ECB Watch

AIB Treasury Economic Research Unit

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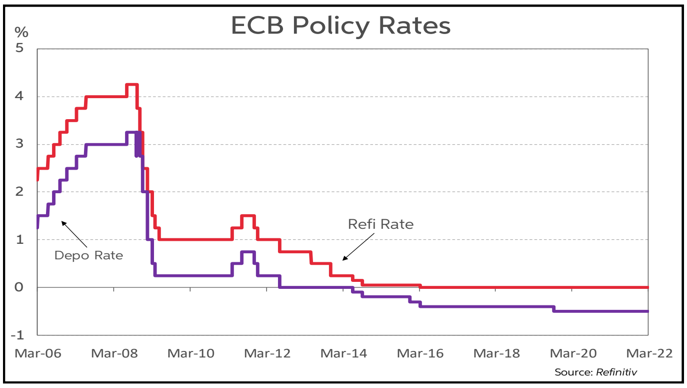
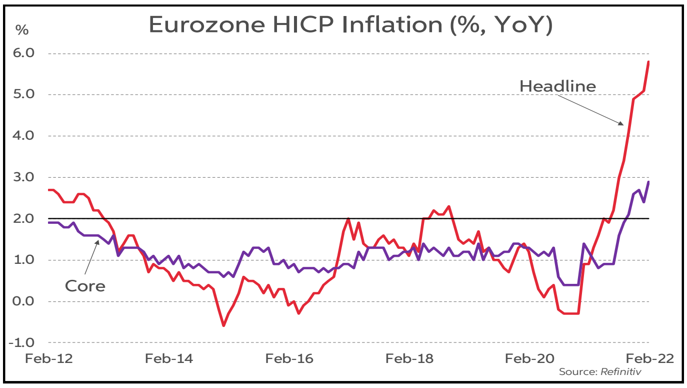
ECB surprises, by announcing quicker end to QE

The March meeting of the ECB's Governing Council saw the central bank surprise markets by announcing a quicker end to its asset purchases than previously envisaged. It now plans to conclude net asset purchases in the "course of Q3". In the lead up to this, the revised bond buying schedule under its Asset Purchase Programme will now amount to €40bn in April, €30bn in May and €20bn in June. This compares to its previously planned schedule of €40bn during Q2, €30bn in Q3 and €20bn from October onwards for as long as necessary. Meanwhile, as expected, the ECB kept its key interest rates unchanged, although it did remove its guidance that rates could go lower.



Today also saw the ECB release its latest macro staff forecasts. Against the backdrop of increased risks to the economic outlook arising from the war in Ukraine, the ECB revised lower its near term growth expectations. It lowered its GDP growth forecast to 3.7% (from 4.2%). Further out, it is now anticipating growth of 2.8% (from 2.9%) and 1.6% (from 1.8%) in 2023 and 2024, respectively. Overall, these changes are quite modest given the heightened uncertainty. The ECB did provide details on alternative scenarios. In its adverse scenario (stricter sanctions on Russia, supply chain disruptions, cuts in Russian gas supplies) GDP growth would be expected to slow to 2.5% this year. Under a more severe scenario (includes features of adverse as well as even higher energy cost, larger second round effects from this, and stronger re-pricing in financial markets), the ECB envisages GDP growth of 2.3% in 2022.



Meanwhile, the Governing Council acknowledged that inflation has continued to surprise to the upside due to "unexpectedly high energy costs". It also noted that inflation pressures have become more broad-based. Against this backdrop, the ECB revised significantly higher its inflation forecast for this year. It is now pencilling in headline inflation to average 5.1% in 2022, compared to 3.2% in its December edition. For 2023, inflation is now projected at 2.1% (from 1.8%) and 1.9% (was 1.8%) in 2024. The ECB noted that across all its scenarios (baseline, adverse, severe) inflation is expected to settle close to its 2% target by 2024. The central bank also emphasised that it sees it as "increasingly likely that inflation will stabilise" at its target over the medium term.

In the press conference, President Lagarde faced a raft of questions on what the acceleration in QE tapering meant for the timing of rate hikes. Most of these questions were centred on what interpretation should be taken from the ECB guidance that any changes to its interest rates will take place "some time after" the end of net asset purchases. However, President Lagarde would not be drawn on specifics in relation to this.

Overall though, it seems reasonable to assume the ECB will start to raise rates before the end of the year. Prior to the escalation of the conflict in Ukraine, the market was anticipating around 50bps of tightening by end year. This was paired back to circa 20bps in the last fortnight. However, following today's QE announcement, futures contracts are now pricing in around 40bps of rate hikes in 2022. Elsewhere on markets, the euro made gains in the initial aftermath of the ECB's QE announcement. The EUR/USD pair briefly moved up to the $1.11 level before trading back down to nearer the $1.10 mark.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2021	2022	2023	2024
HICP	2.6	5.1	2.1	1.9
Real GDP	5.4	3.7	2.8	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $92.6 in 2022, $82.3 in 2023 and $77.2 in 2024.

