Eurozone

The ECB opts for more monetary support: how effective will it be?

At its September monetary policy meeting, the European Central Bank delivered a strong message. Through the broad mobilisation of its unconventional monetary policy tools, it aims to fulfil its mandate and reach its inflation target. At the press conference following the meeting, Mario Draghi seized the occasion to reiterate his call on certain eurozone governments to increase their fiscal support. The ECB is entering a long period in which it will have to remain mute, passing on the baton to the member states with comfortable fiscal leeway. This new round of monetary support is welcome considering the economic troubles facing the eurozone, although there are some doubts about its effectiveness.

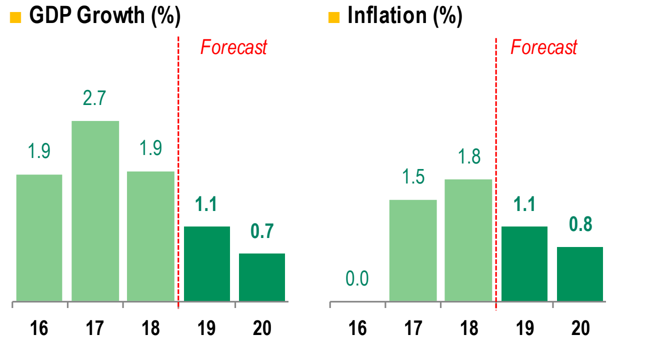
Once again, the European Central Bank (ECB) has shown that it can be extremely proactive. Looking beyond discussions on the redefinition of monetary policy and its targets, Mario Draghi has acted in keeping with his mandate. The big debate is now focused on the effectiveness of the measures announced at the 12 September monetary policy meeting and the adverse effects they might engender. Mr. Draghi again insisted on the need for greater fiscal support.

■ The ECB is preparing the groundwork for greater fiscal support

"In view of the weakening economic outlook and the continued prominence of downside risks, governments with fiscal space should act in an effective and timely manner". The ECB's Governing Council is now unanimously calling for more expansionist fiscal policies in the countries with sufficient fiscal manoeuvring room. Henceforth, fiscal tools will have to be the main instrument for stimulating demand so that the normalisation of interest rates can get underway. In this respect, this new round of monetary easing continues to ensure particularly favourable financing conditions for fiscal policy. The ECB made some major announcements at its 12 September meeting. Despite the reticence expressed by certain Governing Council members, the ECB and its President Mario Draghi decided to act quickly. A package of measures was announced that aims to fulfil its mandate and meet its inflation target:

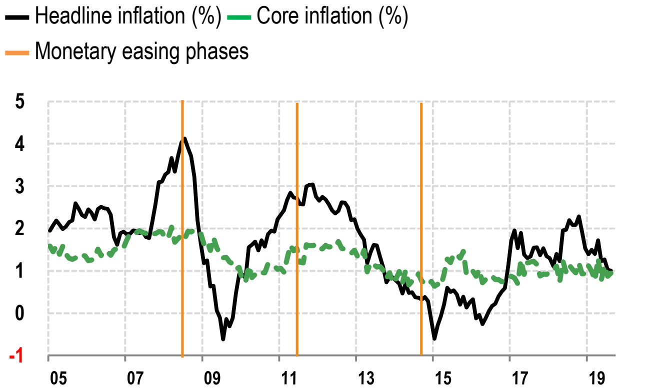
- Forward guidance will be strengthened by ruling out any rate increases until inflation had "robustly" converged with its 2% target. The press release explicitly refers to the core inflation component;
- The conditions for targeted longer-term refinancing operations (TLTRO) granted to eurozone banks will be improved by lowering rates and extending the maturity;
- The deposit rate applied to excess bank reserves will be reduced to -0.5% (from -0.4%) and a tiering system will be introduced. This system exempts part of bank reserves from negative interest rates in order to limit the negative impact on interest margins;
- Net securities purchases will be reactivated as part of Quantitative Easing (QE), with monthly purchases of EUR 20 bn starting in November 2019, for a duration as yet to be determined. These purchases will swell the ECB's balance sheet again, which now accounts for about 40% of the eurozone's GDP, thereby maintaining downward pressure on long-term rates in the eurozone.

1- Growth and inflation



Source: National accounts, BNP Paribas

2- Inflation and monetary policy



Source: ECB

Reading the chart: the orange bars refer to certain monetary easing phases conducted by the ECB. They comprise both key rate cuts and increases in the ECB's balance sheet.

Unconventional monetary measures undertaken by the ECB since 2014 have had a positive macroeconomic effect. Without these measures, GDP growth and inflation would have been lower[1]. The uncertainty currently straining the eurozone economy largely stems from external sources (see part 2). Under this environment, the effectiveness of the newly announced measures might be more limited than during previous phases of monetary easing.

