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Euro Zone's Economic Outlook and What it Means for the United States

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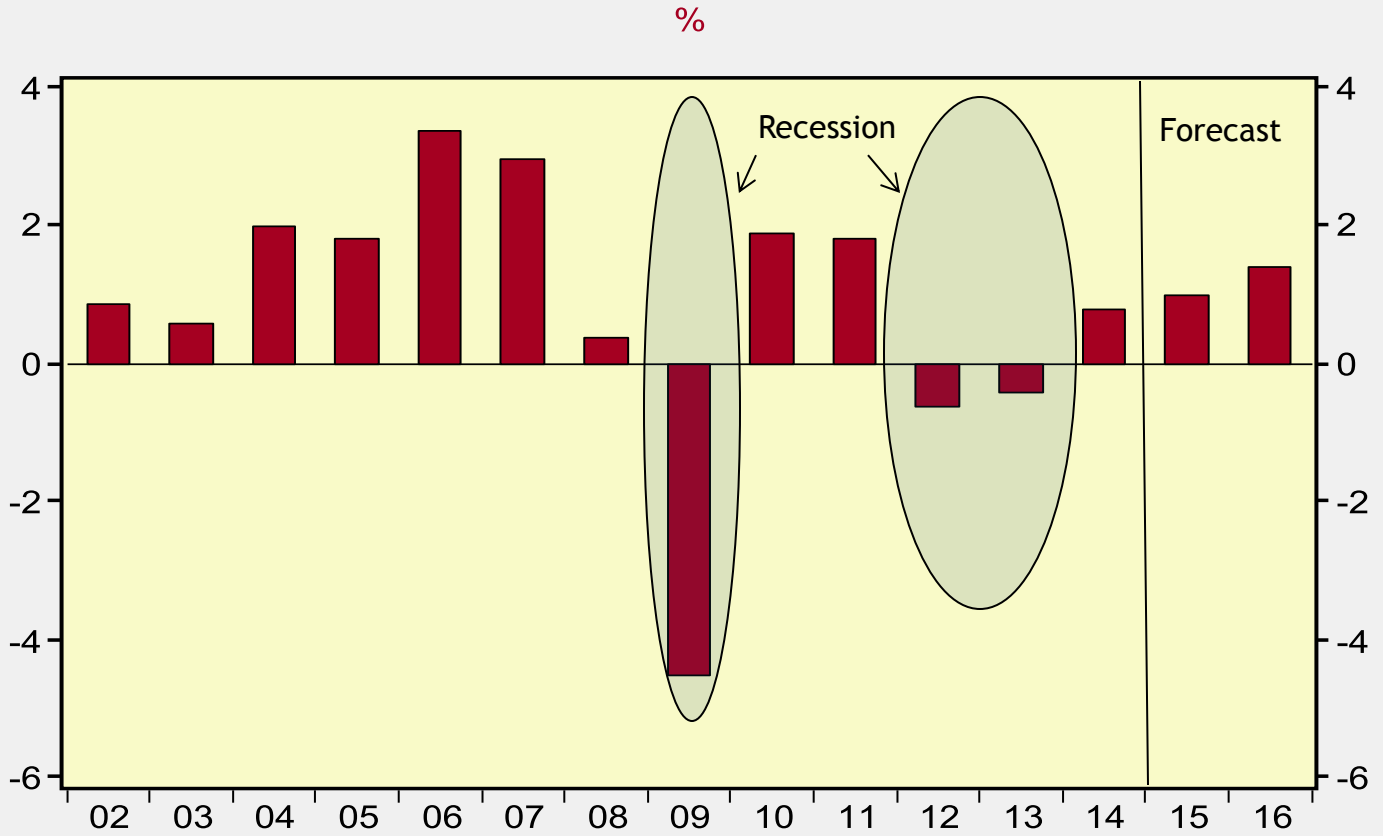
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Outline

- Economic developments in the euro zone
- Economic conditions in the largest member states: Germany, France, Italy, Spain
- Euro zone's economic growth forecast
- How developments in the euro zone affect the global economy and the United States
- Channels of transmission of a potential recession/crisis in Europe to the United States

Euro zone's economy endured two recessions in the past decade. Last year the economy rebounded after two years of contraction.

