Eurozone

The ECB lends its support again

The months pass but nothing seems to change. Growth in the manufacturing sector is struggling to accelerate in a persistently uncertain international environment, while buoyant domestic demand is boosting activity in services. The stronger-than-expected first quarter performance sends a more optimistic message than economic surveys. Faced with a downturn in inflation expectations and the downside risks to the Eurozone's economic scenario, the European Central Bank (ECB) has been proactive again. It is prepared to ease monetary policy further and the new measures have been set up much earlier than expected. Yet faced with stubbornly mild inflation and only limited manoeuvring room, the ECB is bound to take a frugal approach.

Economic growth was stronger than expected in the first part of 2019. In the quarters ahead, activity will continue to be shaped by a precarious balancing act: faltering external demand will continue to strain the manufacturing sector, but without its full impact being carried over to the services sector. Labour market dynamics will play a key role. The ECB says it is prepared to ease monetary policy further.

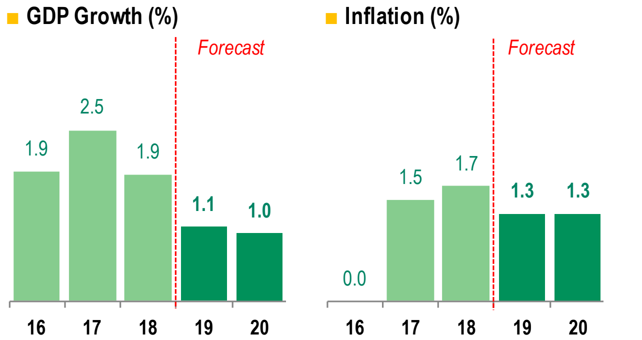
With a strong job market, what could go wrong?

In Q1 2019, eurozone growth was higher than expected at 0.4% q/q, after averaging 0.2% q/q in Q2 2018. Private consumption, the main growth engine in the first quarter, accelerated at a time of falling unemployment and strong wage momentum, while investment is still relatively robust despite the high level of uncertainty. After severely curbing eurozone activity in 2018, foreign trade supported growth in Q1 2019.

The most recent economic publications for the eurozone seem to confirm the dichotomy between growth profiles in the manufacturing and services sectors since the beginning of the year. Manufacturing PMI levelled off somewhat in June (47.8), but has followed a sharp downward trend since year-end 2017 (see chart 2). Services PMI, in contrast, has been resilient, and even rose in June to 53.4, the highest score since end-2018. As we have often pointed out in recent months, these developments illustrate both the rather sluggish external environment and the persistently favourable contribution of domestic support factors. In terms of trade, several factors are squeezing world demand for eurozone exports, including the less buoyant emerging economies, due notably to China's economic slowdown, the slowdown in world trade and high uncertainty due to trade tensions between the United States and some of its key trading partners. This deterioration can be seen in the "new export orders" component of the PMI, which has fallen sharply since the beginning of 2018, to 47 in June.

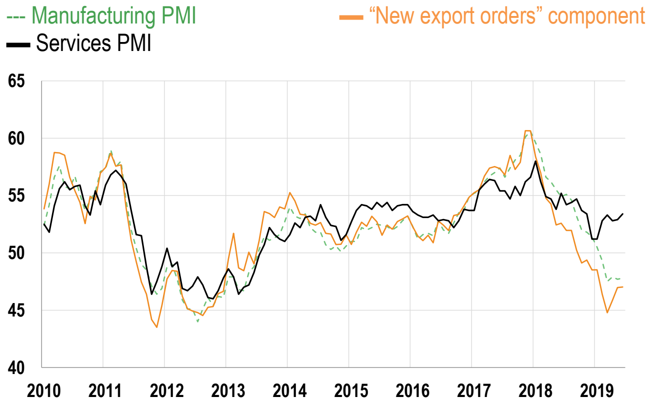
For the moment, the prevailing climate of uncertainty does not seem to have affected aggregate domestic demand, especially investment, which was very resilient in Q1 2019 (+1.1% in q/q) in an extended protracted period of very low interest rates. Household consumption is also very buoyant (+0.5% q/q in Q1 2019). This performance is largely due to the resilient job market, the ongoing decline in the jobless rate (to 7.7% of the active population in Q1 2019) and wage acceleration. Despite the sector's hardships, employment in the manufacturing sector has remained relatively robust. This could signal a labour hoarding effect, since sector players do not expect the slowdown to last very long.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Eurozone PMI



Source: Markit

Looking forward, thanks to a negative gearing effect in H2 2018, eurozone growth is expected to dip sharply in full-year 2019 before levelling off at around 1% in 2020 (see chart 1). Difficulties in the manufacturing sector could eventually carry over to the services sector, since the two sectors are highly interconnected. Maintaining healthy job market dynamics and unemployment trends in the months ahead will continue to play a key role. In the short term, Germany will be hit hardest by the global economic slowdown, given its openness to trade, while Italy will continue to struggle with major structural headwinds. France will also slow but not as sharply, although a sharper-than-expected drop off in German growth could have major indirect consequences.

