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07/08/2014

Eurozone

ECB leaves policy unchanged, awaiting impact from prior stimulus

- **ECB leaves policy unchanged, waiting to gauge the impact from June stimulus package**
- **Surveys giving better indication of underlying economic health than official data**
- **Inflation set to return to 2% in medium term**
- **Events in Ukraine could hold key to further stimulus**

As widely expected, the European Central Bank left policy unchanged at its August Governing Council meeting. At the press conference, President Mario Draghi indicated that policymakers saw no immediate need for further stimulus. The recovery was "weak, fragile and uneven", but nevertheless progressing as expected. Inflation expectations were seen to be well anchored and policymakers were waiting to ascertain how stimulus measures announced in June would help boost the economy and lift inflation in the second half of 2014.

Past stimulus yet to take effect

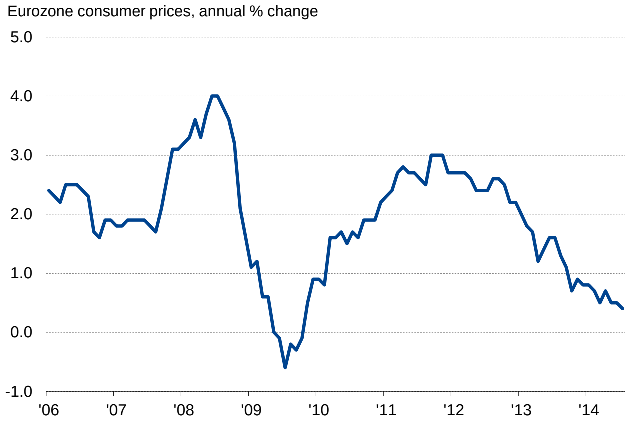
A package of stimulus measures announced by the ECB back in June included a cut to the central bank's main policy interest rate and the introduction of a negative deposit rate, therefore charging commercial banks to hold reserves at the central bank, as well as an incentive programme for banks to lend to households and businesses. The June package held back from buying assets, or quantitative easing, though the Council had agreed at the June meeting "to intensify preparatory work" on the buying of asset backed securities, work which is reported to have been stepped up in recent weeks.

Calls for further stimulus have intensified in recent weeks as euro area Inflation fell in July to its lowest since October 2009, down to just 0.4% and alarmingly lower than the ECB's target of "close to but below 2.0%".

Sluggish but improving recoveries

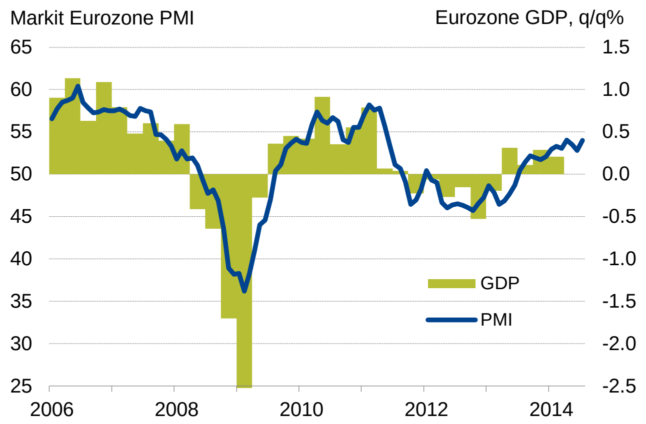
Political pressures to boost the economy are also building, notably from the French, where a renewed

Eurozone inflation



Source: Eurostat via Ecowin.

Eurozone economic growth



Sources: Markit, Eurostat.

economic downturn is intensifying, and in Italy, where recent data showed a slide back into a triple-dip recession in the first half of this year, with GDP down 0.2% in the second quarter. But such political pressures hold little sway with the ECB. The ECB points the finger at national governments and the need to implement more reforms to raise productivity and competitiveness alongside the measures the central bank has already announced. Draghi reiterated that economic growth is strengthening in countries where structural reforms have been successfully implemented (Spain, for example, is enjoying its strongest upturn since 2007, according to the PMI surveys).

The central bank is also of the view that various factors, such as an unusually high number of holidays, may have led official data to understate growth in the second quarter. Recent official data, for example, have shown disappointing industrial production and orders trends in Germany, raising the possibility that GDP may have fallen slightly in the second quarter, but the PMI is running at a level consistent with German GDP growing by 0.7% and eurozone GDP rising at a quarterly rate of 0.4%. It is also reasonable to assume that growth should pick up further as bank lending – the weakness of which is seen by many to have been the crux of the region's disappointing recovery –starts reviving. Recent survey data from the ECB showed that lending conditions in the region improved for the first time since 2007, a trend which should build further when the TLTROs boost lending in the autumn.

Draghi noted that the measures already implemented by the ECB should also help bring inflation back towards 2% in the medium term, with the upside and downside risks to this outlook being "broadly balanced". The main threats centre on geopolitical concerns and the exchange rate.

Ukraine crisis poses key threat to outlook

The case for further stimulus therefore hinges mainly on geopolitics. The ECB has in the past pointed out that full-scale QE will only be likely if there is a major event changes the economic outlook. With the situation in the Ukraine intensifying, the question is whether such a major event may be occurring.

Business surveys have highlighted growing concerns about the potential destabilising impact of the Ukraine crisis. Companies are concerned that, while Russia may only account for a small proportion of Eurozone trade, the impact on economic growth due to heightened risk aversion could be disproportionally large. With Russia today announcing retaliatory sanctions on EU food imports, the situation is clearly worsening. However, at the moment, the economic impact on the eurozone economy appears to be only very limited.

Wait and see

The upshot from the press conference is that the bar to further stimulus remains high, requiring a significant deterioration in the economic outlook as we move through the second half of 2014. Until then, the ECB is in 'wait and see' mode, expecting growth and inflation to rise in the second half of the year as past policy initiatives and reforms take hold.

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