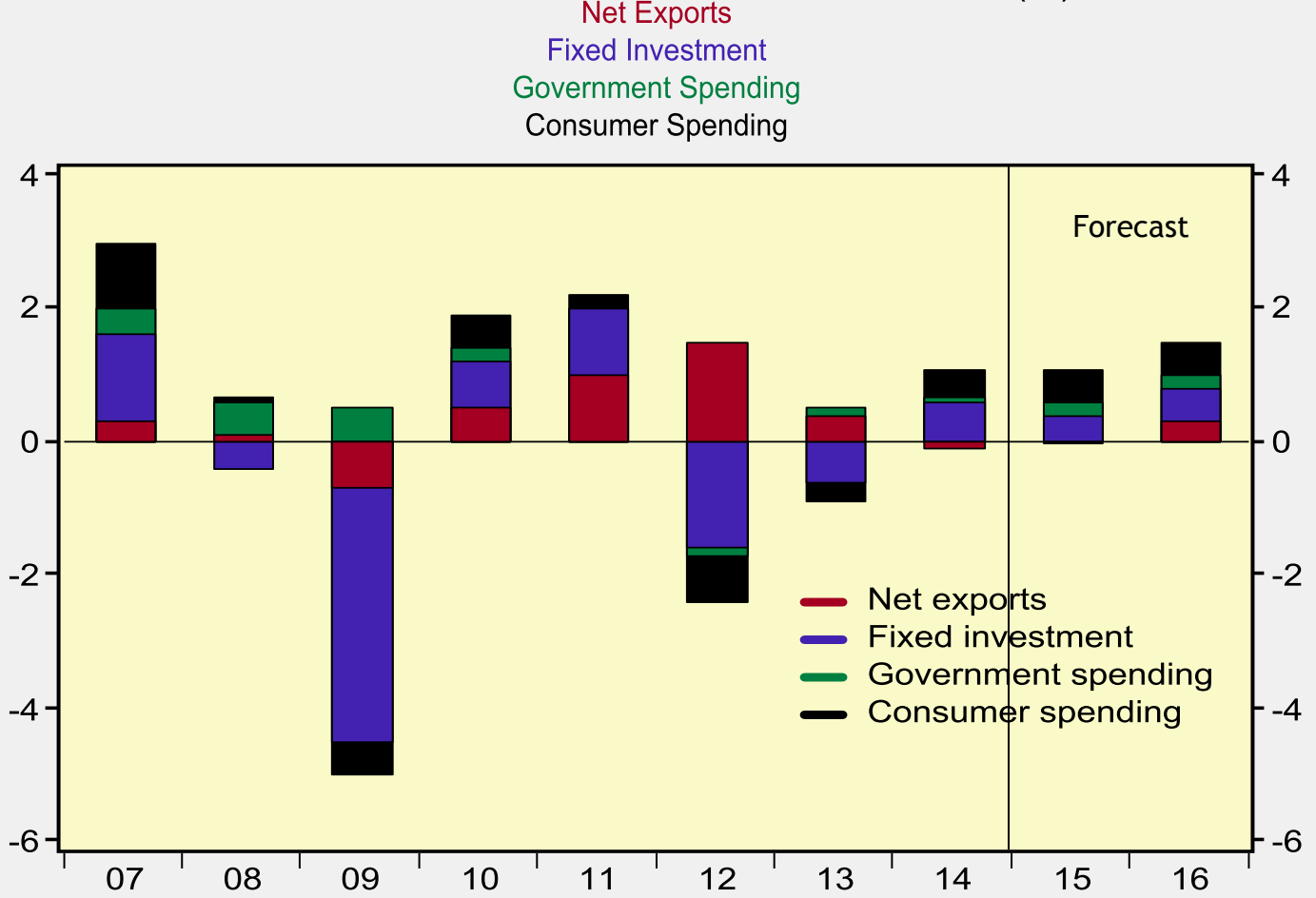
Euro Area: Real Gross Domestic Product, Year/Year Change



