Monetary Policy Review

Outlook deteriorated rapidly – can this be turned around?

International economy, Monetary policy | 03 April 2019

Global economic growth is expected to remain somewhat slower in 2019 than the previous year. Growth is expected to abate gradually in the United States amid the fading effects of the fiscal stimulus. China's economic growth has continued to slow. The approach of the United Kingdom's withdrawal from the EU has weakened the UK economy. Euro area economic growth has also moderated rapidly and more persistently than previously expected. World trade and industrial output in the advanced economies contracted at an alarming pace at the end of 2018. The annual growth rate of world trade in goods turned negative in December. Industrial confidence has declined on a broad front – at the end of 2018 also in the United States.



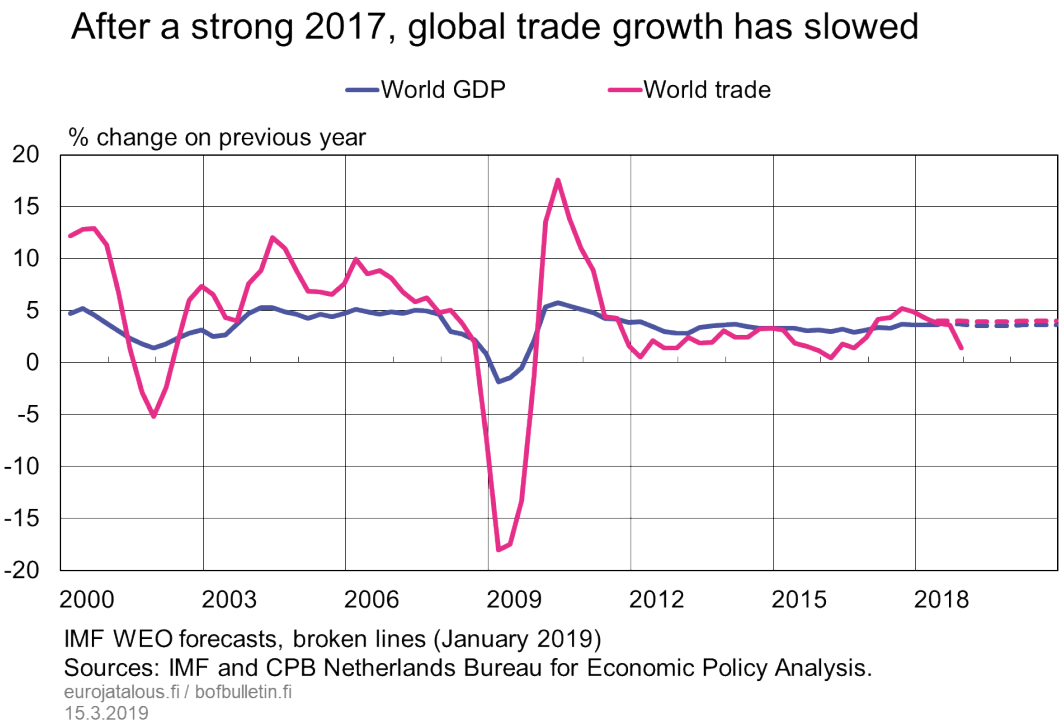
Global economy slows down, uncertainty depresses outlook

During the first half of 2018, the global economy grew at a pace slightly below 4%. In the final months of the year, prospects weakened and global growth is projected to be slower in 2019. Protectionist measures and uncertainty about growth in the major economic regions have eroded confidence and subdued world trade growth. According to the most recent forecasts, global economic growth will remain close to 3.5% in the immediate years ahead (Chart 2), but a weaker

trend is also possible.[1]

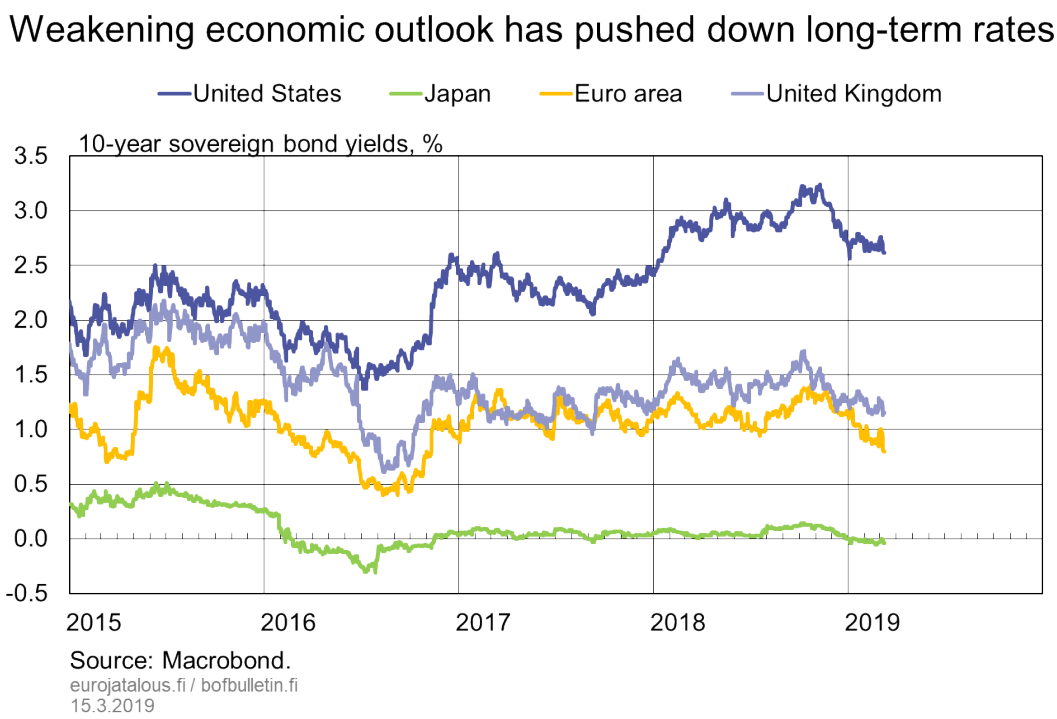
The external environment of the euro area has deteriorated over the past six months. Some of the downside risks to global growth have materialised. The trade dispute between China and the United States that began a little over a year ago remains unresolved despite continued negotiations. Raised import tariffs are currently imposed on the majority of goods traded between China and the United States.[2] Protracted trade tensions have increased uncertainty about the future and, to some degree, already affected investment and export figures. Confidence indicators for predicting future economic growth have weakened (Chart 1).

Chart 1.



The slowing growth in China is a special cause for concern. China has become so important[3] that the impacts of its weakening economic situation is inevitably felt elsewhere in the global economy. US growth is also expected to gradually slow when the effects of the fiscal stimulus fade. In addition to the trade policy dispute between the United States and China, the continuing uncertainty surrounding Brexit is reflected in the rapid weakening of the United Kingdom's economic growth and is dampening external demand in the euro area[4]. Trade negotiations between the EU and the US are also still in progress – the possibility remains that the US could raise tariffs on cars and car parts, which would particularly hurt the German automobile industry.

Chart 2.



Global goods trade has slowed in the past twelve months, even though it continued to grow in 2018 at a rate of just over 3% on the previous year (Chart 2). In the advanced economies, the rate growth in exports has almost halved in one year. Industrial output has slowed in all major economic regions, and especially new export orders have declined.

US economic growth slows as fiscal stimulus fades

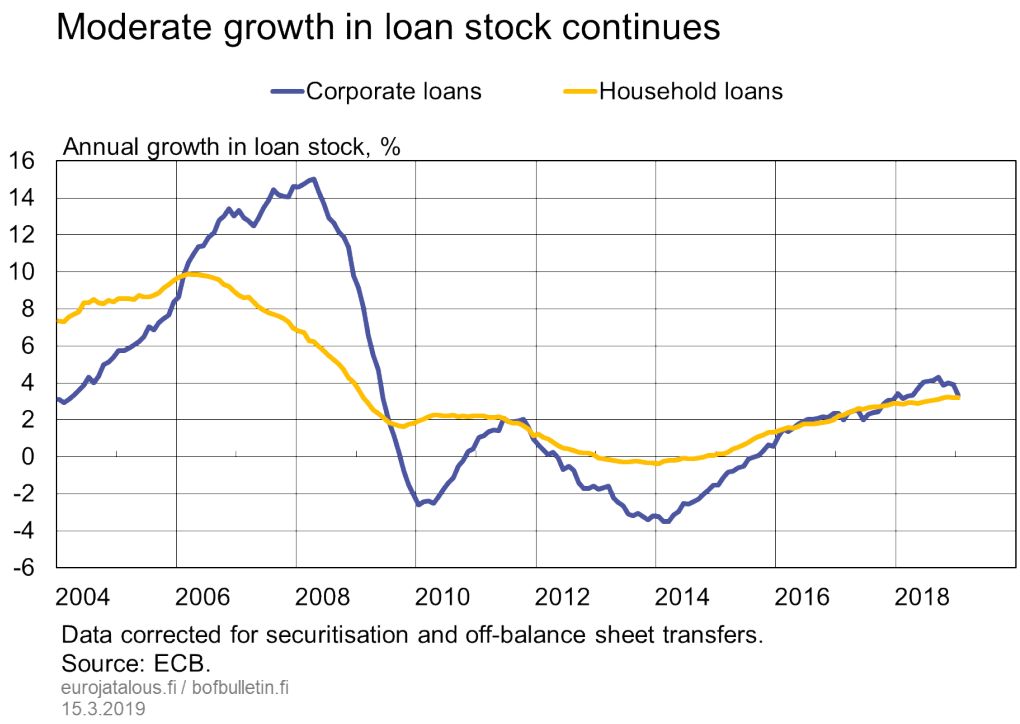
The United States' economy grew rapidly in 2018, by almost 3% (Chart 3). Growth prospects have, however, weakened compared with the autumn figures. Both consumer and industrial confidence declined at the turn of the year. This reflects, in part, the raised import tariffs caused by trade disputes and the partial shutdown of the federal government.[5] Private consumption – the traditional driving force behind US economic growth – may prove weaker than expected in early 2019.

