The euro area economy: an update

Euro Challenge – November 2016

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)

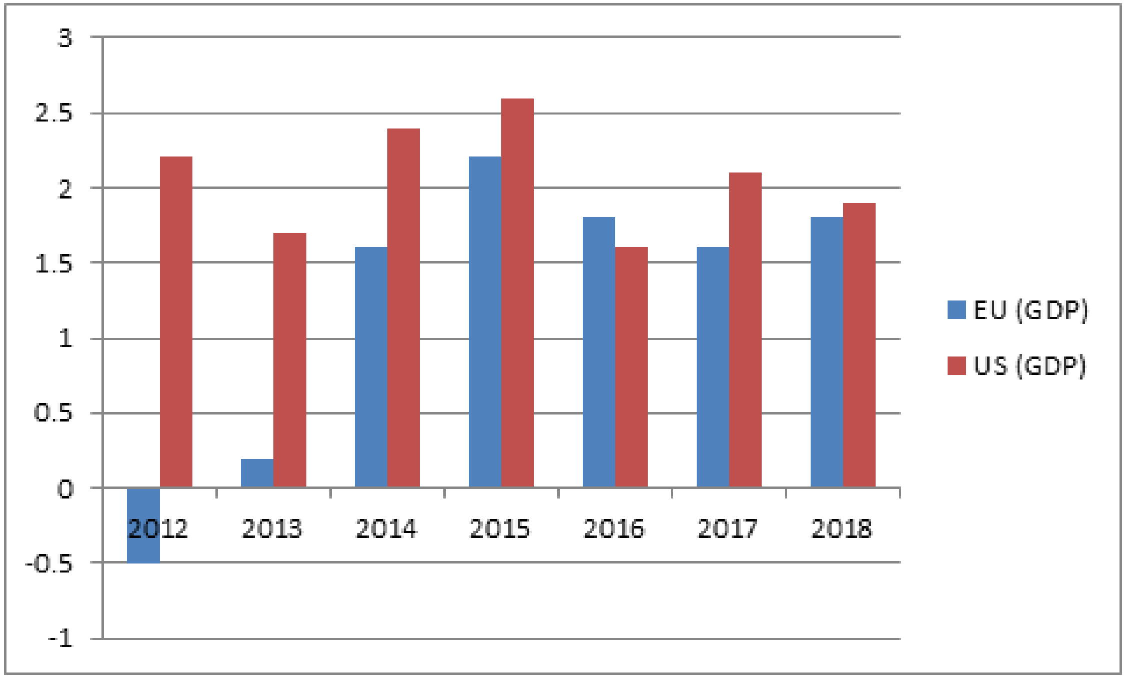
• GDP growth is expressed as a *percentage*

