€URO CHALLENGE

The Euro Area Economy Update

Delegation of the European Union to the United States

www.euro-challenge.org

What this presentation will cover:

- A. Update on the economic situation in the euro area (GDP, Inflation, Unemployment)
- B. A supportive "policy mix"
- C. Risks

What this presentation will cover:

- A. Update on the economic situation in the euro area (GDP, Inflation, Unemployment)

GDP growth: a key economic indicator

Gross Domestic Product measures everything produced by an economy (both goods and services)

- *Gross Domestic Product* (GDP) is the total value of all the goods (e.g. cars, iPods) and services (e.g. haircuts, insurance policies) produced by an economy

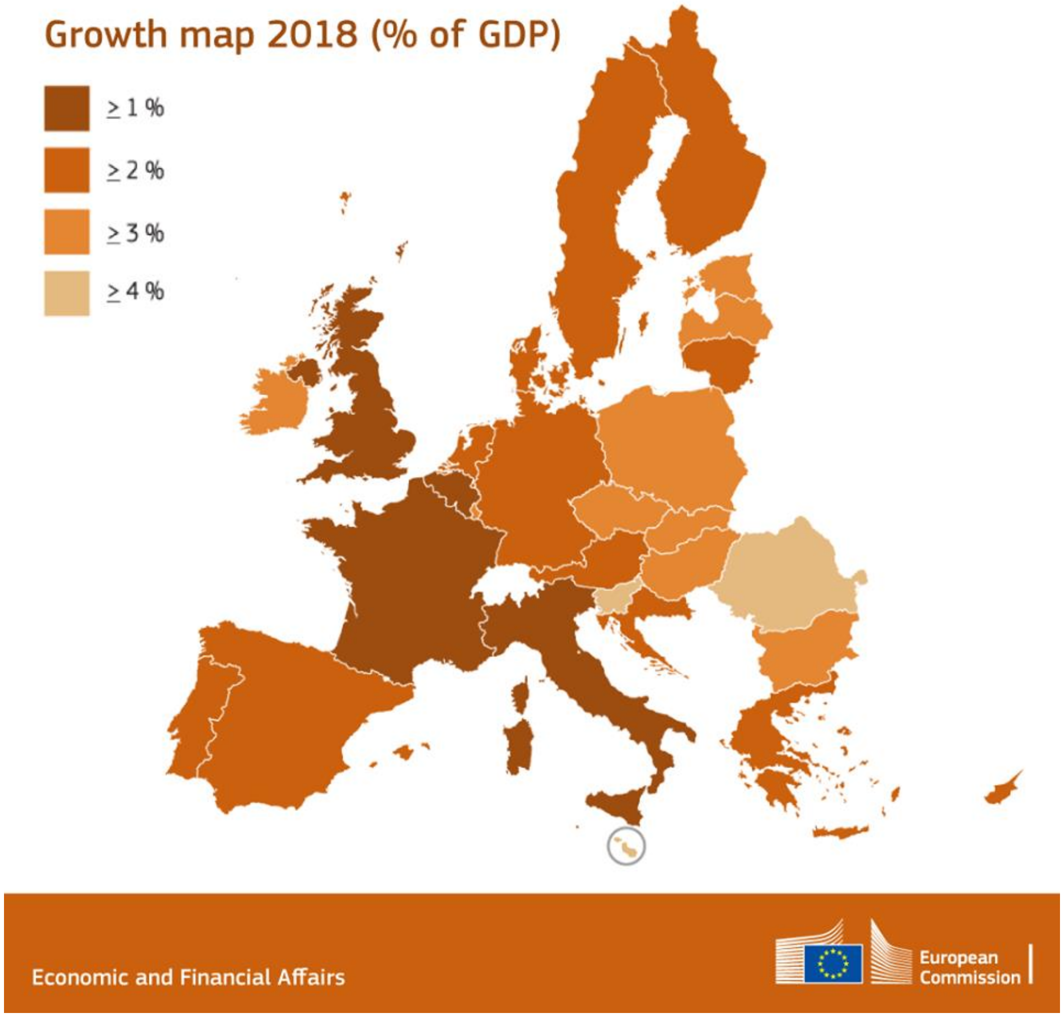
- *GDP growth* tells you by how much GDP has increased compared to the last year (or last quarter)

- GDP growth is expressed as a *percentage*

- When the economy is growing, GDP growth is a *positive number*

- In a recession, GDP growth is *negative* (GDP shrinks)

