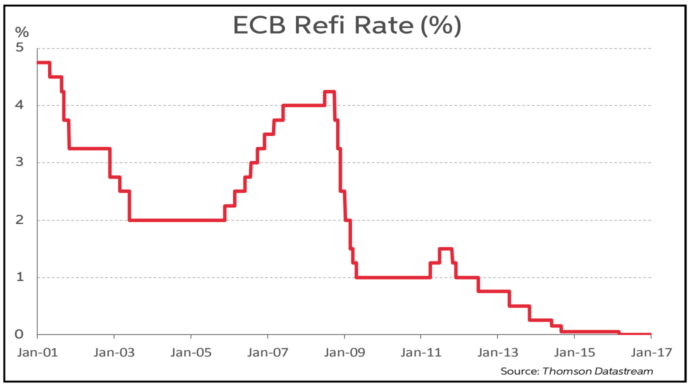
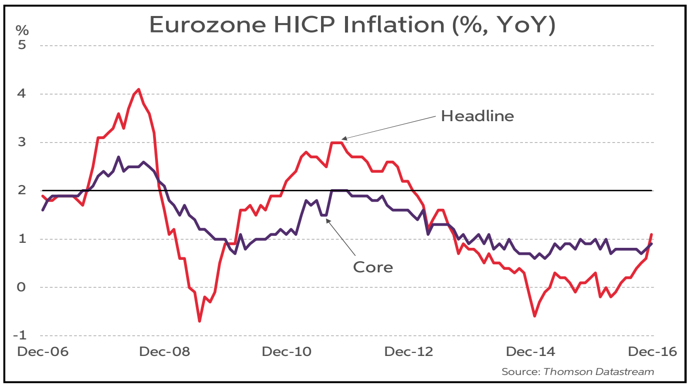
ECB content with current policy initiatives

The January meeting of the ECB's Governing Council was, as expected, a non-event. The ECB kept its key interest rates unchanged at -0.4% for the deposit rate and 0% for the refi rate, which was in line with market forecasts. There was also no change to its plans for its QE programme. It had announced at its previous meeting in December that it was **reducing its rate of purchases from €80bn per month back to its original rate of €60bn per month, starting in April and extending the programme until "end December 2017, or beyond, if necessary".**



In terms of the economic outlook, the ECB continues to expect that economic growth in the Eurozone will "firm further". The most recent ECB staff projections, which were released at its December meeting, showed a GDP growth forecast of 1.7% for this year and 1.6% in 2018 and 2019. **However, the Governing Council is still of the view that the "risks surrounding the euro area growth outlook remain tilted to the downside".** It stated that these risks "relate predominantly to global factors".

Meanwhile, on the inflation front, the ECB commented in today's meeting statement that while headline inflation has increased lately, this is "largely owing to base effects in energy prices", **while underlying inflationary pressures "remain subdued".** The Governing Council envisages a further increase in the headline measure in the "near term" mainly due to base effects from energy prices. However, **underlying inflation is expected to "rise more gradually over the medium term".** It's current projections show that the ECB expects inflation to pick up this year to 1.3% from 0.2%. It expects the uptrend in inflation to continue and it is pencilling in a rate of 1.5% and 1.7% for 2018 and 2019, respectively.



In the post-meeting press conference, ECB President Mario Draghi was asked a number of questions on the issue of Brexit and the incoming US President Donald Trump in relation to what impact these events could have on the outlook for growth and inflation for the Eurozone. He said it was still "too early to comment", especially in relation to Donald Trump. However, he did state that in relation to Brexit, the economic consequences for the currency bloc would on depend on the "shape of the outcome".

There were also numerous questions in the press conference on inflation, given its recent upward trajectory. President Draghi stated that from the ECB's point of view the rise in inflation towards 2% has to be durable and represent the Eurozone average, rather than one particular country. **Indeed, the meeting statement said that the ECB will continue to "look through changes in HICP inflation, if judged to be transient".** President Draghi also repeated that the reduction in QE purchases due to start in April was not tapering and no discussion on tapering had taken place at this month's meeting.

Overall, the ECB retains a bias to ease policy further if required. The meeting statement emphasised that it "stands ready to increase our asset purchase programme in terms of size and/or duration" if the outlook becomes "less favourable". It is likely, though, that the ECB will stand pat in 2017, content with its current policy stance and initiatives in the context of a pick-up in inflation and economic activity.