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

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

GDP is growing

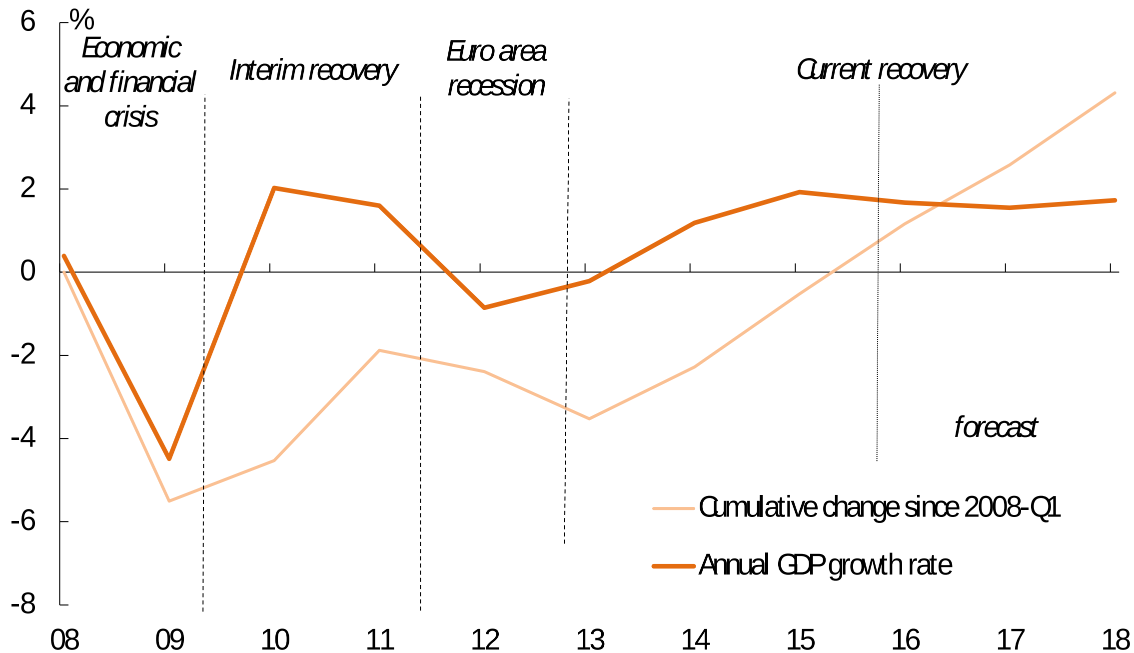
EU and U.S. real GDP growth, in %



Source: European Commission, Autumn forecast, Nov. 2016

Growth outlook is improving

GDP growth, EU



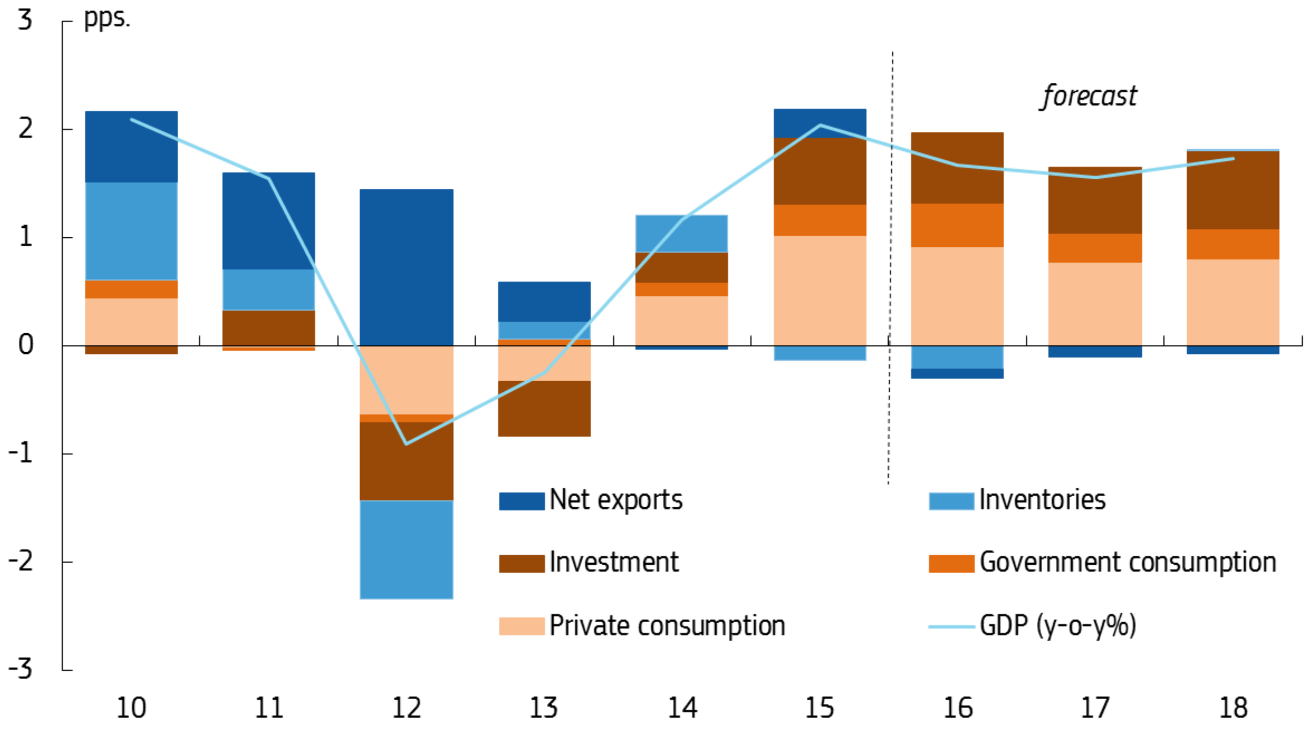
Source: European Commission, Autumn Forecast, 2016

Real GDP grew above its pre-crisis level in 2015. Modest growth in the first 3 quarters of 2016.

EA: 1.7% in 2016, 1.5% in 2017 and 1.7% in 2018

However, the legacy of years of crisis persist and the labour market can still improve.