The EA economy is improving

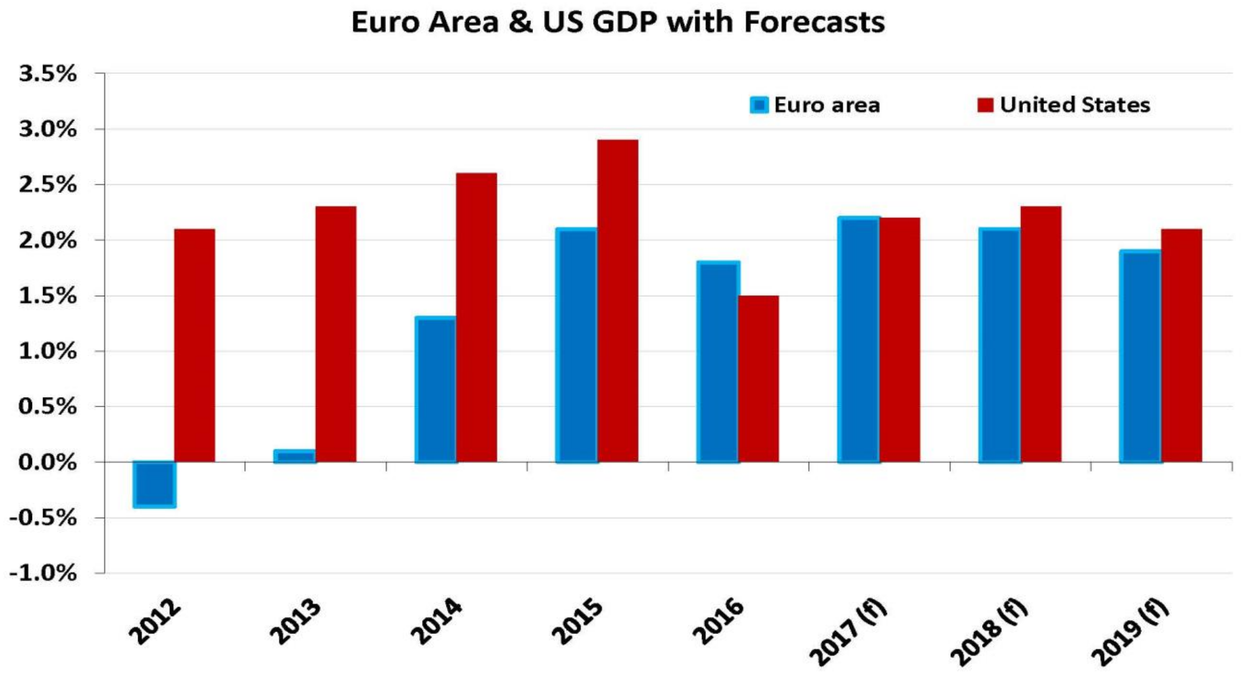


<u>Good news</u>

- All EU MS grew in 2017.
- Stronger than expected employment growth
- Investment is finally growing
- Inflation is expected to pick up
- Public finances are improving gradually
- Growth set to continue
- This robust momentum is accompanied by very strong consumer and business confidence.

