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The Aerial View

Morning Briefing

Oct 29, 2020

Delicate Balancing Act for ECB

- **Eurozone manufacturing pulling away from services again**
- **Demand recovery in Asia helping manufacturing-intensive economies**
- **Internal and external divergence complicating ECB decision**

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On the face of it, the balance of risks to the ECB's October meeting remains skewed toward additional easing. Governments across the eurozone and wider European Union are moving towards increasing social restrictions as the pandemic's second wave continues to bite.

Fiscal support on a national and EU-wide level will remain in place, but as we have highlighted previously, confidence in the region's ability to reflate sustainably is extreme low. As ever, it seems the ECB is under pressure to ease policy simply to keep inflation expectations merely stable.

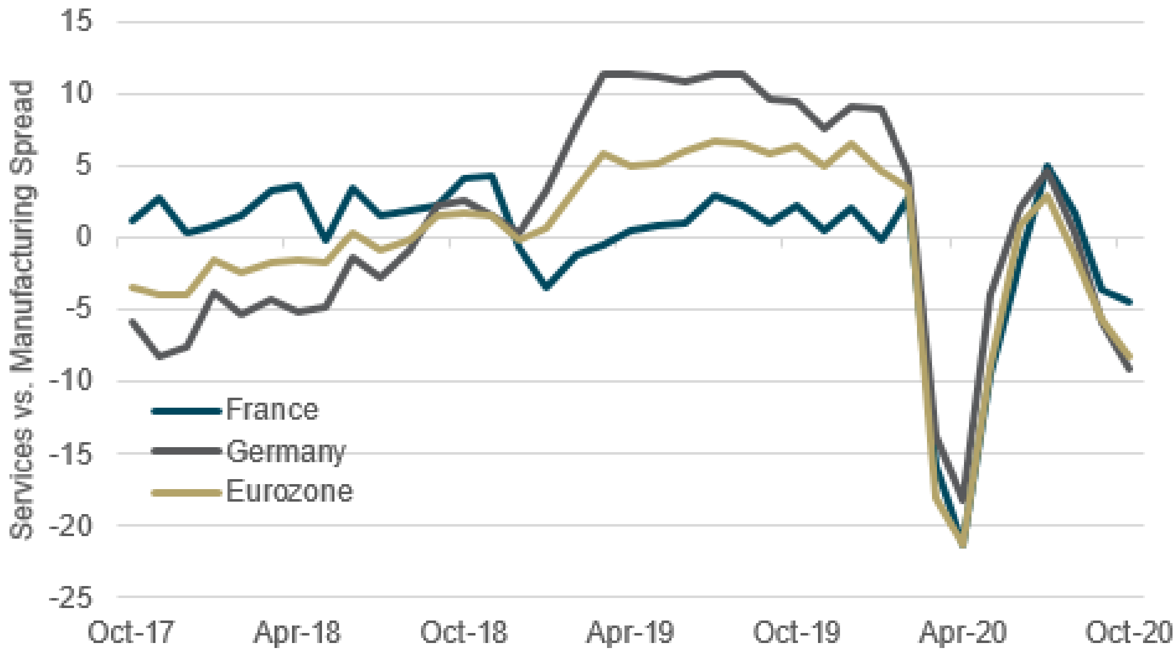
Despite the pressures, we question whether the ECB is ready to act ahead of the release of the next round of staff projections in December.

Despite the headline risks, the present economic situation in the eurozone has very clear differences to emergency conditions seen in Q1 and early Q2. As one would expect with the increase in restrictions on social activity, the services industry across Europe faces a difficult few months ahead.

The chart below shows German, French and eurozone PMIs moving lock-step against services, relative to manufacturing, and further deterioration should be expected. However, on an absolute basis, manufacturing PMIs are in a completely different place.

The latest German manufacturing PMI print of 58 is the strongest since H1 2018. The October IFO release confirmed robust current conditions, stating "a great many more companies were satisfied with their current situation", in addition to a material increase in capacity utilization.