At the beginning of 2018, significant new individual and business tax cuts came into force in the United States. Tax reductions along with increased government spending in 2018–2019 have resulted in a strong fiscal stimulus in an economic upswing. While the United States' economy is expected to slow in the years ahead as the fiscal stimulus fades, growth will remain at around 2.5% in 2019. From then on, growth will slow closer to the potential rate of growth, in the region of

approximately 2%. The business tax cuts will increase the post-tax return on equity, consequently increasing the incentive to invest, while the cuts in personal taxation will increase labour supply. However, estimates of the impact of these effects vary.[6]

The overall general government deficit of the United States is projected to remain high and general government debt to increase (see article Alternative scenarios linked to the global impact of US fiscal and trade policies). The most recent IMF forecasts predict that the overall general government deficit will remain at around 5% of GDP in the years ahead and general government debt will rise to 112% of GDP in 2021. A large general government deficit in the United States increases import demand, which in turn adds to the trade and current account deficits.

Chart 3.



Inflation in the United States slowed to 2% at the end of 2018, mainly due to the falling price of crude oil. Core inflation has remained at slightly over 2%. According to estimates, the labour market is enjoying full employment, which helps to keep the inflation rate at around 2%. The unemployment rate is around 4%, and annual wage growth, based on average hourly earnings, rose to over 3% towards the end of 2018.

Broadly based weakening of growth in China

Economic growth slowed in China towards the end of 2018. Private consumption demand

weakened and investment growth remained subdued. News outlets have reported that unemployment is increasing, especially in the export industries. The trade war has affected the general atmosphere and uncertainty has made companies reassess their investment decisions. China's response to the slowdown has been to increase stimulus efforts. The current economic policy, however, leaves limited room for manoeuvre. Economic policy is expansionary to begin with, as China has determinedly held on to its goal to double real GDP between 2010 and 2020. According to the IMF, the general government deficit has been 10% of GDP in recent years. Business and household indebtedness has also increased rapidly. For an emerging economy, the level of debt relative to the size of the economy is very high, over 250% of GDP (excluding the financial sector).

Chinese economic growth is projected to continue slowing in the years ahead (see BOFIT Forecast for China), which is a natural phase of evolution for China. The structural change towards a service economy constrains productivity growth. The population is ageing rapidly and the share of the working-age population decreasing. Growth is also held back by the sheer size of the economy and environmental problems.

Japan continues to pursue an expansionary economic policy

In 2018, economic growth in Japan slowed to a little under 1%. Despite rising labour force participation among women, growth potential is hampered by a labour shortage caused by the ageing population. Japan is trying to address this issue by facilitating employment-based immigration. The measures adopted so far have been insufficient to meet the demand for additional labour.

Japan continues its expansionary economic policy. The consumption tax increase that enters into force in October will increase tax revenue, but estimates say it will cover only two-thirds of the government's funding needs. Japan's debt-to-GDP ratio remains around 240% and the time frame for achieving a balanced budget has been delayed from 2020 to 2025.

Inflation has remained subdued. The Bank of Japan will continue its accommodative monetary policy and has confirmed that it will hold down interest rates for an extended period as well as continuing the bond-purchasing programme until inflation rises sustainably above the 2% target. The Bank of Japan now holds half of Japanese government debt, and the bank's balance sheet already exceeds the country's GDP.

Brexit is drawing closer

In the **United Kingdom**, total output grew last year by only slightly over 1% from the previous year.

The uncertainty about how Brexit will proceed has contributed to a notable weakening of confidence indicators and observed economic activity alike. The UK economic outlook for the next few years depends on how the Brexit process develops.

Sweden's economic growth will slow down somewhat this year in line with the weakening of global growth. Over the medium term, however, Sweden's growth rate will return to levels close to 2%. Also, the inflation rate is expected to remain close to the 2% target set by the Swedish Riksbank. After its prior slowdown, the housing market picked up slightly last year.

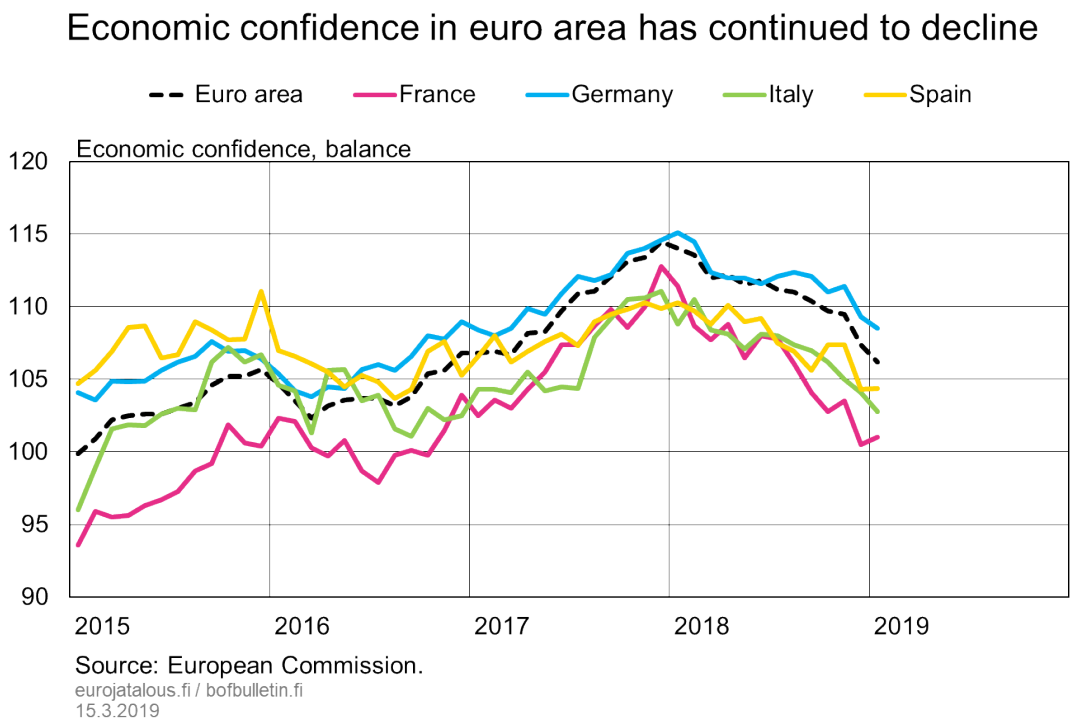
The recovery in the **Russian** economy accelerated in the course of 2018. However, growth is expected to moderate to levels around the potential growth rate of approximately 1.5% (**see BOFIT forecast for Russia**). An increase in VAT will slow growth in private consumption, and political uncertainty weakens the investment outlook, in particular for private companies. If the oil price remains at its current level, both central government finances and the current account will remain in surplus.

Dampening of outlook reflected on global financial markets

The broadly based weakening of the outlook has, together with the prevailing uncertainty, dampened expectations of interest rate increases and caused volatility in stock prices. Stock prices fell sharply towards the end of 2018, but began to rise again after the turn of the year. Stock price indices have been pushed up by the US Federal Reserve's forward guidance on an easier monetary policy stance as well as by positive news on the progress of the US-China trade negotiations. Also, the oil price decreased sharply towards the end of last year, but has risen again, in particular amid production restrictions. The fall in the oil price pushed inflation rates down markedly in all major economic areas. At the turn of the year, OECD countries' inflation rate fell below 2.5% (core inflation around 2%).

The dampening economic outlook and the uncertainty have moderated the expectations of a gradual tightening of monetary policy in key countries. Last year saw four policy rate increases in the US. The weakening of the economic outlook towards the end of the year caused the US Federal Reserve to stress that the pace of policy rate increases was moderating. Indeed, policy rates are now expected to increase at a much slower pace. The impact of this postponement of rate increase expectations is visible in increasing stock prices but also in decreasing long-term interest rates (see Chart 4).

Chart 4.



The slower pace of monetary policy tightening in the US eases, for its part, the situation of those emerging economies that rely on US dollar funding. The dollar has depreciated moderately since late 2018 (see Dollar dominance means US risks also pose risks to others). The depreciation of the dollar and the decrease in interest rates support the exchange rates of emerging economies, lower their debt-servicing costs and thereby decrease capital outflow pressures.

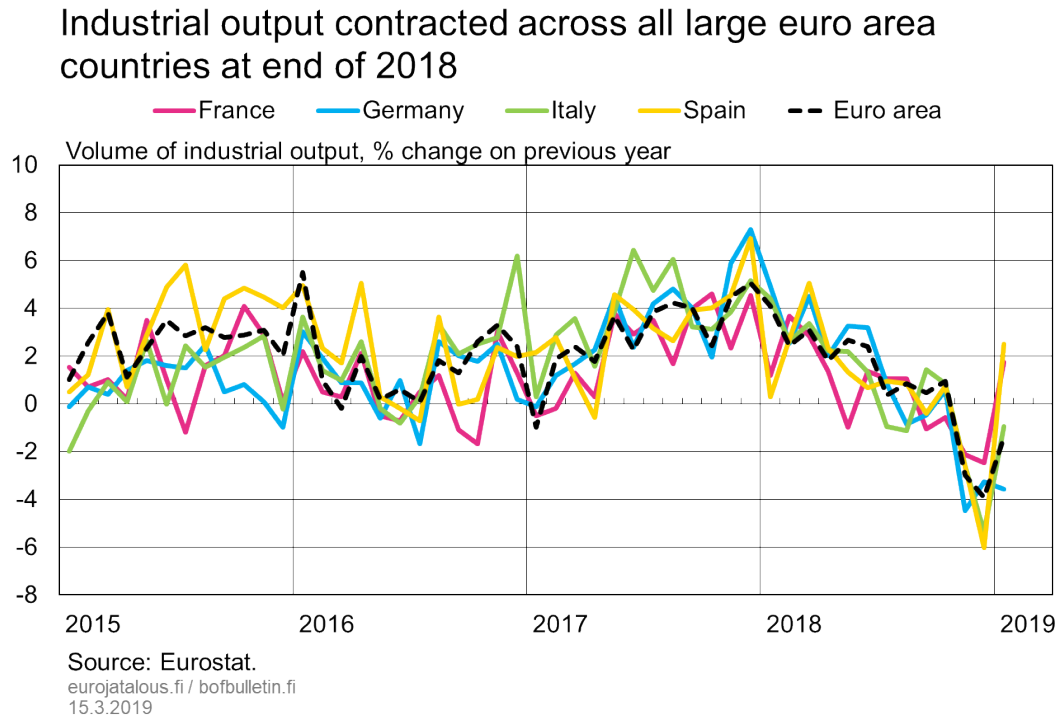
ECB monetary policy remains accommodative

Economic growth in the euro area slowed significantly in the second half of 2018. However, labour market conditions have further improved and wage growth has accelerated, which should support a sustainable strengthening of inflation to levels close to the target of below, but close to, 2%. At the same time, economic activity in the first part of the year looks subdued, and growth forecasts for the current year have been revised down markedly.