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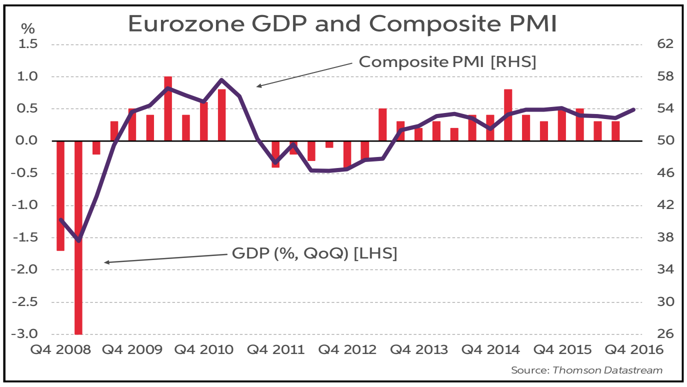
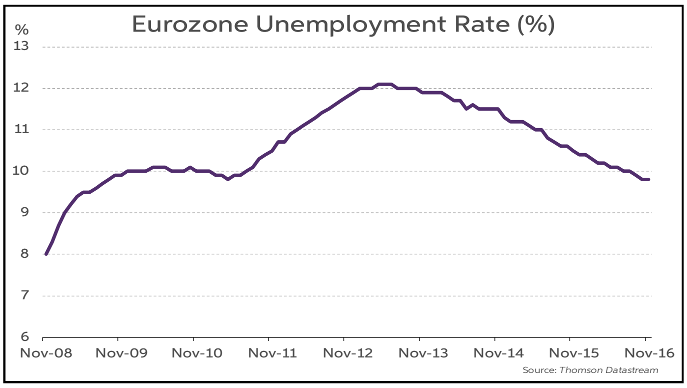
Eurozone growth picks up pace



The Eurozone economy grew by a modest 0.3% in Q3, matching its performance in Q2. Year-on-year growth remained at 1.7% for a third consecutive quarter. The underlying data show that consumer spending was the main contributor to GDP in Q3, adding 0.2 percentage points (p.p.), while inventories and government spending added 0.1 p.p. each. Investment was flat, with net exports acting as a drag, deducting 0.1 p.p. from growth.

In terms of the performance of the economy in Q4, survey data suggest that growth may have picked up. The key Eurozone composite PMI averaged 53.9 in the fourth quarter, which on past form is consistent with a 0.5% rate of quarterly GDP growth. The EC index of Eurozone economic sentiment averaged 106.9 in Q4, compared to 104.3 in Q3. National level indicators such as the German Ifo, French INSEE and Italian ISTAT indices also point to a faster pace of growth in the quarter.

This view is also supported by 'hard' data released so far for Q4. Eurozone industrial production rose by 1% in October/November versus Q3, which saw a 0.5% increase. Underlying data show broad based improvement in output. Meanwhile, retail sales grew by 0.9% in Oct/Nov compared to Q3, in which they rose by 0.3%. The EC measure of Eurozone consumer confidence rose to a 20-month high in December, suggesting spending retained its healthier tone. However, trade data for Oct/Nov suggest net exports could remain a drag on GDP.



In terms of the labour market, the unemployment rate has continued to decline in recent months. It came in at 9.8% in November, an over 8-year low. Furthermore, the 'dichotomy' with regard to the unemployment rates in the major European countries (e.g. Germany 4.1%, Spain 19.2%) is generally narrowing.

Employment has grown at a healthy pace in recent quarters. Year-on-year growth did slow slightly in Q3 2016, though, to 1.2% from the 1.4% rate recorded in H1. **The employment component of the Eurozone composite PMI averaged 52.6 in Q4, its best performance since Q2 2011**. This indicates that employment is continuing to grow at a solid pace.

The Eurozone economy continues to face some challenges, including high levels of unemployment in many countries, a lack of structural reforms in some economies, weak levels of business investment and only modest wage growth. The early signs are that the impact from the Brexit vote on the Eurozone economy has been insignificant, but the uncertainty posed means that downside risks remain. Meanwhile, Eurozone political concerns have increased with anti-establishment and euro-sceptic parties expected to do well in elections in France, Germany and the Netherlands in 2017. An election in Italy is also a possibility, given the destabilising impact on the Government there of the recent referendum defeat.

However, there are also tailwinds for the economy, including relatively low inflation, the relatively weak euro and the impact of monetary policy easing, with interest rates likely to remain at very accommodative levels for the next few years. A modest improvement in global growth should also help to provide some support to the economy. Fiscal policy has also become more expansionary in many countries. The ECB is forecasting GDP growth of 1.7% for this year and 1.6% in 2018. This week's updated IMF forecasts show that it is anticipating growth of 1.6% for both years.

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