# Eurozone

## External dampers, internal hopes

*The eurozone's manufacturing sector has been hard hit by the decline in foreign trade and persistently high uncertainty. Very open internationally, the eurozone is sensitive to global cyclical slowdowns. Internal macroeconomic fundamentals are still solid, and the rally in the services sector is showing resilience. The ECB has taken note of the longer than expected slowdown, and has opted once again for longer-term refinancing operations (TLTRO). Numerous risks still cloud the forecast horizon, which could darken rather quickly if any of these risks were to materialise.*

In the first part of 2019, the eurozone is still showing signs of fragility after the sharp economic slowdown in late 2018. The industrial sector is on the front line when it comes to absorbing the downturn in external demand. Faced with this situation, the European Central Bank (ECB) is remaining vigilant and has reactivated its longer-term refinancing operations (TLTRO).

### Foreign trade hampers growth

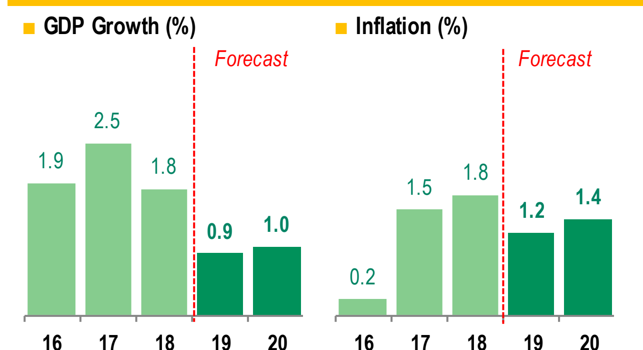
In 2018, foreign trade strained eurozone growth, which rose at an average annual rate of 1.8%. The industrial sector was hard hit by weak external demand, especially in Germany given its high international exposure. Activity slowed sharply compared to 2017, which reported an average annual growth rate of 2.5%. The slowdown worsened in the second semester of the year as Italy entered recession and Germany, hit by temporary domestic shocks, notably in the automobile sector, barely avoided one. Inversely, the French economy proved to be resilient despite social unrest at the end of the year, and Spain maintained a buoyant growth rate.

World trade has been sluggish since the beginning of the year, and there is still uncertainty about Chinese activity and whether stimulus measures will help stabilise the situation. In a rather lacklustre international environment, cyclical indicators in the manufacturing industry continue to trend downwards (see chart 2). Manufacturing Purchasing Managers' Index (PMI) hits a low of 47.5 in March 2019, undermined by the ongoing deterioration of Germany's industrial sector (where PMI dropped to 44.1 in March). More specifically, German industry has been hit by an unusually sharp decline in the "new export orders" component. These dynamics contrast with the eurozone's rebound in industrial output in January, which admittedly followed a particularly downbeat period in late 2018, notably in the transport equipment sector. Data for the entire first quarter of 2019 will provide a more complete picture. Far from the troubles of the industrial sector, the services sector is holding up well in the eurozone. The services PMI rose to a relatively comfortable 53.3 in March, suggesting that internal support factors are still in place.

All in all, eurozone growth is expected to slow sharply in both 2019 and 2020, with average annual growth rates of 0.9% and 1%, respectively. Germany will experience a sharp slowdown while growth in Italy will be nil in 2019 before accelerating slightly in 2020. France is expected to grow at its long-term potential rate, while Spanish growth will decline but remain dynamic.

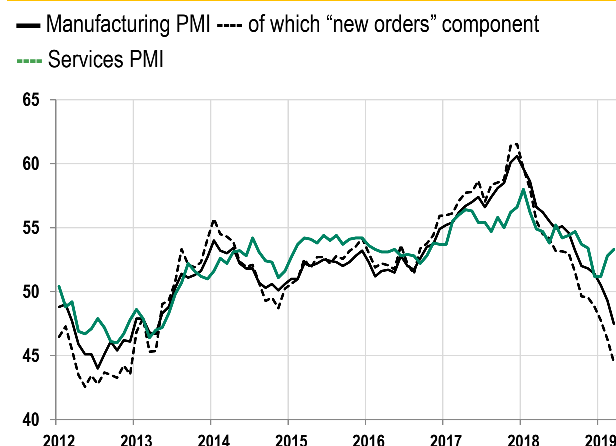
The eurozone economy will have to continue facing up to less vigorous world trade, in an environment of persistently high uncertainty. The outcome of Brexit negotiations, trade tensions – including the possible introduction of tariffs on European automobiles – and the pace of the slowdown in China are all sources of uncertainty for the eurozone's economic agents. Yet the key components of domestic demand are still robust on the whole. Financing conditions are still favourable and corporate margins are comfortable, albeit in decline, which should bolster private investment. A buoyant labour market and wage acceleration will boost household consumption at a time when the jobless rate continues to fall.

