



# **EURO** CHALLENGE

## The Euro Area Economy Update



Delegation of the European Union to the United States

[www.euro-challenge.org](http://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

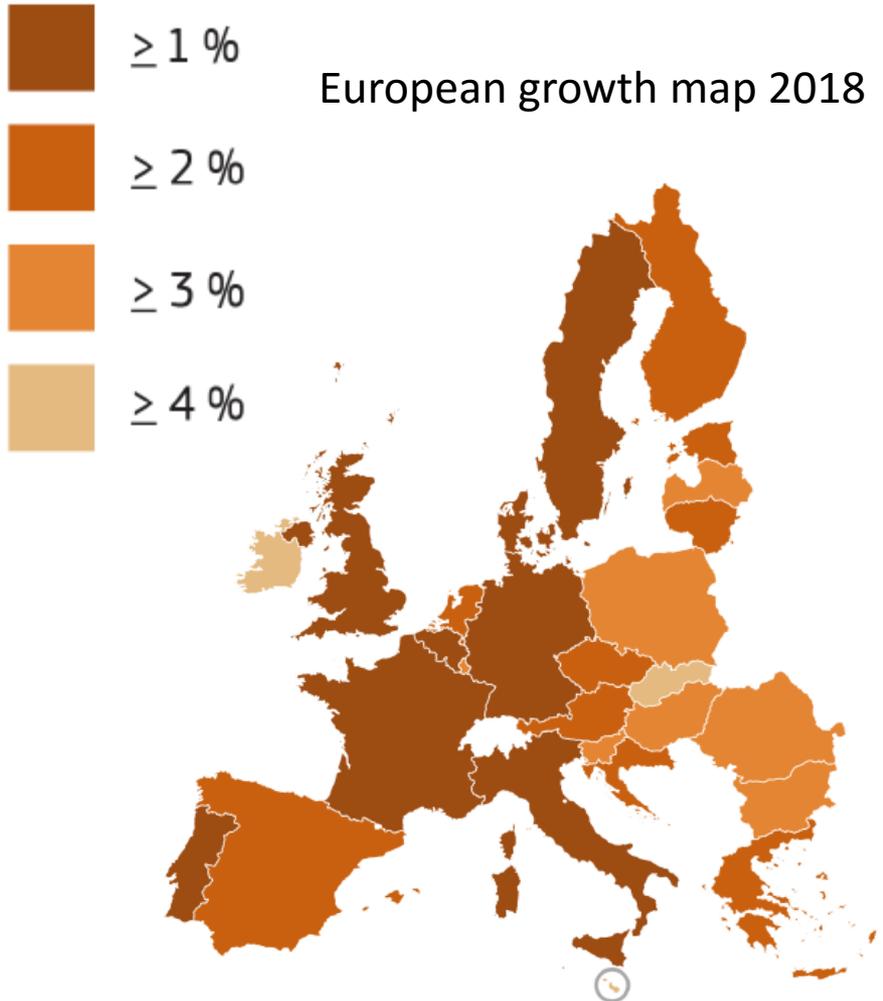
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- A. Update on the economic situation in the euro area (GDP, Inflation, Unemployment)



- **Gross Domestic Product** (GDP) is the total value of all the goods (e.g. cars, iPhones) 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 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 keeps improving

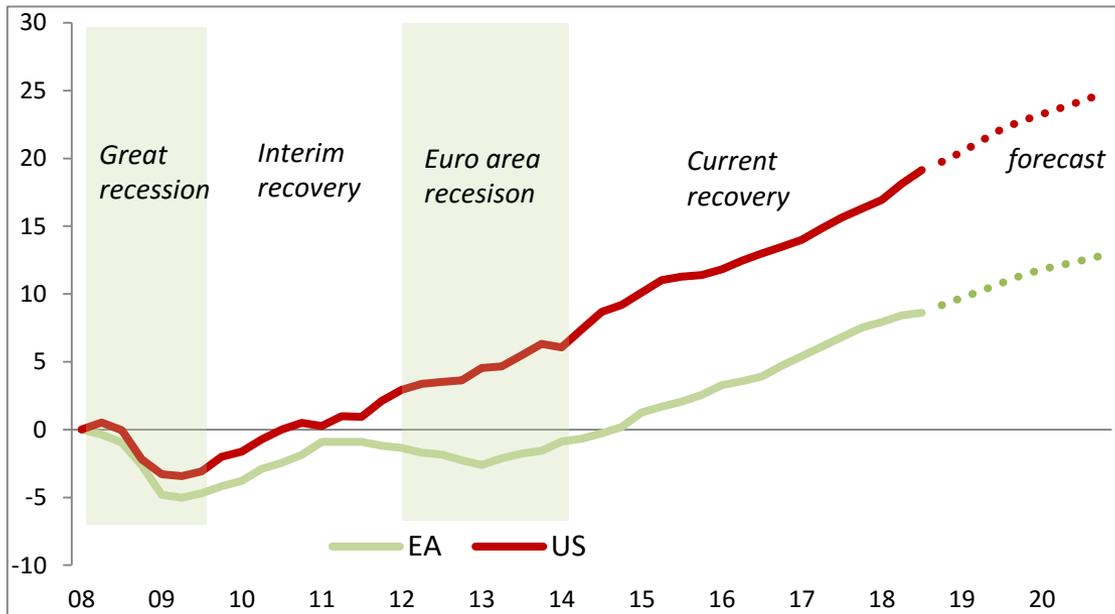


In a nutshell:

- All EU and Euro Area MS grew in 2017 and 2018
- Stronger than expected employment growth
- Investment is picking up
- Inflation remains subdued
- Public finances are gradually improving
- Growth set to continue 2019

Source: European Commission, Spring Forecast, 2018

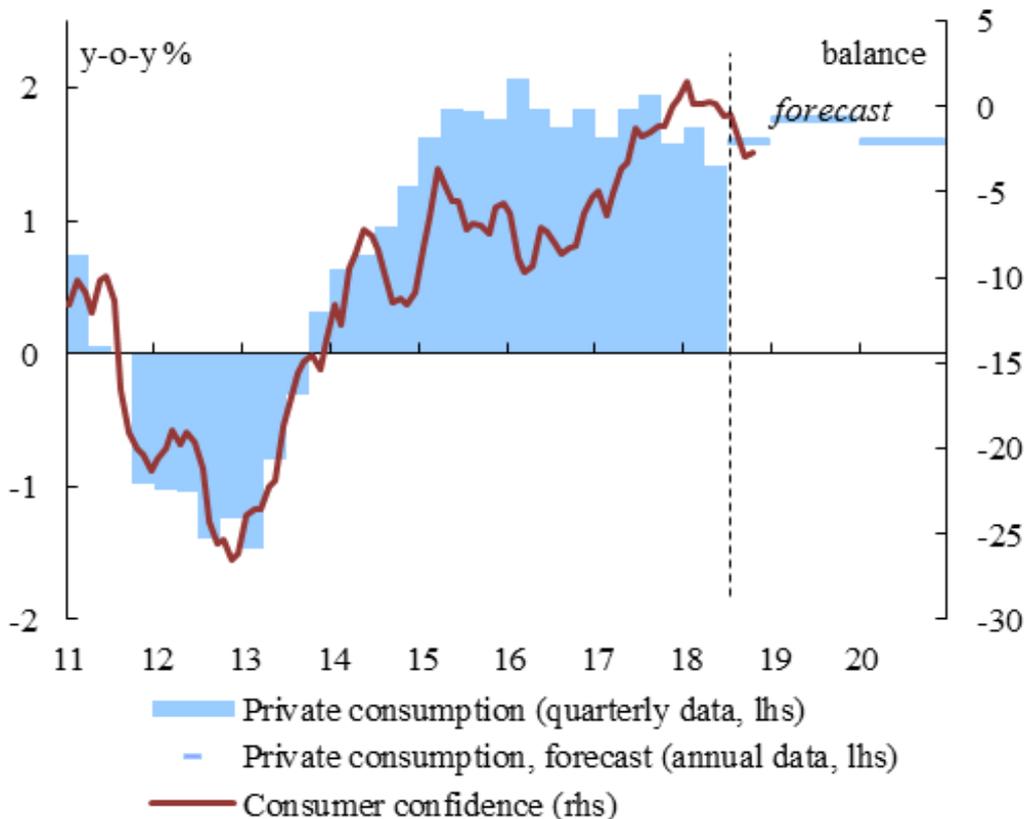
## EA GDP growth and cumulative change



Source: European Commission, Spring Forecast, 2018

- Real GDP grew above its pre-crisis level in 2015. Growth accelerated in the first 3 quarters of 2017.
- EA: 2.4% in 2017, 2.1 % in 2018 1.9 % in 2018 and 1.7% in 2020.
- The recovery in the EA has been ongoing for 22 quarters.
- It has been driven by easy financing conditions, improvements in the labour market and by increasing support from global growth.
- This robust momentum is accompanied by strong, but declining consumer and business confidence.

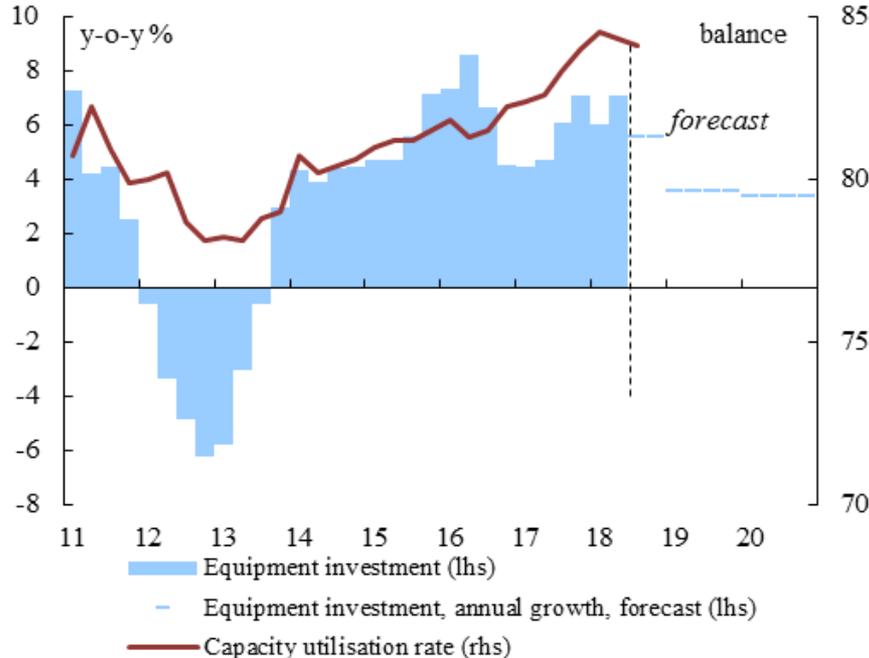
## Private consumption and consumer confidence



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.

