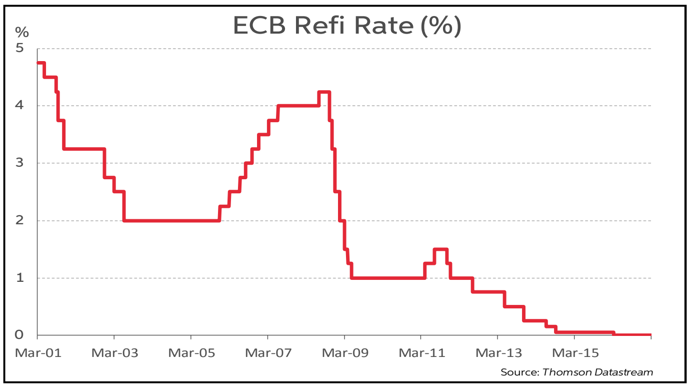
ECB Watch

AIB Treasury Economic Research Unit

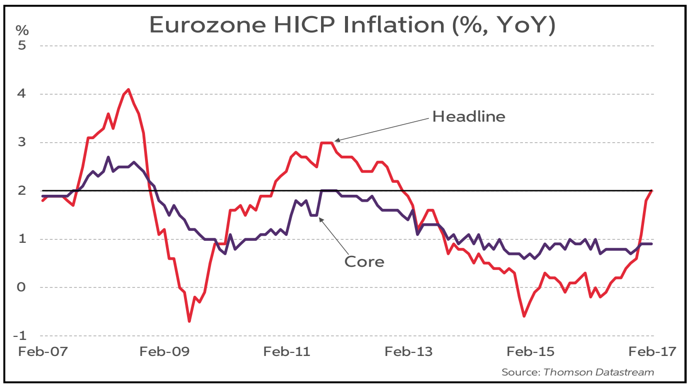
9th March 2017

ECB more optimistic on the economic outlook

Today's meeting of the Governing Council concluded with the "key ECB interest rates unchanged" at –0.4% for the deposit rate and 0% for the refi rate. This outcome was in line with market expectations. **There was also no change to the plans for its asset purchase programme**. The ECB had previously announced at its December meeting that it was reducing its rate of purchases from €80bn per month back to the original rate of €60bn per month, starting in April and extending the programme until end December 2017, or beyond, if necessary.



The tone and wording of the meeting statement indicate that the ECB is becoming more optimistic on the economic outlook. The statement noted that there has been a "steadily firming recovery" in the economy and it acknowledged that "sentiment indicators suggest that the cyclical recovery may be gaining momentum". It also said that incoming macro data increases the ECB's "confidence that the on-going economic expansion will continue to firm and broaden". Indeed, both the meeting statement and President Draghi, in his press conference, said that the "**risks surrounding the euro area growth outlook have become less pronounced"**, although they "remain tilted to the downside".



This more upbeat assessment of the economic outlook is reflected in upward revisions, albeit modest, to the latest staff macro projections. The ECB now expects GDP to grow by 1.8% this year (from 1.7%). Its 2018 forecast was marginally upgraded to 1.7% (1.6%), while its 2019 projection of 1.6% was left unchanged.

There were also upward revisions to the inflation outlook. In the words of the ECB, the 2017 forecast was "revised significantly higher" to 1.7% (from 1.3%), while the change to the 2018 figure was more modest, going from 1.5% to 1.6%. **However, despite these changes, the ECB was keen to emphasise that measures of underlying inflation "have remained low and are expected to rise only gradually over the medium term".**

ECB Macroeconomic Forecasts for the Euro Area

(%)	2016	2017	2018	2019
HICP	0.2	1.7	1.6	1.7
Real GDP	1.7	1.8	1.6	1.7

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $56.4 in 2017 , $56.5 in 2018 and $55.9 in 2019. Source: ECB March 2017

Overall, the March ECB meeting statement and press conference indicate that while it retains an easing bias, the strength of this bias has reduced. President Draghi highlighted the removal of the sentence on forward guidance in relation to "using all instruments available within its mandate" as a **"signal that there is no longer that sense of urgency in taking further actions".** However, at the same time, the ECB is still concerned that "underlying inflation pressures" remain "subdued" and that a "very substantial degree of monetary accommodation is still needed for a sustained upward adjustment in the inflation rate. In this regard, President Draghi stressed that wage growth, which remains muted, is a key "linchpin" of a self sustained inflation rate. In response to a question on the ending of QE, President Draghi stated that no discussion had taken place on exiting its asset purchase programme. **Market reaction to today's meeting has seen the euro and bond yields move slightly higher.**