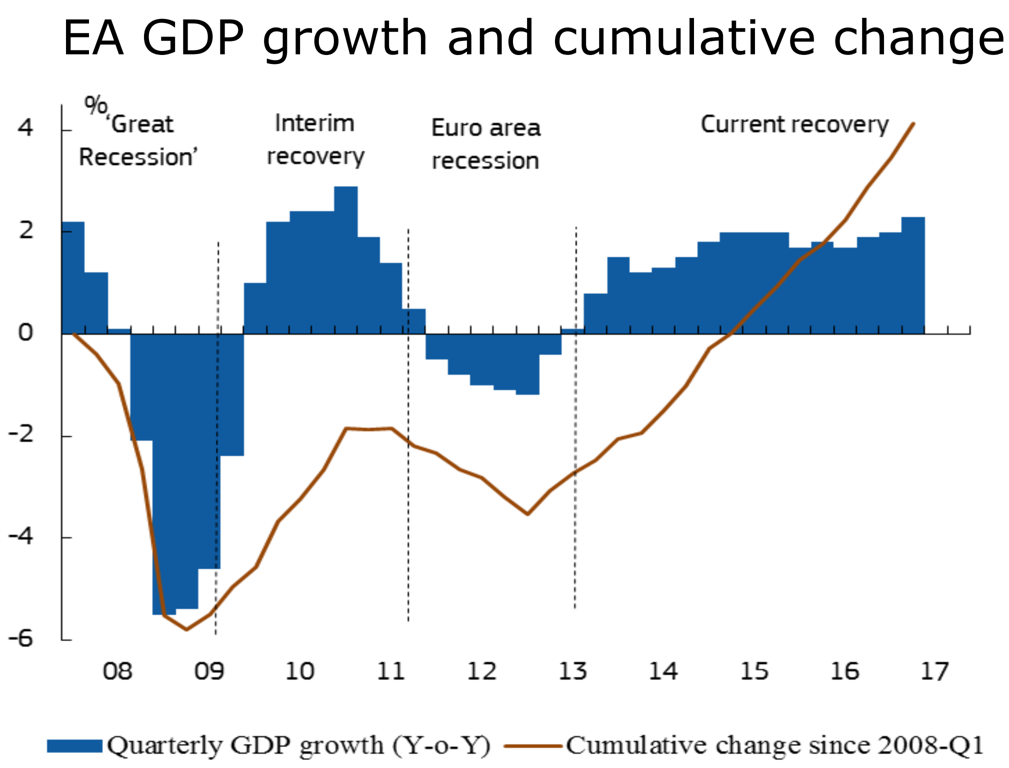
GDP is growing

EU and U.S. real GDP growth, in %



Source: European Economic Forecast - Autumn 2017

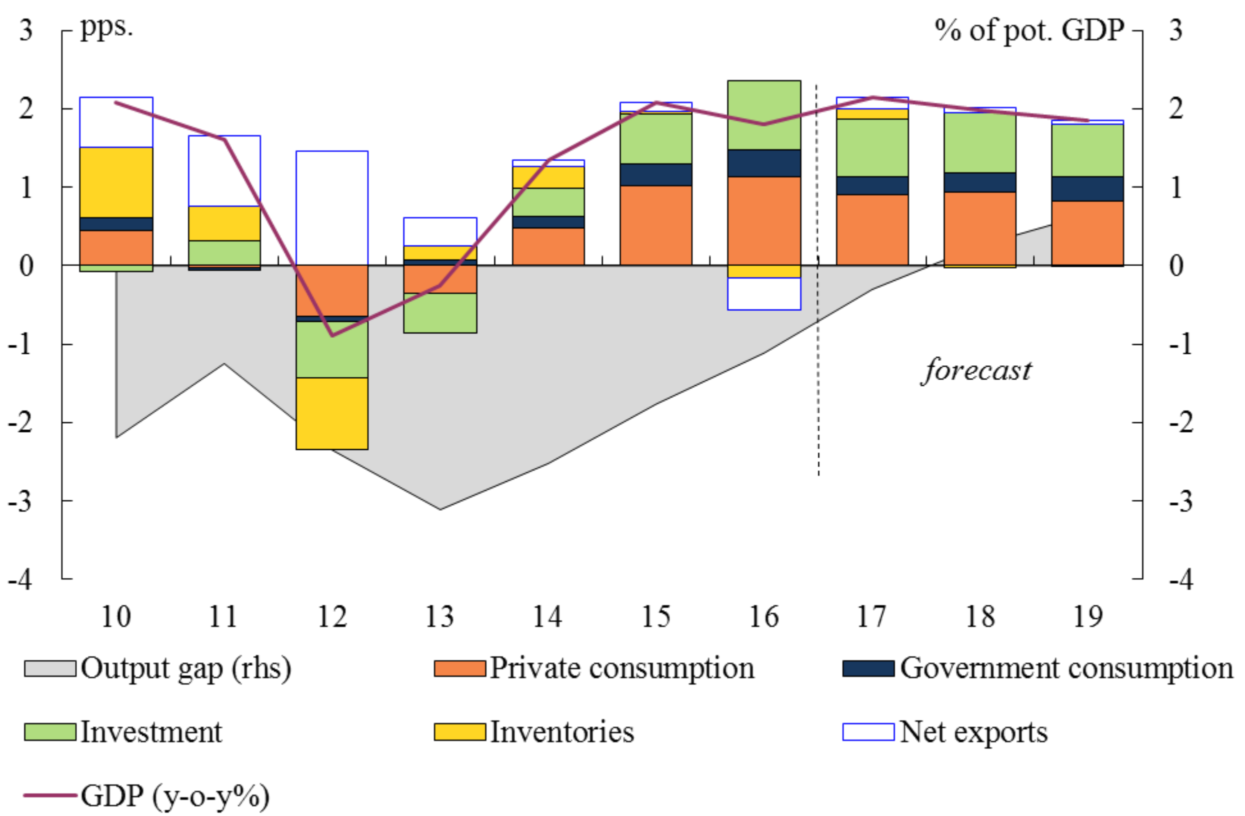
Recovery now in 5th Year



Source: European Commission, Autumn Forecast, 2017

- Real GDP grew above its pre-crisis level in 2015. Growth accelerated in the first 3 quarters of 2017.
- EA: 1.7% in 2016, 1.5% in 2017 and 1.7% in 2018
- The recovery in the EA has been ongoing for 18 straight quarters.
- It has been driven by easy financing conditions, improvements in the labour market and by increasing support from global growth. Consumption has been improving and investment also shows signs of a broad-based pick-up.

