ECB Watch

AIB Treasury Economic Research Unit

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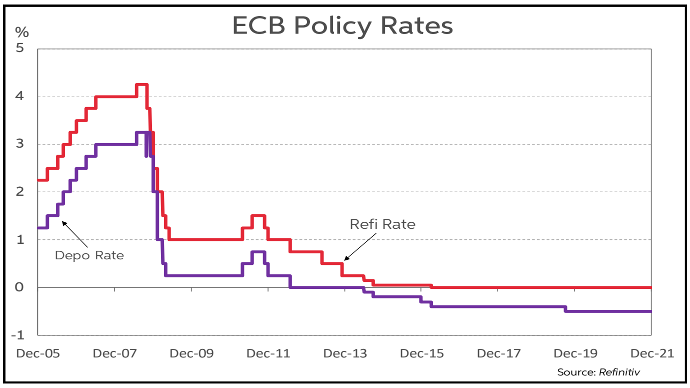
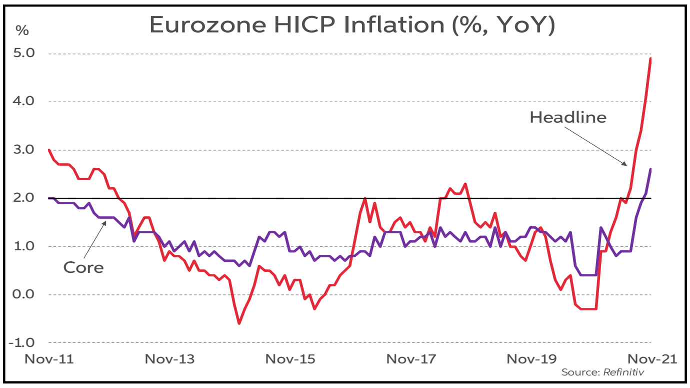
ECB to scale back quite significantly on QE during 2022

The December meeting of the ECB's Governing Council saw the central bank decide, as largely expected, that it would scale back quite significantly the quantity of bond purchases under its QE programme during 2022. The monthly asset purchases under its Pandemic Emergency Purchase Programme (PEPP), which had already been lowered to €60bn, will be reduced further in the next couple of months and the programme will conclude in March as planned. However, as expected this will be offset to some extent by an increase in bond buying activity under the ECB's other QE vehicle, the Asset Purchase Programme (APP). **The size of monthly purchases under the APP is to increase from €20bn presently, to €40bn during Q2, and €30bn in Q3, falling back to €20bn from October onwards.**



There was a large majority on the Governing Council in favour of the decision, but not unanimity. Meanwhile, the ECB re-affirmed that **the conditions which needed to be met to warrant rate hikes were very unlikely to be in place next year,** indicating the key deposit rate can be expected to be kept on hold at –0.5% in 2022. Overall, then, **the ECB intends to maintain a loose monetary stance next year, though the size of its QE programme will be significantly lower.**

There was some surprise in markets at the extent to which the ECB intends to scale back QE purchases. The view was that APP purchases would be lifted to €40bn per month for the whole of the April-December period. **As a result, bond yields rose modestly in response to the policy announcement,** especially in Southern European markets, where ten year yields increased by circa 5bps. The euro was also slightly stronger. The ECB, though, highlighted that net purchases under the PEPP could be resumed, if necessary, to counter negative shocks related to the pandemic.



The scaling back of QE purchases should be viewed in the context of the ECB's economic outlook, as reflected in its updated macro projections which were released today. While it lowered its GDP growth forecast for 2022 to 4.2% from 4.6% previously, it upped the 2023 forecast appreciably to 2.9% from 2.1%. Furthermore, it still assesses the risks to the economic outlook for the Eurozone as being broadly balanced.

More importantly, the ECB, revised up its near-term inflation forecasts quite sharply. It is now projecting that headline inflation will average 2.6% (up from 2.2%) this year, and is forecasting a rate of 3.2% (from 1.7%) in 2022 and 1.8% (from 1.5%) in 2023. Core inflation is now forecast at 1.4% in 2021, 1.9% in 2022 and 1.7% in 2023, which also represent upward revisions compared to September. Crucially though, while inflation will prove considerably stronger than anticipated both this year and next, **the ECB emphasised that this is largely due to much higher than expected energy prices.** Furthermore, the ECB still expects the annual rate will start to fall back during next year, while the inflation rate is still envisaged to be below its 2% target in both 2023 and 2024, at 1.8%. Finally, the ECB still expects the special conditions applicable under TLTRO 3, in particular a refi rate of –1%, will end next June, while it is also going to reassess the calibration of banks two-tier system for reserve remuneration.

ECB Macroeconomic Forecasts for the Euro Area

(%)	2021	2022	2023	2024
HICP	2.6	3.2	1.8	1.8
Real GDP	5.1	4.2	2.9	1.6

Forecasts are mid-point of a range and based on assumption that Brent crude oil prices will average $77.5 in 2022, $72.3 in 2023 and $69.4 in 2024.