Source: Economist Intelligence Unit /Haver Analytics

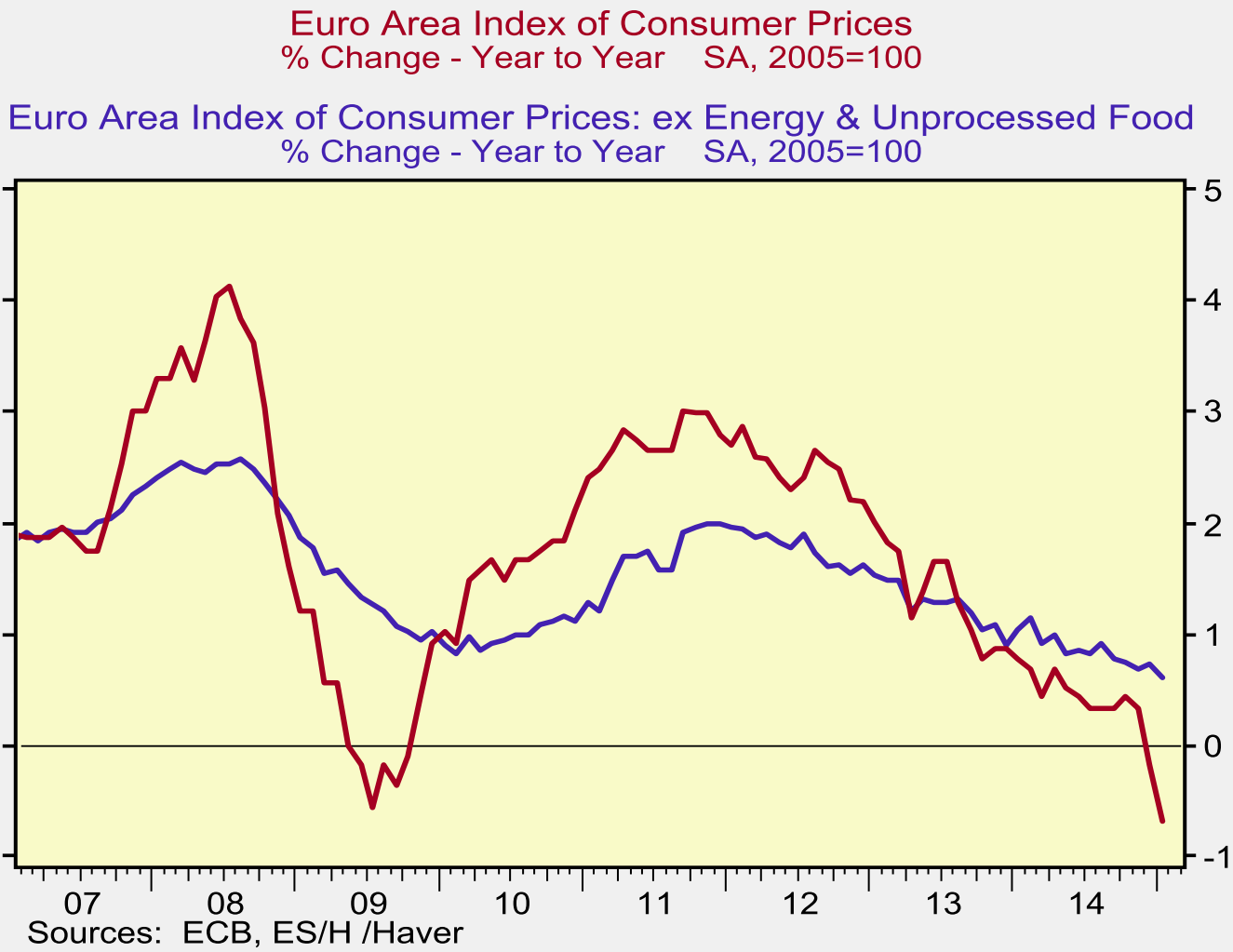
Upturns in consumption and fixed investment are expected to drive growth after two years of being significant drags on the economy.

