Bank of Ireland

Economic Research Unit

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A tale of two central banks

Overview The ECB Governing Council eased monetary policy at its December 3 meeting in light of 'downside risks' to the economic outlook. It cut the deposit rate by 10bps to -0.3% and extended its asset purchases programme (QE) by six months to March 2017, though it kept the pace of purchases at €60bn a month. The measures announced fell short of what the market thought the ECB would deliver (a larger deposit rate cut and an increased rate of monthly asset purchases), prompting a sizeable enough reaction with the euro strengthening, bond yields rising and stocks falling. Meanwhile, the Fed finally raised interest rates at its December 15/16 meeting, lifting the target range for its key policy rate by a quarter-point to 0.25% to 0.5%. This was what the Fed had pretty much told the market to expect, hence the reaction to the decision was relatively muted. Looking ahead, the Fed says it expects economic conditions to 'evolve in a manner that will warrant only gradual increases' in interest rates, and its projections indicate that a further four quarter-point rate hikes may be appropriate by the end of 2016. While this is a slower pace of increase in rates than seen in previous tightening cycles, it is still more than the two hikes the market is currently pricing in. The latter is likely to prove too sanguine in our view, which suggests that the dollar will strengthen against the euro next year as the Fed raises interest rates by more than the market expects.

ECB eases policy again

UK unemployment falls further

Fed raises interest rates

Diary

	Euro Area	UK	US
Central Bank Meetings	Jan 21	Jan 14	Jan 26/27
GDP	Feb 12	Jan 28	Jan 29
Inflation	Jan 5	Jan 19	Dec 23
Labour Market	Jan 7	Jan 20	Jan 8

Forecasts

Forecasts	End Dec 2015	End Mar 2016	End Jun 2016	End Sep 2016
Exchange Rates				
€/$	1.08	1.06	1.05	1.05
€/£	0.72	0.70	0.69	0.70
£/$	1.50	1.51	1.52	1.50
Swap Rates (5 year)				
Euro Area	0.25	0.35	0.50	0.65
UK	1.50	1.70	2.00	2.20
US	1.70	1.90	2.20	2.40

ECB eases policy again

GDP increased by 0.3% q-o-q in Q3 2015 driven largely by a further increase in consumer spending. Investment was weak again in the quarter, while export growth slowed. The latest PMIs point to another moderate increase in GDP in Q4. Employment rose for an eight consecutive quarter in Q3 and the unemployment rate continues to fall (10.7% in November). Inflation has moved out of negative territory, though at 0.2% it is still subdued. In light of 'downside risks' to the economic outlook, the ECB eased policy at its December 3 meeting. It cut the deposit rate by 10bps to -0.3% and extended QE by 6 months to March 2017, though it kept the pace of asset purchases at €60bn a month. While significant, the measures fell short of what the market expected, prompting a rebound in the euro, a rise in bond yields, and a fall in stocks. The ECB says it will continue to monitor closely the outlook for inflation and will act again if necessary.

UK unemployment falls further

The second GDP estimate confirmed that the economy grew by 0.5% q-o-q in Q3 2015. Consumer spending was the main driver of growth, albeit business investment picked up from Q2. Net exports, in contrast, made a negative contribution to GDP growth. The composite PMI rose in October and November - reflecting strengthening services activity for the most part - and points to a slight pick-up in growth in Q4. The unemployment rate (5.2%) has fallen to its lowest level since May 2008, but earnings growth has slowed recently, which the BoE suggests may be partly due to subdued inflation dampening pay settlements. The BoE has also indicated that the slowing in earnings growth is likely to delay an interest rate increase, though whether it holds off until Q1 2017 as the market currently expects is debateable. Sterling has weakened to over 72p against the euro from a recent high of sub 70p.

Fed raises interest rates

The economy expanded by 0.5% q-o-q in Q3 2015, slightly stronger than initially estimated (0.4%). Consumer spending and business investment increased at a solid pace, but export growth slowed reflecting weaker global demand and the dollar's appreciation. The latest indicator data point to an increase in GDP of around 0.5% again in Q4. Headline PCE inflation has moved up recently but remains subdued at 0.2%, while the unemployment rate continues to edge lower and at 5% is broadly in line with the Fed's estimate of 'full employment'. The continuing improvement in the labour market prompted the Fed to raise interest rates by a quarter-point at its December meeting (the new target range for the federal funds rate is now 0.25%-0.5%), the first increase in rates in more than nine years. Its latest projections point to a further four quarter-point hikes by the end of 2016.

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