Private consumption slowing down but still driving growth

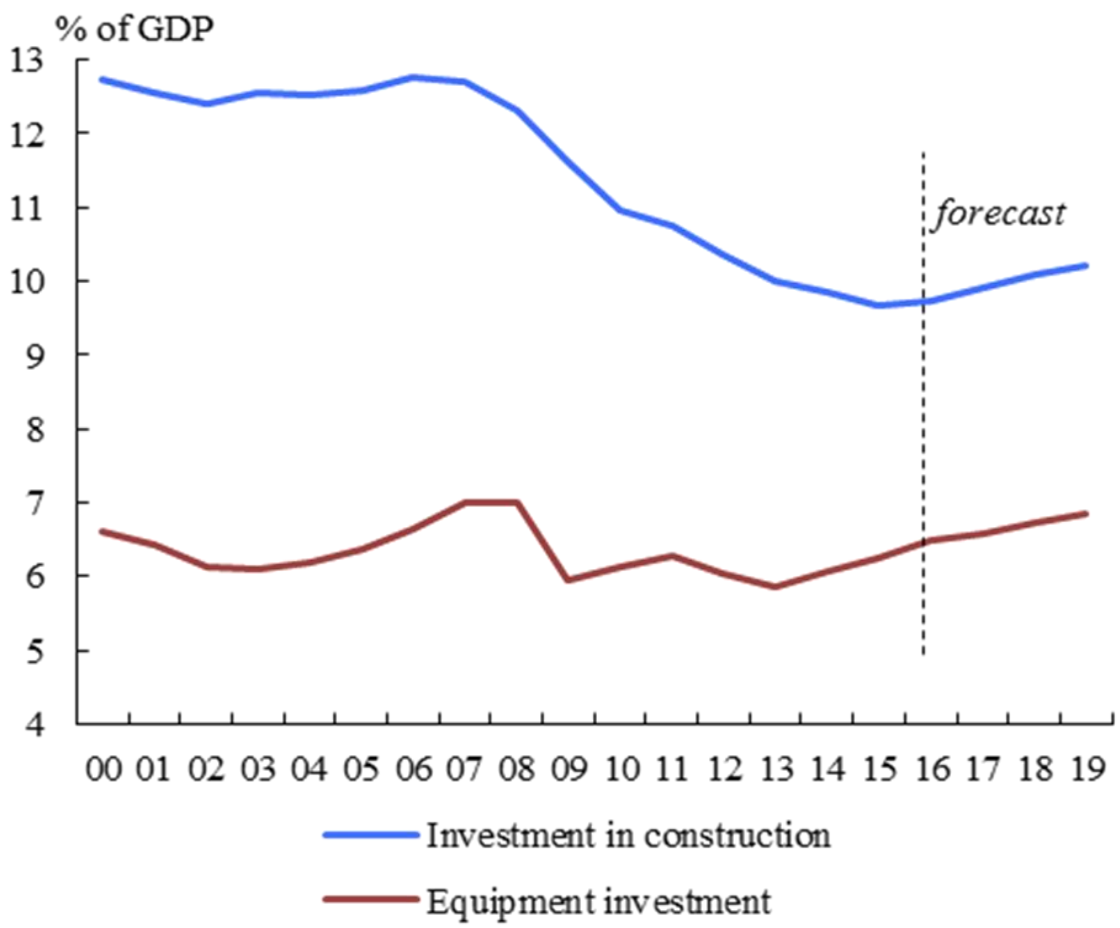


Source: European Commission, Autumn Forecast, 2017

Private consumption has been the key factor in the recovery's recent strength and it will continue over the coming 2 years:

- Job gains are boosting nominal income.
- Low inflation is increasing purchasing power.
- The slowing pace of job creation and the drag from slightly increasing inflation on the purchasing power of households should moderate the growth of private consumption over the next two years.

Investment is picking up

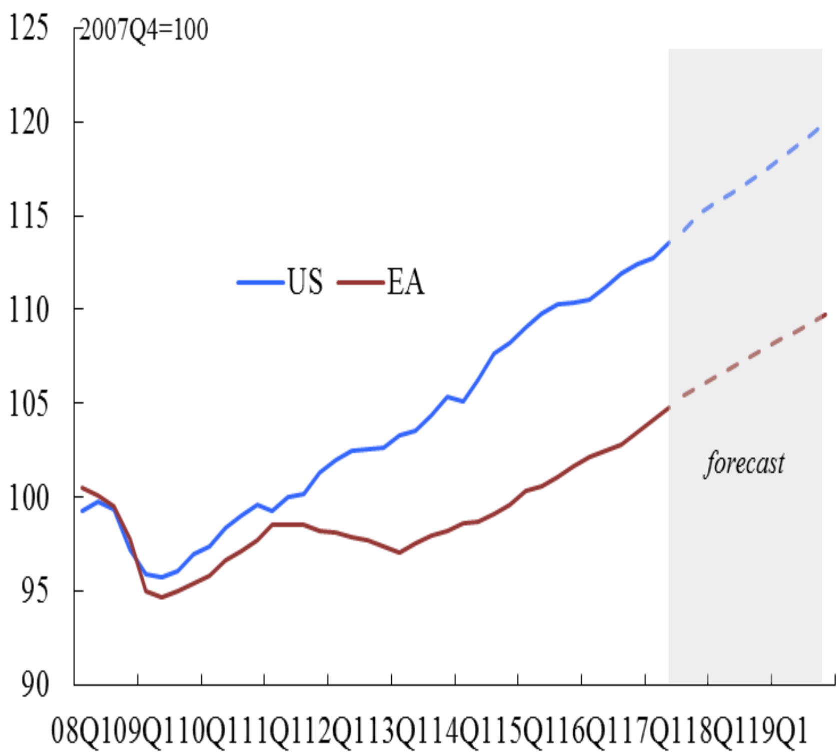


Source: European Commission, Autumn Forecast, 2017

Investment is set to accelerate in 2018:

- Higher demand, diminished uncertainty, strong business sentiment and increased corporate profitability all helping to boost investment.
- Financing conditions have improved and should continue to do so.
- Capacity utilization above LTA
- External demand helping

But the recovery is not yet complete



Source: European Commission, Autumn Forecast, 2017

- It still depends on policy support, fiscal and financial fragilities stemming from the crisis persist, and domestic demand is subdued compared to past recoveries.
- Remaining slack in the labour market and slow productivity growth constrain wage dynamics and dampen inflation.
- The euro area recovery is also less advanced than in other advanced economies such as the US. This clearly suggests that there is scope for continued robust growth without inflationary pressures.