Source: ECB March 2022

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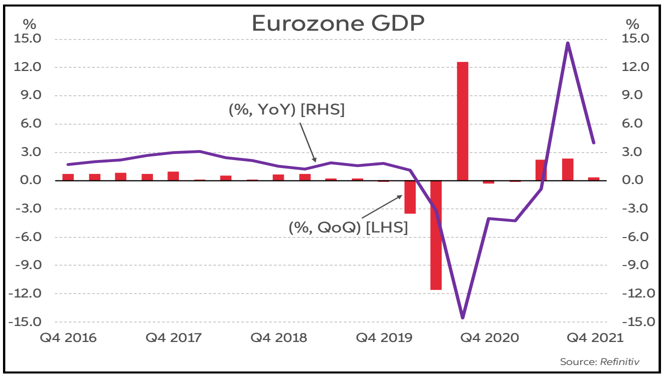
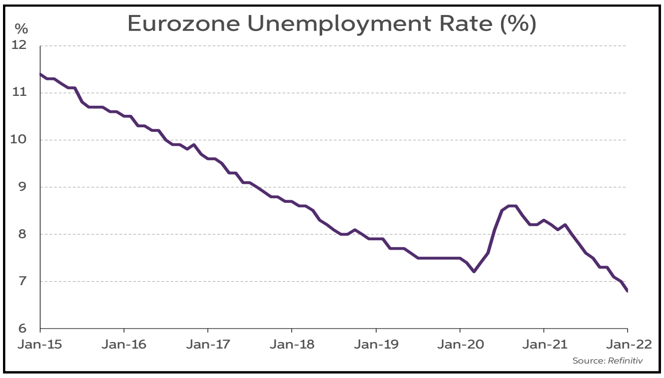
Strong recovery in 2021, but inflation concerns rise

Growth in the Eurozone decelerated markedly in the fourth quarter of the year. Preliminary data shows GDP grew by just 0.3% in the three months to December, as the bloc grappled with the Delta and Omicron waves of Covid-19. Overall though, the Eurozone economy staged a robust rebound in 2021, expanding by 5.3%. As a result, Eurozone GDP was 0.2% above its pre-pandemic level in Q4. However, among the large Eurozone economies, there were substantial differences in performance. Although French GDP was 0.9% above its pre-pandemic level in Q4, it was 0.7% and 1.4% below this level in Italy and Germany. Spain lagged even further behind, with the economy still 4% below its pre-Covid level.



Regarding the underlying breakdown, growth in Q4 was driven by an increase in investment. Gross fixed capital formation rose by 3.5% in the quarter, contributing 0.7 percentage points (p.p.) to the total. Government spending added a further 0.1 p.p. to GDP. Unsurprisingly, given the re-imposition of some Covid restrictions, household consumption declined, clipping 0.3 p.p. from output. Net trade subtracted 0.6 p.p. from growth, as imports rose by more than exports. However, this was offset by a rise in inventories which boosted GDP by 0.3 p.p..

Survey data suggest the economy regained some momentum during the first quarter. Having declined in December (53.1) and January (51.1), the services PMI rebounded once more in February (55.5). Meanwhile, the manufacturing PMI remained firmly in expansion mode throughout the opening months of 2022 printing at 58.7 and 58.2 respectively, in January and February. Similarly, the EC sentiment indices improved in February also, as most Covid-19 related restrictions were removed. However, consumer confidence deteriorated for the fifth month in-a-row, falling slightly to –8.8 in February as rising inflation continued to weigh on sentiment. It should be noted though, that the data were all collected before the full scale Russian invasion of Ukraine got underway. In terms of the limited hard data available, retail sales rose by just 0.2% in January, suggesting consumption remained somewhat muted at the start of the year.



Meanwhile, the labour market has performed very strongly since last summer. Indeed, the unemployment rate edged down to a new record low of 6.8% in January, from a “Covid peak” of 8.7% in mid-2020. Perhaps even more impressively, employment moved above its pre-pandemic level in Q4 2020. This is in contrast to both the US and UK, were employment has been slower to recover.

Turning to inflation, headline HICP rose to 5.8% in February, from an already record level of 5.1% in January. Energy prices, the main contributor to inflation, were a record 31.7% higher year-on-year also. Worryingly though, February’s increase was broad based, with prices rising in all of the major categories. The ex-food & energy reading jumped to 2.9% from 2.4%. Meanwhile, since then energy prices have risen sharply higher once again, as the conflict in Ukraine has placed even more upward pressure on a large swathe of commodities. At the press conference today, President Lagarde noted that the upside risks to inflation have increased. The latest forecasts from the ECB show headline inflation averaging 5.1% in 2022, before falling back to 2.1%, in 2023 and 1.9% in 2024.

The Eurozone economy is now facing a challenging period despite a good start early in 2022. Inflation has continued to increase by more than anticipated, in part, due to the conflict in Ukraine. The war in Ukraine will weigh on economic activity both directly and indirectly, by reducing trade flows between the Euro-area and Russia, and by reducing real incomes through higher inflation. This will likely weigh on consumption. Increased uncertainty may dampen investment in the near-term also.

Yet, there are grounds for optimism. The economy performed better than expected in 2021. The labour market is also on a much firmer footing. Looking ahead, household spending could be a key driver of growth if the large build -up of savings in 2020-21 are run down somewhat. The latest ECB staff projections have been revised lower. They show that the ECB expects GDP to grow by 3.7% this year, before falling back to 2.8% in 2023 and 1.6% in 2024 respectively, which would still be solid growth given the circumstances.

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