Euro area growth dependent on domestic demand

21 Mar 2016 – Monetary Policy Review – Monetary policy

The Governing Council of the ECB decided on an expanded asset purchase programme (EAPP) in January 2015. Purchases have thus far been conducted to a total value of almost EUR 780 billion. At its monetary policy meeting in March 2016, the Governing Council decided to further ease the monetary policy stance. Accordingly, markets expect monetary policy to remain accommodative for a prolonged period.

The euro area economy continued to recover in 2015. GDP grew at a rate of 1½% and the unemployment rate decreased by one percentage point, to stand at 10½%. However, in 2016–2018, growth will rest more than before on domestic demand. The outlook for export market growth has deteriorated, and the contribution of net exports to growth will be negligible over the forecast period.

Despite positive developments in the real economy, the annual average inflation rate in the euro area was zero in 2015, the lowest outcome since the start of Monetary Union. The low inflation rate mainly reflected developments in the price of oil, which decreased further in the course of 2015. The underlying inflation rate (which excludes oil and food price changes), while remaining more stable, has also been low and hovered around only 1%. The pick-up in inflation is forecast to be moderate over the entire forecast horizon. It is supported by stabilisation of the oil price, the continued accommodative stance of monetary policy, and the narrowing of the negative output gap.

Euro area growth is exposed to both external and internal risks. The most important external risk relates to a broad-based strong slowdown of the global economy, which would dampen both growth and inflation in the euro area. Another risk is that the strong fall in oil prices and the slowdown of global economic activity could end up having nonlinear effects, as the balance sheets of highly indebted economies can no longer bear the ever weakening situation.

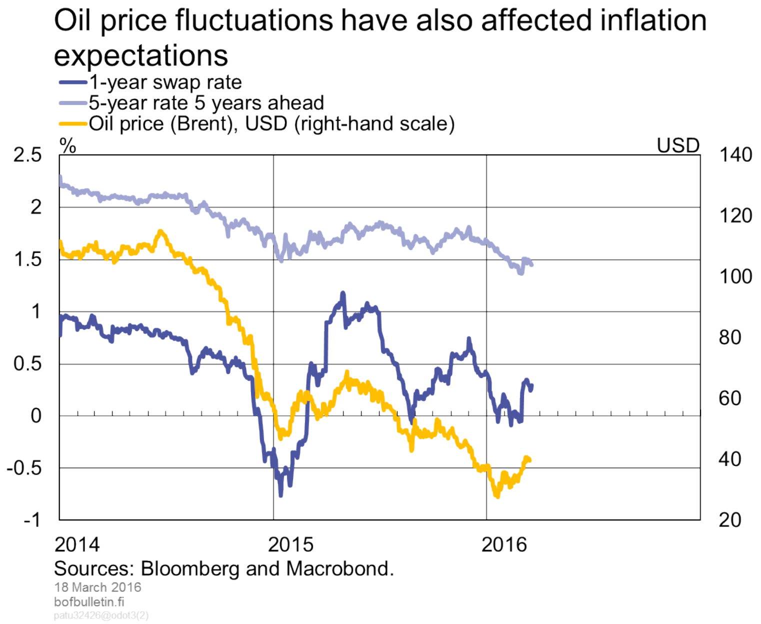
Internal risks relate to the fact that the recovery in the euro area economy is still fragile. The protracted nature of the crisis is visible across a range of factors, as illustrated by the persistently sluggish capital investment and high levels of long-term and youth unemployment. The refugee crisis represents a new shock to the euro area, and its effects are surrounded by a high degree of uncertainty. Political uncertainty in Europe is further compounded by the upcoming referendum on the UK's EU membership.

ECB adopted extensive additional measures

In 2015, the real economy in the euro area continued to recover. During the year, GDP grew at a rate of 1½% and the unemployment rate decreased by one percentage point, to stand at 10½%. Despite these positive economic developments, the euro area inflation rate remained at zero. 2015 was already the third consecutive year in which the inflation rate remained well below 2%, thereby falling short of the price stability objective.

The sluggish inflation rate can mainly be explained by the path of the oil price, which started to decline again after mid-2015. Besides lowering the actual inflation rate, this dip in oil prices has also dampened inflation expectations over the short – but also longer – term (see Chart 1). The uncertainty surrounding the global economic outlook has increased since the beginning of 2016, leading to a substantial increase in financial market volatility. These factors have weakened the outlook for growth and price stability in the euro area.