[1] Speech by Philip R. Lane, *Monetary policy and below-target inflation*, Bank of Finland, July 2019

The ECB's next President, Christine Lagarde, is generally expected to be in line with Mr. Draghi. During a recent speech to the European Parliament, the former head of the IMF underlined the importance of fiscal policy to counter the current slowdown. Ms. Lagarde also reiterated the need to deepen institutional cooperation within the eurozone, notably through the creation of a common fiscal tool.

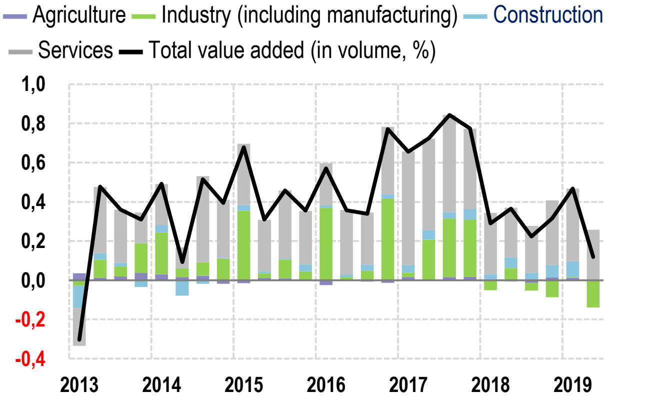
The divergence of industry and services: an unprecedented situation?

The current economic slowdown in the eurozone fits within a more global slowdown that can be seen in both the advanced economies and in the emerging markets. After a robust year in 2017, GDP growth in the eurozone seems to have faltered, slipping to an average of only 0.3% in the first half of 2019 (+0.2% in Q2 2019 and +0.4% in Q1). On the whole, private consumption -- the main growth engine in early 2019 -- has been resilient at a time of declining unemployment and dynamic wage growth. Investment has slowed, in part due to the high level of uncertainty. Despite a rather lacklustre international environment, foreign trade made a positive contribution to eurozone growth in the first half of 2019 after sharply curtailing activity in 2018.

For several months, the eurozone's economic situation has been marked by a sharp divergence between the dynamics of the manufacturing and services sectors. Since early 2018, manufacturing industry has made a generally negative contribution to eurozone growth (see chart 3). Inversely, the services sector is still resilient, thanks to strong domestic demand bolstered by an improving job market situation. This divergence is confirmed in the most recent economic publications for the eurozone. The purchasing managers index (PMI), which is closely monitored by economic observers for its sector-by-sector report on the health of the economy, has declined sharply in the manufacturing sector since the end of 2017 (see chart 4), while the services sector has been resilient.

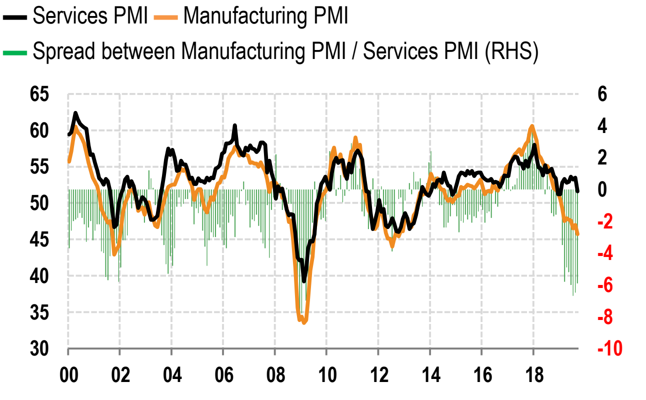
Structurally, activity in the manufacturing sector is more sensitive to shocks, especially external ones. However, the current situation seems to be rather unusual with regard to the eurozone's short history. Manufacturing PMI is particularly weak compared to the high score reported in the services sector. With the exception of 2008-2009, this is the widest gap ever reported since the euro's creation (see chart 4). This observation is especially true for the German economy, which has a bigger manufacturing sector and higher openness rate than its neighbouring countries. The absence of a rebound in world trade, confirmation of China's economic slowdown and uncertainty generated by trade tensions and Brexit negotiations are straining external demand and the manufacturing sector in particular. Though its share is growing, the services sector still accounts for only about 20% of global exports[2].

3- Contribution to the growth of total value added (pp)



Source: Eurostat

4- Spread between manufacturing PMI and services PMI



Source: Markit

How long can this situation last? How much longer will activity in the services sector withstand the troubles in the manufacturing sector? The key lies in the dynamics of domestic demand, and private consumption in particular. Consequently, we should keep a close eye on the job market situation in the short term.

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