

THE EURO AREA: ECONOMIC SITUATION, PROSPECTS AND CHALLENGES

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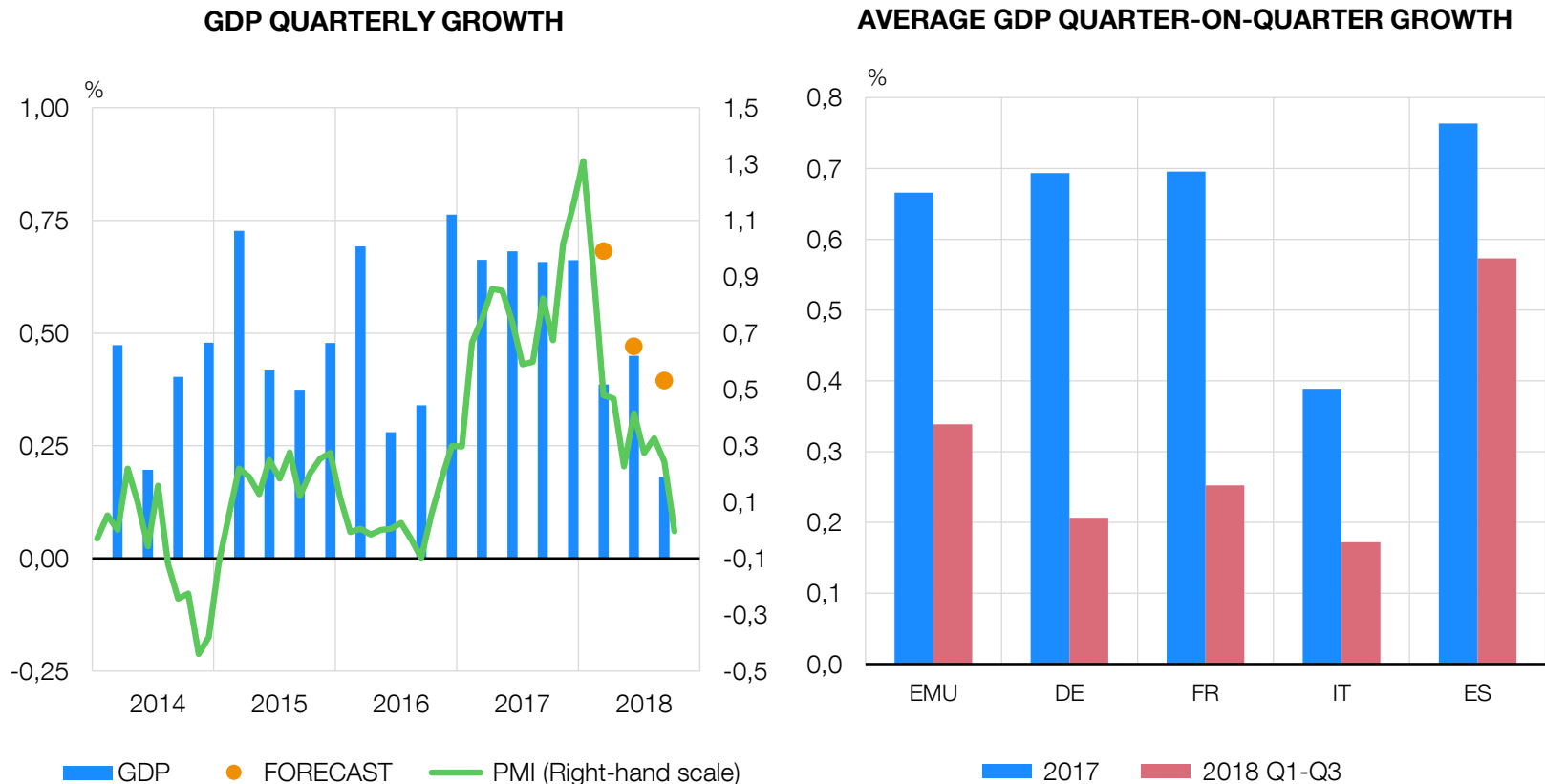
The euro area: economic situation, prospects and challenges

OUTLINE

1. The slowdown of economic growth in the euro area
2. Growth and inflation prospects
3. Rising risks
4. Main challenges

The slowdown of economic growth in 2018

- Following strong momentum in 2017, growth in the EA is slowing: Average qoq growth stood near 0,7% in 2017; 0,3% in the first three quarters in 2018 (0,15% in Q3).
- The slowdown has been larger than anticipated, and affects all large euro area countries



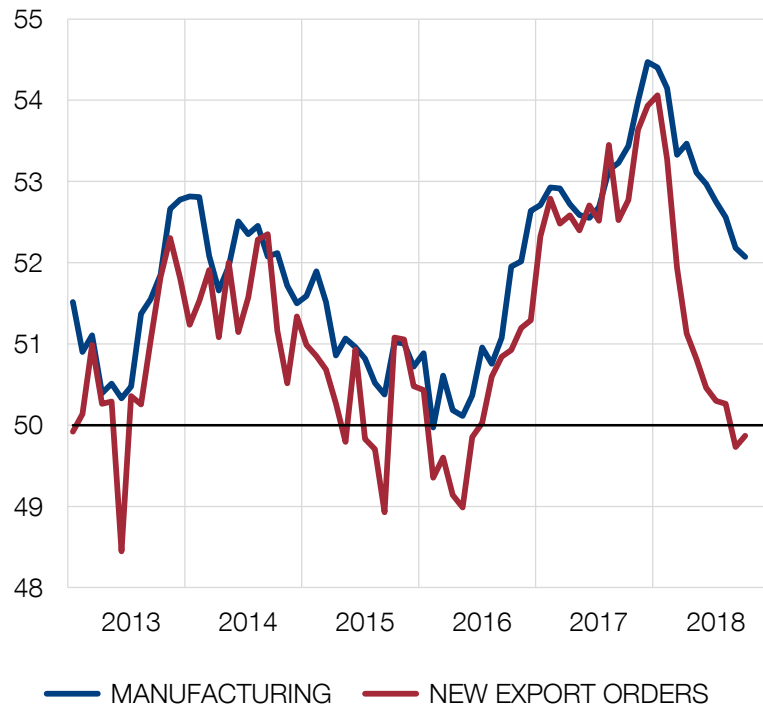
Sources: Eurostat, European Commission, ECB and IHS Markit.