## Equipment investment and capacity utilisation, euro area

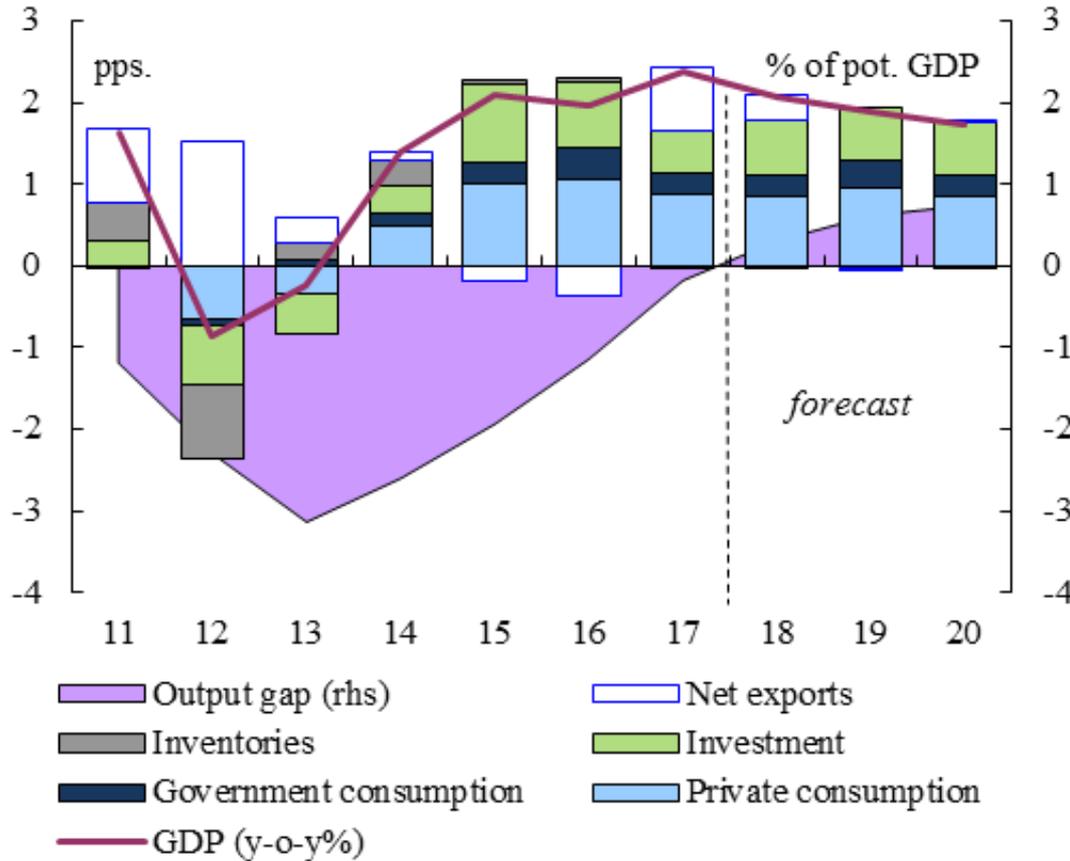


Investment has accelerated in 2018:

- 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

Investment growth is expected to stabilise at lower levels.

# Conditions have been supportive so far but the gap with the level of potential economic activity has now closed



Overall growth in the EA has benefited from supportive conditions:

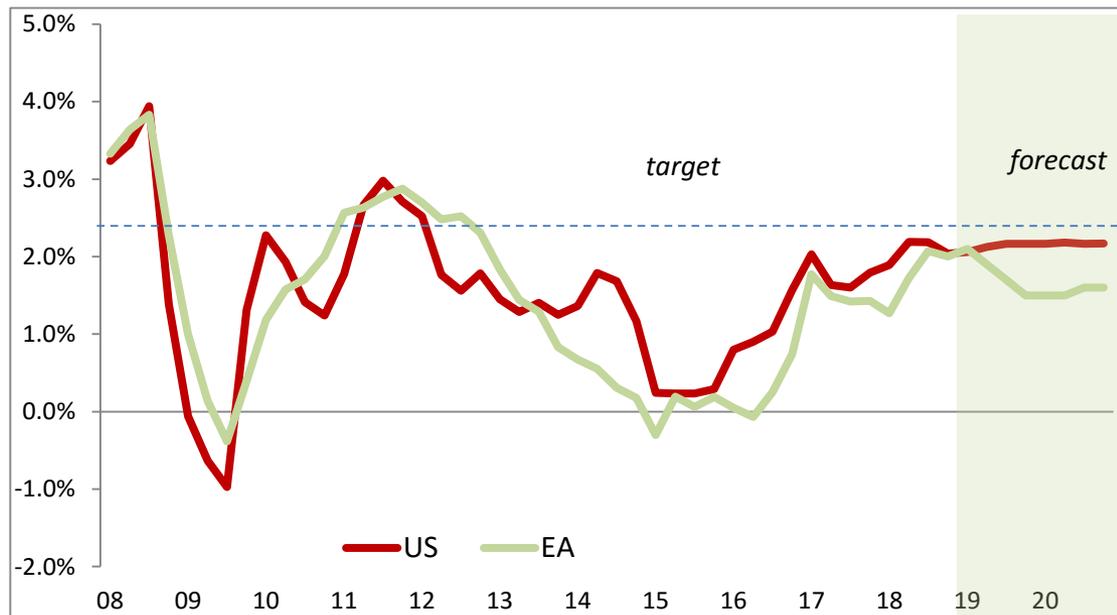
- Global demand has contributed to the strong 2017 performance, but is set to slow as global economic activity decelerates
- Its contribution is set to decelerate in 2019, while government spending is set to partly offset the drag on growth of faltering global demand
- Output gap is estimated to have closed by 2018, so the economy is expected to start growing above potential



- 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 above potential). When growth is too weak, there may be a risk of deflation (falling prices) – which sounds great but can be very bad!