Euro Area: Contribution to Real GDP Growth (%)

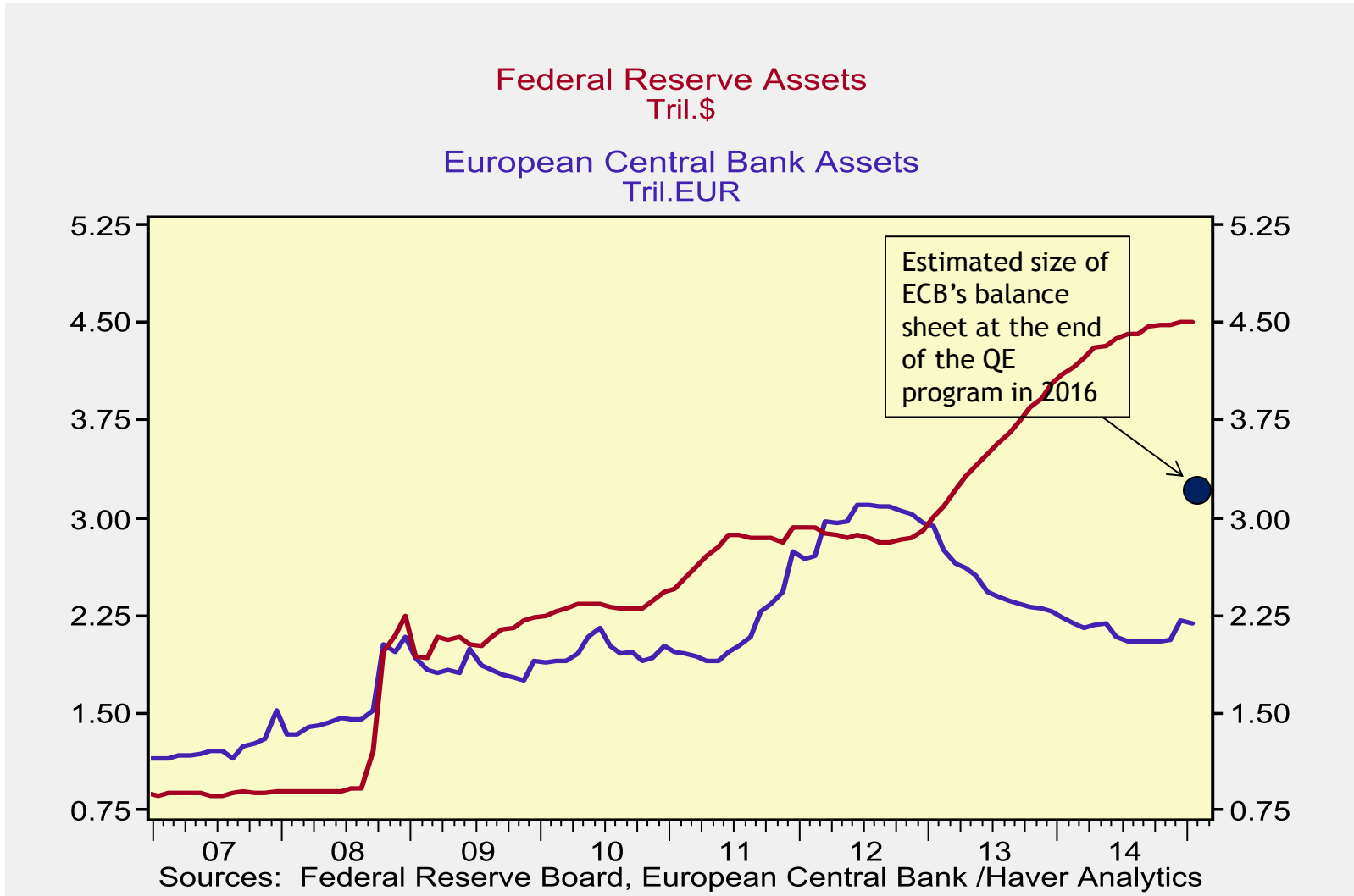


Source: Economist Intelligence Unit /Haver Analytics

Consumer price inflation has been steadily declining. Headline inflation was negative in December and January, as energy prices dropped.