(a) Nearest ECB forecast. Last March, June and September exercises for Q1, Q2 and Q3, respectively

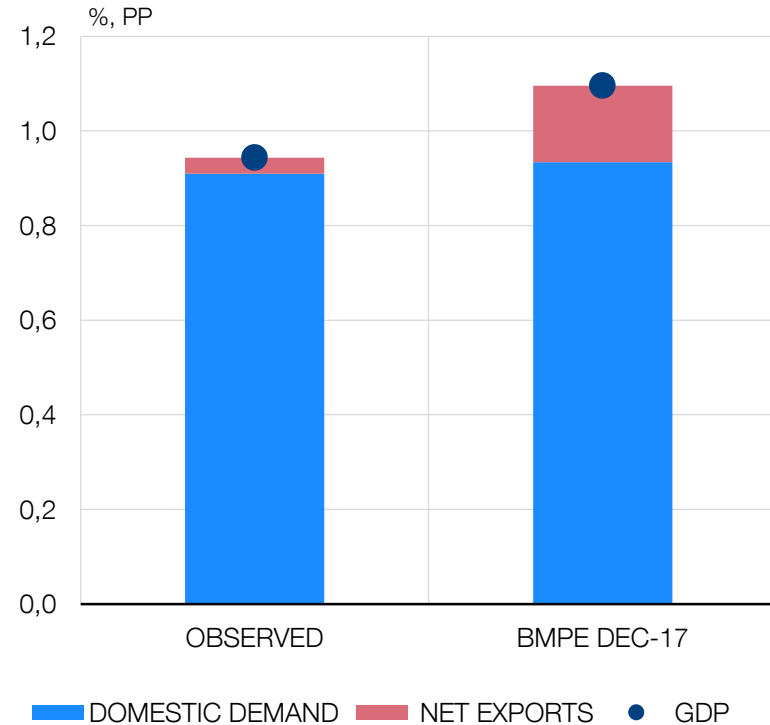
External Factors stand behind the larger than expected moderation

- Modest growth during 2018 largely reflects global trade moderation: Net trade contribution to growth has been negligible
- Transitory factors could have also played a role in some countries (weather, strikes, diesel...)

GLOBAL PMI



REAL GDP GROWTH AND CONTRIBUTIONS
FIRST HALF OF 2018

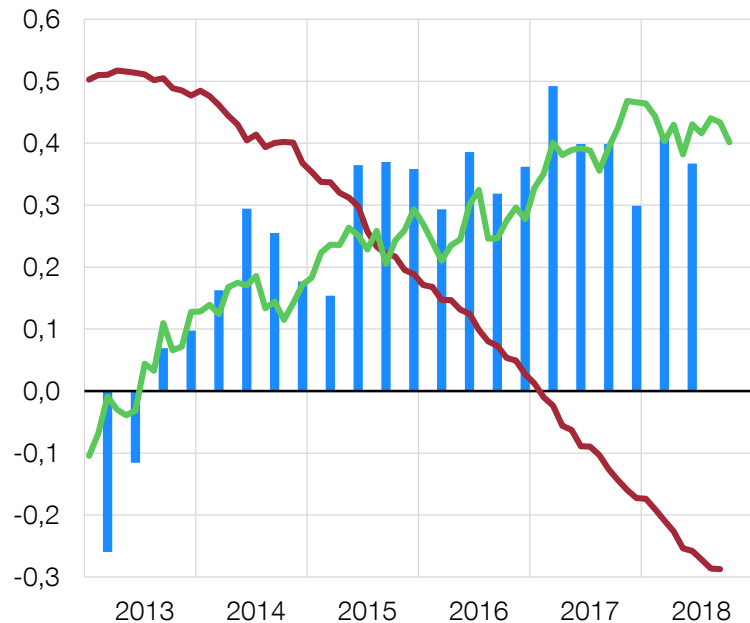


Sources: ECB, Eurostat and IHS Markit. Last date: 2018, October for PMI

Domestic fundamentals (I): Labour market developments

- Domestic fundamentals remained resilient, underpinning economic growth
- Job creation has been key in the expansion and is expected to remain robust
- Labour market improvements are starting to be transmitted to wage growth. The rise in wages is broad-based by sectors and countries.

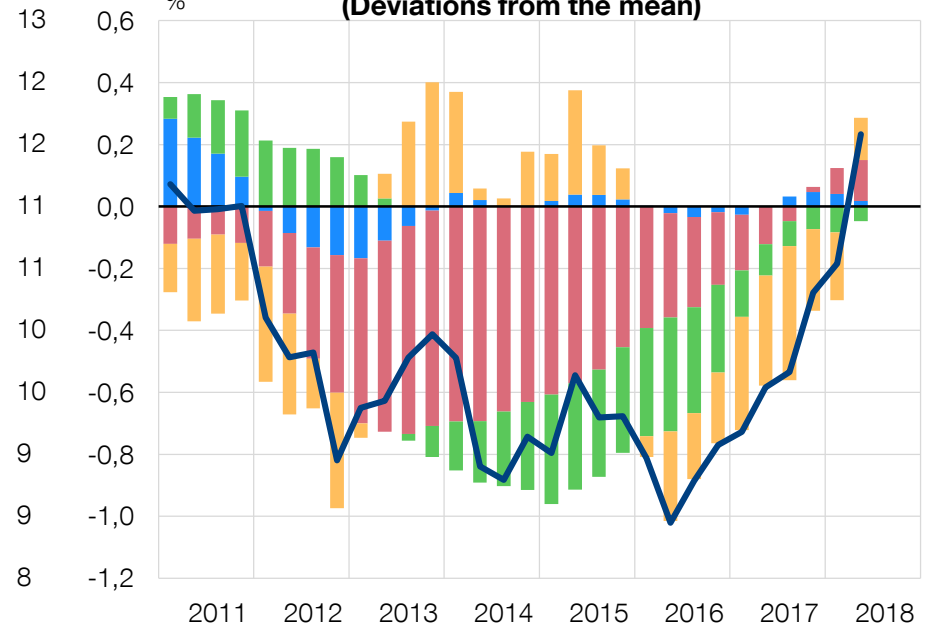
EMPLOYMENT, UNEMPLOYMENT AND PMI INDEX



■ EMPLOYMENT (quarter-on-quarter growth)
— UNEMPLOYMENT RATE (Right-hand scale)
— PMI ASSESSMENT OF EMPLOYMENT (Right-hand scale)

