ECB Watch

AIB Treasury Economic Research Unit

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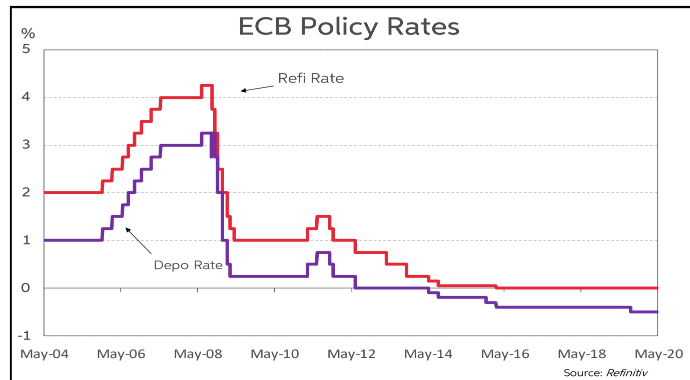
4th June 2020

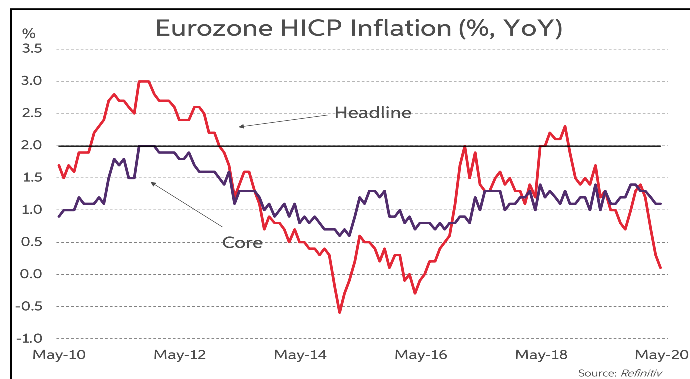
ECB eases policy further as QE programme is increased

The ECB today announced a further of easing of policy to help support the Eurozone economy amid the deep recession caused by the coronavirus pandemic. It is to **expand the size of its main QE bond purchase vehicle, the Pandemic Emergency Purchase Programme, or PEPP, from €750bn to €1,350bn.** An increase had been flagged by a number of ECB policymakers recently, while the current €750bn envelope would have been exhausted by October at the present rate of weekly purchases. **The €600bn increase, though, exceeded market expectations.**



The ECB also announced that it would **continue with net purchases under the programme until at least June 2021.** In its previous guidance, the ECB had indicated that net purchases would run up to the end of this year at least.

As expected, **the ECB left its key interest rates unchanged,** with the deposit rate maintained at -0.5%. The ECB will have been encouraged by the fall in money market rates recently. Easing liquidity pressures have seen market rates move back down more into line with the deposit rate, possibly helped by the ECB lowering the refi rates on the TLTROs at its last two policy meetings. Further interest rates changes were not expected at today's meeting.



The additional easing measures announced today will be seen as being justified by the further downward revisions to the ECB's macroeconomic forecasts. **The ECB's new central forecast is for an unprecedented contraction of 8.7% in Eurozone GDP in 2020.** The ECB had previously guided at its end April meeting that its central scenario was for a fall of 8% in GDP this year. **The ECB staff forecasts see GDP growth rebounding by 5.2% next year and rising by 3.3% in 2022.**

Thus, it is going to take the Eurozone economy some time to recover the fall in output that occurs in H1 2020. The ECB warned that **the balance of risk to the forecasts is to the downside,** indicating that GDP could fall by 12.6% in 2020 in a more severe scenario where tough coronavirus containment measures have to remain in place for a longer period of time.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2019	2020	2021	2022
HICP	1.2	0.3	0.8	1.3
Real GDP	1.2	-8.7	5.2	3.3

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $36.0 in 2020, $37.2 in 2021 and $40.7 in 2022

Source: ECB June 2020

Not surprisingly, the deep recession, combined with the collapse in oil prices this year, is already putting **severe downward pressure on inflation.** The HICP rate fell to 0.1% in May, 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, markets expect the ECB to maintain an ultra loose monetary policy. **Futures contracts look for the first 10bps hike in the deposit rate at end 2023, with further 10bps increases priced in for end 2024 and end 2025. This would still leave the deposit rate at –0.2% by Dec 2025.** The bigger than expected increase announced in the PEPP triggered strong gains by peripheral bond markets, as well as resulting in a firming of the euro, with the EUR-USD rate climbing above $1.1250.