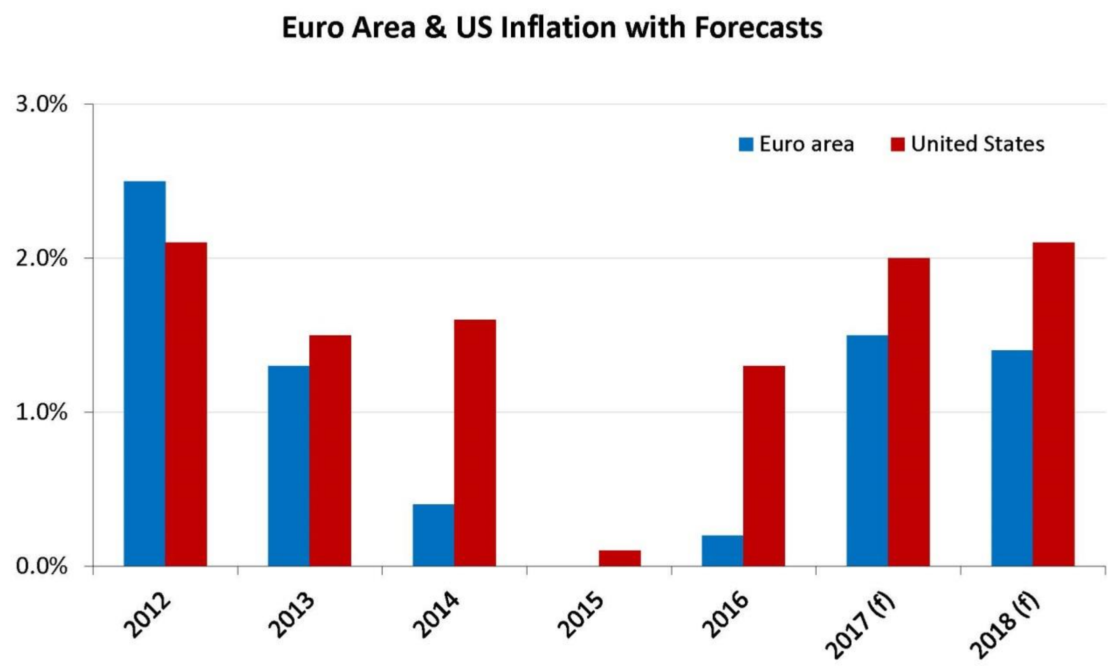
Inflation

- Inflation is the general increase in the level of certain measured prices over a certain period. It is expressed as a percentage change.

- A little inflation is fine, even desirable, but too much of it can be damaging, both to people's livelihoods and to the economy as a whole.

- High inflation usually occurs when an economy is over-heating (growing too quickly). When growth is too weak, there may be a risk of deflation (falling prices) – which sounds great but can be very bad!

Inflation has been low but is expected to pick up more



Source: European Economic Forecast - Autumn 2012

- Despite the backdrop of a strengthening economic recovery, price pressures remain weak and the outlook for inflation remains subdued.
- Headline inflation is projected to pick up only very gradually. It is forecast to ease from 1.5% this year to 1.4% in 2018 and to tick up to 1.6% in 2019.

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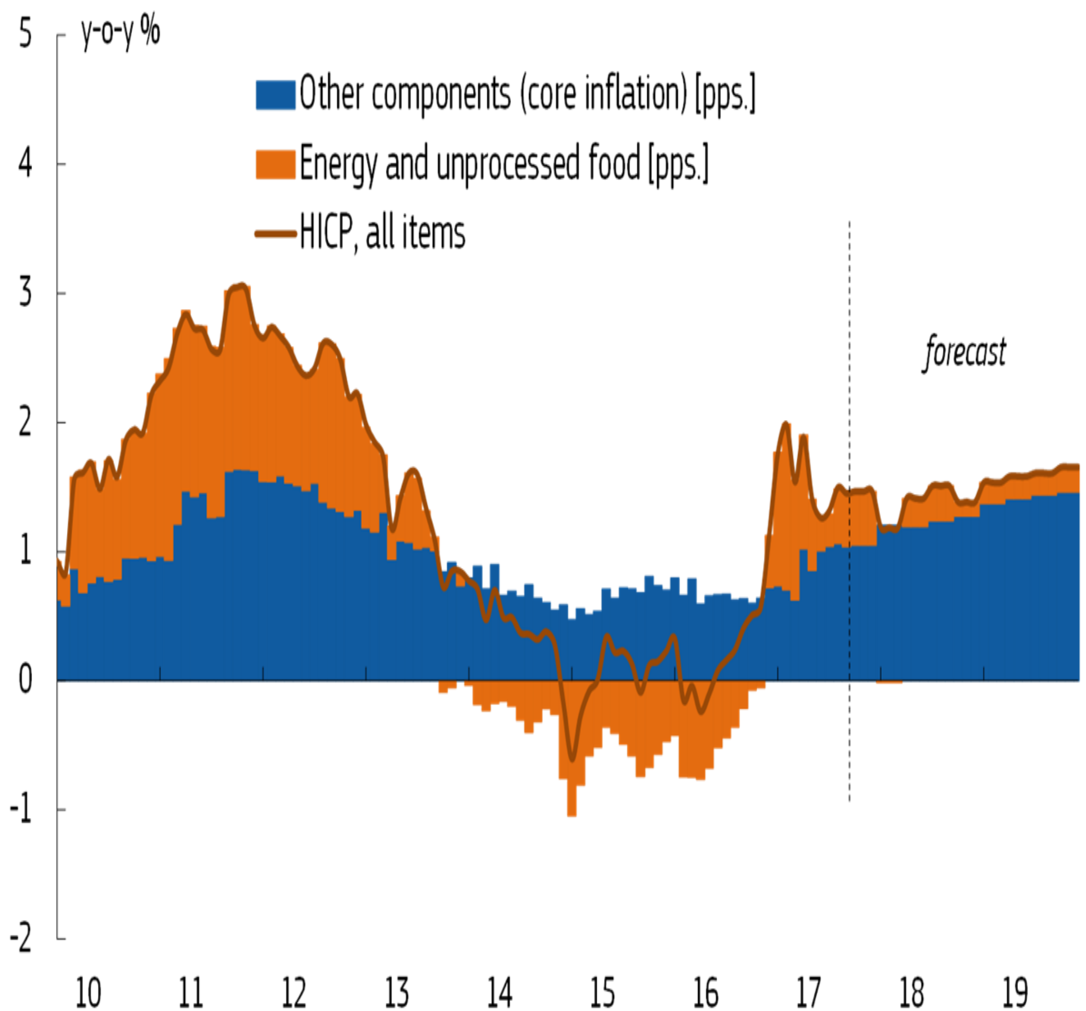
Inflation