As anticipated, the Governing Council of the ECB stopped its net asset purchases under the expanded asset purchase programme at the end of 2018. However, the Eurosystem will continue to purchase securities as reinvestments of the principal payments from maturing securities (see Chart 5). It is estimated that such purchases will be made at an average monthly pace of EUR 17 billion in 2019. In December, the Governing Council enhanced its forward guidance on reinvestments by announcing that they will continue for an extended period of time past the date

when the Governing Council starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

Chart 5.



In March, the ECB revised down its projections for euro area GDP growth and inflation. The Governing Council considered the risks surrounding the euro area growth outlook remain on the downside. Market expectations regarding policy rate increases had shifted significantly ahead since early autumn (see Chart 6).

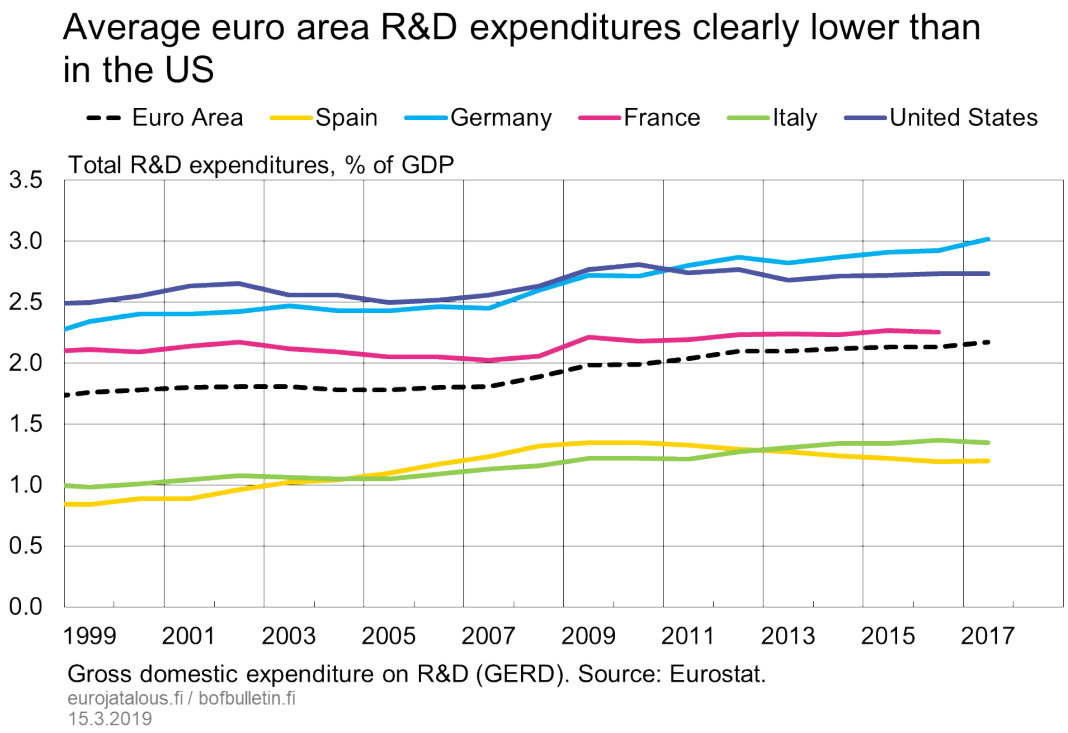
As a result of the weakened economic outlook, the Governing Council changed its forward guidance on key interest rates at its meeting in March. The Governing Council now expects the key interest rates to remain at their present levels at least through the end of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term. Previously, key interest rates were expected to remain at their current level through next summer. The change in the forward guidance on key interest rates also implies an extension of the period of reinvestment of maturing securities, as these reinvestments are linked to the start of key interest rate increases.

In March, the Governing Council also announced a new series of quarterly targeted longer-term refinancing operations (TLTRO-III) that will be available for banks. From September 2019 to

March 2021, banks will have the possibility to obtain loans from the Eurosystem with a maturity of two years and an interest rate tied to the rate on the main refinancing operations. These loans are aimed at maintaining favourable developments in bank lending in the euro area.

The Governing Council also decided in March that the Eurosystem will continue conducting its lending operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the reserve maintenance period starting in March 2021. The Governing Council stands ready to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards the Governing Council's inflation aim in a sustained manner.

Chart 6.



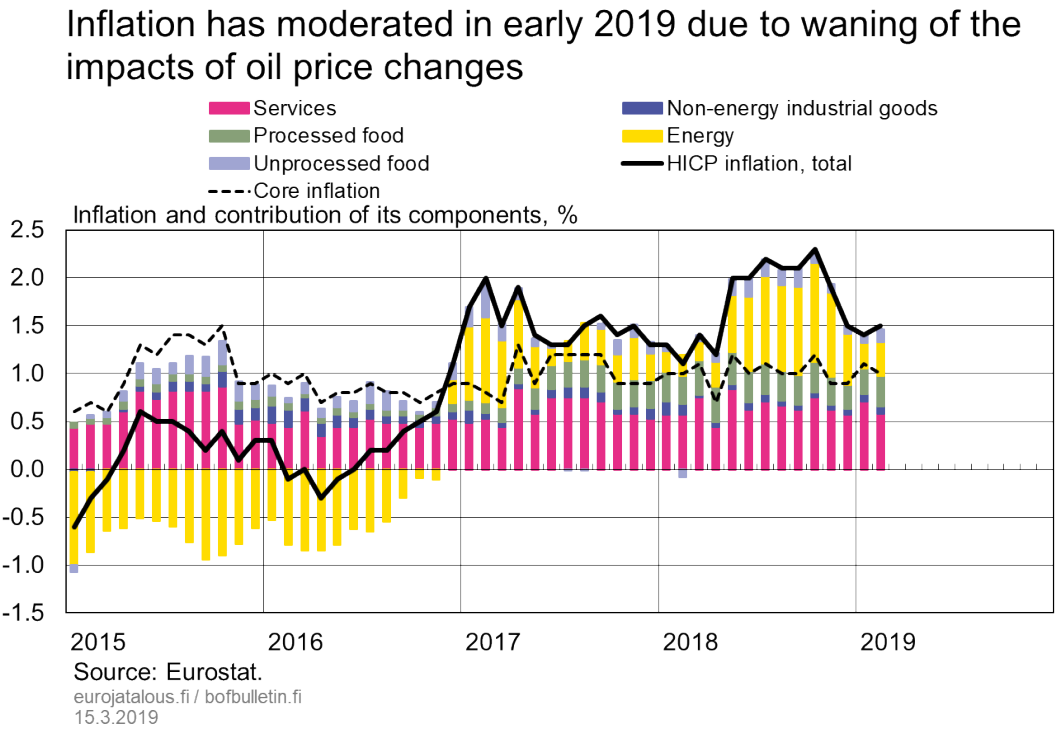
The Governing Council decisions taken in March increase the accommodative impact of monetary policy. After the decisions, expectations regarding the start of key interest rate increases shifted ahead, long-term sovereign bond yields decreased and the euro depreciated against other currencies. Financing conditions in the euro area will remain accommodative for an extended period, supporting economic growth.

Moderate increase in bank lending

Towards the end of last year, the annual rate of loan growth was around 4% for corporate loans and slightly over 3% for household loans (see Chart 7). The acceleration of loan growth has

flattened out in recent months. Growth still remains moderate in comparison with the period preceding the financial crisis when annual growth in corporate loans peaked at 15%, and household loans at 10% approximately. Cross-country differences in loan growth figures are significant. In southern Europe, the stock of loans has grown relatively slowly, whereas in the north loan growth has, on average, been much faster.

Chart 7.



The ECB has supported lending by the banking sector, for instance by means of targeted longer-term refinancing operations, the third series of which will start in September 2019 (see **box on TLTROs**). These favourably priced long-maturity operations have contributed to a decrease in banks' funding costs, which has also been reflected in bank lending rates. Indeed, the interest rates applied by euro area banks in their lending to the private sector have remained historically low, at slightly below 2%.

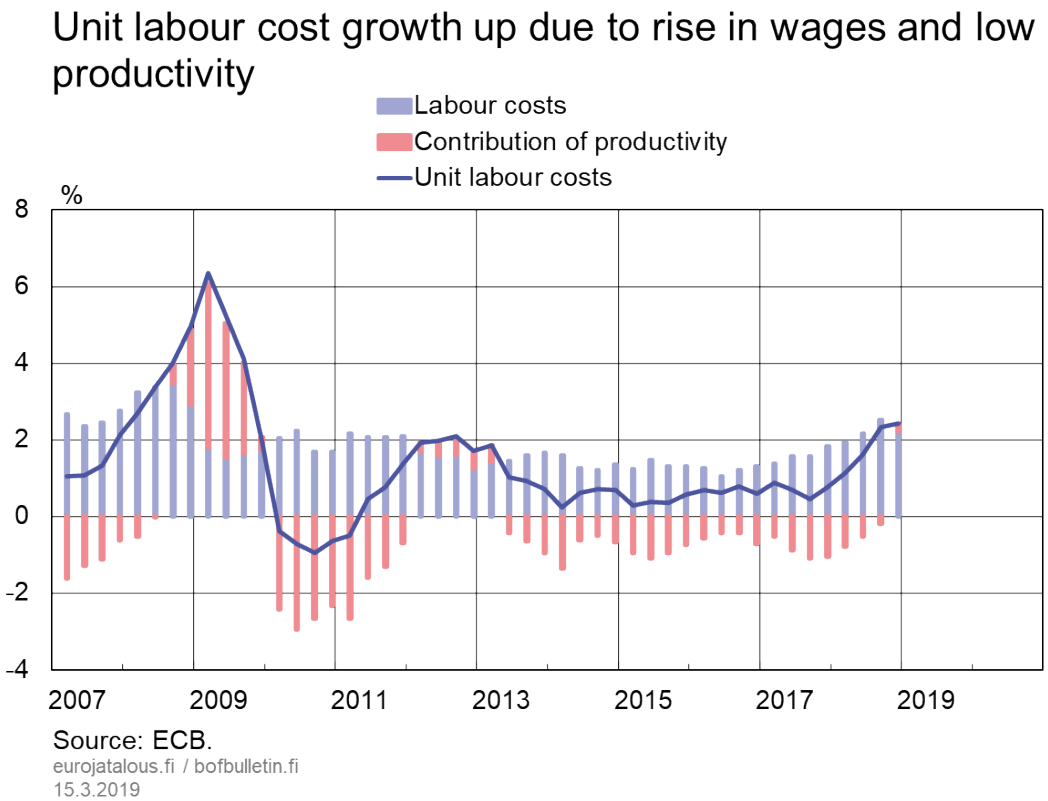
The results of the latest ECB Bank Lending Survey contain signs of tightening credit conditions for the private sector in Italy. Loan margins have been increased and collateral requirements have been tightened. The yields on Italian sovereign bonds increased on the back of political uncertainty at the end of May 2018. Compounded by deteriorating economic conditions, the increase in sovereign bond yields weakens the balance sheets of Italian banks and pushes up their funding costs.