Source: Eurostat and IHS Markit. Last date: 2018 Q2 to employment and compensation per employee, 2018 September to unemployment and 2018 October to PMI

COMPENSATION PER EMPLOYEE GROWTH DECOMPOSITION
Breakdown based on Phillips Curve estimation
(Deviations from the mean)

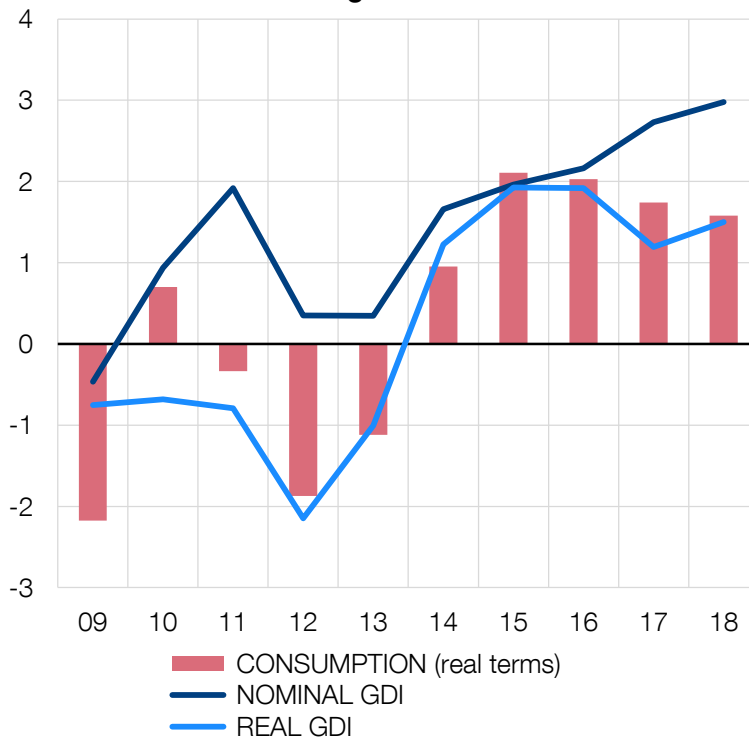


■ RESIDUAL
■ INFLATION
■ UNEMPLOYMENT GAP
■ PRODUCTIVITY
— COMPENSATION PER EMPLOYEE

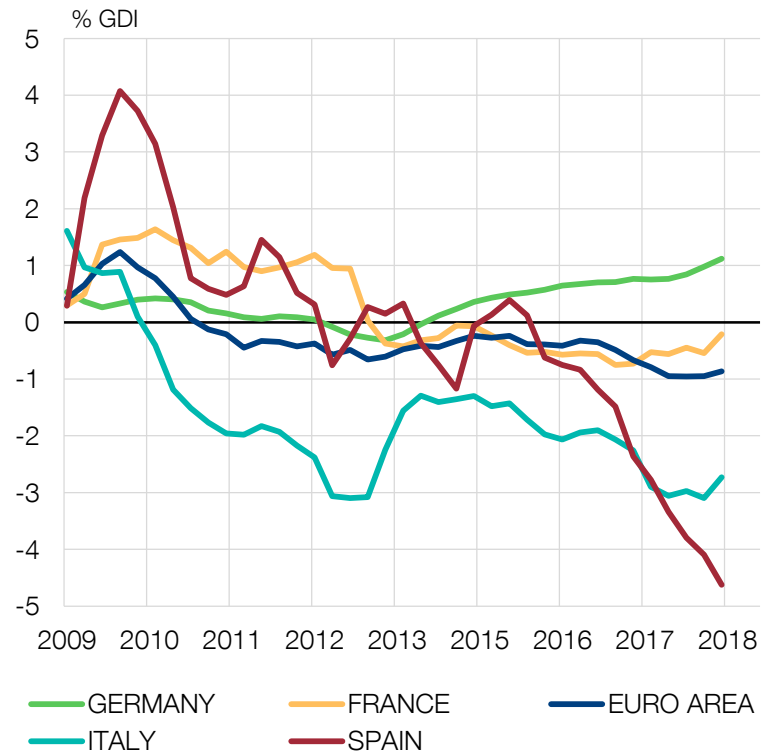
Domestic fundamentals (II): Household income

- Strong job creation and (recent) increases in wages are supporting household income, though rising inflation is dampening household purchasing power
- Household consumption growth has closely followed income developments, with saving rates near historic lows (except in Germany)