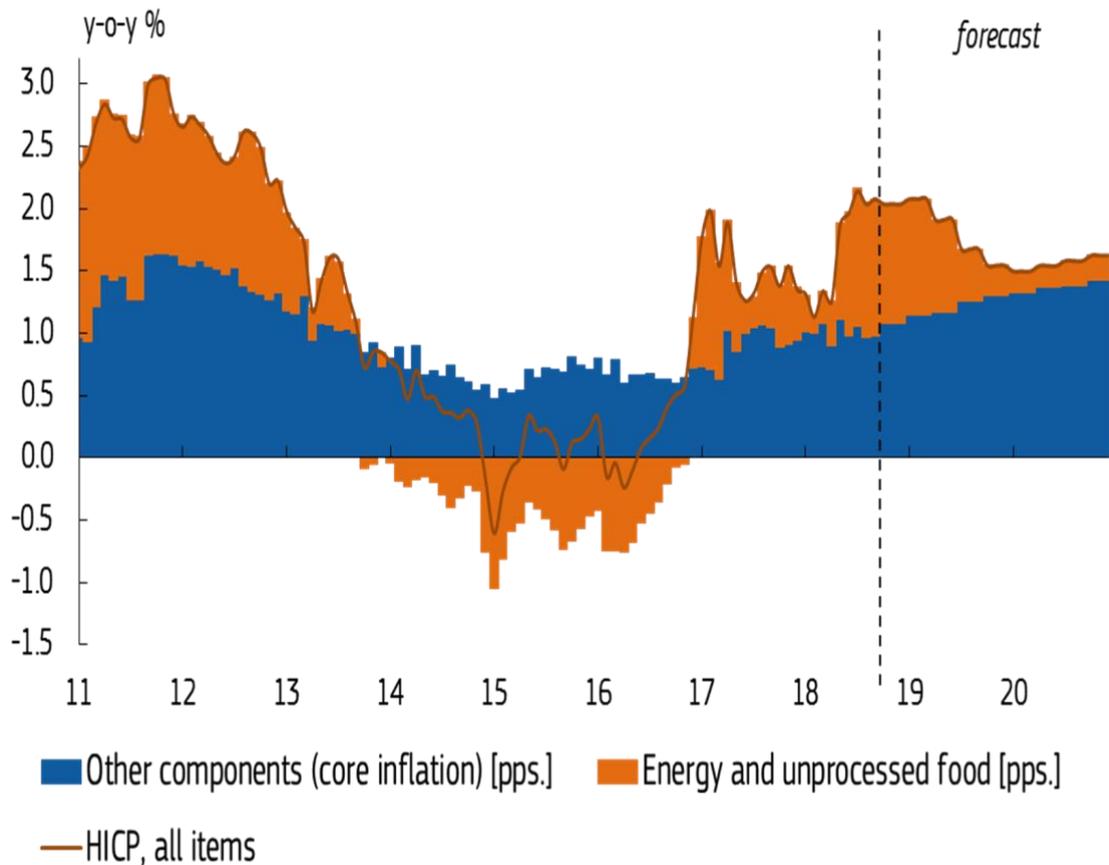
# Inflation has been low and is expected to remain subdued

## EA and U.S. headline inflation rate



- 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 increase from 1.5% this year to 1.8% in 2018 and 2019 before going down to 1.6% in 2020.
- This dynamics is partly explained by volatile energy prices

# Core inflation and headline inflation

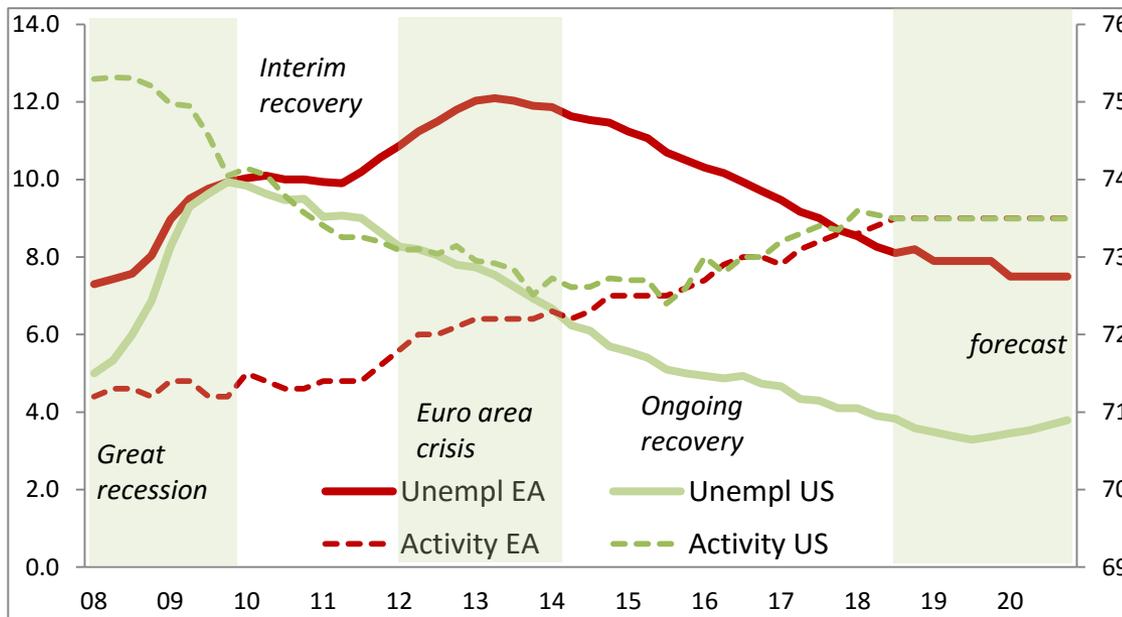


- In principle when growth is above potential (core) inflation is expected to pick up
- Why inflation has remained so low has been a key question for policy makers in both the US and the EA
- High unemployment rates have meant little wage pressure in the EA, but as they come down inflation should begin 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



- 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 active population (unemployed + employed) 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.

