Article | 3 October 2019

Eurozone: Fiscal policy to the rescue?

Forward-looking indicators like new orders and hiring intentions point to a further growth slowdown in the coming months, although strong real money growth and a modest fiscal stimulus would be compatible with some improvement in the course of 2020. The ECB is unlikely to remove any monetary stimulus before 2022

President-elect of the European Central Bank, Christine Lagarde

Source: Shutterstock

Vindication for the ECB

The continuing deceleration and tenaciously low inflation pushed the European Central Bank to act again in September with both a 10 basis point rate cut and a €20 billion monthly restart of the asset purchase programme (APP). Note that in the forward guidance no specific end date was given for both measures. Apart from that, the ECB lengthened the duration of the latest targeted longer-term refinancing operation (TLTRO) to three years at more generous conditions. Finally, a tiering system for the excess liquidity was announced to mitigate the negative impact of the current interest rate policy on the banks.

The ECB surely must feel vindicated by the most recent survey results. The flash composite PMI fell in September to 50.4, only just above the boom-or-bust level of 50, while the European Commission's economic sentiment indicator shrank more strongly than expected. The slowdown in sentiment indicators in the PMI survey is to a large extent driven by new orders for goods and services dropping at the sharpest rate since June 2013. No surprise that companies are starting to become more cautious in hiring new staff, though for the time being eurozone unemployment is still declining.

Second half of 2019 will be weak

In Germany, the weakness in the important manufacturing sector has started to spread to other sectors, though growth in services remains positive and the latest consumption and labour market data surprised to the upside. This remains the story for the whole of the eurozone: a manufacturing sector flirting with a recession on the back of the contraction in world trade, while the services sector and to some extent also construction still manages to hold up.

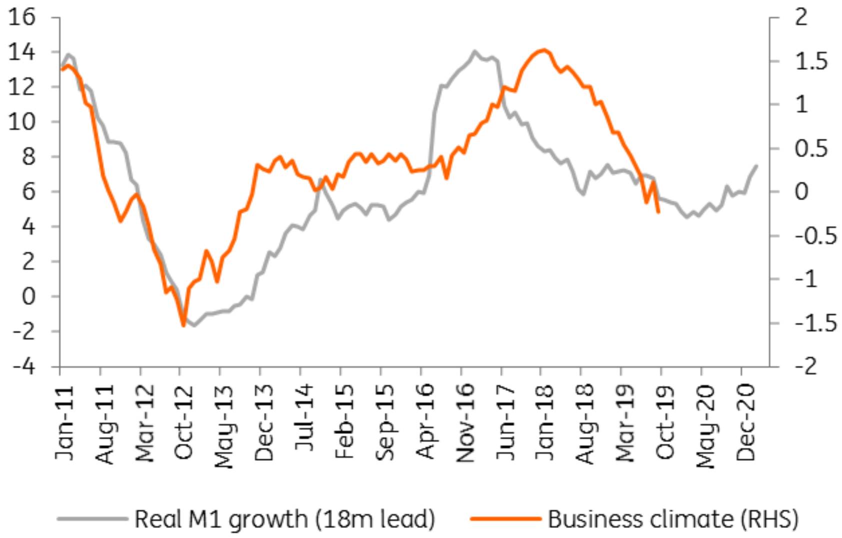
Therefore, we expect the second half of 2019 to be weak, though GDP growth of 1.1% for the whole of the year still seems feasible.

The question is where we go from here

If some of the uncertainties (think trade war and Brexit) are lifted in the first half of 2020 and the inventory cycle in the manufacturing reaches its lowest point, we might well see some growth acceleration in the course of 2020. Don't forget that a number of member states are also thinking of fiscal stimulus, something the ECB has been advocating. In France and the Netherlands, tax cuts have already been announced, which should give consumption a boost next year. While Germany has come up with a "green package", providing a small stimulus for the coming years, and the planned end of the so-called solidarity tax, the government has also suggested that it could do more if the economy tanks.

Thankfully, German consumption isn't looking as lacklustre as industrial activity: German consumer confidence actually went up in October. From the monetary side, there is of course also plenty of support. Financing conditions remain quite favourable, with interest rates at historically low levels. Looking at real M1 growth, which has been a good leading indicator in the past, an acceleration in the second half of next year seems likely. However, because of the weak base effect from the second half of 2019, this will only translate into 0.7% GDP growth, whereas 2021 should come out slightly higher. We're now pencilling in 1.0% growth.

Real money growth signals turnaround in 2020



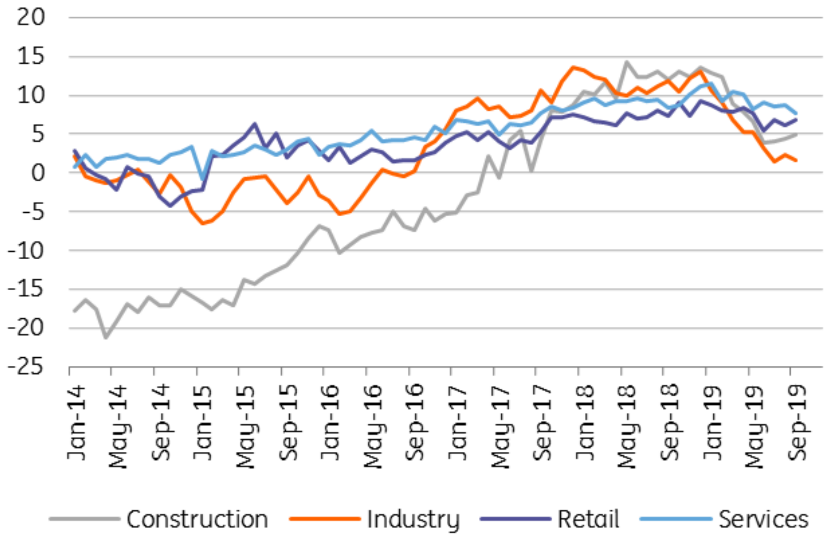
Source: Refinitiv Datastream

Inflation remains low, so do interest rates

Wage growth has been picking up slightly, but this is unlikely to translate rapidly into higher inflation. Selling price expectations in industry and services actually declined in September, while they increased somewhat in retail trade and construction. We see core inflation hovering between one and 1.5% for some time, on the low side of where the ECB wants it to be.

More action from the ECB has become unlikely, given the big package they announced in September. On top of that, the number of dissenters in the Governing Council has grown, with some of them not hesitating to contest the ECB's monetary policy in public. But even then, the ECB is likely to continue its very easy policy for the foreseeable future. That means that money market rates will remain firmly in negative territory until at least the end of 2021, while it will likely also take some time for the German 10 year Bund yield to rise above 0%.

Inflation expectations soften



Source: Refinitiv Datastream

Author

Peter Vanden Houte
Chief Economist, Belgium, Luxembourg, Eurozone
peter.vandenhoute@ing.com