Chart 1

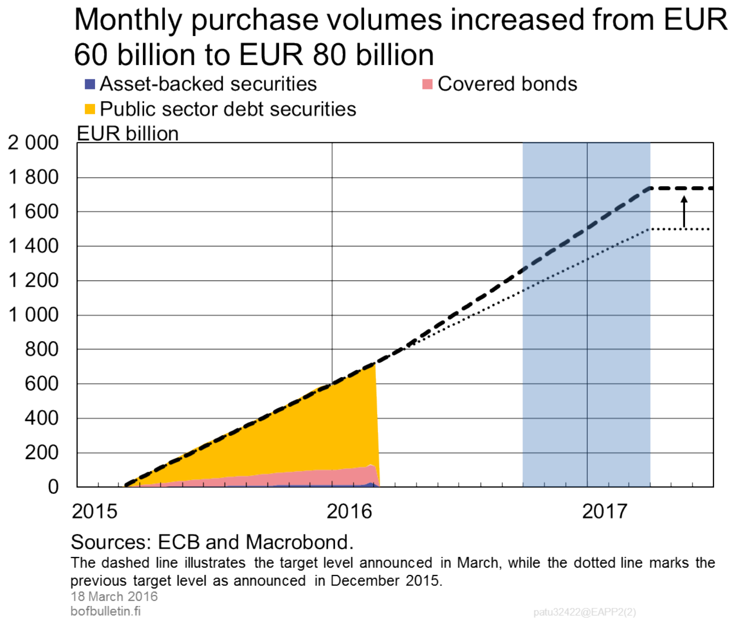


At its meeting in March 2016, the Governing Council of the ECB therefore decided on a comprehensive package which will further ease the monetary policy stance. Firstly, the Governing Council decided to decrease all key ECB interest rates: the rate on the main refinancing operations was lowered by 0.05 of a percentage point to 0.00% and the rate on the marginal lending facility also by 0.05 of a percentage point to 0.25%, while the rate on the deposit facility was cut by 0.10 of a percentage point to –0.40%. Secondly, the asset purchase programme was further extended to cover debt securities issued by the non-bank corporate sector, and the monthly volume of asset purchases was increased. Starting from April 2016, purchases will be conducted at a monthly pace of EUR 80 billion. Thirdly, the Eurosystem will in June launch a series of targeted longer-term refinancing operations, the loan conditions of which are linked to additional lending to the corporate sector.

Asset purchase programme eases monetary conditions

The Governing Council decided on an expanded asset purchase programme (EAPP) in January 2015. At that time, it was decided that purchases would be conducted as of March 2015 for a monthly volume of EUR 60 billion and that these monthly purchases would run until at least September 2015, leading to an aggregate purchase volume of EUR 1,140 billion. Implementation of the programme has proceeded as announced, with debt securities issued by euro area governments constituting the majority of the purchased securities (see Chart 2).

Chart 2



In December 2015, the asset purchase programme was extended to run at least until the end of March 2017 (see the shaded area in Chart 2). The Governing Council also decided that the principal payments on maturing securities would be reinvested for as long as necessary. This means that the combined volume of the purchases will remain at targeted levels even if the monthly purchases were to be discontinued (see the horizontal portion of the dotted line in Chart 2).

At its meeting in March, the Governing Council decided to expand the monthly purchases from EUR 60 billion to EUR 80 billion (see the differential between the dashed line and the dotted line in Chart 2). As a result, the overall volume of the programme will increase to at least EUR 1,740 billion. In addition, investment-grade euro-denominated bonds issued by non-banking sector corporations established in the euro area were included in the list of assets eligible for purchase.

These asset purchases ease monetary conditions in the euro area in three ways.

Firstly, the duration of the purchase programme illustrates the Governing Council's commitment to maintaining interest rates at low levels for an increasingly long period (the signalling effect). This effect is also supported by forward guidance, according to which the Governing Council expects key interest rates to remain at present or lower levels well past the horizon of the Eurosystem's net asset purchases.

Secondly, the programme creates additional demand for the securities covered by it, thus reducing the risk premia related to these securities. This translates into lower yields and thereby lower interest rate levels in the economy.

Thirdly, in addition to these direct effects, the sellers of securities covered by the purchase programme are likely to substitute the sold securities with other, riskier assets, thereby also narrowing the risk premia related to these assets. This increase in the demand for securities not covered by the purchase programme, and its broader positive impact on the capital market, is known as the portfolio balancing effect.

All in all, the purchase programme lowers the level of interest rates in the economy.[1] The decrease in interest rates creates incentives to consume and invest and has the potential to induce a depreciation of the exchange rate. These factors increase aggregate demand and, over time, also the inflation rate.