Source: European Commission, Autumn Forecast, 2017

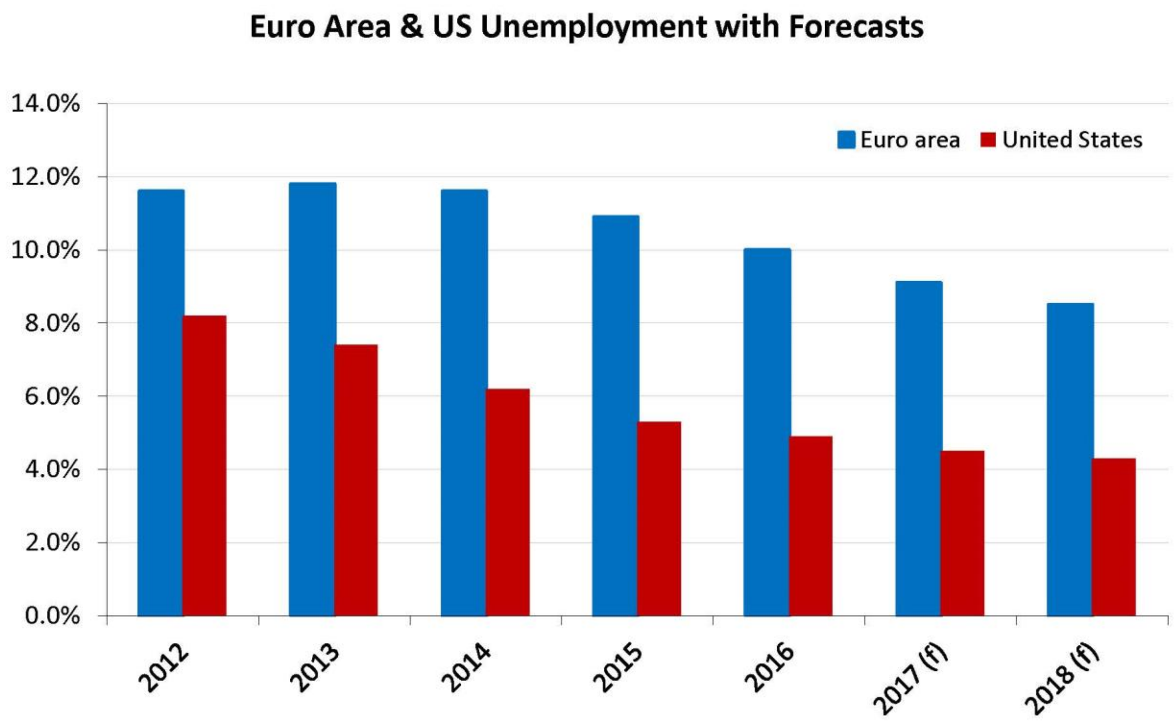
- Why inflation has remained so low has been a key question for policy makers in both the US and the EA.
- High unemployment rates have meant little wage pressure in the EA, but as they come down inflation could begin to increase.
- Still, inflation is forecast to remain below the ECB's target (below, but close to 2% over the medium term). Monetary policy will likely remain accommodative for as long as needed to secure a sustained adjustment in the path of inflation.

Unemployment

- The definition of unemployment is the number of people that are actively looking for work and have not found it in a certain period.
- The unemployment rate is the share of the working-age population that is looking for work but not employed.
- Unemployment normally rises in times of slow or declining GDP growth, and tends to fall in times of stronger GDP growth.
- As economic activity increases, firms hire more workers to produce the goods and services people are consuming.