**1- Growth and inflation**




Source: National accounts, BNP Paribas

**2- Eurozone PMI**




Source: Markit

The downside risks to our eurozone growth forecast could have a significantly negative impact if they were to materialise. Eurozone activity would be hard hit by a no-deal Brexit or by a more abrupt slowdown in the Chinese economy, especially in Germany with its very open economy[1].

## Proactive monetary policy

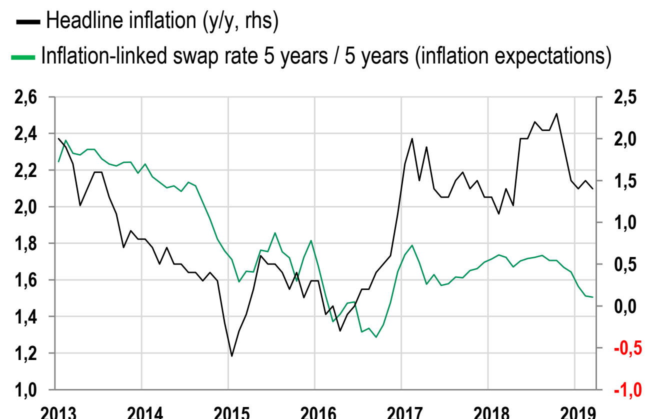
After a first wave in mid-2014, the President of the ECB announced, earlier than expected, that it would launch a new wave of long-term lending operations to eurozone banks (*TLTRO-III*) at its March 2019 monetary policy meeting. These operations, with a maturity of two years, will begin next September and run through March 2021. They will be indexed to the main refinancing rate (currently zero), which could thus vary[2]. These long-term loans will help prevent a negative liquidity shock, particularly with regard to bank regulatory ratios. They are also designed to facilitate monetary policy transmission and thus credit supply, which still seems to be going rather strong in general in the region.

The ECB also revised its forward guidance. Key rates will remain unchanged at least through the end of the year. They will also hold at current levels in 2020 according to our outlook. By terminating the programme at the end of the year, and not later, the Governing Council avoids tying the hands of Mario Draghi's successor, after his term ends next October. On the whole, key rates are expected to remain low for a long time. Long-term rates will remain low throughout our forecast horizon, as the ECB rolls over the securities on its balance sheet arriving at maturity, thereby maintaining the stock unchanged. The yield on 10-year German bonds recently slipped into negative territory as the current upsurge in uncertainty reinforces the attractiveness of German bunds, which investors see as a safe haven.

All of this is occurring in the midst of sluggish inflation: the core component is fluctuating around 1% since 2013, after dropping to only 0.8% year-on-year in March, according to preliminary estimates. Inflation expectations have also slipped, and have been trending downwards since mid-2018 (see chart 3). According to our scenario, annual inflation will hold well below the target rate of 2%, at +1.2% in 2019 and +1.4% in 2020.

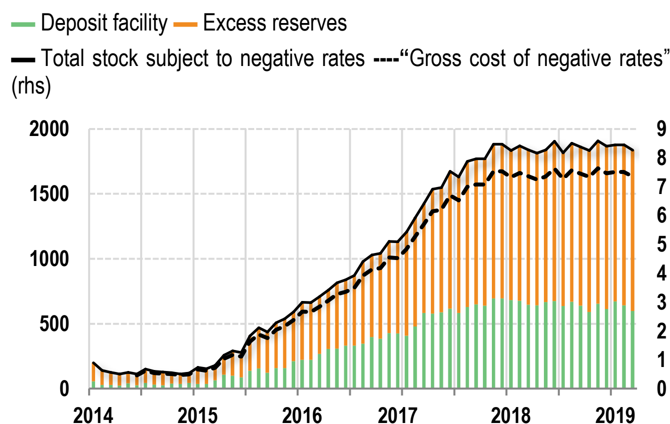
Since 2014, the ECB, like other central banks, has integrated negative interest rates in its policy instruments (the deposit facility rate was -0.4%). The protracted application of negative rates is straining the intermediation margin of eurozone banks, particularly those with major excess reserves (in Germany and France, in particular). Ideas are being explored to try to mitigate the impact on the banking system's profitability[3]. One solution would be to set up a "tiering" system[4]. If adopted, the effectiveness of this measure, notably in terms of the credit pulse, would depend on bank behaviour, especially with regard to the average rate applied to their entire stock of excess reserves.

**3- Inflation and inflation expectations**




Source: ECB

**4- Estimated gross annual cost of negative rates (bn EUR)**




Source: ECB, BNP Paribas

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[1] F. Cornuet et al., *Evaluating the impact of Brexit on the activity of the UK's partners: trade channels,* note de Conjoncture, Insee, March 2019

[2] The indexation to the main refinancing operations rate allows the rate of TLTRO-III to move, as from the start of next year.

[3] ECB, *Account of the monetary policy meeting*, March 2019 (https://www.ecb.europa.eu/press/accounts/2019/html/ecb.mg190404~edc605830b.en.html)

[4] This system, implemented in Switzerland and Japan, allows for some excess reserves to be exonerated from negative rates.