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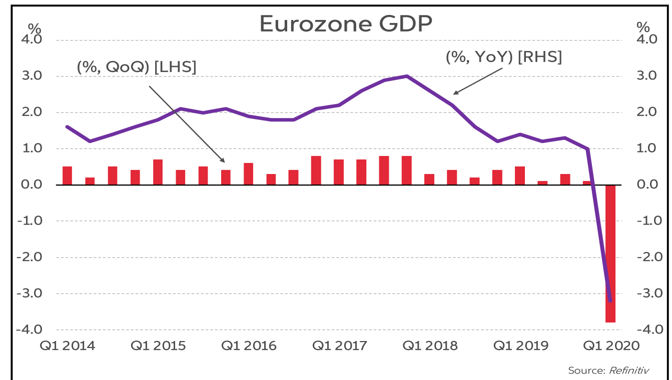
Eurozone hit by deep recession from Covid impact

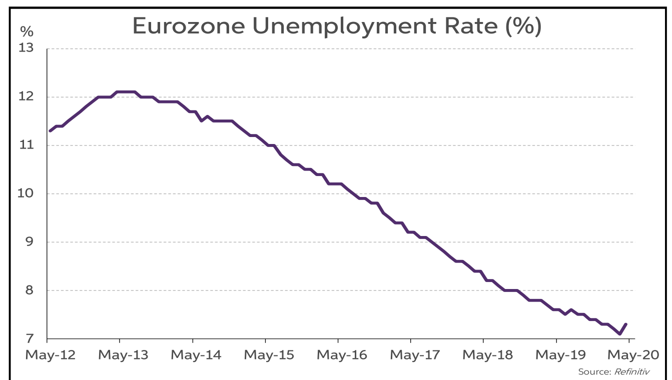


Eurozone GDP dropped by 3.8% in the opening quarter of the year, which left the year-on-year growth rate at -3.3%. This represented the economy's worst quarterly performance on record, reflecting the uniquely severe impact from Covid-19 lockdowns. France, Italy and Spain, the countries that bore the initial brunt of the virus, experienced the most acute contractions, with output dipping by 5.3%, 5.3% and 5.2%, respectively. In contrast, German GDP dipped by a less sharp 2.2%.

Predictably, the available April data have been abysmal across the board. The composite PMI dropped to a record low of just 13.6 in the month as the widespread imposition of lockdowns across the region prompted activity to grind to a virtual halt. With regard to the underlying breakdown, the services index plunged to 12.0, while the output component of the manufacturing PMI was registered at just 18.1. In terms of the hard data, the closure of shopping outlets saw retail sales volumes collapse by 11% in April, leaving them down 19.6% yoy.

Survey data for May, however, suggest that the worst of the downturn may be behind us, even if activity remains at a very subdued level. The gradual easing of lockdown restrictions across Europe was reflected in the composite PMI rising to 30.5. Granted this is still a level associated with contraction, but it may have been the case that survey respondents had in mind where output was relative to pre-Covid-19 levels. The improvement was driven by increases in both the manufacturing and services indices. On a national level, the German Ifo and French INSEE measures of business confidence also all moved off their lows in the month.

Developments on the labour market front have been relatively benign given the scale of the crisis. The jobless rate edged up in April, but only to 7.3% from 7.1%. This partially reflects technicalities surrounding the measurement of unemployment, but also the relative success of furloughing schemes in preventing mass lay-offs. At the beginning of May, circa 1 in 4 Eurozone workers were enrolled in such schemes. It is unclear, however, how employment will fare when governmental supports are removed. Lay-offs are likely to rise as the Covid recession prompts permanent business closures. The EC estimates the unemployment rate may average 9.6% this year.



The sudden and sharp decline in domestic demand due to the outbreak, as well as the collapse in oil prices, has prompted downward pressure on prices. Headline HICP fell to 0.1% in May from 0.3% in April and 0.7% in March. At the same time, the core measure held at 1.1%. It is worth noting that the data may be somewhat unreliable, given the difficulty in collecting returns.

The near-term outlook for the Eurozone is downbeat. The Covid outbreak will depress activity for some time. The uncertain environment and falling incomes will weigh heavily on consumer spending. Threatened supply chains and reduced demand pose significant threats to firms and provide a challenging backdrop for investment. The outbreak will also delay indefinitely the expected recovery in global trade, another headwind for the export orientated economy. **However, there are some grounds for optimism, with most Eurozone economies now beginning to re-open.** The sizeable fiscal stimulus measures announced across the bloc, including the European Commission's proposed €750bn EU Recovery Fund, and the substantial action taken by the ECB will aid the nascent recovery. The EC's proposal, which allows for €500bn of fiscal transfers, as well as the ECB's efforts to stop periphery bond spreads from widening, has also reduced the possibility of another debt crisis.

In the staff forecasts released today, the ECB expects that GDP will fall by 8.7% this year, even with a pick-up in activity in the final two quarters of 2020. The central bank, though, forecasts strong GDP growth of 5.2% next year, assuming there is no second wave to the virus. The IMF is forecasting a GDP contraction of 7.5% this year and a recovery in 2021 with growth put at 4.7%. The EC projection is a GDP fall of 7.7% in 2020 and a rebound of 6.3% next year. The major risk to the rebound hopes is a second wave to the virus later this year or in 2021.

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