HOUSEHOLD GROSS DISPOSABLE INCOME (GDI) AND CONSUMPTION
Annual growth rates



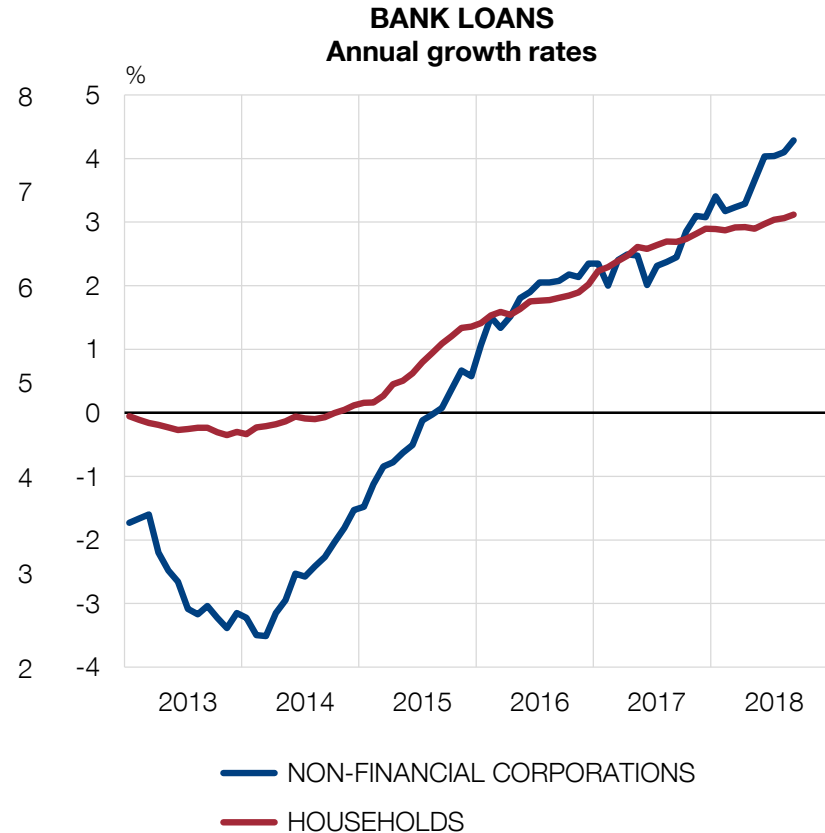
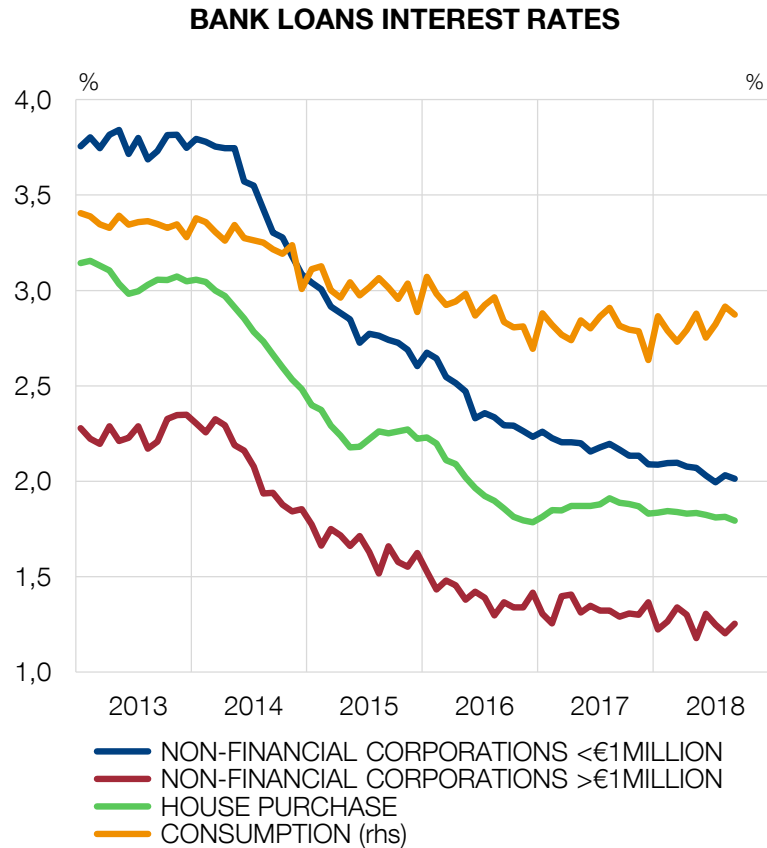
SAVING RATE
Deviations from long-term average (1999-2018 Q2)



Sources: ECB and Eurostat. Last date: 2018, second quarter.

Domestic fundamentals (III): Favourable financing conditions

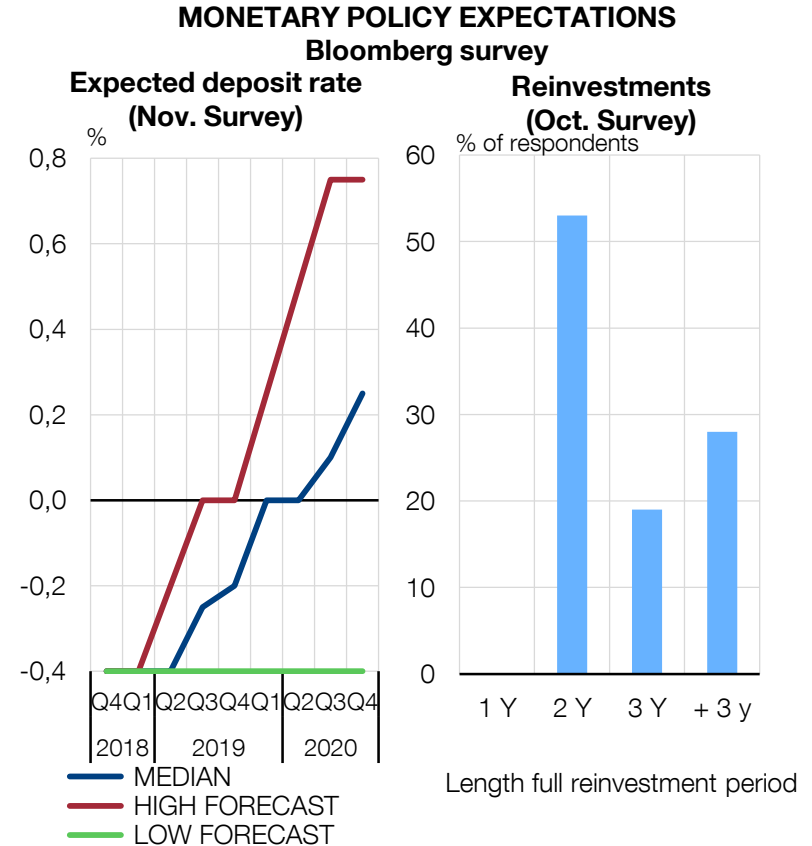
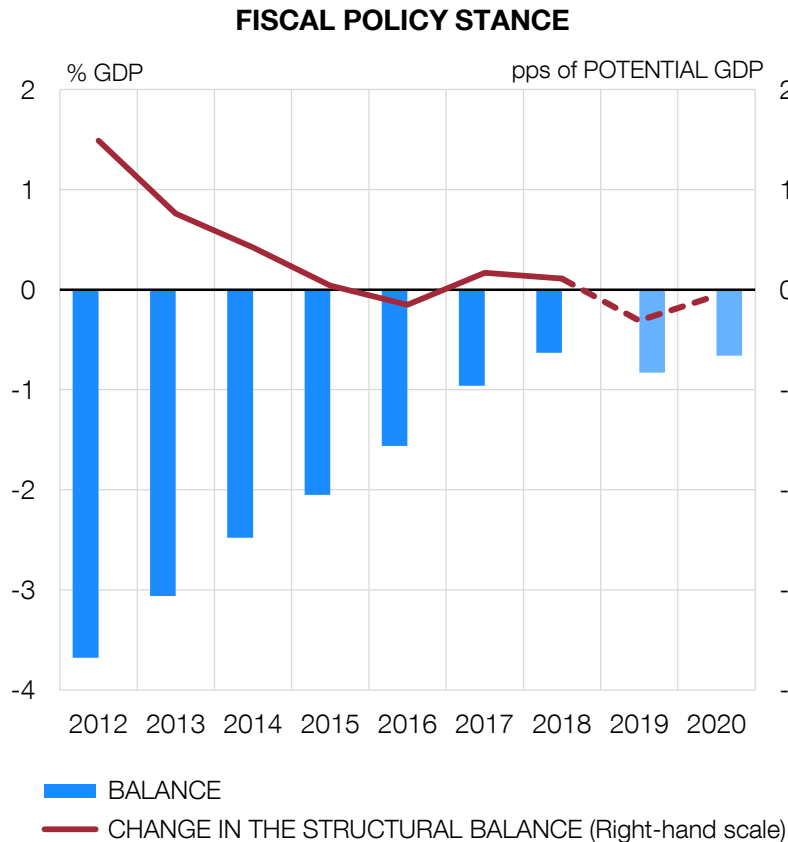
- Very loose financial conditions continue to support lending to the private sector, with loan rates at historical lows