Targeted longer-term refinancing operations enhance the effectiveness of monetary policy

In the current situation, the rate on the deposit facility in effect constitutes the ECB's policy rate. This is due to the fact that the sizeable asset purchases conducted by the central bank have created an ample supply of liquidity (or reserves) exceeding the corresponding demand. This excess supply pushes down the Eonia rate. Given that excess liquidity (or reserves) is remunerated by the central bank at the rate on the deposit facility – which is the minimum rate at which banks are willing to lend to each other – Eonia has recently closely mirrored the deposit rate, with a very small difference.

The immediate reaction of longer-term market rates to a decrease in the deposit rate (or policy rate) depends on the prevailing expectations regarding monetary policy. In an environment of low interest rates, a decrease in the deposit rate may have unusual

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1. For an analysis of the impact of the asset purchase programme on the level of interest rates, see Alta villa et al., (2015), ECB Working Paper Series, No 1864.

effects. When the expected path of short-term rates is, into the distant future, limited to its lower bound (that is, to the expected level of the deposit rate), a decrease in the deposit rate results in a decrease in the expected path of short-term interest rates over a long time horizon. As long-term interest rates can be expressed as the average of short-term rates, long-term rates also decrease. Hence, a decrease in the deposit rate may have a stronger impact on long-term market rates.

The Governing Council decided in March on a series of four new targeted longer-term refinancing operations (TLTRO II) to be conducted on a quarterly basis between June 2016 and March 2017. In these operations with a maturity of four years, banks will be entitled to borrow up to 30% of their stock of eligible loans as at 31 January 2016. The interest rate applied in these operations will be fixed at the rate on the main refinancing operations. However, for banks whose eligible lending to corporations and households (excluding loans for house purchase) exceeds a certain threshold, the interest rate will be lower and can be as low as the rate on the deposit facility at the time of take-up.

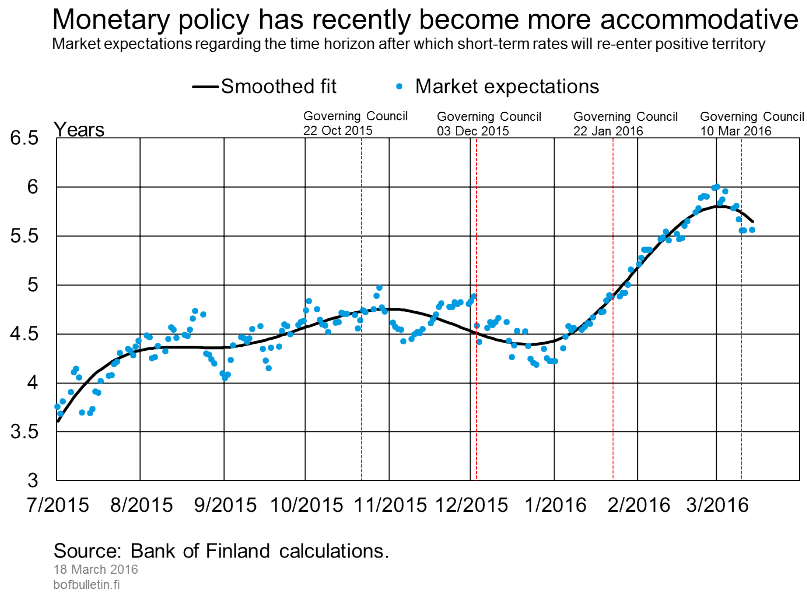
With the decrease in key interest rates and the EAPP, market rates have been pushed down to very low levels. The TLTROs enhance the transmission of monetary policy to the real economy. In this way, the various monetary policy measures included in the package reinforce each other.

Markets expect interest rates to remain low for an extended period

One way to assess the monetary policy stance in an environment of low interest rates is to examine changes in market expectations regarding the time span after which short-term rates will turn positive.[2]

2. The dates (see Chart 3) should be regarded as indicative. They have been calculated under the assumption of risk neutrality which, in the current situation, may result in an overestimation of the expected date. Furthermore, any interpretation should take into account that the expectations reflect the view of the market, which may differ from that of the central bank.

Chart 3



In July 2015, market expectations suggested that it would take some 3.5 years, or until early 2019, for short-term rates to return to positive territory (see Chart 3). Thereafter, economic developments and the ECB's forward guidance pushed back the expected turning point farther still, by approximately one year, as the market expected a further easing of monetary policy. Following the Governing Council meeting in December 2015, market expectations regarding the end of the period of negative short-term rates were brought forward by approximately half a year. In December, however, the expected monetary policy stance was more accommodative than, say, in July 2015. Since the beginning of 2016, the fall in oil prices, the uncertainty surrounding global economic developments, the increase in financial market volatility as well as the Governing Council's forward guidance have led to an adjustment in market expectations towards a more accommodative monetary policy stance. The markets expect short-term rates to turn positive in the first half of 2022.