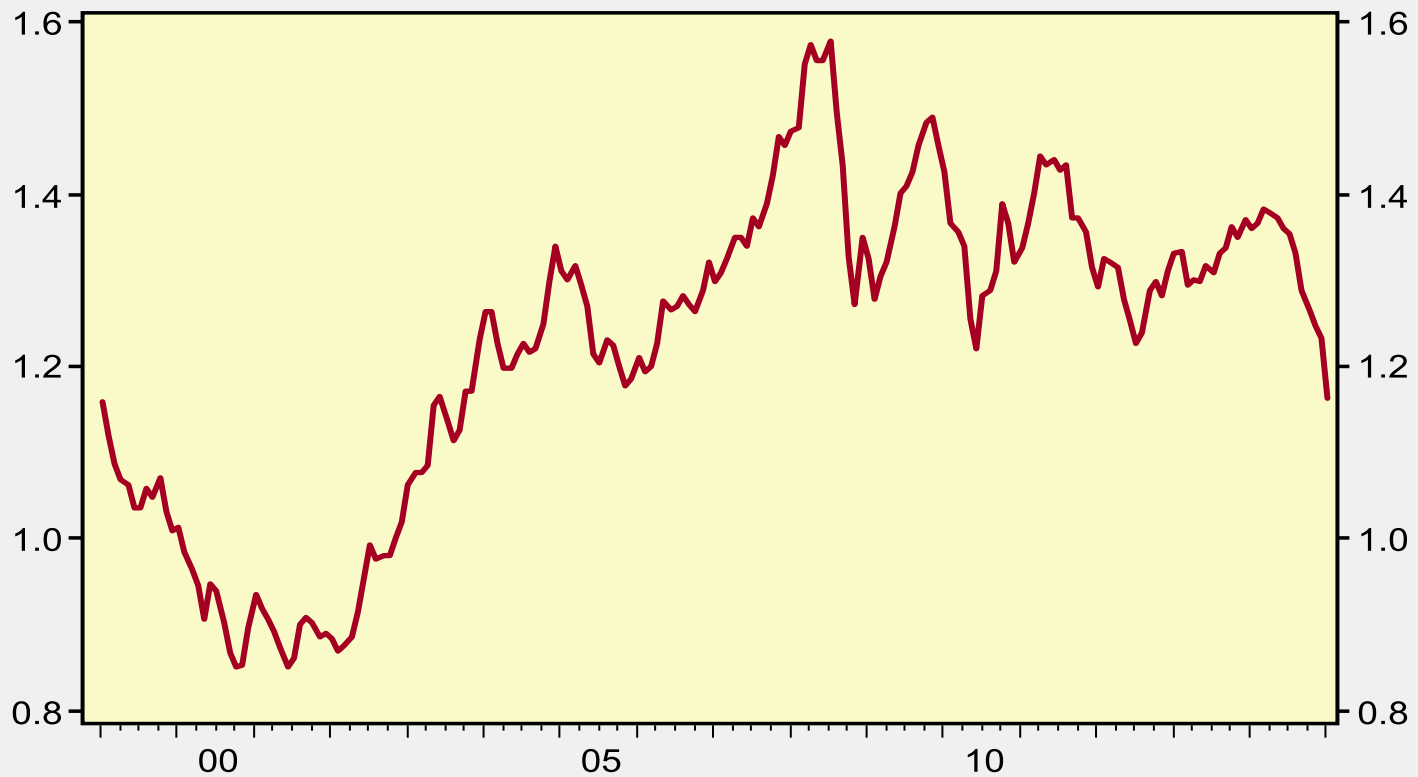
In response to continued declines in inflation and inflation expectations, European Central Bank announced in January an expansion of its existing asset purchase program (QE) to include public debt.



The euro has declined significantly against the U.S. dollar and, to a lesser extent, against a number of other currencies.