According to euro area companies, their access to finance has further improved. In the ECB Survey on the Access to Finance of Enterprises (SAFE), only 7% of respondents name access to finance as the most important problem for their business.[7] This share has been continuously decreasing since 2012. Despite growing loan stocks, the ratio of overall corporate sector debt to GDP has, on average, further decreased in the euro area.

Profitability remains a challenge for banking sector

In spite of a slight recovery, profitability remains stagnant in the euro area banking sector. Low interest rate levels, heightened political risk, and weakening economic conditions have all dampened banks' profit outlook. Over the past year, equity prices of euro area banks have fallen considerably more than broad market indices. At the same time, banks' market funding costs have increased (Chart 8). Markets and banks anticipate only slight growth in return on equity for the euro area's large banking groups by 2020, to about 8% (cf. 6.9% in Q3 2018).

Chart 8.



Subdued profit growth in core banking remains a sticking point for profitability overall. The challenging operating environment has proved especially caustic for banks' primary source of operating revenue, net interest income. Although bank lending has begun to recover in recent

years, many banks have not been able to compensate for weak net interest income growth with other sources of revenue.

Banks are also beleaguered by longer-term structural issues. In many euro area countries, banks are weighed down by rigid cost structures and are too numerous relative to the size of the economy. Looking ahead, banks will have to contend with a host of challenges posed by major trends, such as digitalisation.

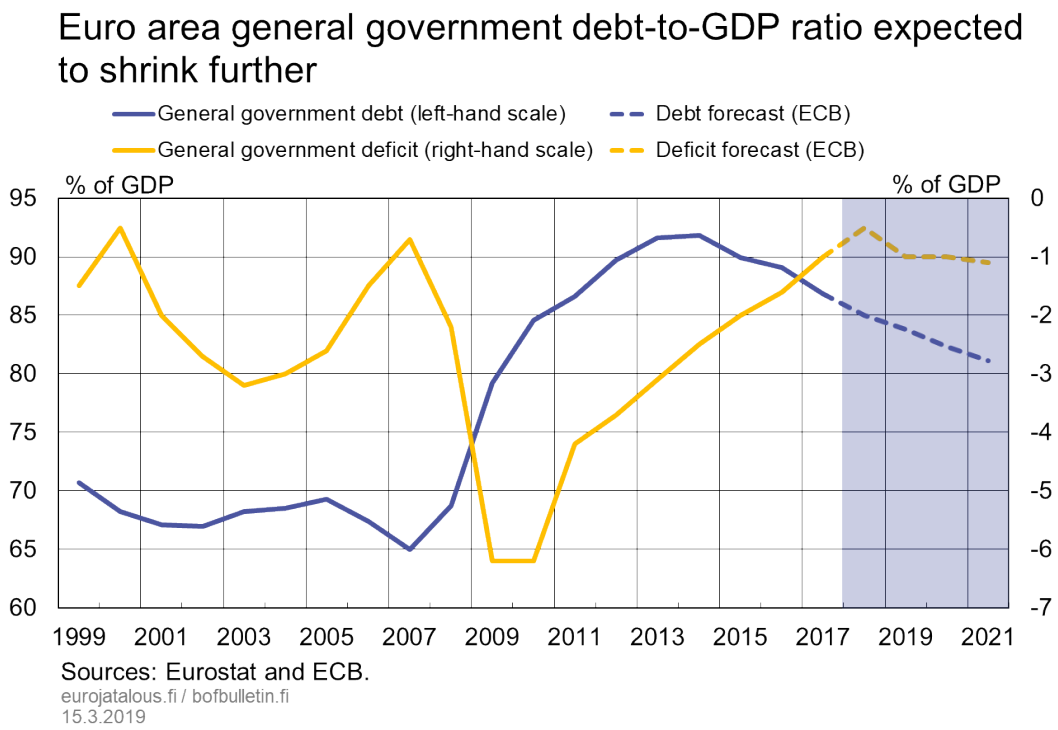
Nevertheless, euro area banks have still made progress in expunging credit risk from their balance sheets. At the same time, banks have strengthened their capital positions and bolstered their risk resilience. Reducing loan losses as well as credit risk has had a substantial effect in supporting the recovery of banks whose domiciles bore the brunt of the sovereign debt crisis. According to the European Single Supervisory Mechanism (SSM), euro area banks held EUR 628 billion worth of non-performing loans on their balance sheets in Q3 2018 – about 17% less than a year earlier. As a result, non-performing loans accounted for 4.2% of the total loan stock in Q3 2018. In spite of relatively broad-based progress, non-performing loans still present a hurdle for some European countries.

Euro area growth has slowed rapidly

Euro area real GDP grew strongly in 2017, by 2.5%. In 2018, GDP growth began to decline from the peak levels reached in the latter half of 2017, as did confidence indicators for the euro area economy (Chart 9). Growth still remained fairly strong through the second quarter of 2018, owing to positive developments in investment. The growth rate has since slowed, however, as declining global trade pushed euro area net exports into negative territory and industrial output contracted. Weakened economic sentiment weighed on private consumption growth.

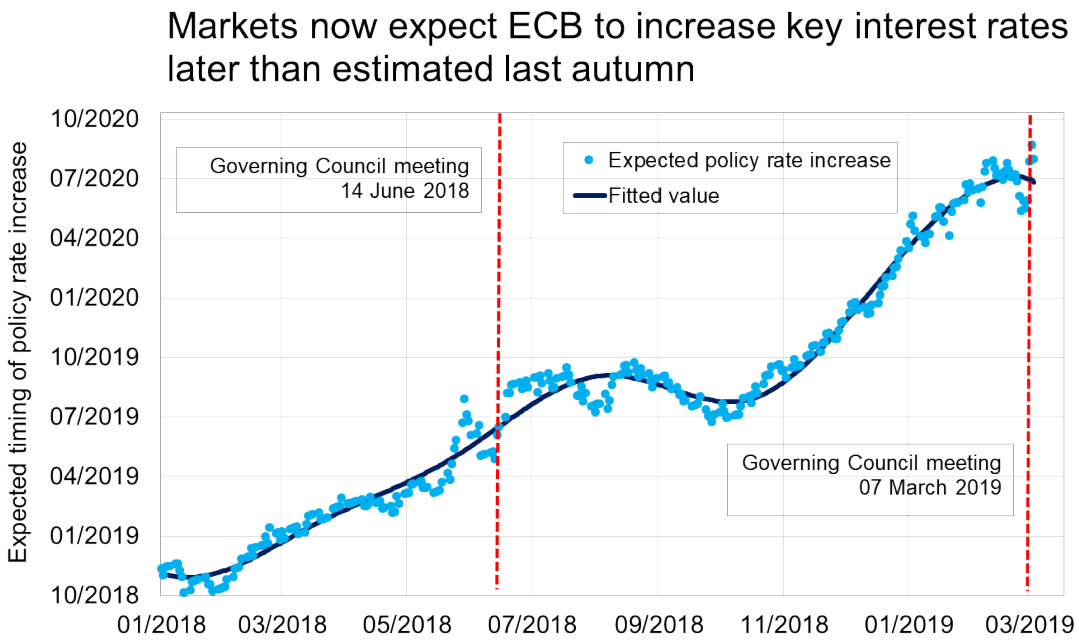
Economic sentiment continued to decline through the end of 2018 and into early 2019, with export orders contracting. Private consumption indicators exhibited no signs of recovery. Growth was driven mainly by investment.

Chart 9.



Real GDP growth in the euro area in 2019 is expected to come in substantially below previous forecasts (Chart 10). According to the ECB's latest macroeconomic projections for the euro area, real GDP growth will reach 1.1% in 2019 (cf. 1.7% in December forecast), 1.6% in 2020 (1.7%) and 1.5% in 2021 (1.5%). According to the European Commission's February forecast, real GDP growth in the euro area will reach 1.3% in 2019 and 1.6% in 2020.

Chart 10.



Private consumption growth in early 2019 will be less than previously forecast. Private consumption will, however, remain one of the key drivers of euro area growth, as households' available incomes are lifted by the improved employment situation and rising earned income.

Euro area investment growth has been broadly based since 2014. Private fixed investment and housing investment have increased almost throughout the entire region. Investment growth is being bolstered by low interest rates, the need to renew the capital base, and deleveraging in the non-financial corporate sector. The need for, and growth of, investment is also reflected in the euro area's capacity utilisation rate. At the end of 2018, capacity utilisation had only slightly declined from the summer, when it approached its highest figures on record since measurement began in 1980.

Growth in euro area exports to the rest of the world slowed in 2018. Exports declined most notably to the United Kingdom and Turkey. In addition, moderating growth in China dampened the country's appetite for euro area exports. Growth figures in 2018 were buttressed by positive export growth to the United States. However, the outlook for net exports is bleak, and they will contribute negatively to growth in early 2019. Faltering consumer demand in China and uncertainty over trade and Brexit are all dimming the euro area's export outlook.