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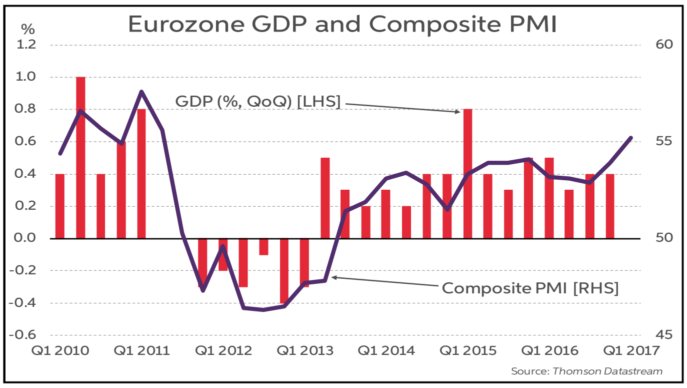
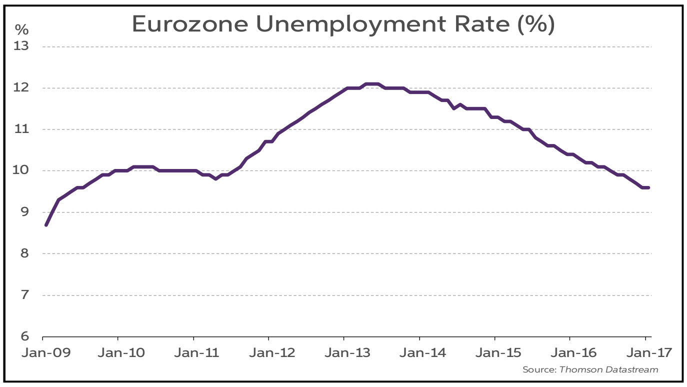
Eurozone growing at an encouraging pace



The Eurozone economy grew by an encouraging 0.4% in Q4, matching its performance in Q3. As a result, the economy grew by 1.7% in 2016 as a whole. The underlying data show that consumer spending remained the main contributor to GDP in Q4, adding 0.2 percentage points (p.p.), while inventories, investment and government spending added 0.1 p.p. each. Net exports acted as a drag, deducting 0.1 p.p. from growth.

Leading indicators of activity have suggested that growth has picked up pace in the first two months of 2017. For example, the key Eurozone composite PMI rose further to 56 in February, its strongest level since April 2011. The January/February average level of 55.2 is consistent with quarterly GDP growth of 0.6%. The EC index of Eurozone economic sentiment averaged 108 in Jan/Feb, its best performance since early 2011. National level indicators such as the German Ifo, French INSEE and Italian ISTAT indices have also generally pointed to a faster pace of growth in the quarter.

The limited 'hard' data for Q1 have been mixed. Retail sales edged down by 0.1% in January. Although, this follows on from solid growth of 0.7% in Q4. Meantime, industrial production data from Germany, the Eurozone's largest economy, showed that output there rose by 2.8% in January, more than reversing its 2.4% decline in December. This reflected a strong pick-up in manufacturing (+3.7%).



In terms of the labour market, the unemployment rate has continued to decline in recent months. It came in at 9.6% in January, an 8-year low. Although, the 'dichotomy' with regard to the unemployment rates in the major European countries remains vast. German unemployment declined further to 3.8% in January, while the level in France, Italy and Spain remained at or above 10%.

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%. **The employment component of the Eurozone composite PMI rose to 53.8 in February, its highest level since October 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. Meanwhile, Eurozone political concerns remain high, with anti-establishment and euro-sceptic parties expected to do well in upcoming elections in the Netherlands (March 15), France (April 23) and Germany (September 24). An election in Italy remains a possibility.

However, there are also tailwinds for the economy, including relatively low underlying inflation, the generally 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 1.8% for this year and 1.7% in 2018. The recent forecasts from the European Commission are for growth of 1.6% this year and 1.8% in 2018. Overall then, the expectation is that the Eurozone economy will continue to grow at a steady pace in the next couple of years.

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