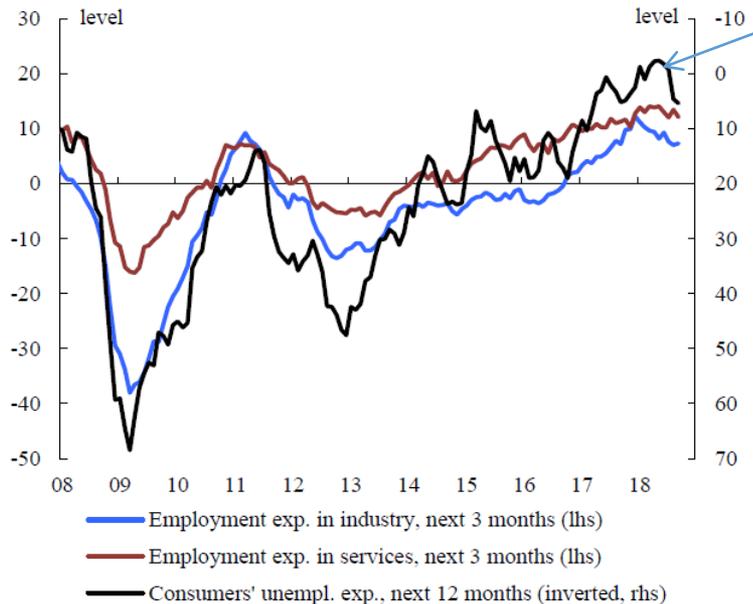
## EU and U.S. unemployment rate and participation rate, in %



- The unemployment rate in the EA, while remaining high, is set to come down from roughly 12% in 2013 to 8.4 % this year. It should decline further to 7.9% by 2019.
- Unemployment has declined in a context of increasing labor market participation – now on par with US for people aged 15 to 65
- Large disparities between countries' unemployment rates, which ranged from 3.5% (in Germany) to just under 20% (in Greece) in late 2018. Spain has seen unemployment drop from almost 30% in 2013 to under 16% today.

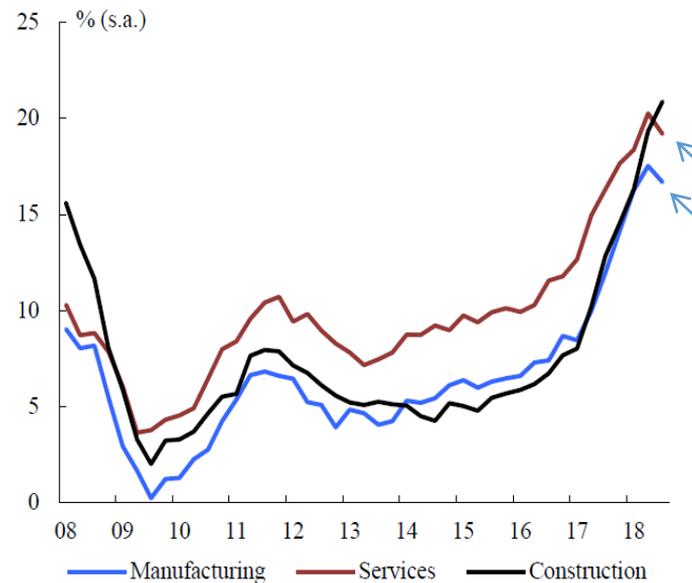
# Employment set to keep increasing, but bottlenecks are emerging

Employment expectations



- Hiring intentions of firms remain above their long-term averages
- Unemployment expectations remain on historical lows, but have registered some deterioration

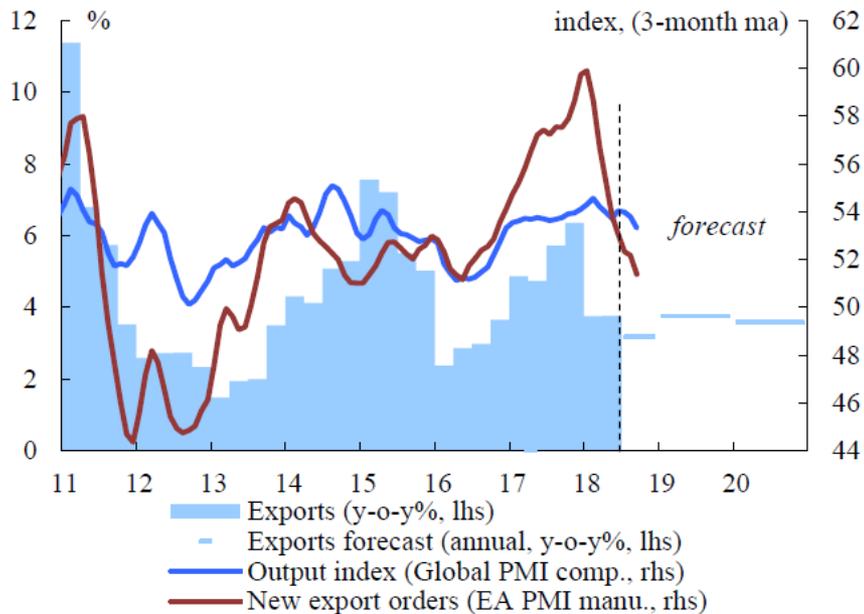
Labour seen as limiting factor of activity