The euro area's current account surplus stood at about 3% of GDP at the end of 2018. While the

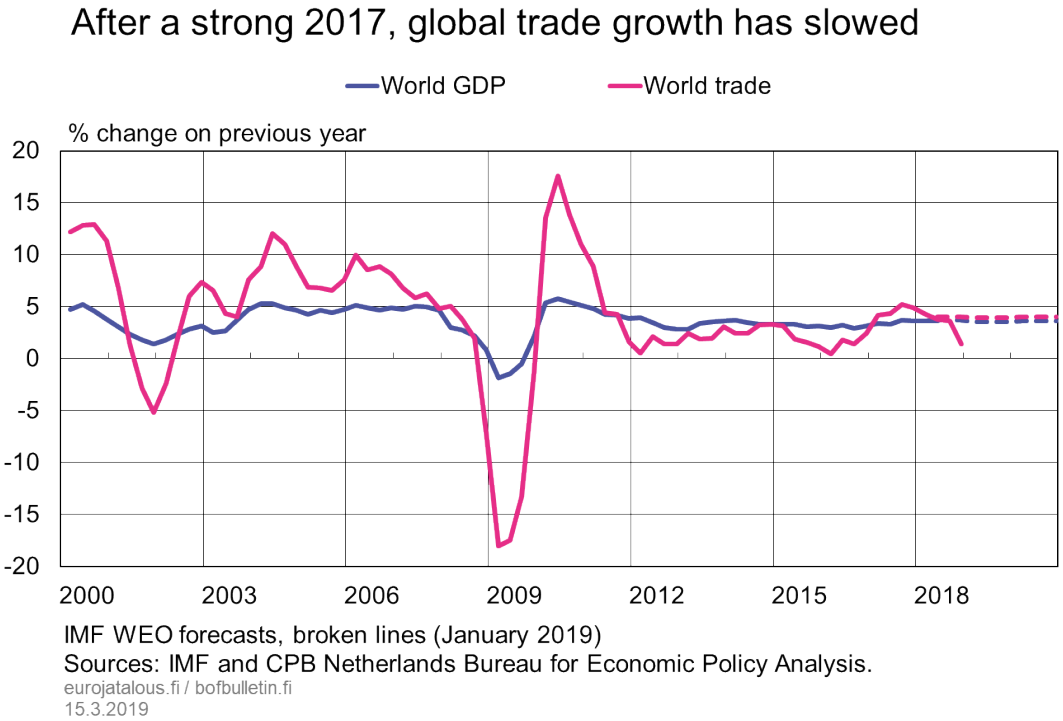
current account surplus provides a buffer against potential economic shocks, it also signifies a higher degree of savings over investment, meaning that investment growth in the euro area is still subdued in that respect.

Overall, the pace of growth in the euro area is considered to have passed its cyclical peak. Since the latter half of 2018, growth has already decelerated below its long term potential, or equilibrium rate. Major estimates of the euro area's annual potential growth rate have recently settled at 1.4–1.5%. However, estimates of the potential rate are always subject to considerable uncertainty.

Scale of slowdown in German economy a surprise

Each of the four largest euro area economies has seen its outlook decline from autumn 2018. The European Commission lowered its 2019 growth forecasts for the entire euro area in February — most notably for Italy and Germany. Industrial output has suffered from weak export growth and uncertainty over the trade war (Chart 11). France, Italy and Germany have been especially vexed by various country- and sector-specific factors.

Chart 11.



The slowdown in the German economy has proved surprisingly rapid and far-reaching, particularly in manufacturing. Declining export demand and country-specific factors related to manufacturing

have weakened Germany's growth outlook and weighed on economic sentiment. Import growth outpaced exports in 2018, with net exports contributing negatively to GDP growth. Industrial output contracted in several manufacturing industries at the end of 2018 — most notably in the automobile industry, which has suffered from temporary setbacks related to the emissions testing scandal. German real GDP grew by 1.5% in 2018, but the European Commission expects growth to slow to just over 1% in 2019. The European Commission has revised its forecast for German GDP growth significantly downwards in 2019, but left its 2020 estimate unchanged at 1.7%. GDP growth in Germany has mainly been kept afloat by domestic demand, which, in turn, has been buttressed by continued employment and wage growth and low interest rate levels.

French real GDP growth reached 1.5% in 2018 — the same pace as Germany's. French growth is similarly expected to moderate in 2019, although less so than in Germany. Political uncertainty and social unrest have reflected unfavourably on consumer confidence. Unpopular structural reforms are confirmed to continue but will be counterbalanced with public spending concessions. It is feared these concessions will weaken the public finances — given that general government is already in deficit.

Italy's economic growth has for several years now ranked among the weakest of the large euro area economies. Italian real GDP increased only by about 1% in 2018, and growth is likely to be near 0% in 2019. The Italian economy sunk into a technical recession in the latter half of 2018, following two consecutive quarters of falling output. As in Germany, Italy's industrial output contracted substantially at the end of 2018. Italy's public debt-to-GDP ratio is high (about 130% of GDP), and its sovereign bond yields have remained significantly elevated from May 2018, as a result of the heightened political uncertainty.

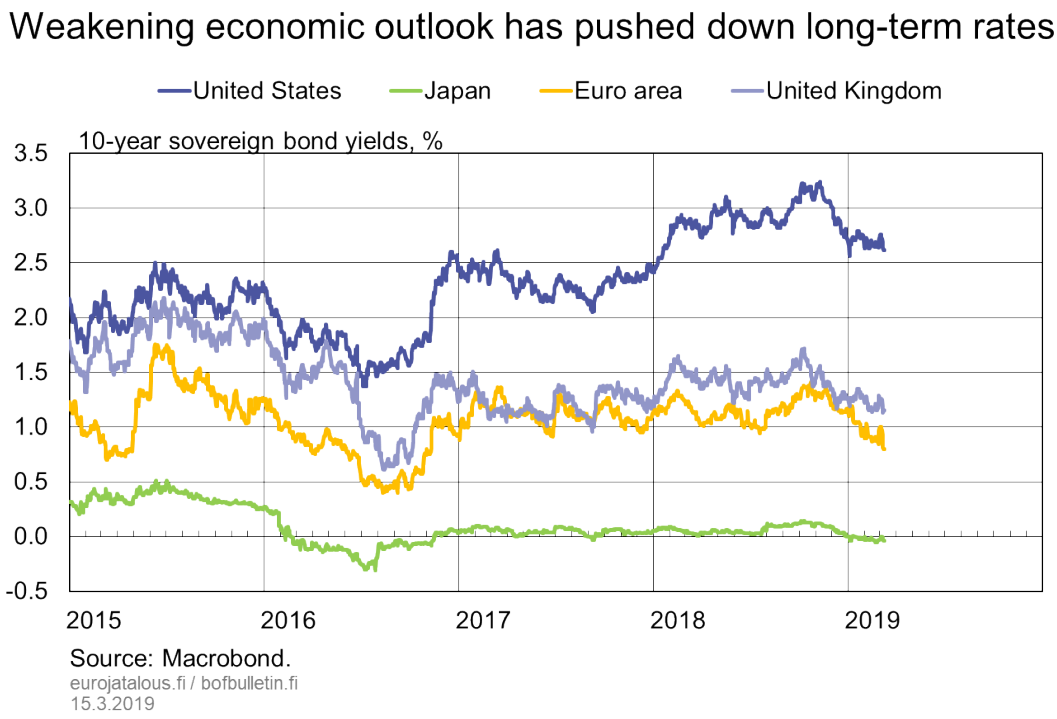
Spain was the fastest growing of the large euro area economies in 2018, with real GDP growth at 2.5%. Although the pace of growth has since moderated, with forecasts also having been revised downwards, real GDP growth is expected to remain at about 2% in 2019 and 2020. Industrial output and export growth have both weakened, but investment growth has performed well. Spain's public finances look to be on a fortuitous path, with the debt-to-GDP ratio forecast to shrink — albeit slowly.

Sluggish productivity development holds back euro area growth

The longer-term outlook for the euro area is dampened by weak productivity development. Productivity growth in the euro area began to slow already in the early 2000s. During the euro area crises, productivity growth decelerated further and has remained sluggish ever since.

Importantly, the productivity slowdown is a euro area-wide phenomenon, homogenously observable across countries.[8] However, a comparison of hourly labour productivity across the euro area, as measured by GDP per hour worked, reveals pronounced differences in the levels of productivity in different countries (Chart 12).

Chart 12.



France and Germany display similar productivity levels and have followed a comparable productivity trend over the past two decades, while the productivity gap between France and Germany, on one side, and Italy and Spain, on the other, continues. The productivity levels in France and Germany, in turn, rank below the US counterpart, and the euro area aggregate displays a pronounced productivity gap relative to the United States.

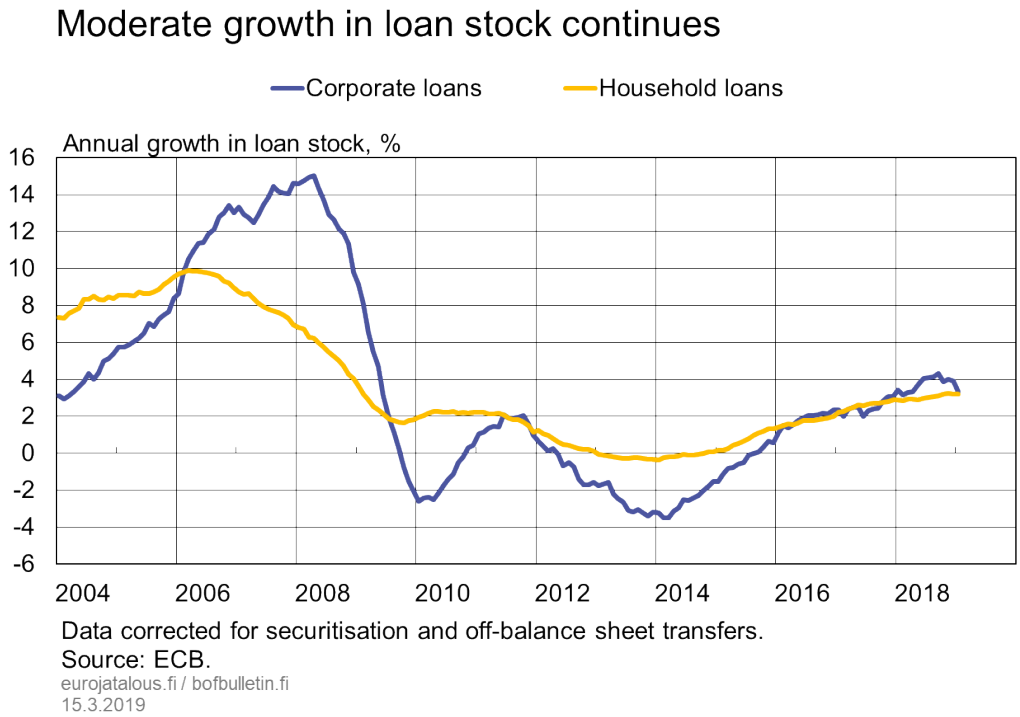
Productivity differentials within the euro area remain significant. The ratio between productivity levels in Germany and Spain was 1.3 in 2017 and has thus remained largely unchanged vis-à-vis the corresponding ratio in 2000 (1.2). Productivity growth in Italy can be characterized as more-or-less stagnant over the past two decades. Spain experienced a similar stagnation in labour productivity growth in the early 2000s up until the Great Recession, while, since the crises, productivity has started to increase at a faster, albeit still rather slow, pace. Consequently, cross-country productivity differentials, prevalent already two decades ago, have persisted and signs of an early reduction of the underlying productivity gaps are not discernible in the data at present.[9]

Productivity gaps also reflect heterogeneous R&D investment across countries

Generally, a host of factors determine labour productivity growth, ranging from the degree of capital deepening, management practices and business dynamism to the efficiency of the allocation of production factors across sectors and firms. Among those determinants, a key contributor is a country's capacity to innovate, driven by its activity in research and development.[10] Thus, while various factors likely explain the productivity differentials across euro area countries as well as the euro area versus United States productivity gap, differentials in productivity are likely to also reflect, at least partly, the cross-country heterogeneity in R&D investment.[11]

Chart 13 illustrates the evolution of research and development expenditures both across the euro area and in comparison with the United States. Overall euro area R&D investment equalled 2.2% of GDP in 2017 and has generally ranked below the corresponding US investment in innovation. The magnitude of R&D expenditures varies substantially across the euro area.