After the monetary policy meeting in March 2016, and in line with the Governing Council's forward guidance, markets expect interest rates to remain low beyond the announced horizon of the asset purchase programme. All in all, during the past six months, the monetary policy stance has been substantially adjusted towards more accommodation.

Lending rates keep decreasing in GIIPS countries

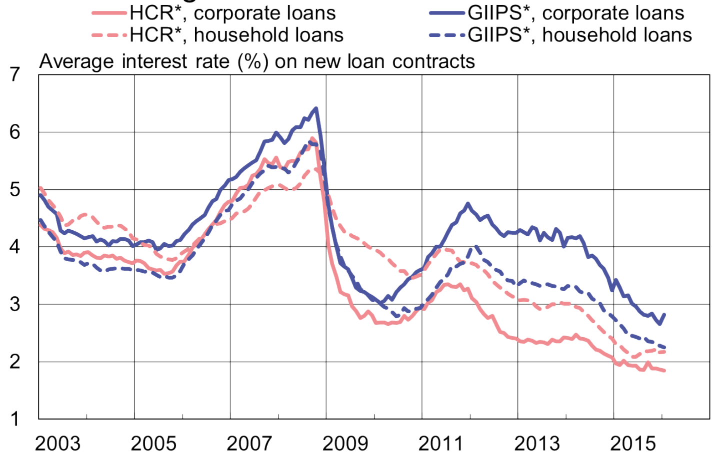
In the euro area, monetary policy feeds through to the real economy primarily via the banks. An easing of monetary policy leads to a decrease in market rates, and this decrease is reflected in banks' lending rates.

Interest rates on corporate loans have decreased in the euro area since summer 2014. In countries with high credit ratings (here: Austria, Belgium, Finland, France, Germany and the Netherlands), the decrease bottomed out in the course of 2015 (see Chart 4). In

GIIPS countries (Greece, Italy, Ireland, Portugal and Spain), the fall in average rates on new loans has continued, but these rates still remain higher than the euro area average.

Chart 4

Fall in lending rates bottomed out in countries with high credit ratings



Sources: ECB and Macrobond.
*HCR = countries with high credit ratings (Austria, Belgium, Finland, France, Germany and the Netherlands). GIIPS = Greece, Italy, Ireland, Portugal and Spain.
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The bottoming out of lending rates observed in countries with high credit ratings is the result of several factors. The fall in reference rates decreases net interest income, thereby weakening banking profitability, unless the fall in interest rates is compensated for by increasing the margins added to the reference rates. At the same time, while also generating profits for their owners, banks have to increase their capital ratios in response to tightening regulation. In addition, demand for loans is picking up in countries with high credit ratings, which may result in a bottoming out of the fall in interest rates. As regards financing costs, and in particular deposit rates, there is little margin left for rate decreases, unless euro area banks pass on the negative rate on the deposit facility to their retail customers. On the other hand, in Germany and France, fixed-rate loans accounted for a notably larger share of new loan contracts in 2015 than in the previous year. Interest rates on fixed-rate loans were, on average, half a percentage point higher than those on variable-rate loans, thereby increasing the average interest rate.

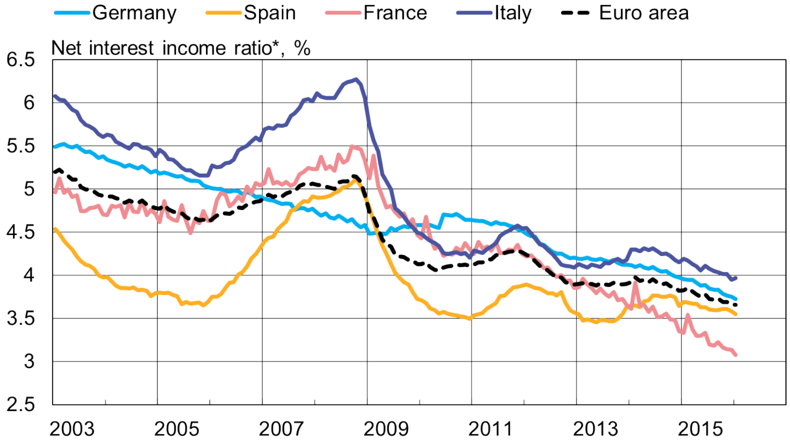
In GIIPS countries, in contrast, the conditions exist for further decreases in lending rates, especially in Spain and Ireland. Interest rates are being pressed down by the competition for customers and the sluggish (at best) growth in the loan stock. Furthermore, banks' financing costs have decreased in GIIPS countries proportionally more than in countries with high credit ratings, which boosts their net interest income. In January 2016, however, the protracted decrease in corporate lending rates came to a halt in the GIIPS countries as well. This partly reflected an increase in uncertainty in the banking sector, especially in Italy and Portugal. In addition, the persistently high share of non-performing loans in these countries weakens banking profitability and may dampen the decrease in lending rates.