Services vs Manufacturing PMI Spread



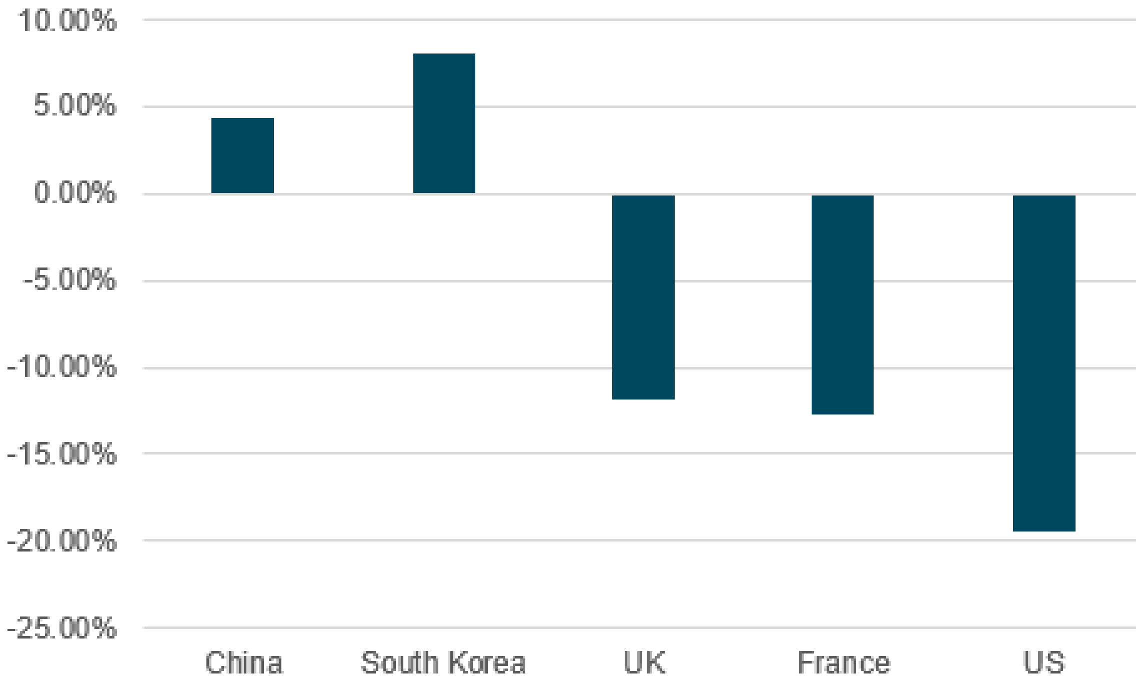
Source: BNY Mellon Markets, Bloomberg L.P.

We believe one of the main reasons behind the manufacturing recovery, especially in Germany, is the country's stronger exposure to Asia, where the recovery has become much more pronounced and sustainable.

The hard data speaks volumes: for the three months between June and August, German exports to China and South Korea were up 4.3% y/y and 8.1% y/y respectively. In contrast, exports to other major partners are down double digits.

Given PMI figures have shown clear upside momentum for manufacturing only during the same period, it is likely that the order book is filling up with demand from the east.

Germany Export Value Change (Annualized), Jun - Aug 2020.