Chart 13.



German innovation expenditures corresponded to 3% of GDP in 2017, and R&D investment as a share of GDP has generally been on a similar scale to its US equivalent. R&D investment relative to

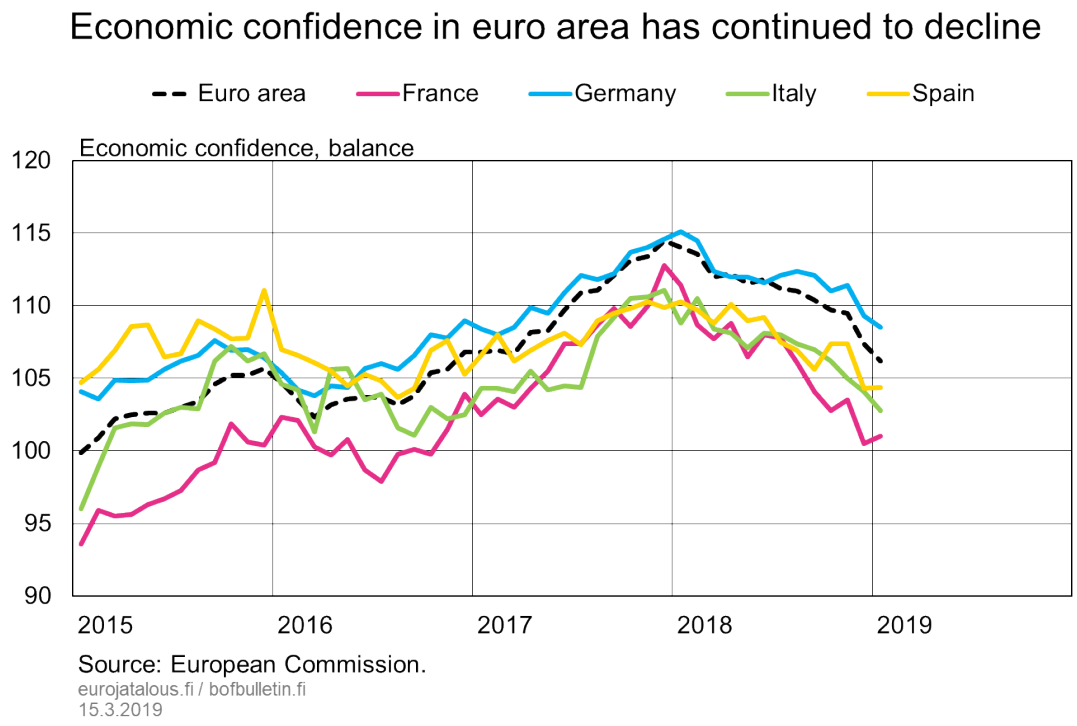
GDP in France has ranged somewhat above the euro area average and equalled 2.3% in 2016. In Italy and Spain, by contrast, investment in innovation has remained at relatively low levels over the past two decades and corresponded to respectively 1.4% and 1.2% of GDP in 2017, highlighting the heterogeneity in terms of R&D expenditures within the euro area.

Euro area labour markets have tightened

Unemployment in the euro area has declined further in 2018. The unemployment rate has fallen steadily from the peak of about 12% in 2013 to around 8%, i.e. below the average euro area level prevailing prior to the crisis (see Chart 14). At the same time, the number of employed has increased considerably and the labour force participation rate has edged up.

In fact, there are already indications of labour shortages in many sectors in the euro area. Competition for workers is tightening, reflecting an increase in the number of jobs vacant. Survey data show that many companies are already suffering from a shortage of skilled labour. It is estimated that the euro area unemployment rate has already reached the non-accelerating inflation rate of unemployment (NAIRU), which refers to an unemployment rate that has a neutral effect on inflation. According to the ECB's assessments, unemployment will decline further in the immediate years ahead, despite a weakening of the cyclical momentum.

Chart 14.



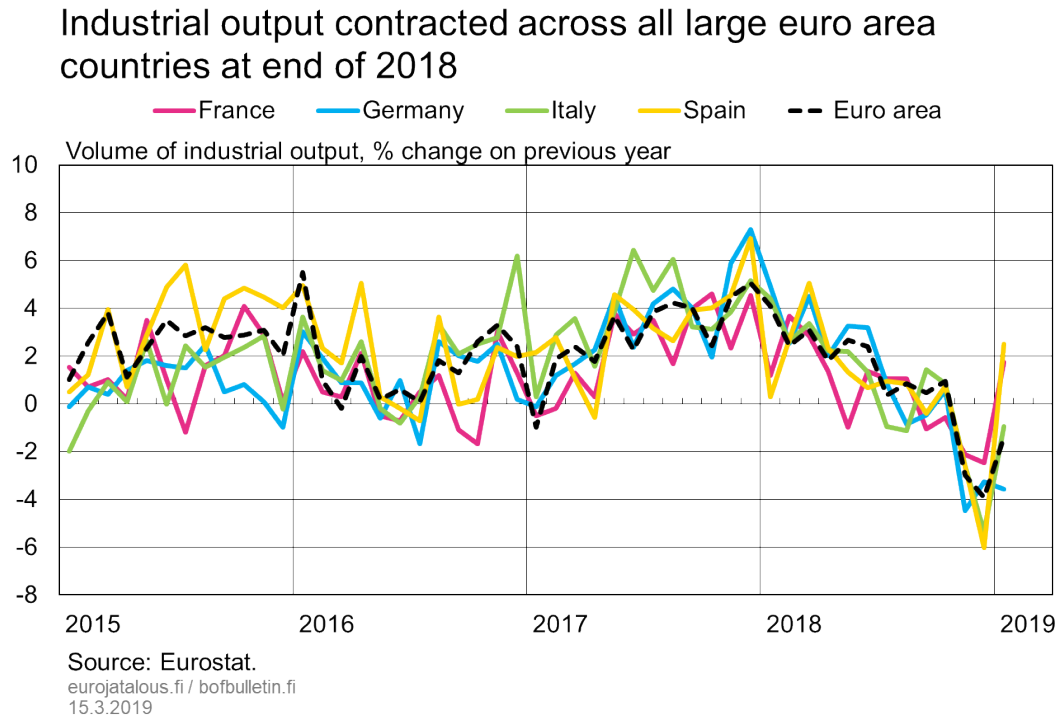
However, there are still substantial differences in labour market conditions among euro area countries. In Germany, in particular, the labour market is already very tight, based on several indicators. Meanwhile, youth unemployment is still a significant problem in many euro area countries.

Wage growth has not yet boosted core inflation

Euro area inflation averaged 1.7% in 2018. It picked up in May to around 2% and was unchanged until November (see Chart 15). Since December, the pace of inflation has been slower.

Inflation was mainly fuelled by an increase in oil prices, the inflation effects of which are reflected through both higher costs and mechanically, via base effects. Inflation is measured as a year-on-year change in prices. Hence, if oil prices are higher than in the corresponding period a year earlier, this will have an upward impact on the inflation figures. The contribution of energy to inflation in 2018 was about one-third. Based on oil futures prices at the beginning of March 2019, oil prices in the next few years will stabilise to upwards of USD 60 per barrel, which would reduce inflation during 2019.

Chart 15.

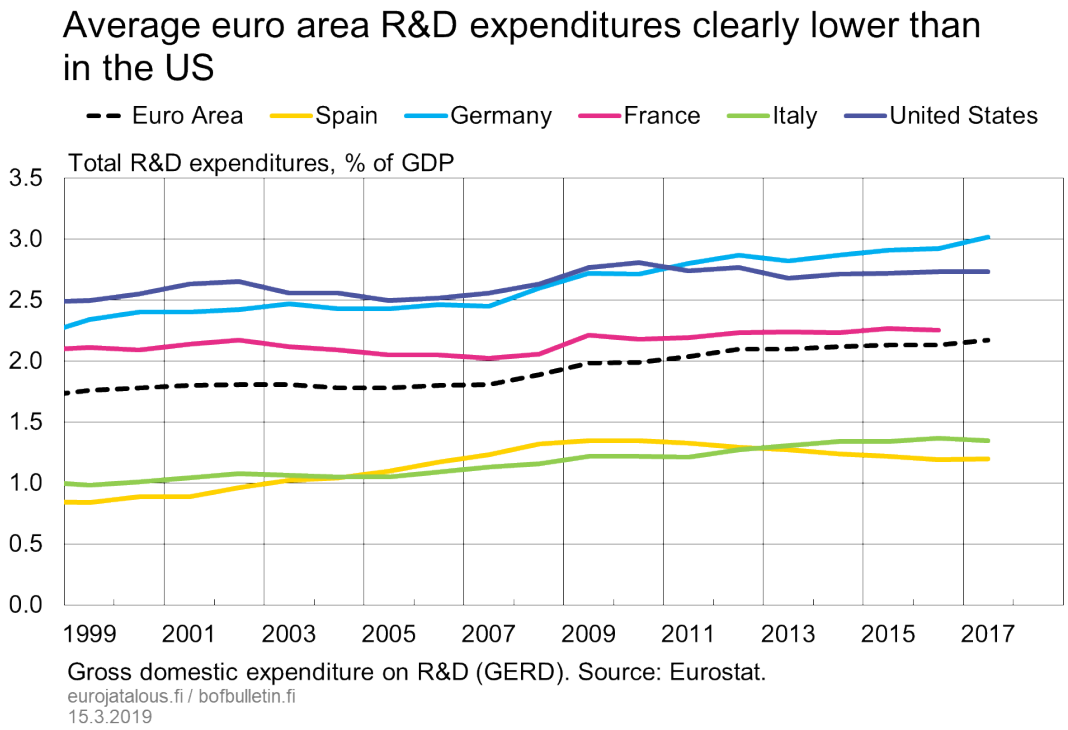


In the euro area, however, oil is an external factor that causes temporary fluctuations in inflation but does not reflect the more permanent underlying factors affecting prices. From the viewpoint

of the price stability objective, it is also advisable to analyse core inflation which excludes the prices of energy and food and reflects internal price pressures within the euro area. Core inflation has persisted at around 1% since 2014.