Private consumption slowing down but still driving growth

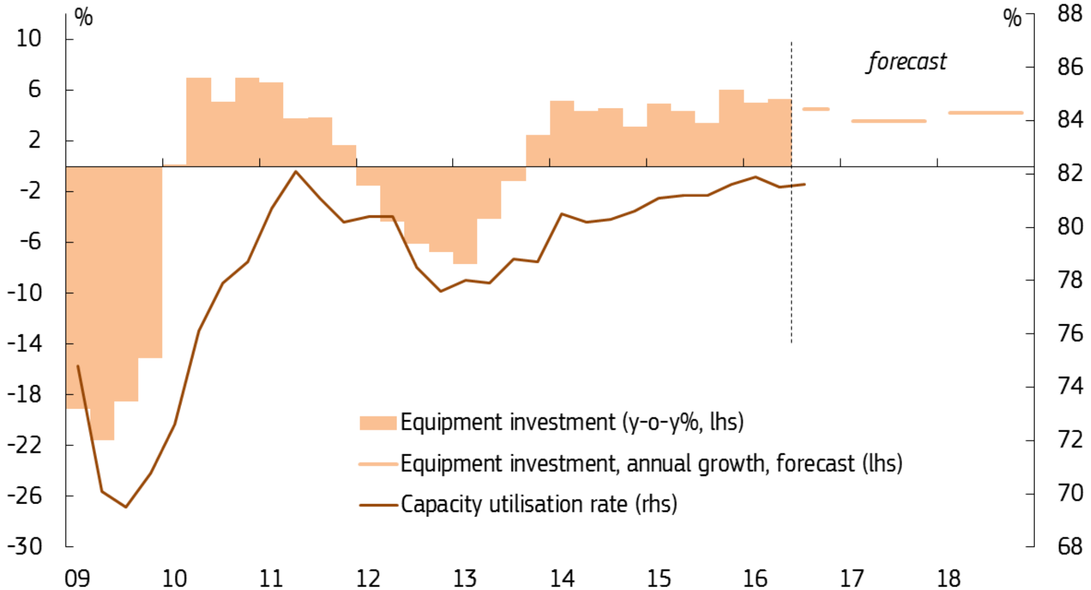


Private consumption has been the key factor in the recovery's recent strength and it will continue over the coming 2 years:

- Job gains and wage increases are boosting nominal income.
- Low inflation is increasing purchasing power.
- However, as energy prices rebound, the pace of growth in consumption may slow.

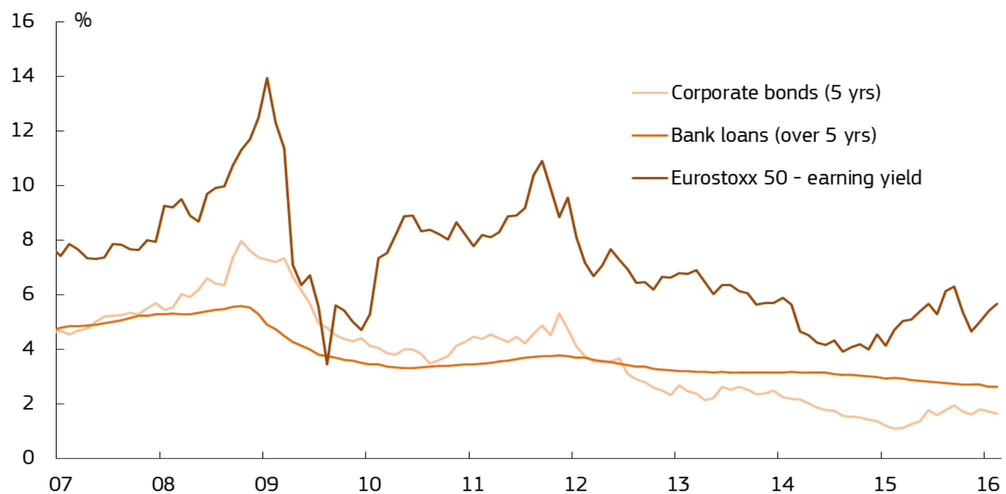
Source: European Commission, Autumn forecast, Nov 2016