Sources: ECB. Last date: 2018, September.

The role of monetary and fiscal policies

- Fiscal policy is expected to have a slight expansionary stance both in 2018 and 2019
- Monetary policy will still provide substantial monetary stimulus in order to support a build-up of domestic price pressures over the medium term



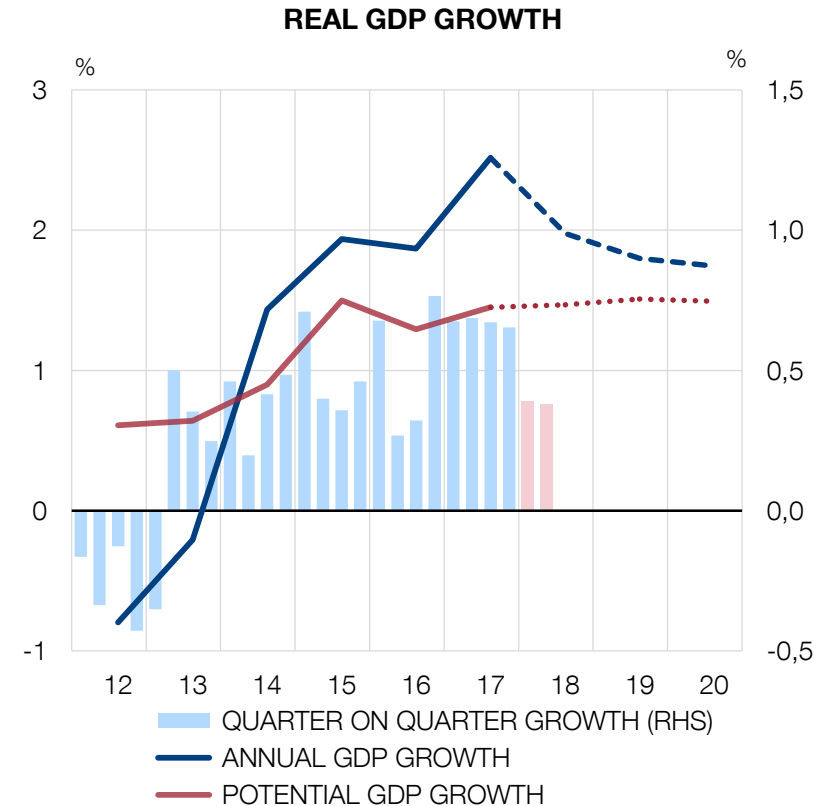
Source: European Commission (Autumn 2018 forecast) and Bloomberg.

GDP prospects

- Domestic fundamentals will remain underpinning economic growth, above potential, although the slowdown in external trade and rising uncertainty will weigh in growth

GDP GROWTH FORECAST

	2017	2018	2019	2020
ECB				
September 18	2.5	2.0	1.8	1.7
<i>June 18</i>	2.5	2.1	1.9	1.7
European Commission				
November 18	2.4	2.1	1.9	1.7
<i>July 18</i>	2.4	2.1	2.0	...
MFI				
October 18	2.4	2.0	1.9	1.7
<i>July 18</i>	2.4	2.2	1.9	...
OECD				
September 18	2.5	2.0	1.9	...
<i>May 18</i>	2.5	2.2	2.1	...
Survey Professional Forecasters				
October 18	...	2.0	1.8	1.6
<i>July 18</i>	...	2.2	1.9	1.6
Consensus				
October 18	2.5	2.0	1.8	1.4
<i>September 18</i>	2.5	2.1	1.8	...
Eurobarometer				
October 18	2.5	2.0	1.8	1.6
<i>September 18</i>	2.5	2.1	1.8	...



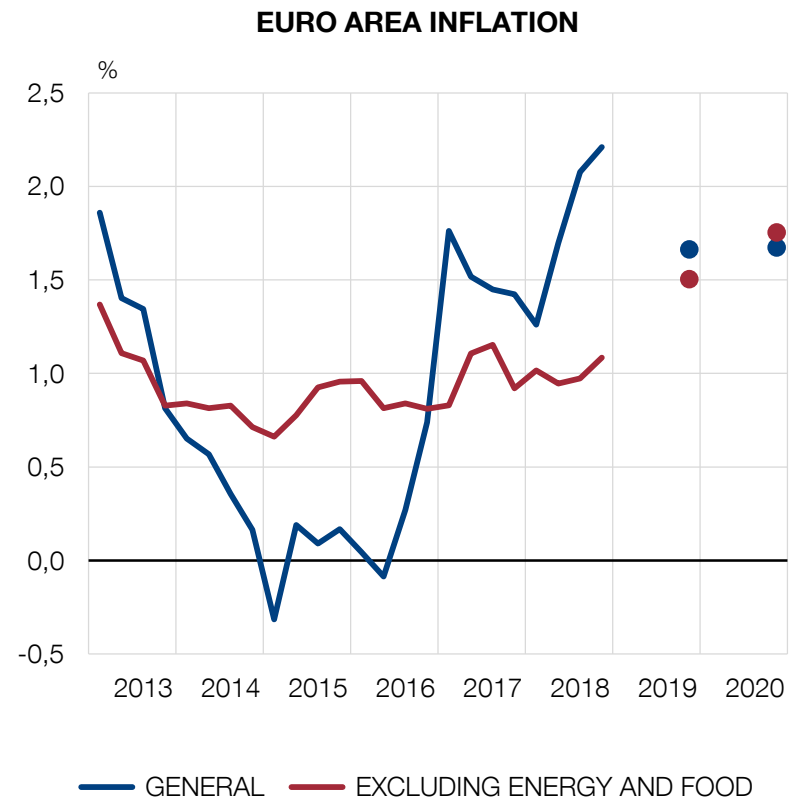
Source: Eurostat and European Commission.