Foreign Exchange Rate: European Monetary Union

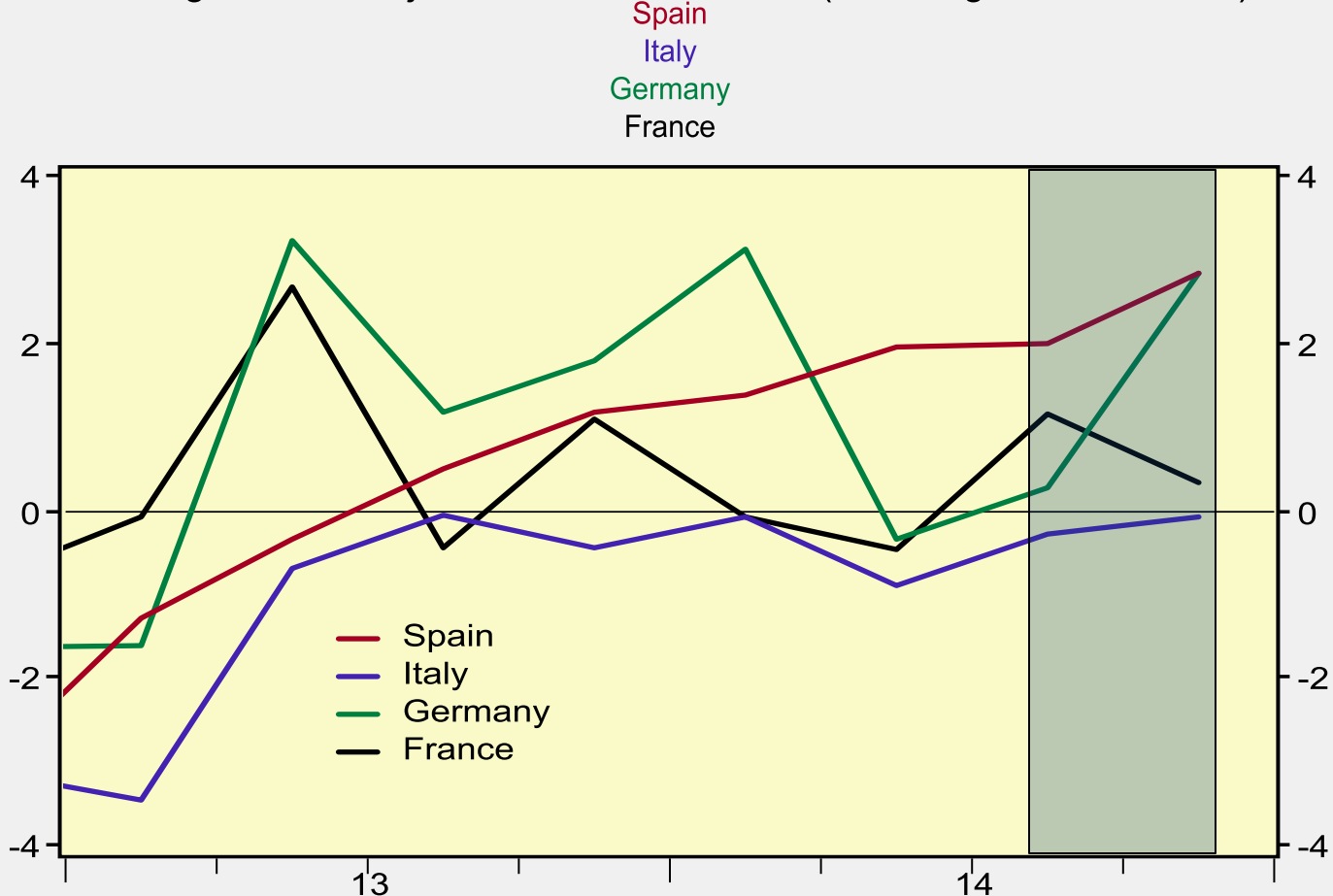
US\$/Euro



Source: Federal Reserve Board /Haver Analytics

At the end of 2014, Germany and Spain grew strongly, France's growth slowed, while Italy remained in a recession.