Improving investment conditions



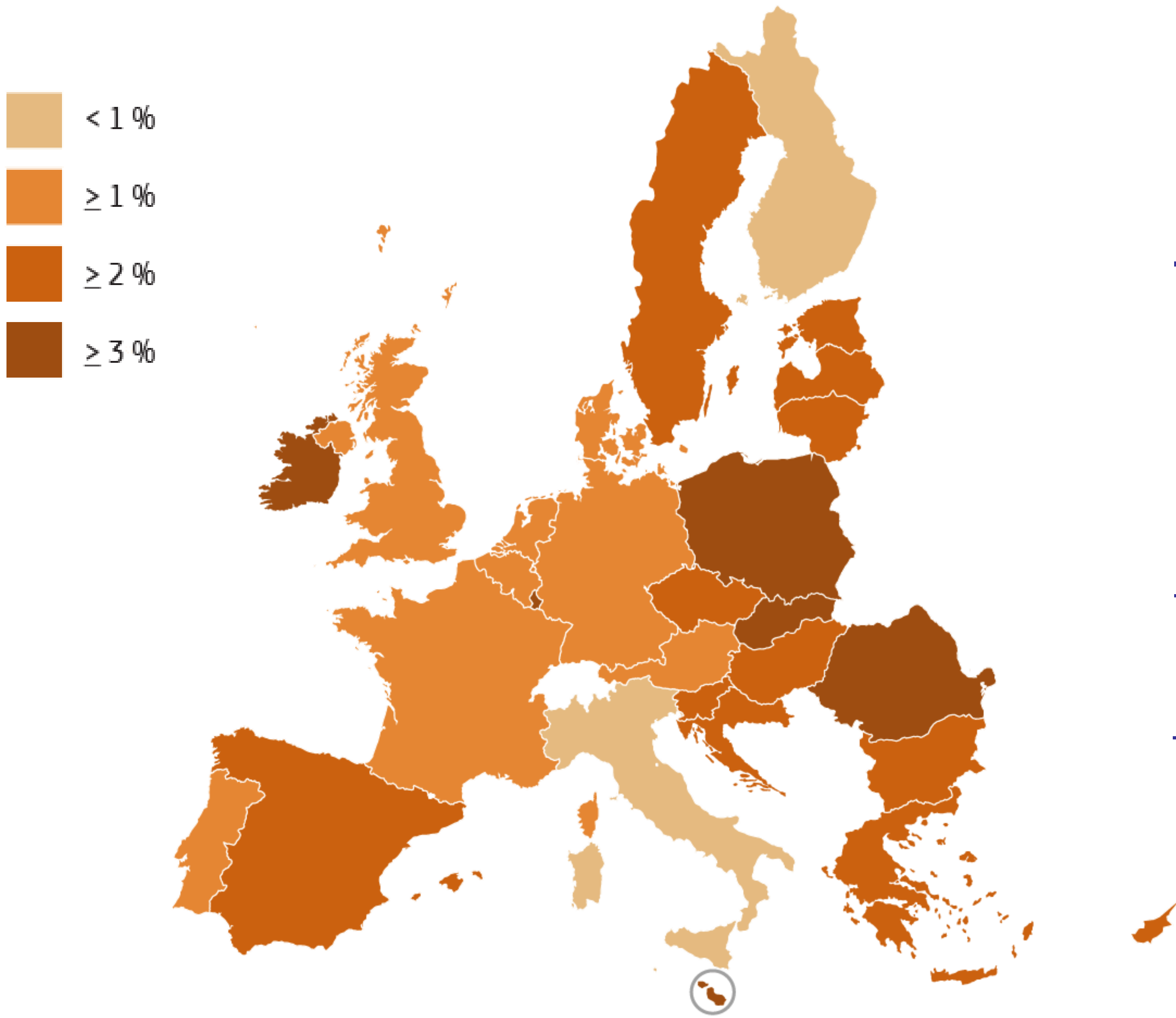
Investment is set to accelerate in 2018:

- Encouraging outlook.
- Financing conditions have improved and will continue to do so.
- Capacity utlilization above LTA
- External demand expected to gradually strengthen



Source: European Commission

Growth is forecast in all EU countries in 2017



Good news:
- All EU MS set to grow in 2017.

- Stronger than expected employment growth

- **Investment is finally growing**
- **Inflation is expected to pick up**
- **Public finances are improving gradually**