Inflation prospects

- Growth rates above potential and tightening labour markets support confidence on the sustained convergence of inflation towards the medium-term reference.
- Although core inflation is still hovering around 1%.

INFLATION FORECAST

	2017	2018	2019	2020
ECB				
September 18	1.5	1.7	1.7	1.7
June 18	1.5	1.7	1.7	1.7
European Commission				
November 18	1.5	1.8	1.8	1.6
July 18	1.5	1.7	1.7	...
MFI				
October 18	1.5	1.7	1.7	1.8
April	1.5	1.5	1.6	1.8
OECD				
September 18
May 18	1.5	1.6	1.8	...
Survey Professional Forecasters				
October 18	...	1.7	1.7	1.7
July 18	...	1.7	1.7	1.7
Consensus				
October 18	1.5	1.7	1.7	1.7
September 18	1.5	1.7	1.6	...
Eurobarometer				
October 18	1.5	1.7	1.6	...
September 18	1.5	1.7	1.7	1.7



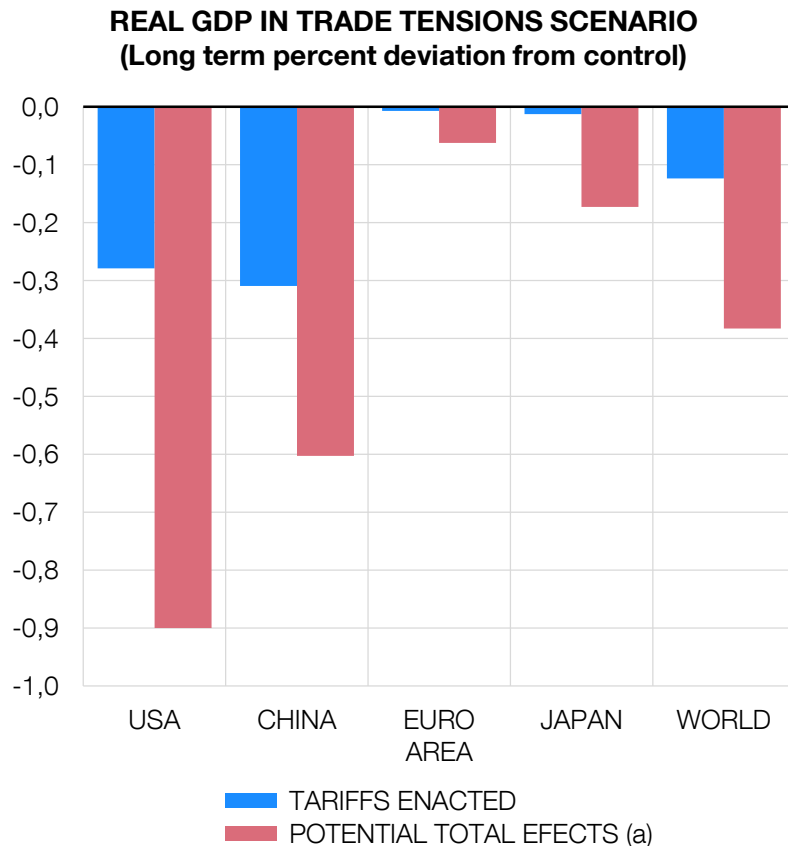
Source: Eurostat and ECB. Last date: 2018 October

Rising risks to the economic scenario

- **Downside risks have related to both global and domestic factors have intensified:**
 - **Protectionism tensions** *Most estimates of the impact of enacted tariff increases suggest limited effects for the euro area, but larger effects through confidence effects and postponement of investments cannot be discarded*
 - **Global policy uncertainties and turmoil in emerging markets:** *Fiscal expansion in the US and the gradual normalization of Fed's monetary policy tighten global financial conditions, with a stronger impact on highly indebted EMEs.*
 - **Uncertainty about the degree of slack of the euro area economy:** *high levels of capacity utilization and some labour shortages point to possible supply side restrictions in some sectors/countries.*
 - **Tensions in Italy:** *So far, contagion effects have been limited, but it cannot be ruled out that further bouts of uncertainty over the Italian fiscal situation might have more significant adverse effects in the future*
 - **Risk of no deal for Brexit:** *it would entail important changes in trade relations after April 2019 with potentially large impact on some financial market segments/instruments*

Protectionism tensions

- Trade tensions have further increased in recent months. Most estimates of the impact of enacted tariff increases suggest limited effects for the euro area.
- But large indirect effects -through confidence and uncertainty leading companies to postpone or cancel investment projects- cannot be discarded



Source: IMF, October 2018.

(a) Effects of tariffs enacted plus other potential retaliation measures, confidence effects and market reactions

EU TRADE POLICY

- The EU imposed tariffs to \$3.3 billion worth of US goods in response to iron and steel tariffs

US-EU TRADE AGREEMENT

- Work towards a free trade area, with zero tariffs on non-auto industrial goods, zero non-tariff barriers and zero subsidies on non-auto industrial goods. EU will increase imports of gas and soya beans from the US.
- Work together to reform the WTO and to protect intellectual property rights
- The deal lacks of details and specifics.