Core inflation in the euro area has been dampened by a protracted sluggish growth in wages. Since 2017, however, wages have risen at a steady pace (see Chart 16). This will create inflationary pressures via rising costs and consumers' enhanced purchasing power.

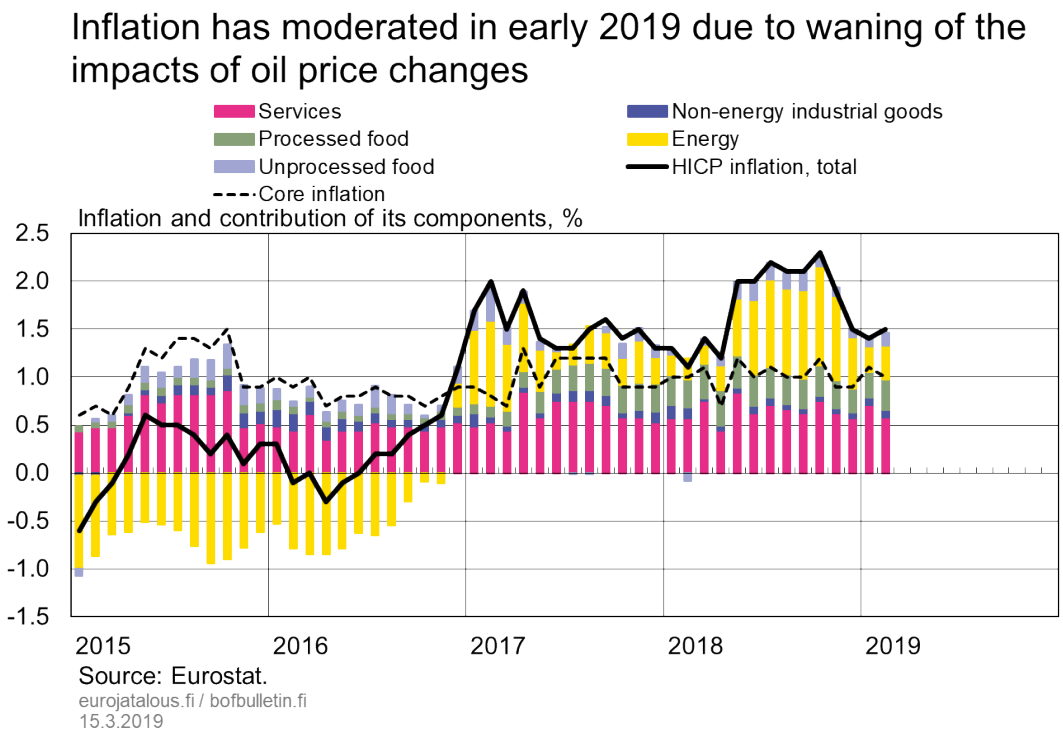
Chart 16.



At the same time, productivity growth has recently remained relatively muted, leading to a rise in unit labour costs (see Chart 17). If corporate profit margins remain unchanged, this will increase firms' pressures to raise their prices. The pick-up in wage growth is underpinned by the continued economic growth in the euro area and tight labour markets. The euro area output gap, which measures the difference between actual and potential output in the economy, has closed. Unemployment has already fallen below its natural (NAIRU) level. Therefore, the economy is largely running at full capacity, leading to a situation in which competition for limited resources will create pressures to raise wages. So far, the pick-up in wage growth has not been reflected in higher core inflation, however. One reason suggested is that firms absorb part of the higher costs by reducing their profit margins. The specific reasons behind wage growth can also have an effect on the extent to which wage growth is reflected in inflation.[12] In addition, in an environment of low inflation, higher labour costs may pass through to prices more slowly than during periods of

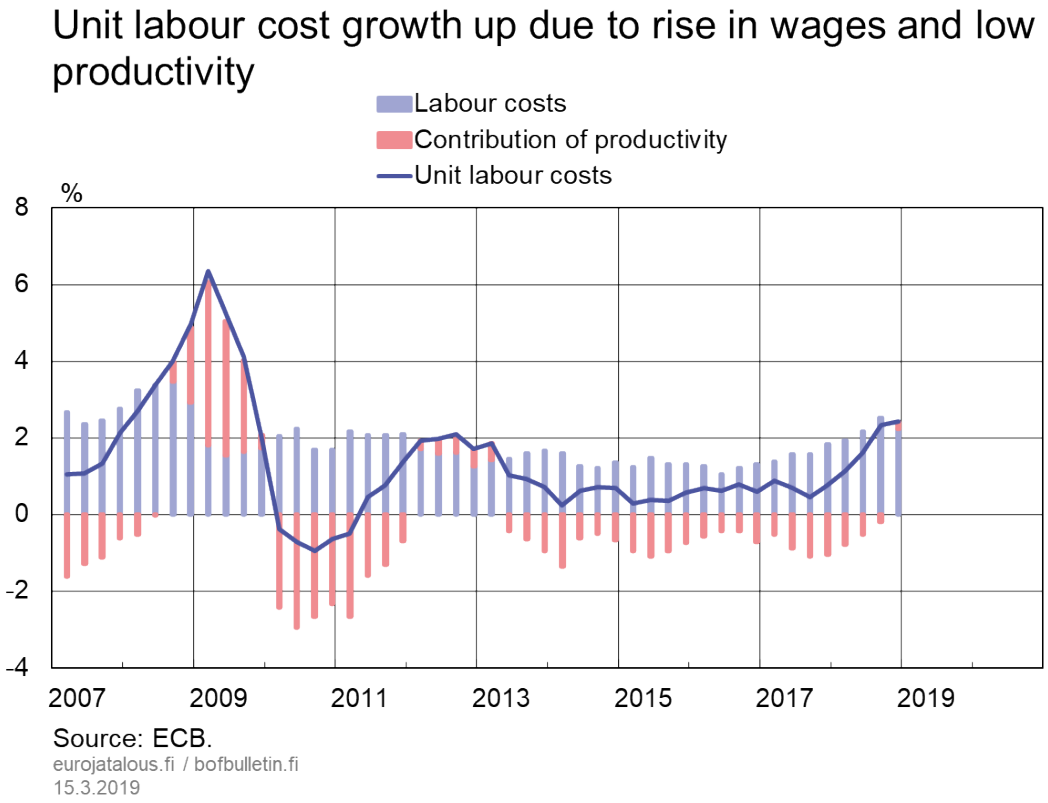
rapid inflation.[13]

Chart 17.



Inflation expectations have weakened, based on both market information and survey data (see Chart 18). Market-based inflation expectations have been declining ever since the summer of 2018. It is particularly noteworthy that long-term expectations extending over the business cycle have fallen, which may trigger a self-fuelling process and lead to an actual moderation in the rate of inflation.

Chart 18.

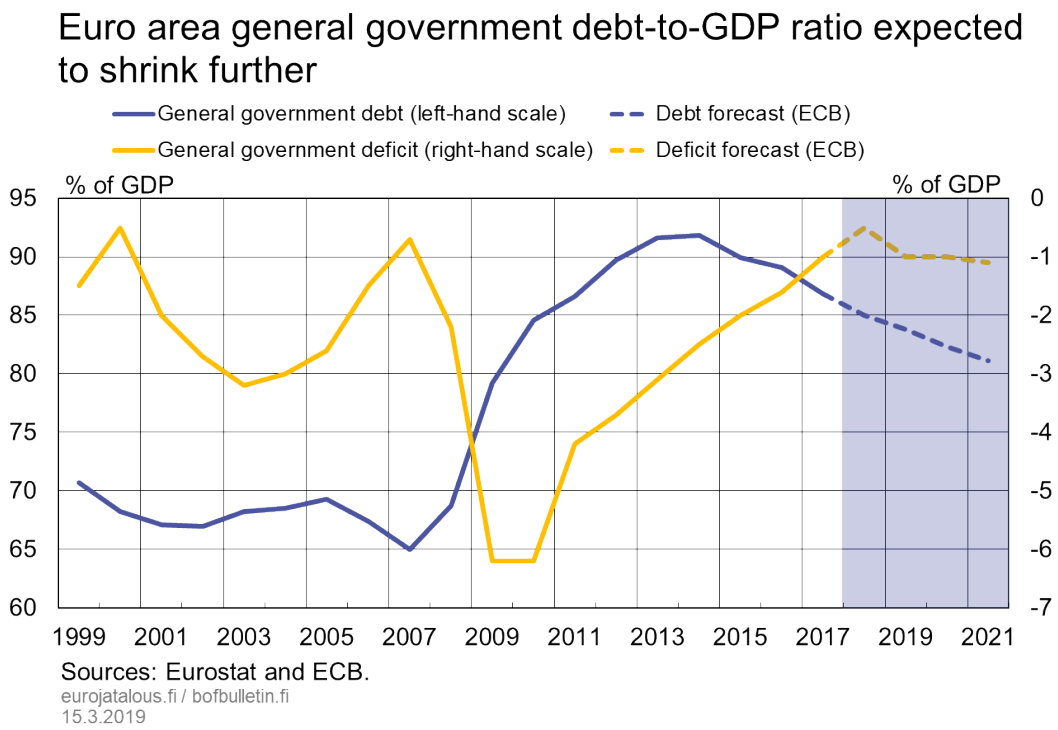


The outlook for inflation has weakened somewhat compared with the end of 2018. Both the ECB and the European Commission have revised downwards the inflation estimates in their most recent forecasts. Inflation will moderate notably during 2019, mainly due to base effects related to oil prices. Once the base effects fade out, inflation will gradually pick up. According to the Commission forecast, inflation will be around 1.5% in 2019 and 2020. This is largely consistent with the ECB's March 2019 projection that foresees inflation of 1.2% in 2019, 1.5% in 2020 and 1.6% in 2021.