Source: European Commission, Autumn Forecast, 2016

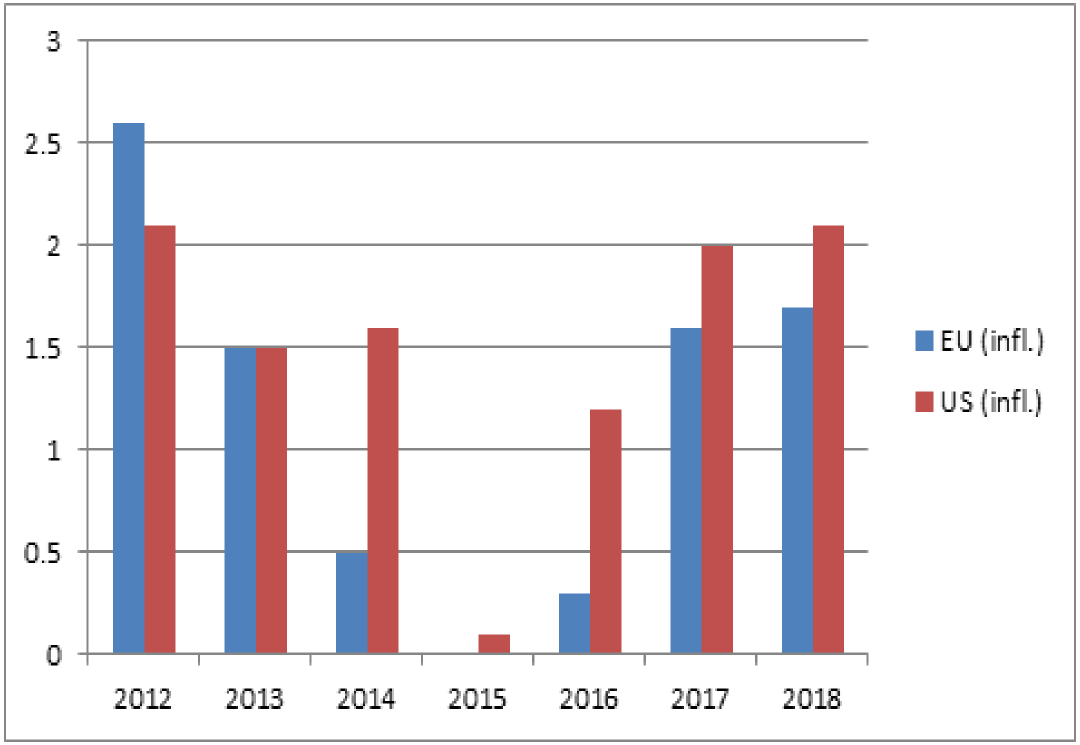
Inflation

• 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



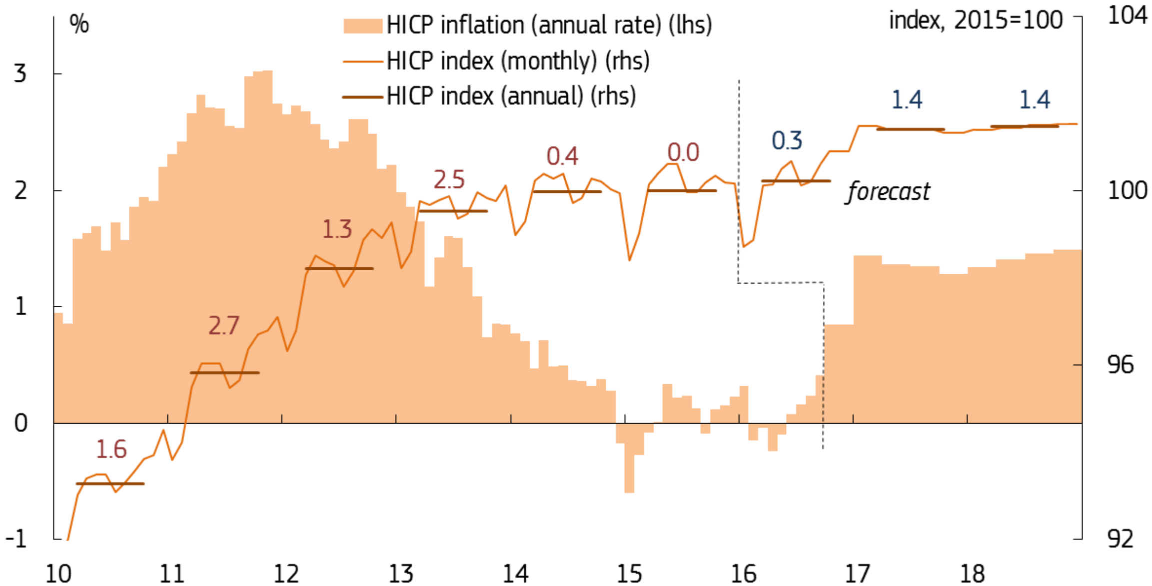
Low inflation has been caused primarily by declining energy prices.

But the impact should prove transitory and euro area inflation is expected to begin rising as the economy improves and the unemployment rate falls further.

Source: European Commission, Autumn Forecast, 2016

Inflation is picking up

Inflation, Euro Area



Figures next to horizontal bars are annual inflation rates.

Source: European Commission, Autumn Forecast, 2016

- **Inflation in the euro area was very low in the first half of 2016.**
- **Declining energy prices have been keeping inflation, but inflation started to pick up in the third quarter of 2016, as the transitory effects of these factors wear off and the economic recovery gathers pace.**
- **Euro area inflation is expected to rise from 0.3% in 2016 to 1.4% in 2017 and 2018.**
- **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.