A favourable policy mix for growth

"*In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required*"[1]. In his Sintra speech on 18 June, ECB president Mario Draghi opened the door to new monetary easing measures. These measures could be set up more rapidly than expected.

Several announcements were already made at the 6 June monetary policy meeting. The ECB decided to extend its forward guidance for another six months, pushing back any key rate increases until mid-2020. It also presented a few details on the next wave of TLTRO (TLTRO-III). Compared to previous operations, conditions seem to be slightly less accommodating, notably in terms of interest rates. The rates accompanying these operations will reach -0.3% at best, compared to -0.4% for TLTRO-II.

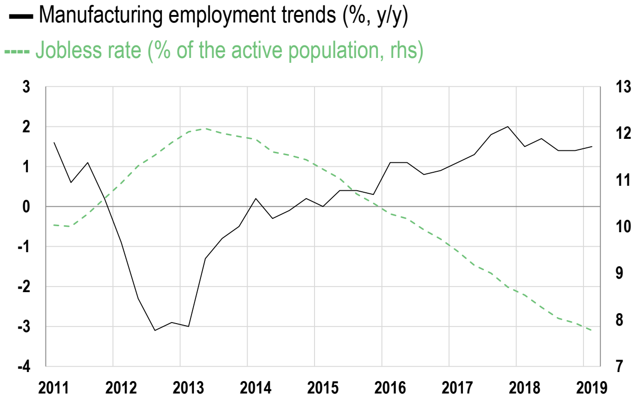
Why did the ECB soften its monetary message within just a 2 week interval, between 6 and 18 June? First, the ECB was responding to the first signs of an uncoupling of inflation expectations. Second, the US Federal Reserve was scheduled to meet the next day, and was expected to adopt a more accommodating stance. In this respect, the sharper tone of the ECB president's speech was an attempt to prevent the euro from appreciating against the dollar. Following his speech, German 10-year yields dropped even more sharply into negative territory, while French 10-year rates hit 0%. The ECB is thus prepared to intervene again. Although it still has some manoeuvring room, it is smaller and not without risks, which means it must be used sparingly.

Fiscal policy is also expected to ease, which would stimulate demand and growth in the eurozone. This is notably the case for Germany, where taxes have been cut for low wage earners, for example, and in France, thanks to emergency measures adopted following the "yellow vest" movement. Although the overall easing of the policy mix could have a favourable impact on economic activity, it might not have the intended impact on inflation dynamics.

Inflation: far below target

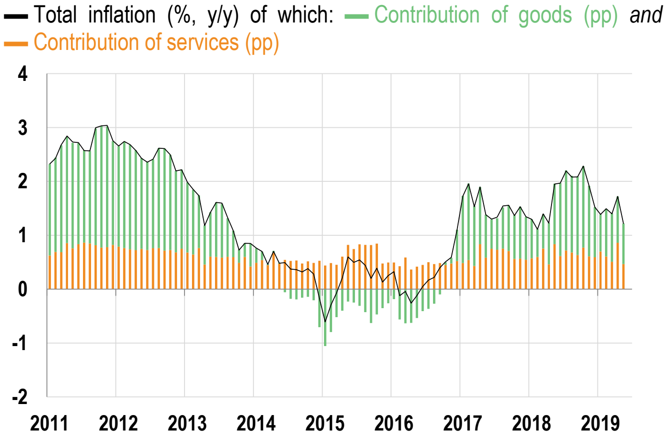
Eurozone inflation is still below its medium-term target of 2% and has not benefited so far from the upside pressure on unit labour costs. The structural weakness of inflation in the advanced countries is not limited exclusively to the eurozone. Some reasons for this structural weakness include globalisation, digitalisation, and income inequality. Benoit Cœuré[2] recently highlighted the tertiary expansion of the eurozone economy as a factor limiting inflation's responsiveness to monetary policy. Prices in the services sector change less frequently due to wage rigidity (services are labour intensive) and less exposure to international competition (although rising, the services sector still accounts for only 20% of total exports).

3- Unemployment and manufacturing employment



Source: Eurostat

4- Inflation of goods and services



Source: Eurostat, BNP Paribas

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[1] *Twenty years of the ECB's monetary policy*, Speech by Mario Draghi, ECB Forum on Central Banking, Sintra, 18 June 2019

[2] *The rise of services and the transmission of monetary policy*, Speech by Benoit Cœuré, 21st Geneva Conference on the World Economy, 16 May 2019