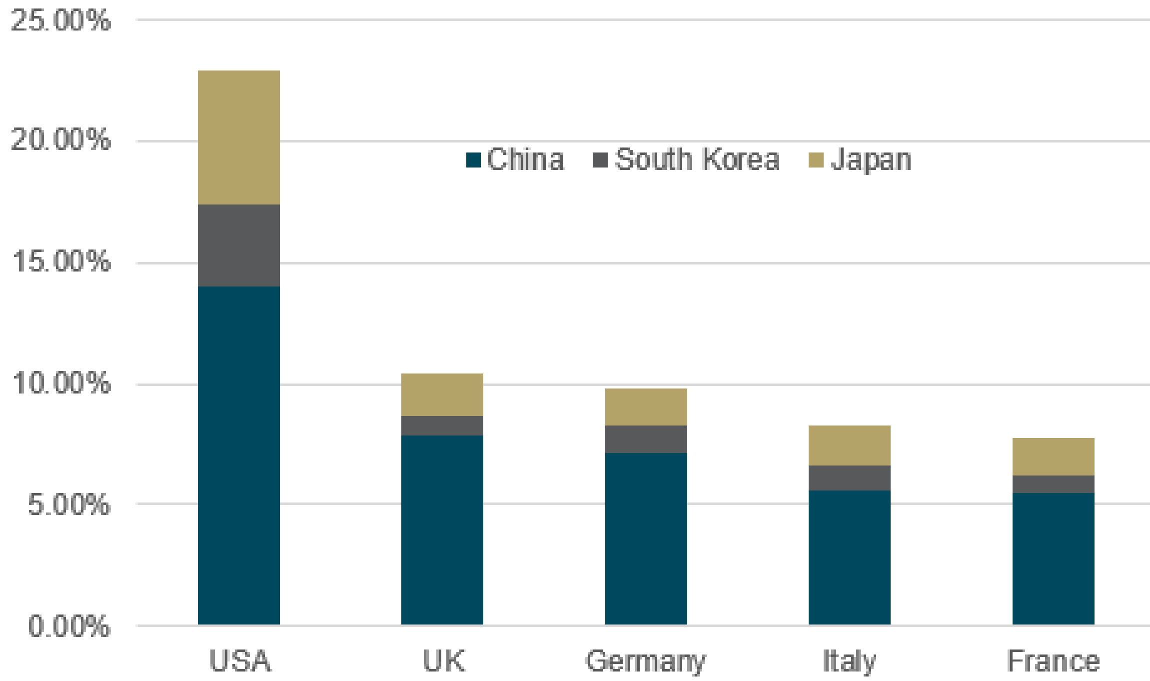
Source: BNY Mellon Markets, Bloomberg L.P.

In this respect, it is not only Germany or eurozone manufacturers which stand to benefit. As a share of total exports, the US and UK actually have higher exposure to key Asian economies (see below chart): China's share of US exports is double for that of Germany.

In addition, the export composition is also skewed towards manufactured items despite the clamor over agricultural goods over the past few years during Sino-US trade negotiations. Accordingly, US manufacturing-related hard data such as durable goods orders have also been surprising to the upside.

> ***The eurozone's growth exposure to manufacturing – led by Germany – is generally higher***

