European Central Bank announces major policy reversal

Nick Beams
8 March 2019

The European Central Bank has reversed its policy of slight monetary tightening and announced a new stimulus package in the face of data which show a sharp downturn in growth in the euro zone. The unanimous decision was taken at the meeting of the ECB's governing council held in Frankfurt yesterday.

The decision came just three months after the central bank announced it was phasing out its asset purchasing program. The bank indicated it would keep interest rates at historic lows at least until next year and potentially indefinitely and set out a new program to offer cheap loans to euro zone banks.

It also indicated it would continue to reinvest the proceeds of bonds which mature under its €2.6 trillion quantitative easing program for an "extended period of time" with reinvestments amounting to about €20 billion a month.

The decision is the first by a major central bank to reverse monetary tightening in the face of growing signs of a slowing global economy. The US Fed has indicated that it has put interest rate rises on hold but has not yet taken steps to ease monetary policy.

The decision by the ECB came as a result of what president Mario Draghi characterised as a "substantial" downward revision of growth estimates for the region. He said the new outlook for annual growth in gross domestic product was 1.1 percent for 2019, 1.6 percent for 2020 and 1.5 percent in 2021.

This compares with estimates just last December of 1.7 percent for 2019 and 1.7 percent and 1.5 percent for the following two years. This means that so sharp has been the fall-off in economic activity that the ECB has slashed its growth estimate for this year by more than one third.

A similar projection has been made by the Organisation for Economic Cooperation and Development. On Wednesday it cut its growth forecast for the euro zone to 1 percent from the prediction of 1.8 percent which it made just last November.

The revised figures come after the euro zone experienced its biggest increase in growth in 2017 for a decade. This was accompanied by claims that the world economy was experiencing synchronised growth and that it was finally starting to turn the corner following the economic devastation resulting from the global financial crisis of 2008–2009.

But from the beginning of 2018 the growth momentum began to slow and the deceleration increased throughout the year, with Germany, the region's largest and most significant economy, barely escaping a recession in the final two quarters.

Growth in China has also been slowing and last year hit its lowest level in three decades, with a further lowering expected for 2019. The US managed to buck the trend, largely as a result of the stimulus provided by the Trump administration's tax cuts. But there are signs that this is starting to wear off with the US recording lower than expected growth in the fourth quarter of last year.

Reviewing the factors which had led to the decision to reverse course, Draghi pointed to weaknesses particularly in the manufacturing sector, "reflecting the slowdown in external demand" compounded by some country and industry specific factors.

"The risks surrounding the euro area outlook are still tilted to the downside, on account of the persistence of uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets," he said.

The ECB also significantly reduced its forecast for inflation in an indication that its target of around 2 percent for the area—regarded as sign of a steadily growing economy—is further away than ever. It reduced the forecast of inflation for 2019 to 1.2 percent, down from the projection of 1.6 percent in December with similar reductions for the following two years.

Other economic data also indicate deep-seated problems. According to Eurostat, productivity shrank in the second half of 2018 for the first time since the financial crisis. Output per hour fell by 0.4 percent on a year-on-year basis in the last quarter of 2018, the sharpest rate of contraction since 2009. This followed a contraction of 0.1 percent in this third quarter.

The contraction was driven by Germany which recorded an annual 0.9 percent decline in output per hour worked. In the third quarter of last year, the German economy contracted for this first time since 2015, with growth remaining flat in the last quarter.

In Italy output per hour fell 0.3 percent in the last quarter, its third consecutive fall.

According to Andrew Harker, associate director at IHS Markit, which publishes purchasing managers indexes that track business sentiment, its data suggested that "the manufacturing sector was the main source of the latest reduction, with industrial productivity decreasing to the greatest extent in almost a decade."

The ECB decision sent European markets down—a trend which extended to the US—indicating market concerns over global growth. The Dow fell 200 points, the S&P 500 dropped by 0.8 percent and the Nasdaq lost 1 percent, with traders indicating that the decision pointed to a softening of the euro zone economy and added to "uncertainty."

In a comment published on *Bloomberg*, the chief economic adviser to the global insurance and financial giant Allianz, Mohamed El-Erian, said the ECB move was as dramatic as the Fed's "flip-flopping" in January. It showed that ten years after stocks hit their low following the global financial crisis, investors could still rely on "exceptional liquidity support from systemically important central banks."

He wrote that the "great hope" had been that after "prolonged period of unconventional monetary policies (which almost by definition, don't offer sustainable solutions but merely buy time at the risk of collateral damage and unintended adverse consequences)" the central banks would be able to hand over to governments. Instead, he continued, as demonstrated by the ECB decision "central banks remain stuck in a morass."