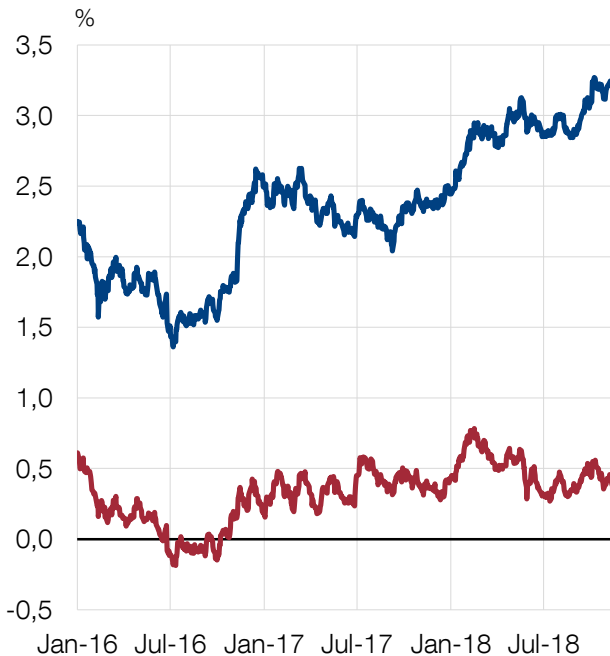
JAPAN- EU ECONOMIC PARTNERSHIP AGREEMENT

- Removal of the majority of tariffs and opening of agricultural and services markets.
- For the first time, the agreement includes a specific commitment to the Paris climate change.

Global policy uncertainty and financial conditions

- Fiscal expansion in the US together with tighter monetary policy is leading to a tightening of global financial conditions. Highly indebted EMEs have been the most vulnerable, with strong depreciations of their currencies
- The euro has significantly appreciated in nominal effective terms since 2017

10 YEAR INTEREST RATES



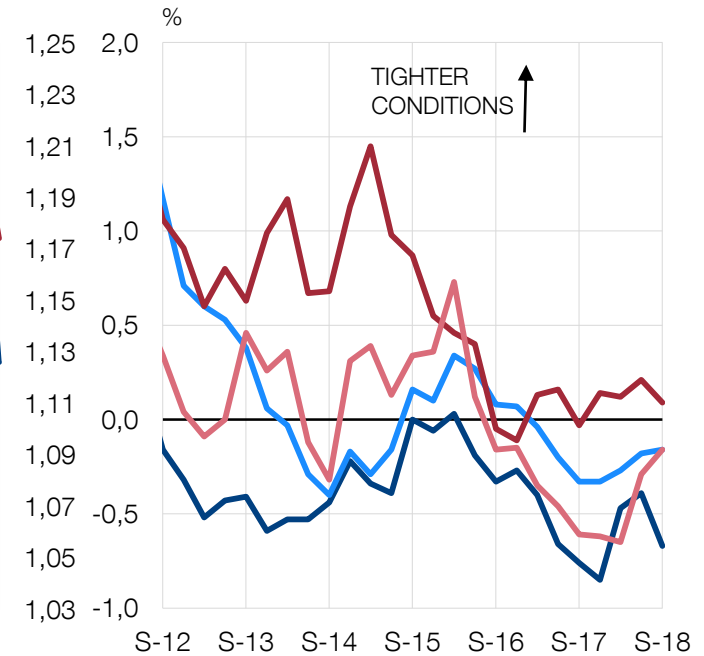
— USA — GERMANY

EXCHANGE RATE



— Euro Effective Exchange Rate EER-38 — DOLLAR (Right-hand scale)

GLOBAL FINANCIAL CONDITIONS INDICES



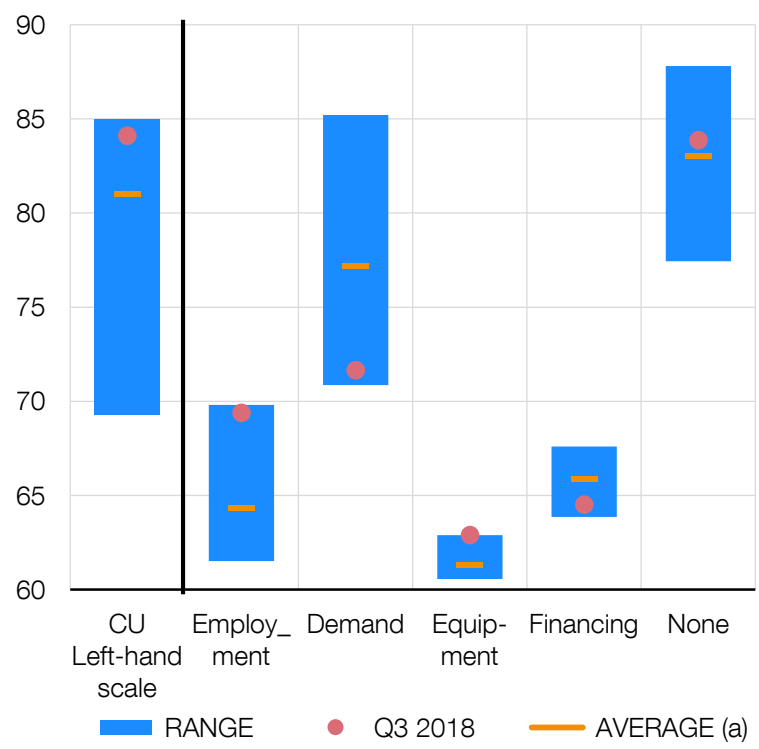
— USA — Other Systemically Important Advanced Economies — CHINA — Other Systemically Important Emerging Economies

Sources: ECB and IMF GSFR October 2018. Last date: November, 13.