Share of Total Exports



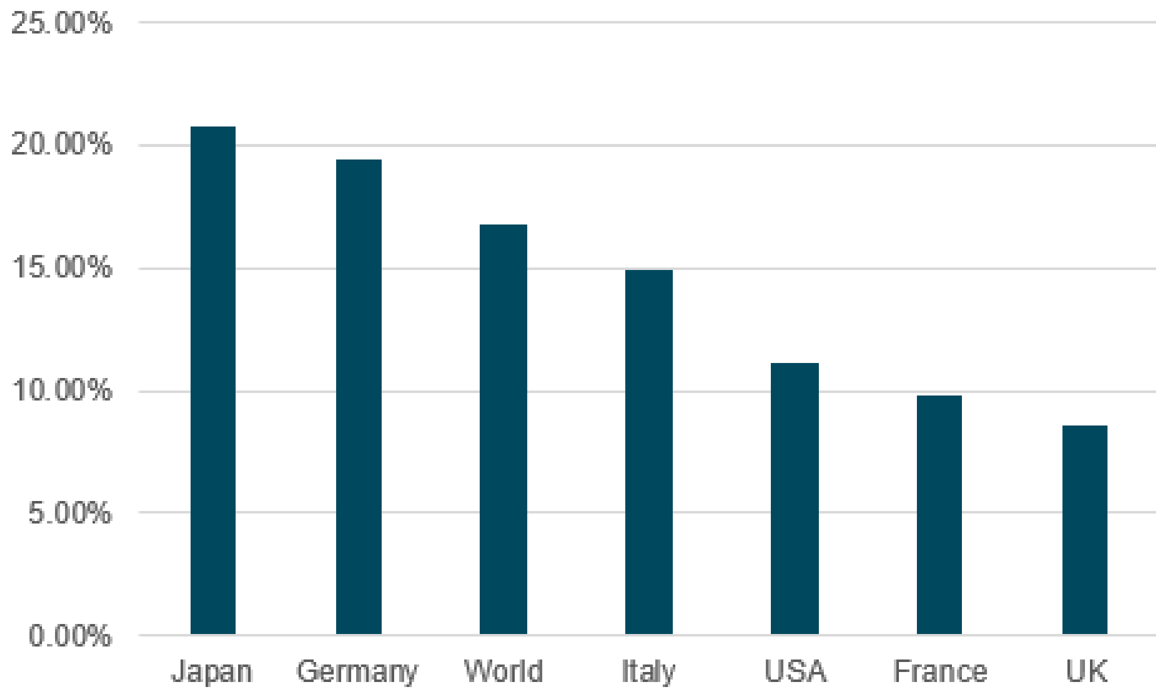
Source: BNY Mellon Markets, Bloomberg L.P.

The difference, however, is that the eurozone's growth exposure to manufacturing – led by Germany – is generally higher (see below chart). As such, the outperformance in manufacturing will generate a stronger GDP lift relative to the services decline.

If general capacity utilization continues to rise in line with what the IFO survey has reported, while strong fiscal support manages to contain the fallout in other sectors, the eurozone may ultimately be much more successful in limiting economic scarring.

The policy implications for the ECB are obvious: a better output gap result is ultimately favorable for inflation outcomes – a matter where the ECB continuously struggles for credibility.

Share of GDP Value-Add (2019 Data for Europe, 2018 for Japan, 2017 for US)



Source: BNY Mellon Markets, World Bank

On the other hand, it is important to not exaggerate the downside risks. Barring extreme volatility in November (still possible surrounding the US elections), exchange rate passthrough will likely exert less pressure on near-term inflation expectations. Other inputs, such as oil prices, have also been caught in a range since the September round.

In addition, there is enough of a ‘time buffer’ built into the outlook as the ECB had incorporated a second wave and “gradual widespread deployment” of a “satisfactory medical solution” only towards the end of 2021.

> ***The Governing Council will need to assess how close to general "stringent containment measures" eurozone governments are***

Ultimately, a judgement call will have to be made on the severity of the current wave of the pandemic and the subsequent government response.

Current ECB staff projections included a scenario analysis whereby the “*severe scenario envisages a strong resurgence of the pandemic, leading governments to restore stringent containment measures*”.

Crucially, under the severe scenario, HICP will remain under 1% through 2022 – almost certainly guaranteeing a strong ECB response as such an outcome would risk a failure to meet its mandate and permanent de-anchoring of inflation expectations.

The bottom line is the Governing Council will need to assess how close to general "stringent containment measures" eurozone governments are.

Germany is already planning a "limited" lockdown for November while, in the words of Chancellor Merkel, "keeping the economy intact as much as possible". France may follow suit.

Intense political discussions are taking place at present within individual countries, sometimes pitting regional leaders against their national counterparts, with the ECB mostly a bystander and unable to make accurate economic assessments at short notice.

In light of the divergence in growth between domestic sectors, global trade partners and uncertainty surrounding the severity of impending social restrictions, the ECB will likely emphasize the risks to their central outlook to the fullest extent, but fall short of acting until there is more clarity in December.

Please direct questions or comments to:

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