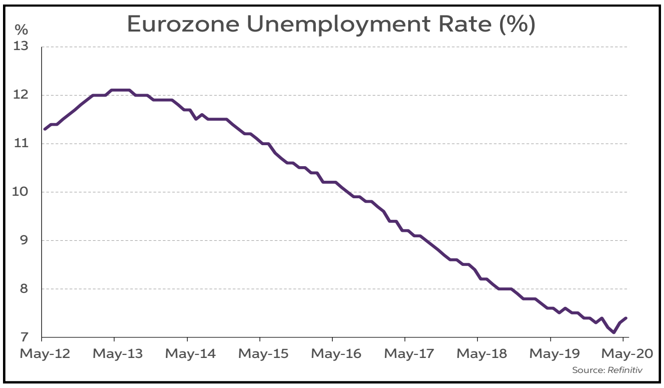
Covid-19 lockdowns saw Eurozone GDP drop by 3.6% in the opening quarter of the year. Southern Europe fared worse than the North, reflecting the severity of the Covid outbreaks in Spain, France and Italy which resulted in the imposition of more stringent restrictions than in Germany. **In relation to the Eurozone level breakdown, domestic demand collapsed as restrictions were introduced.** Consumption plunged by 4.7% and gross capital formation sank by 4.3%. Government spending dipped by 0.4%, with most fiscal stimulus measures not being introduced until Q2. Meanwhile, net trade acted as a slight drag as exports fell by 4.2%, while imports declined by 3.6%.



Worse, however, is to come in Q2 as the near total imposition of lockdowns throughout April saw activity grind to a virtual halt. The PMIs fell to historic lows in the month, with the services sector bearing the brunt of the damage. The hard data releases were also abysmal. Industrial production plunged by 17% in the month after a 12% fall in March, while retail sales were 21% on end-February levels by April.

The easing of lockdowns since the beginning of May has allowed an economic recovery get underway, though activity remains well below normal levels. Retail sales rebounded by 17.8% in May, while industrial production rose by 12.4% in the same month. In terms of timelier indicators, the PMIs have continued to trend upwards. The composite index was put at 48.5 in June, still below the 50 level that separates growth from contraction, but this may be due to respondents comparing activity to pre-Covid norms. The manufacturing and service sector indices have moved higher across the Eurozone.

Developments on the labour market front have been relatively benign given the scale of the crisis. The jobless rate edged up in May, but only to 7.4% from 7.3%. This partially reflects technicalities surrounding the measurement of unemployment, but also the relative success of furloughing schemes in preventing mass lay-offs. However, as government supports are removed we would expect lay-offs to rise as the pandemic prompts permanent business closures.



In relation to inflationary developments, the headline rate of HICP edged up to 0.3% in June from 0.1%. This reflected the impact from the recent rebound in oil prices. Meanwhile, the negative demand shock is weighing on the core measure, which edged down to 1.1% from 1.2%. Looking ahead, VAT cuts, most notably in Germany, will act as significant headwinds to inflation for the remainder of the year.

Notwithstanding the recent signs of economic recovery, the near-term outlook for the Eurozone is downbeat. The Covid outbreak will depress activity for some time. The high degree of uncertainty and falling incomes will weigh heavily on consumer spending. Threatened supply chains and reduced demand pose significant threats to firms and provide a very challenging backdrop for investment. The outbreak will also delay indefinitely the expected recovery in global trade, another headwind for the export orientated economy. There remains the risk of a second, smaller outbreak of the virus at some stage. Meanwhile, social distancing measures will remain a feature until a vaccine is available. The high degree of exposure of the Southern European economies to more 'at-risk' sectors such as tourism is also a concern.

However, there are also some grounds for optimism. Sizeable fiscal stimulus measures have been announced across the bloc. This includes the European Commission's proposed €750bn EU Recovery Fund, though it has not yet been agreed upon. The substantial QE and TLTRO programmes undertaken by the ECB have been crucial in allowing governments announce blowout budget deficits this year without a dramatic spike in bond yields. Its decisive action has reduced the possibility of another debt crisis. **Overall, the economic outlook is very uncertain, which is reflected in the latest GDP forecasts from the ECB.** The central bank is projecting a fall in output this year of 8.7%, to be followed by a partial recovery in 2021 with growth put at 5.2%. These are in line with European Commission's forecasts, which look for a decline in output of 8.7% in 2020 and growth of 6.1% in 2021.