GDP growth in major euro zone countries (% change - annual rate)



Sources: INE, ISTAT, Bbk, INSEE /Haver

Germany

Outlook: growth is likely to remain strong

- **Labor market** is improving
- **Consumer indebtedness** is low
- **Export** demand should pick up
- **Investment** is likely to rebound

Risks to outlook:

- **Euro zone** falls in a recession
- **China** slows significantly
- **Russia** increases its military presence in Ukraine
- **Greece** leaves the euro zone

Risks warnings

- **GDP**: foreign growth may weaken
- **CPI**: fall in inflation should be temporary
- **Current account**: should remain in a large surplus
- **Fiscal balance**: budget is likely to remain balanced
- **Government debt**: low
- **External debt**: not a concern

France

Outlook: growth is likely to improve somewhat

- **Consumer spending** should strengthen
- Euro depreciation should help **exports**
- **Investment** is likely to modestly recover

Risks to outlook:

- **Euro zone** falls in a recession
- **China** slows significantly
- **Greece** leaves the euro zone

Risks warnings

- **GDP**: recovery is sluggish
- **CPI**: very low core inflation (national)
- **Current account**: deficit is expected to decline
- **Fiscal balance**: budget deficit is likely to exceed Maastricht requirement
- **Government debt**: is set to rise to more than 100% of GDP
- **External debt**: high

Italy

Outlook: growth is likely underperform the rest of the euro zone

- **Financing conditions** are improving
- Euro depreciation should help **exports**

BUT:

- **Labor market** is struggling to recover
- **Weak investment** is likely to remain a drag on the economy

Risks to outlook:

- **Euro zone** falls in a recession
- **China** slows significantly
- **Russia** increases its military presence in Ukraine
- **Greece** leaves the euro zone

Risks warnings

- **GDP:** weak growth
- **CPI:** deflation is a real concern
- **Current account:** should remain in surplus
- **Fiscal balance:** deficit should move down to below 3%
- **Government debt:** above 130% of GDP - one of the highest in the euro zone
- **External debt:** 35% held by non-residents

Spain

Outlook: growth to accelerate

- **Export** demand should strengthen further
- **Investment** is likely to pick up
BUT:
- **Headwinds remain:** fiscal restraint, deleveraging by businesses, high unemployment

Risks to outlook:

- **Euro zone** falls in a recession
- **China** slows significantly
- **Russia** increases its military presence in Ukraine
- **Greece** leaves the euro zone

Risks warnings

- **GDP:** solid growth
- **CPI:** deflation is a risk
- **Current account:** should remain in surplus
- **Fiscal balance:** deficit reduction is likely to continue
- **Government debt:** is expected to reach 110% of GDP
- **External debt:** high

Euro zone

Outlook: growth to accelerate but will remain modest

- Depreciation of the **euro** should boost exports
- **Consumer spending** is likely to strengthen
- **Credit availability** is improving

Risks to outlook:

- **China** slows significantly
- **Russia** increases its military presence in Ukraine
- **Greece** leaves the euro zone

Risks warnings

- **GDP:** growth should improve
- **CPI:** deflation is a concern
- **Current account:** should remain in surplus
- **Fiscal balance:** continued recovery should help to further narrow the deficit
- **Government debt:** high
- **External debt:** not a concern

Implications for the global economy

- Historically, European crises have not derailed global economic expansion.
- Now, Europe is a much bigger risk to global growth.
 - Trade linkages are important, but not powerful enough - euro zone's imports are only 4% of global GDP.
 - Financial linkages have become increasingly important -- bank funding and capital markets.
- Continued deleveraging by European banks has tightened global credit conditions.
 - European banks are an important supplier of credit to other regions, especially Emerging Markets (EM).

Implications for the United States

- Crisis and/or recession in Europe is one of the biggest downside risks to U.S. recovery.
- Channels of contagion:
 - *Market confidence and prices of financial assets*
 - *Trade flows and value of the dollar*
 - *Consumer and business confidence*
 - *Banking system*

Implications for the United States

- Trade flows
 - The United States is not overly exposed to the euro zone -- only 15% of our exports go there, mostly to Germany and France.
 - The dollar appreciation is likely to affect U.S. trade with a multi-quarter lag.
- Market confidence, equity and bond prices
- Consumer and business confidence → consumer spending and business investment and hiring

Wrap Up

- Questions?
- Webinar Evaluation
 - <http://www.instant.ly/s/DPpVq>
- Evidence of Participation Email
 - Will be sent later this week based on webinar report
 - If on phone only, please stay on at end of webinar so we can account for your participation