Euro area fiscal stance slightly looser

The euro area general government debt-to-GDP ratio shrank to approximately 85% in 2018. The debt ratio is expected to shrink further, while remaining above the pre-crisis level (below 70% of GDP) in the immediate years ahead (Chart 19). In Germany, the general government debt-to-GDP ratio in 2018 was approximately 60%, in France and Spain nearly 100%, and in Italy 130%. Differences between the country ratios are expected to remain large. The euro area's overall fiscal deficit shrank to around 0.5% of GDP in 2018. It is expected to grow slightly.

Chart 19.



The euro area general government debt-to-GDP ratio is expected to shrink, mainly because nominal GDP growth is expected to remain higher than the interest rates on public debt, while the primary balance remains positive. The fiscal stance is expected to be slightly expansionary in the immediate years ahead. The expansionary stance is due to the planned withdrawal of pension reforms and the introduction of basic income In Italy, and reductions in social security contributions in e.g. Germany and the Netherlands.

Blanchard (2019) proposes that public debt does not necessarily create fiscal costs if interest rates are expected to remain below nominal GDP growth rates for a long time.[14] These conditions do not apply in all euro area countries, as clearly evidenced by the rise in Italian sovereign bond yields in 2018 (see Chart 20).[15] In heavily-indebted countries, gradual consolidation of public finances would bolster market confidence and provide governments with more fiscal room for manoeuvre.

Downside risks to global economy remain large

The global economy is expected to grow by some 3.5% in the immediate years ahead, but the outlook is dampened by downside risks. The likelihood of exceptional developments outside the euro area, in particular, has increased. This has been partly reflected in financial market volatility.

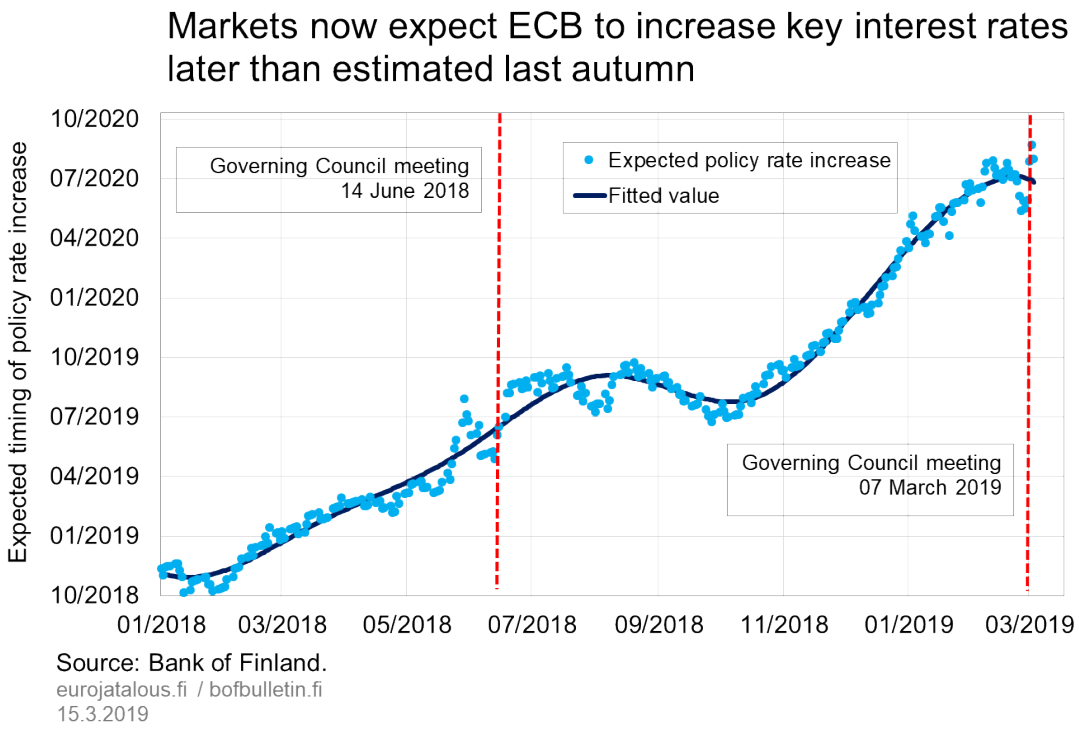
The euro area's three most important partners for goods trade are the United States, the United Kingdom and China. All these economies are subject to considerable downside risks.

The final outcome of the United Kingdom's withdrawal from the EU, i.e. Brexit, was still unclear in early March, even though, based on the original timetable, Brexit is set to take place on 29 March 2019. In early March, the UK Parliament had not yet approved the withdrawal agreement that was reached between the United Kingdom and the European Union and that seeks to ensure an orderly and soft withdrawal from the EU. A no-deal Brexit would have a significant negative impact on trade between the United Kingdom and the countries of the European Union, and also on the long-term outlook for the UK economy. Brexit will weaken particularly the UK economy. As the United Kingdom is an important trading partner of the euro area, a no-deal Brexit would also be reflected in a slowing of euro area exports and the economy in general. The impact would be significant particularly for Ireland, but the United Kingdom is also an important trading partner for e.g. the Netherlands and Belgium.[16] Machinery, equipment and vehicles are the main products exported by the euro area to the United Kingdom. A significantly prolonged negotiation period would be reflected as protracted uncertainty and a slowing of investment and exports.

The trade and fiscal policies of the United States are also linked with considerable negative growth risks (see article Alternative scenarios linked to the global impact of US fiscal and trade policies). With regard to protectionist measures, the United States have agreed with the EU and China on a negotiation period during which the parties will refrain from new tariff increases. This has calmed the situation, but if the parties fail to reach agreement during the negotiation period, there is a risk of new barriers to global trade.[17] On the other hand, if the parties were to achieve a long-term agreement, this would reduce uncertainty, and in the best case it would make global trade fairer and could make a positive contribution to growth.

China's debt has ballooned, and in nearly all historical cases where countries have rapidly accumulated debt in the manner of China this led to a rapid deceleration on the pace of GDP growth. In the second half of 2018, the Chinese economy witnessed a broad-based slowdown. Contradictory goals in domestic economic policy have led to a stop-go scenario, which, combined with slower growth and the deteriorating debt problem, could increase market disturbances. Market agents ought to prepare for a considerably sharper decline in growth. A slump in the Chinese economy could have significant consequences for global confidence, commodity prices, world trade and global growth. Moderation of Chinese growth may also exacerbate the problems in other emerging economies.

Chart 20.



Of internal downside risks in the euro area, the key risks are developments related to fiscal policy and financial market uncertainties in some euro area countries. The risk yields on Italian sovereign bonds, in particular, are still high. According to an assessment by the European Commission, Member States' budget proposals for 2019 are in compliance with the Stability and Growth Pact. In some Member States, debt levels are, however, still high, and according to the Commission, economic developments in these countries are subject to substantial risks in the medium term. To reduce risks, Member States should ensure that there is sufficient room for fiscal manoeuvre. Structural improvements in the economy would reduce structural unemployment in the euro area and possibly boost productivity growth, which has been weak since the financial crisis. There is a threat that a general weakening in the outlook for the euro area may slow the reduction in general government debt and improvements in the banking sector in several countries.

Notes

1. IMF January forecast and March estimates by the OECD and ECB (excluding the euro area). ↑
2. The raised tariffs affect half of China's exports to the US (valued at around USD 250 billion) and 80 % of US exports to China (valued at around USD 110 billion). General tariffs placed by the US on washing machines, solar panels, aluminium and steel are still in effect, apart for some individual countries that have been granted exemptions. ↑
3. China's share accounts for just under one fifth of the total global GDP. ↑

4. The UK Parliament rejected Theresa May's Brexit deal a second time on March 12, 2019. ↑
5. Read more about the raised tariffs' impacts on the US economy, Amiti, M. et al. (2019) The Impact of the 2018 Trade War on U.S. Prices and Welfare, CEPR Discussion Paper no.13564 and Fajgelbaum, P.D., et al. (2019) The Return to Protectionism, Working Paper, March 2019. ↑
6. See for example JCT (2017) Macroeconomic Analysis of the Conference Agreement for H.R. 1, The "Tax Cuts and Jobs Act", JCX-69-17, or Barro (2018) Tax Reform Will Pay Growth Dividends, WSJ 4.1.2018. ↑
7. The most recent SAFE survey covers the period from April to September 2018. ↑
8. See also ECB Economic Bulletin, Issue 3/ 2017: 'The slowdown in euro area productivity in a global context'. ↑
9. The productivity gap within the euro area and the gap in euro area versus US labour productivity have also been stressed recently by other institutions, such as the IMF and the European Commission. See IMF (2017) IMF Country Report No. 17/236: Euro Area Policies; and European Commission (2018) Science, Research and Innovation Performance of the EU 2018: Strengthening the Foundations for Europe's Future. ↑
10. On the link between R&D, innovation and productivity growth see Romer (1990) 'Endogenous Technological Change', Journal of Political Economy, Vol. 98 (5); and Grossman and Helpman (1991) 'Quality Ladders in the Theory of Growth', Review of Economic Studies, Vol. 58, pp. 43–61. ↑
11. See European Commission (2018) for the importance of R&D in advancing euro area productivity growth and with regards to the euro area – US productivity gap. ↑
12. See the article 'The role of wages in the pick-up of inflation', ECB Economic Bulletin 5/2018. ↑
13. See Bobeica – Ciccarelli – Vansteenkiste (2019) The link between labor cost and price inflation in the euro area. ECB Working Paper No 2235/2019. ↑
14. See Blanchard (2019) Public Debt and Low Interest Rates, AEA Presidential Lecture, January 2019. ↑
15. For a discussion on the contractionary effects of the rise in interest rates on Italian government borrowing, see Blanchard and Zettelmeyer (2018) The Italian Budget: A Case of Contractionary Fiscal Expansion?, PIIE Realtime Economic Issues Watch, October 2018. ↑
16. A survey by the National Bank of Belgium on the impact of Brexit on the EU27: Bisciari (2019): A survey of the long-term impact of Brexit on the UK and the EU27 economies, National Bank of Belgium Working Paper no. 366; and Calculations by the Bank of England on the effects of Brexit on the UK: BoE (2018) EU withdrawal scenarios and monetary and financial stability: A response to the House of Commons Treasury Committee. ↑
17. The economic effects of protectionist measures are analysed in e.g. the following articles: Bank of Finland Bulletin (4/2018) 'Trade policy tensions casting shadow on economic horizon', published 4 October 2018; and ECB (2018) 'Implications of rising trade tensions for the global economy', ECB Economic Bulletin 3/2018. ↑

Keywords

euro area, inflation, international economy, monetary policy