Unemployment is declining

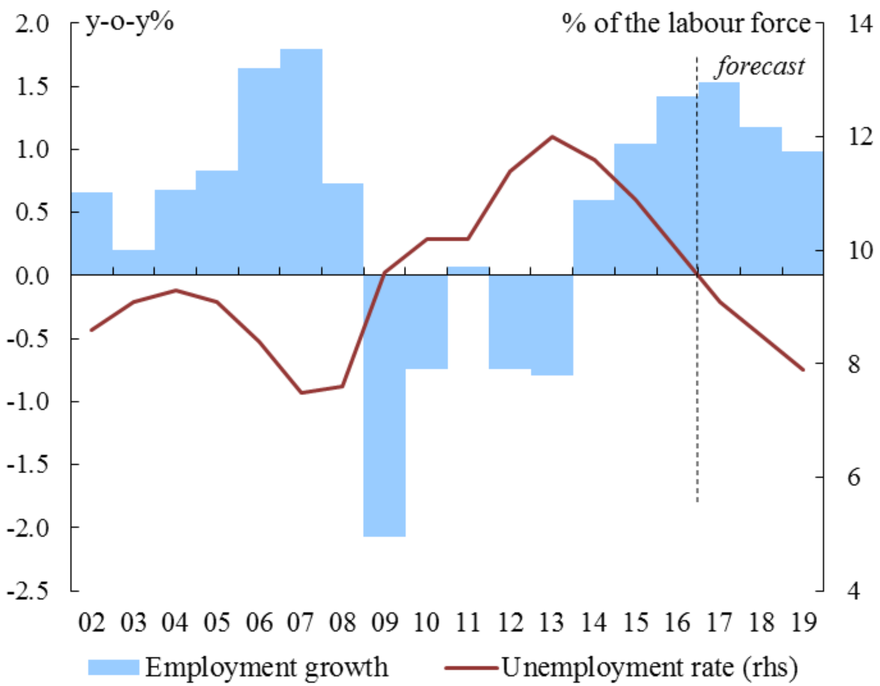
EU and U.S. unemployment rate, in %



Source: **European Economic Forecast - Autumn 2017**

Improved labor market conditions

Employment growth and unemployment rate, EU



Source: European Commission, Autumn Forecast, 2017

- Employment has continued to grow since mid-2013 and grew faster this year than at any time since 2008. Employment growth is expected to moderate slightly but still remain solid in 2018-19.

- The unemployment rate in the EA, while remaining high, is set to come down from roughly 12% in 2013 to 9.1% this year. It should decline further to 7.9% by 2019.

- Large disparities between countries' unemployment rates, which ranged from 3.7% (in Germany) to above 21% (in Greece) in late 2017. Spain has seen unemployment drop from 26% in 2013 to roughly 17% today.

What this presentation will cover

- B. A supportive policy mix

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High debt and deficits

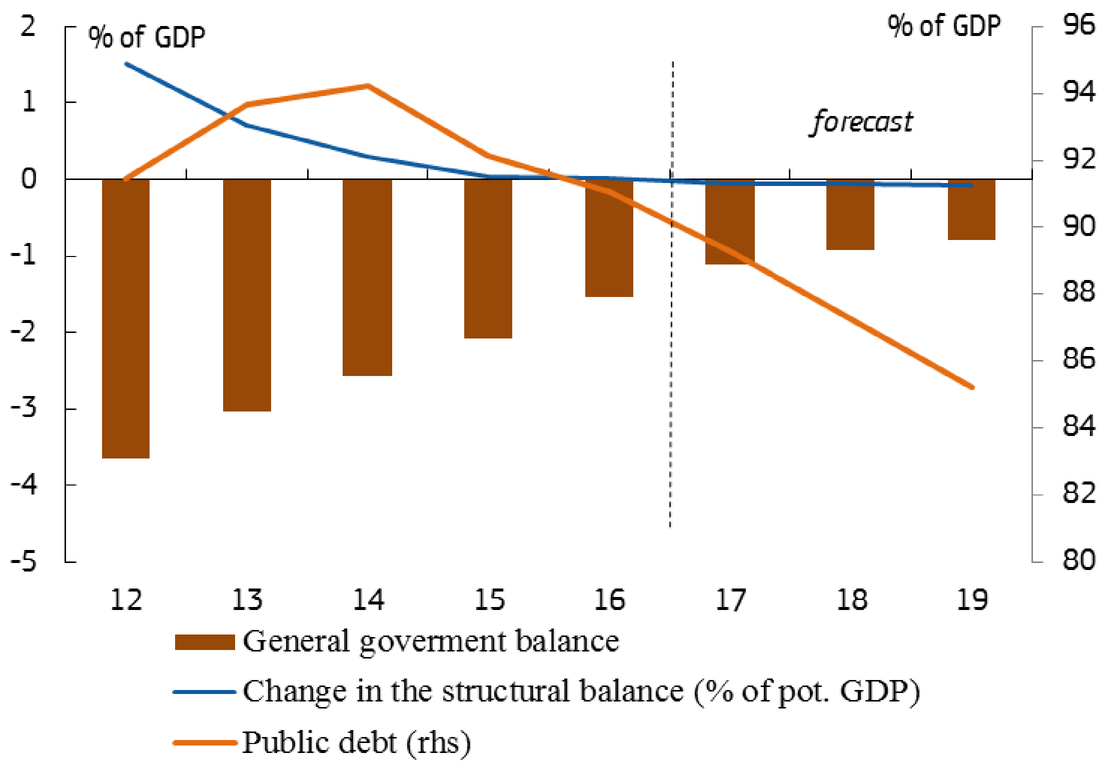
- The *deficit* is the difference between the amount of money a government takes in (revenue) and what it spends (outlays) in a given year. If that number is positive, there is a *surplus.*