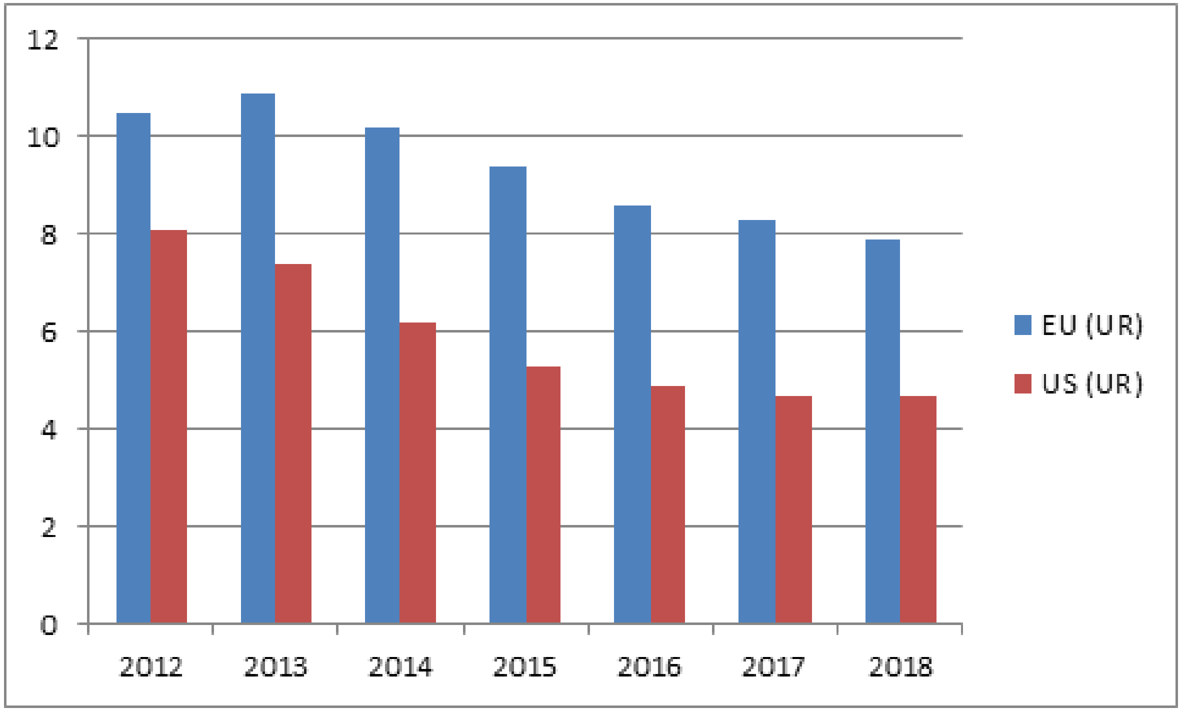
- The unemployment rate is the share of the working-age population that is looking for work but not employed.

- 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 Commission, Autumn forecast, Nov. 2016

Improved labour market conditions

Employment growth and unemployment rate, EU

- Employment has continued to grow since mid-2013. Employment is expected to grow faster this year than at any time since 2008 – and remain solid in 2017-18.

- The unemployment rate in the EU has declined from 11% in 2013 to around 8 ½ % this year. The unemployment rate, while remaining high, is set to come down to 9.2% in the EA in 2018.

- There are large disparities between countries' unemployment rates, which ranged from below 3.8% to above 23% in October 2016.

Source: European Commission, Autumn Forecast, 2016

What this presentation will cover

- B. A supportive policy mix

High debt and deficits

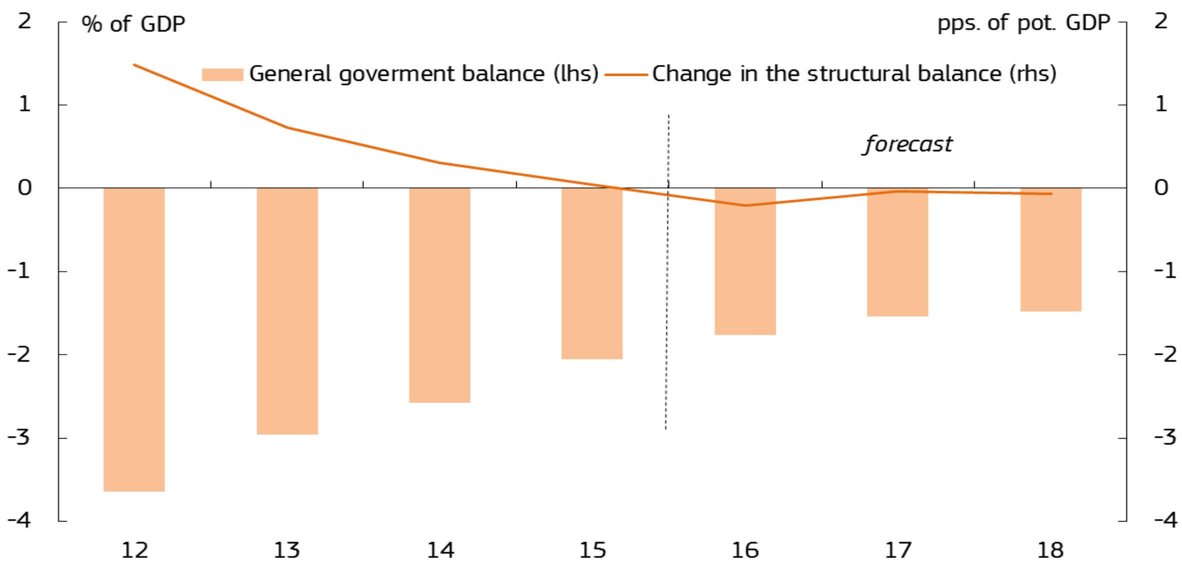
- The *deficit* is the difference between the amount of money a government takes in (revenue) and what it spends (outlays) <u>in a given year</u>. If that number is positive, there is a *surplus.*

  The *debt* is the <u>total</u> 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 supportive

Budgetary developments, Euro Area



- After substantial adjustment in the past few years, fiscal policy is no longer a drag on growth since 2015.
- General government deficits are being reduced. Deficit to GDP ratios are forecast to fall to 1.5% in EA in 2017-18.
- Debt to GDP ratios have peaked and is expected to fall from 91.6% in 2016 to 89.4% in 2018.