- Firms have faced increasing challenges from a tightening labour market
- In the last quarter of 2017, the seasonally-adjusted job vacancy rate reached a new all-time high
- ... but new worries seem to emerge

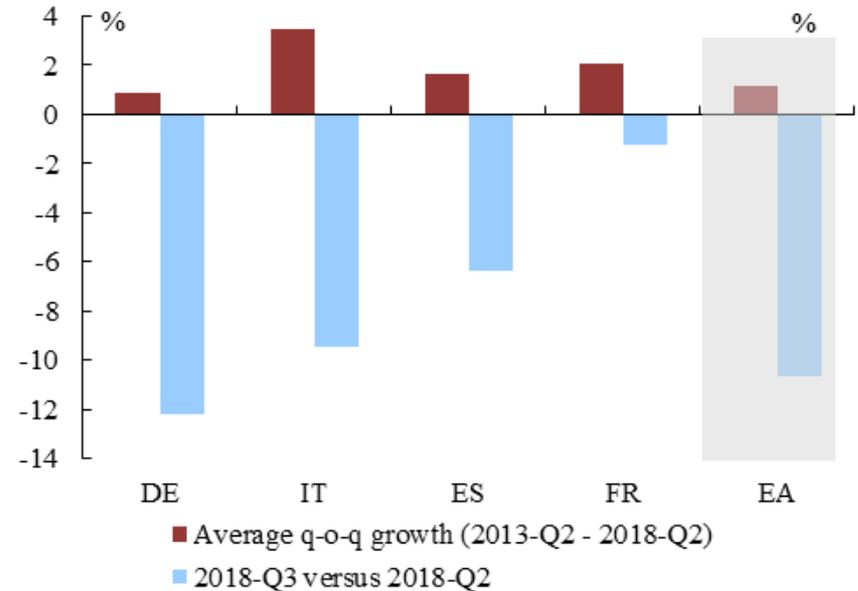
# But trade uncertainties are biting while car production was hit by new emission standards

## Global demand, euro area exports and new export orders



Source: EC, Markit Group Limited.

## Production of motor vehicles in 2018Q3



# What this presentation will cover

- B. A supportive policy mix

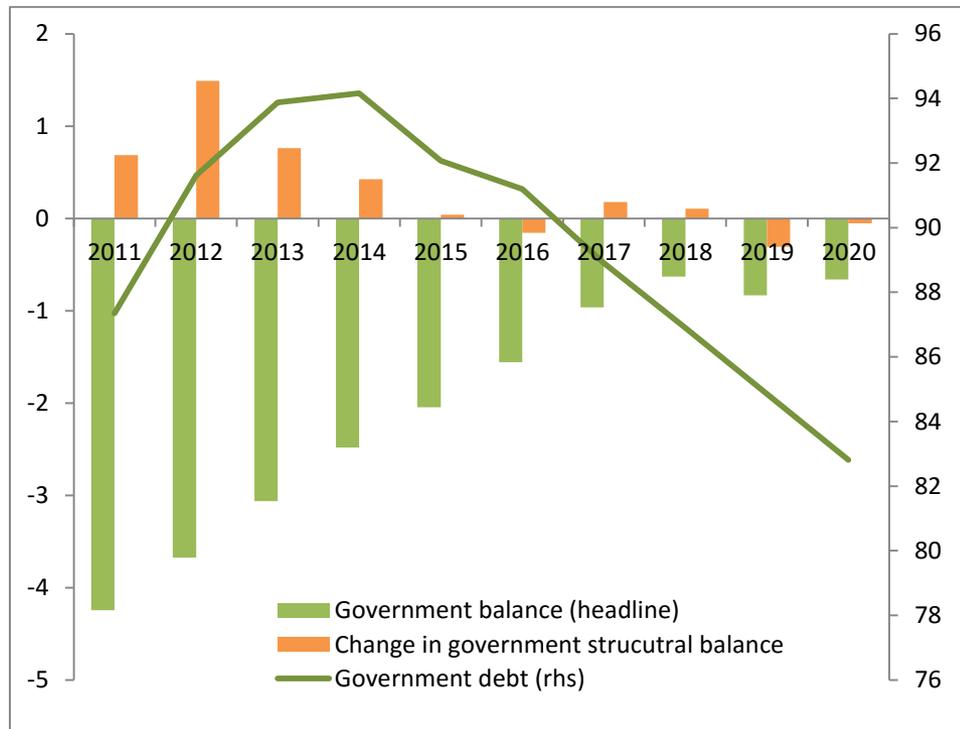
# Fiscal policy, deficit, debt



- When the government increases spending or reduces taxes it carries out an **expansionary fiscal policy**, which typically has a positive impact on GDP growth in the short run.
- When the government increases taxes or reduces spending it is said to carry out a **contractionary fiscal policy (austerity)**. This tends to have a negative impact on GDP growth in the short run.
- The budget **deficit** is the difference between government revenue and 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 results from accumulating deficits over time. 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 and higher interest rates make it more difficult to reduce deficits and debt – producing a debt spiral.