Uncertainties related to the extent of supply side constrains

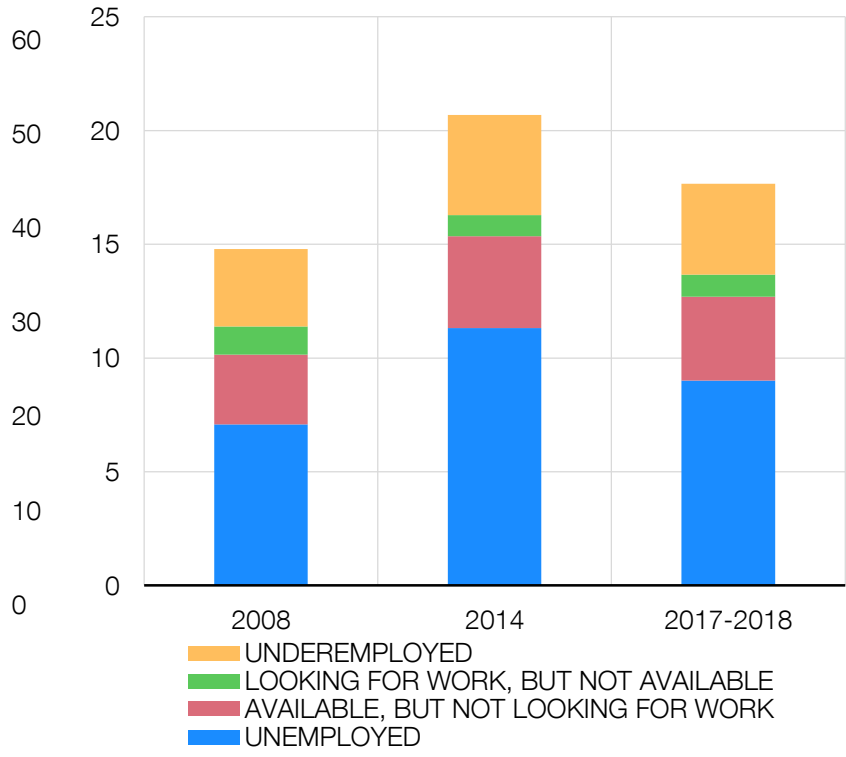
- There is uncertainty regarding the degree of slack of the economy: high levels of capacity utilization and some labour shortages point to possible supply side restrictions
- But, there are some signals of remaining slack in the labour market, as broader definitions of unemployment reflect.

EURO AREA.CAPACITY UTILISATION AND FACTORS LIMITING ACTIVITY



EURO AREA.BROADER ESTIMATIONS OF UNDERUTILIZATION OF LABOR

% BROADENED ACTIVE POPULATION

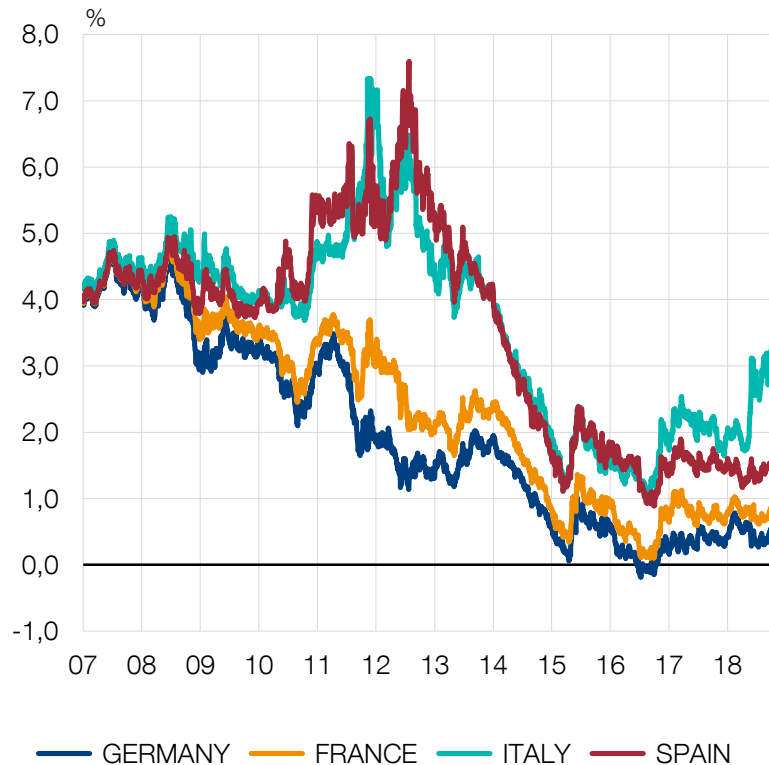


Sources: European Commission and Eurostat. Last date: 2018, October for opinion indicators and September 2018 for unemployment.
 (a) Average since 1999 for capacity utilization and since 2004 for factors limiting activity.

Italy

- High public debt and low-growth are a notable source of vulnerability.
- Rising sovereign yields and the reactivation of sovereign-bank risk nexus could eventually offset the positive effects arising from fiscal expansion
- So far, contagion effects towards other euro area countries have been limited, but further bouts of uncertainty cannot be ruled out

10 YEAR SOVEREIGN YIELDS



ITALY. SOVEREIGN-BANK NEXUS
CDS 5-YEARS



Sources: ECB and IFS Datastream. Last date: November, 13.

The impact of Brexit under a WTO scenario

Trade channel

Scenario		WTO		
Country	Variable	GDP	Inflation	Employment
Country	5 yr Horizon			
UK		-4.4	-2.2	-2.6
Euro Area		-0.3	-0.1	-0.1
US		0.3	-0.1	0.1
Japan		0.1	-0.1	0.0
China		0.1	-0.1	0.0
World				
		GDP	World Trade (Exports)	
		-0.1		-2.8

GDP: Accumulated % difference from baseline scenario.
 Inflation: Accumulated level difference from baseline scenario.
 Employment: Accumulated % difference from baseline scenario.

Source: Own simulations carried out with NiGEM

Migration channel

Scenario		WTO		
Country	Variable	GDP	Inflation	Employment
Country	5 yr Horizon			
UK		-0.9	0.3	-1.2
Euro Area		0.0	0.0	0.2
US		0.0	0.0	0.0
Japan		0.0	0.0	0.0
China		0.0	0.0	0.0
World				
		GDP	World Trade (Exports)	
		0.0		0.0

GDP: Accumulated % difference from baseline scenario.
 Inflation: Accumulated level difference from baseline scenario.
 Employment: Accumulated % difference from baseline scenario.

The euro area economy challenges

- **Monetary policy normalisation will need to be proceed with caution** to ensure a continued sustained convergence of inflation towards the medium term reference,
- On **fiscal policy**, the economic expansion and low interest rates call for rebuilding fiscal buffers, particularly in countries with high public debt.
- Meeting low productivity and demographic challenges will require **further efforts on structural reforms** to boost potential long-term growth, improve shock-absorbing capacity and reduce vulnerabilities.
- **Culmination of Brexit negotiations**: the terms of the separation and the nature of the future UK-UE relationship are yet to be defined
- In the medium term, the stability of **the Eurozone will require deeper integration**:
 - The **institutional reform agenda must progress faster** through parallel risk-reduction and risk-sharing measures while enhancing national responsibility.
 - The key priorities are completing the **banking union**, advancing on the **capital market union** agenda and designing **supranational instruments to help to cope with asymmetric shocks** and to support monetary policy in the event of big negative shocks.