Source: European Commission, Autumn Forecast, 2016

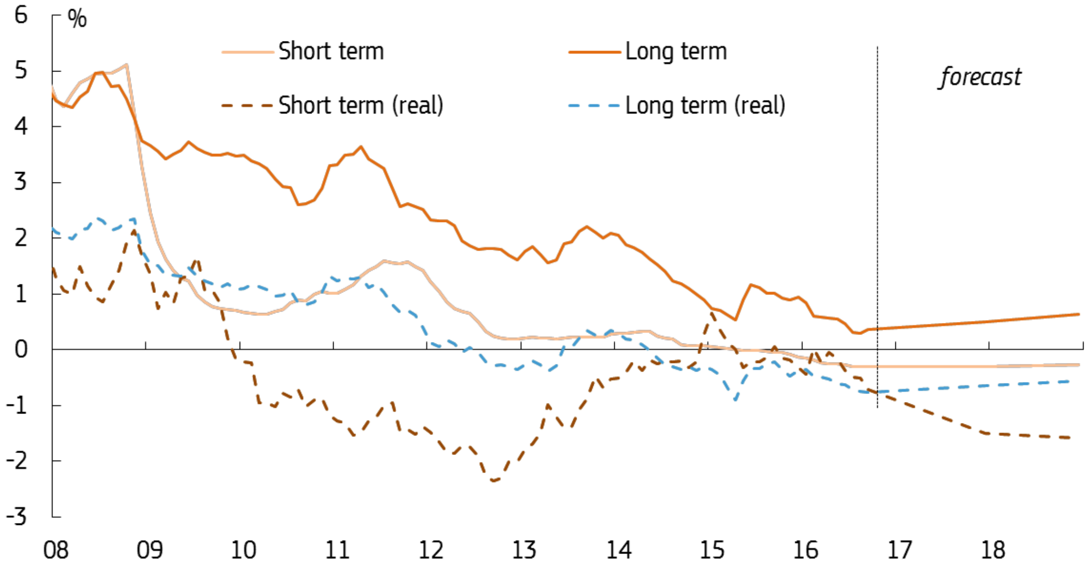
What is monetary policy?

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;

- **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**
- **Sovereign bond yields have continued to decline**
- **The positive impact on confidence and credit should continue, which will support investment and consumption.**