Source: ECB December 2021

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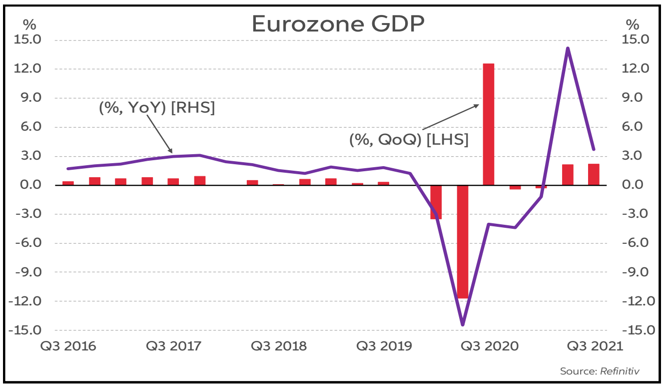
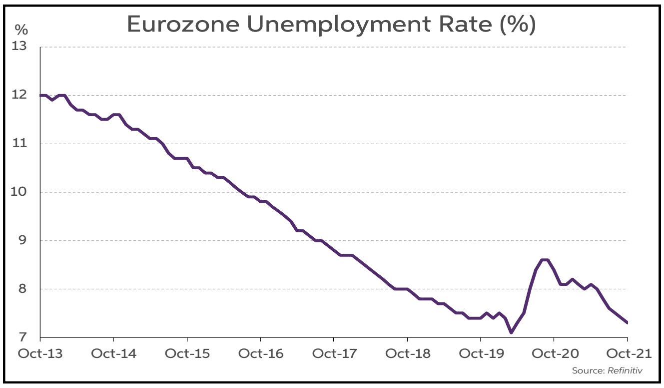
Growth slowing, but expected to pick up pace again



The economic recovery in the Eurozone remained firmly intact in Q3. GDP rose by 2.2% in the three-months to September, growing at the same rate in Q2. The rebound continued to be led by consumer spending, as restrictions were eased further across the bloc. Household expenditure grew by 4.1%, boosting output by 2.1 percentage points (p.p.). Government expenditure contributed 0.1 p.p. to growth, although, fixed capital formation clipped 0.2 p.p. from GDP. Exports (+1.2%) outpaced imports (+0.7%), adding 0.3 p.p to the total. This was offset though, by a rundown in inventories which knocked 0.1 p.p. from GDP. Overall, the strong rebound saw Eurozone GDP rise to within 0.5% of its pre-pandemic level in the third quarter.

Survey data suggest the Eurozone economy has continued to grow, albeit at a slower pace, in the fourth quarter. The manufacturing PMI, which has printed in expansion mode for the past 16 months, inched lower throughout Q4. The index averaged 60.9 in Q3, but this has declined slightly to 58.2 in Q4 as supply chains remain under intense pressure. Similarly, the services PMI has averaged 54.6 in Q4, down from 58.4 in Q3, with the index printing at its lowest levels since April in December. The emergence of the Omicron variant, on top of already rising case numbers, has led to some restrictions being re-imposed across the EU. This is weighing on services activity as well as expectations of future growth, although firms still expect the economic recovery to continue in 2022.

In terms of hard data, retail sales rose by 0.2% in October, meaning they were 3.9% above their pre-pandemic level. However, the re-imposition of restrictions may reduce the level of sales in the months ahead, albeit not to the same extent as during the early stages of the pandemic. Meanwhile, the latest industrial production data show that output is still circa 0.7% below its pre-Covid level in the Eurozone, with output in Germany (-6.5%) and France (-4.5%) well below its February 2020 peak.



Turning to the labour market, the impact from the pandemic has been limited. The jobless rate continued to trend lower in October, falling to 7.3% down from a 'Covid' peak of 8.7% in mid-2020. It is now just 0.2% above its pre-pandemic level. This reflects the success of labour support schemes in shielding the jobs market (which have in part been funded by the EU SURE programme, to the tune of €90bn) and the strong demand for labour since economies re-opened during the spring/summer.

Meanwhile, headline HICP inflation jumped to 4.9% in November from 4.1% in October. The increase in the headline rate this year has been largely due to a rise in energy prices, which are 27.4% higher year-on-year. However, the ex-food & energy reading has also been rising in recent months, and stood at 2.6% in November, up from 2.1% in October. Rising input prices and supply chain issues could continue to put upward pressure on the core rate in the coming months. The latest forecasts from the ECB released today show headline inflation averaging 2.6% this year and 3.2% in 2022, before falling back to 1.8%, in both 2023 and 2024. Core inflation is seen averaging 1.9% in 2022, 1.7% in 2023 and 1.8% in 2024. Crucially, then, the ECB still believes the sharp rise inflation during 2021 will prove temporary and CPI rates falling back in 2023-24.

The Eurozone economic recovery is now entering a more challenging phase. Growth was slowing even before the Omicron variant emerged. Inflation has also increased by more than anticipated in 2021. However, it should be remembered that the economy has also performed better than expected this year. Household spending can remain a key driver of growth as the large build-up of savings in 2020-21 is run down somewhat. The labour market is also on a much firmer footing than anticipated. Businesses and economies have also become better able to cope with the pandemic and restrictions on activity, with vaccines a major help in countering Covid-19. The ECB is also set to maintain a very accommodative monetary stance in 2022. The latest staff projections show that the ECB expects GDP to grow by 5.1% this year, 4.2% next year, and by 2.9% and 1.6%, respectively, in 2023 and 2024. Thus, after slowing over the winter, the ECB expects to see the economy return to a strong growth path in 2022-23.

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