# The fiscal stance in the Euro Area is neutral

Budgetary developments, Euro Area



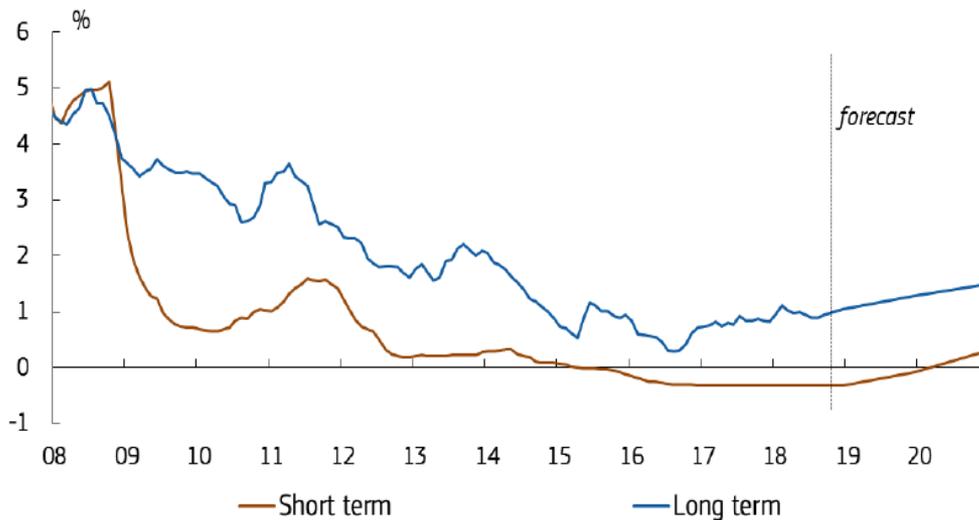
- After substantial adjustment in the past few years, fiscal policy, as measured by the structural balance, is expected to become mildly expansionary in 2019.
- General government deficits are forecast to increase somewhat. For the EA as a whole, deficit to GDP ratios are forecast to increase from 0.6 % in 2018 and 0.8% in 2019 and return to 0.6 in 2020.
- Debt to GDP ratio has peaked at 94 % in 2014 and is expected to keep falling to around 82% in 2020 (12 pps below the peak).

# What is monetary policy?



- 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.

## Interest rates, euro area



Source: European Commission, Autumn Forecast, 2018

- 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, but asset purchase programme is set to stop in December

# What are structural reforms?



- Structural reforms are measures that change the fabric of an economy, the institutional and regulatory framework in which businesses and people operate and the incentives they face (aka supply side reforms)
- Well-designed structural reforms increase the rate of potential growth and strengthen the resilience of the economy to adverse shocks, but tend to have adverse short-term effects (difficult to implement)
- Structural reforms tend to be difficult to implement as they face the opposition of voters, lobbyists and interest groups

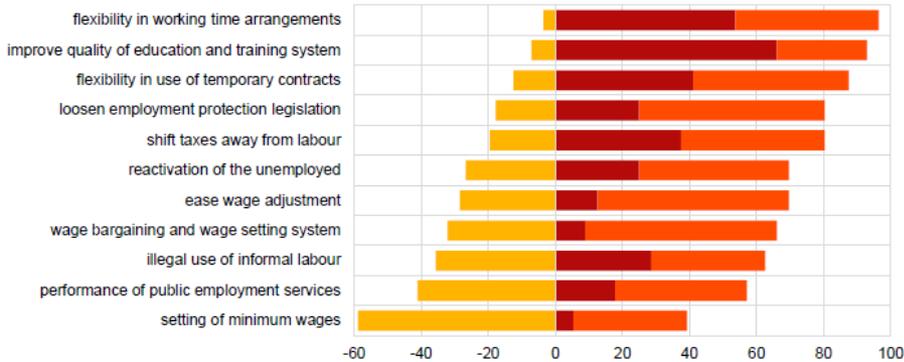
# Which structural reforms for the Euro area?



## Labour market reform needs in the euro area

(percentage of respondents; responses ranked by overall rating)

■ very important  
■ important  
■ not important

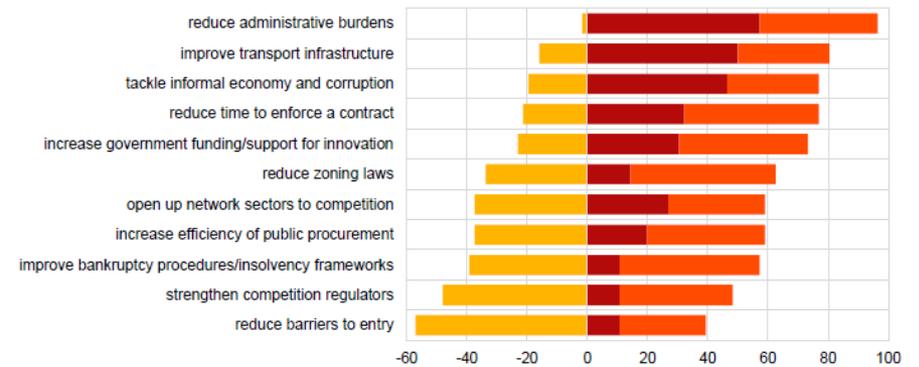


Sources: ECB Structural Reforms Survey and ECB staff calculations.  
 Notes: based on responses to the question "How do you assess labour market reform needs in the euro area countries in your sector?" Negative percentages refer to respondents reporting elements as "not important".