Source: European Commission

What this presentation will cover

- C. Risks

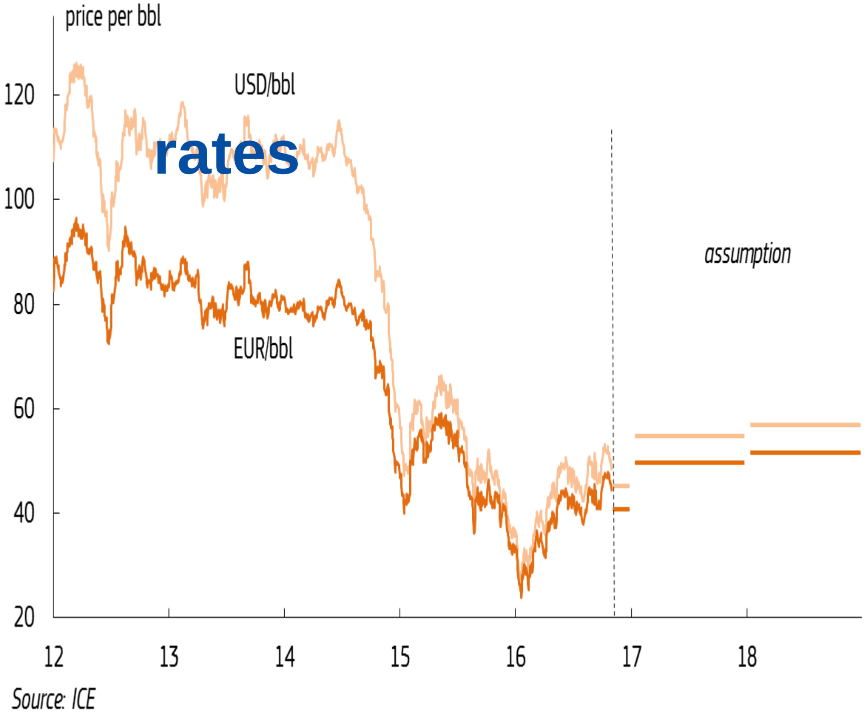
The recent tailwinds are fading

Oil price decline (since 2014) has run its course

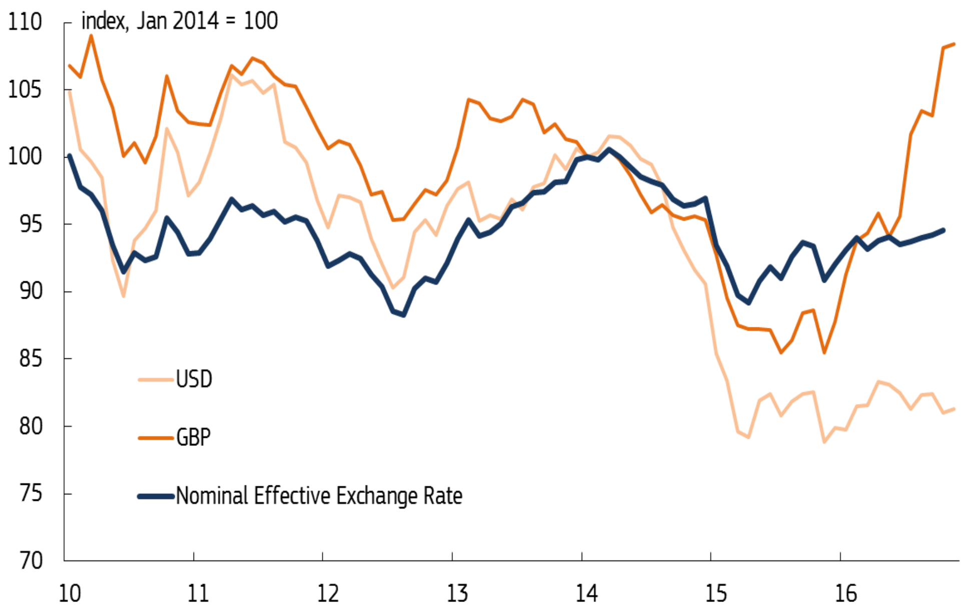
Euro depreciation since 2014 had supported European exports – recent appreciation

Global GDP growth has been slowing

Brent oil spot price assumptions rates

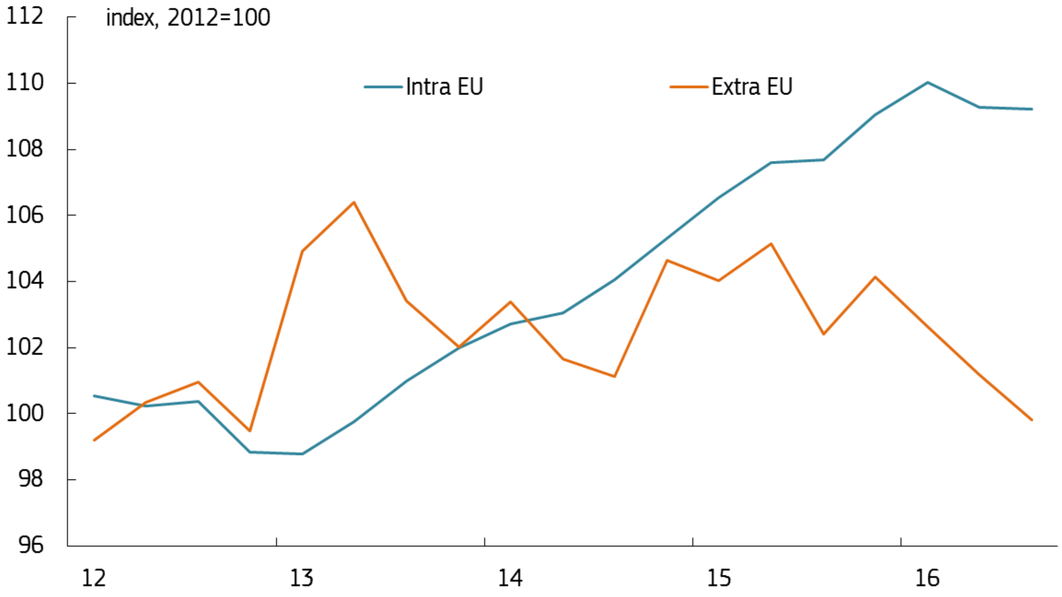


Euro exchange



Source: European Commission

External trade remains weak



Source: European Commission

The current weakness of global trade outside the EU is weighing on exports

Intra-European trade has been resilient

Looking ahead to 2018, we expect positive growth impulses from external trade

Risks to the growth outlook

(-) Brexit-related uncertainty

(-) Political and policy uncertainty

(-) China's economic adjustment and

slower growth in non-EU advanced economies

(-) Geopolitical tensions and security threats

(-) Capacity of the banking sector to support investment recov

Thank you for your attention!

ec.europa.eu/dgs/economy_finance/index_en.htm (Brussels)

www.ecb.int (Frankfurt)

euintheus.org (Washington)