- The *debt* is the total amount of money the government owes. It is usually expressed as a percentage of GDP.

- A debt level that is too high can lead to higher borrowing costs and slower economic growth. And slower GDP growth makes it more difficult to reduce deficits and debt!

The fiscal stance in the Euro Area is neutral

Budgetary developments, Euro Area



Source: European Commission, Autumn Forecast, 2017

- After substantial adjustment in the past few years, fiscal policy, as measured by the structural balance, is expected to stay broadly neutral over the next couple of years.
- General government deficits are being reduced. For the EA as a whole, deficit to GDP ratios are forecast to fall to 1.1% in 2017 and 0.9% in 2018.
- Debt to GDP ratios have peaked and is expected to fall from 89.3% in 2017 to 85.2% in 2019.

What is monetary policy?

The euro area's monetary policy is run by the ECB

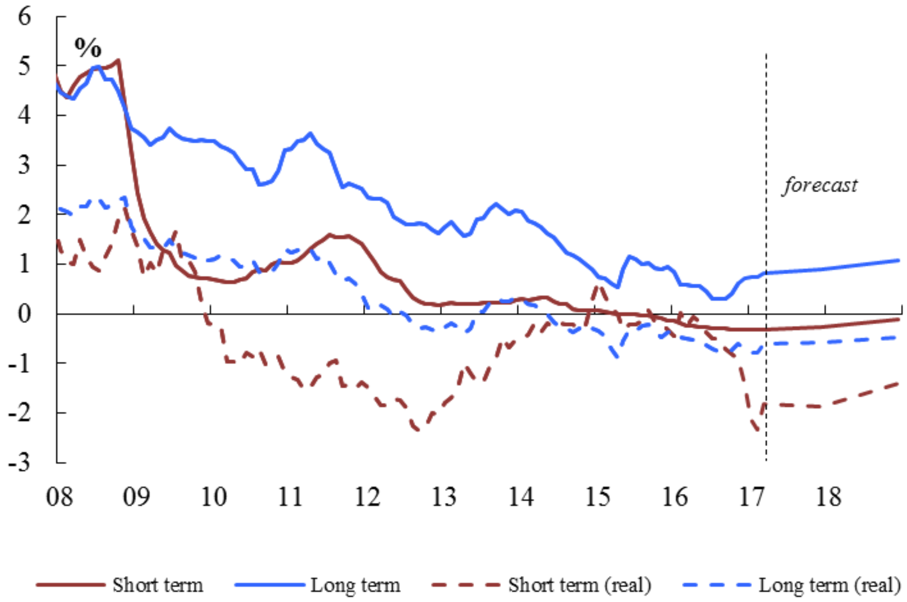
- Monetary policy is the process by which a central bank controls the supply of money for the purpose of steering economic growth and limiting inflation.

- By setting interest rates, central banks can influence borrowing and lending decisions by households and firms. Lower interest rates generally spur economic activity, while higher interest rates slow inflation down.

- Monetary policy can be described as *neutral*, *expansionary* ("loose/easy"), or *contractionary* ("tight"). The ECB targets and inflation rate of close to, but below, 2%, and adjusts monetary policy to meet that target.

Monetary policy is accommodative

Interest rates, euro area



Short term rate: 3M Euribor; Long term rate: 10Y interest swap.

Source: European Commission, Autumn Forecast, 2017

- Interest rates have come down and the ECB has provided additional measures of quantitative and credit easing

- These measures have eased financial fragmentation and improved access to credit.

- The positive impact on confidence and credit should continue, which will support investment and consumption.

- Markets do not expect the ECB to begin raising interest rates until 2019.

What this presentation will cover

- C. Risks

Risks are broadly balanced

For the first time in a long time, risks surrounding the outlook are balanced.

External risks

(-) Elevated geopolitical tensions

(-) Potentially tighter global financial conditions

(-) Shifting US trade policies

(-) Disorderly adjustment in China

(+) Rebound in global growth

Domestic risks

(-) Faster steepening of the yield curve

(-) A stronger euro

(-) Outcome of Brexit negotiations

(+) Improving sentiment

(+) More dynamic investment

(+) Progress on the completion of EMU

Source: European Commission

Key Messages

- Acceleration of growth with all MS participating
- Robust employment growth ahead though moderating
- But the recovery remains incomplete
- The outlook for inflation remains subdued
- The fiscal outlook is improving

And for the first time in a long time…

Risks are broadly balanced!

Good luck in the 2018 Euro Challenge!

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