## Business environment reform needs in the euro area

(percentage of respondents; responses ranked by overall rating)

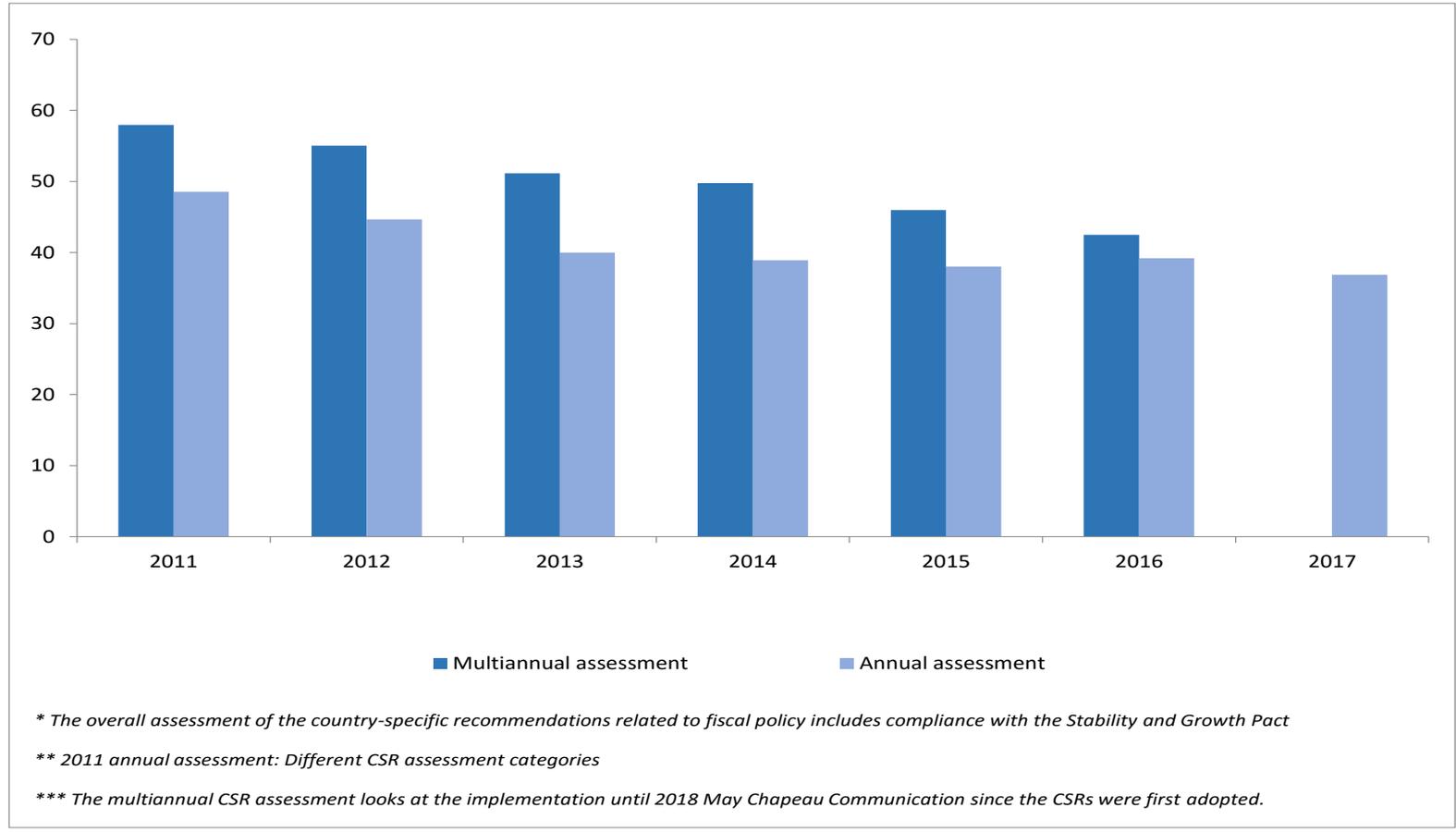
■ very important  
■ important  
■ not important



Sources: ECB Structural Reforms Survey and ECB staff calculations.  
 Notes: based on responses to the question "How do you assess structural reform needs relating to the business environment at country level in the euro area in your sector?" Negative percentages refer to respondents reporting elements as "not important".



## Implementation of structural Country Specific Recommendations, annual and multiannual



# The big debate: what policy mix for the Euro area?



- Intense debate between economists on adequate fiscal and monetary policy mix during the Euro crisis and especially Greek rescue program
- There is a broad agreement that the current macro policy mix (supportive monetary policy and neutral fiscal stance) is adequate **on average**
- ...but fiscal stance should be more expansionary in some countries and less so in others while...
- ...implementation of structural reforms has slowed down.

# What this presentation will cover

- C. Risks

The risks surrounding the outlook all negative

## External risks

(-) Unwarranted effects of the US fiscal stimulus (e.g. faster monetary tightening in the US)

(-) Global financial market stress / pick-up in yields

(-) Trade disputes and protectionism

(-) Geopolitical tensions

## Domestic risks

(-) Uncertain outcome of the Brexit negotiations

(-) Fiscal developments in Italy

- ➔ Growth decelerating, but remains strong
- ➔ The expansion is broad based: all demand components (consumption, investment) and all member states are growing
- ➔ Employment keeps expanding robustly: activity rates are up and unemployment is down
- ➔ Despite emerging bottlenecks in the labor market, inflation remains subdued
- ➔ The fiscal output is improving

But:

Significant downside risks



**Good luck in the 2019 Euro Challenge!**



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