A decrease in banks’ net interest income

Monetary policy measures are aimed at keeping short-term interest rates at low levels for a protracted period while also further depressing longer-term rates. Although low interest rates stimulate economic activity, they also have an inadvertent negative impact on banks’ net interest income.

Chart 5

Banks' net interest income decreased markedly during the crisis



Sources: ECB and Macrobond.
* Net interest income ratio = interest income from lending to the private sector, minus interest expense from deposits, as a percentage of the loan stock.
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Interest income accounts for some 65% of banks’ earnings in the euro area. On average, deposits from and loans to the private sector make up some 60% of the euro area banking sector’s assets and liabilities, respectively. When the level of interest rates in an economy falls and the difference between short-term and longer-term rates decreases, banks’ interest income diminishes. For this analysis, the imputed net interest income shown in Chart 5 is only indicative, as banks’ other interest income and interest expenses are not included. Nonetheless, it points in the right direction, given that retail banking accounts for a significant share of banking sector earnings in the euro area. In recent years, the interest paid by banks on their bonds has mirrored the fall in other market rates, which has decreased the cost of banks’ market-based debt. However, the role of bonds as a source of banks’ funding has, on average, diminished in the euro area.

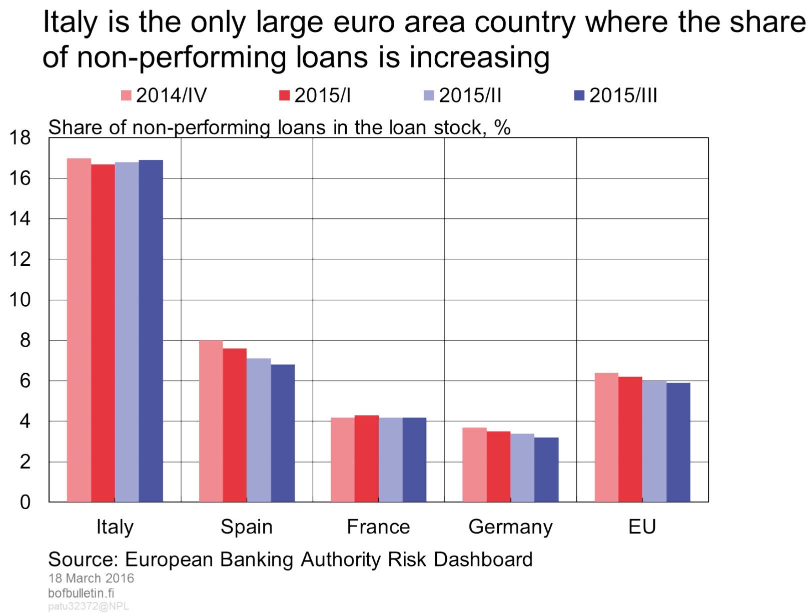
As the extended asset purchase programme exerts downward pressure on the interest rates on debt securities, profits generated from the sale of these securities, as well as valuation gains which are partly reflected in the balance sheet, contribute to an increase in banks’ capital. By supporting economic growth, the low interest rate level decreases credit risk and credit losses and leads to a decrease in the share of non-performing loans. In this way, the low level of interest rates also underpins banks’ profitability.

Increase in non-performing loans is a problem for just a few countries

The share of non-performing loans remains relatively large in Europe and will decline only slowly. In the third quarter of 2015, non-performing loans (meaning loans with payments more than 90 days overdue) accounted for some 6% of the loan stock in EU countries (see Chart 6).

In the comprehensive assessment of banks conducted by the ECB in 2014, the definitions of non-performing loans were harmonised. As a result, some 15% of the loan contracts of Italian banks had to be reclassified as non-performing. Despite a number of tax and law reforms, the share of non-performing loans in Italy had not begun to decline by the end of the third quarter of 2015. In January 2016, the Italian government negotiated an agreement with the EU which allows it under certain conditions to grant state guarantees for non-performing loans sold by banks, with the aim of attracting more investors.

Chart 6



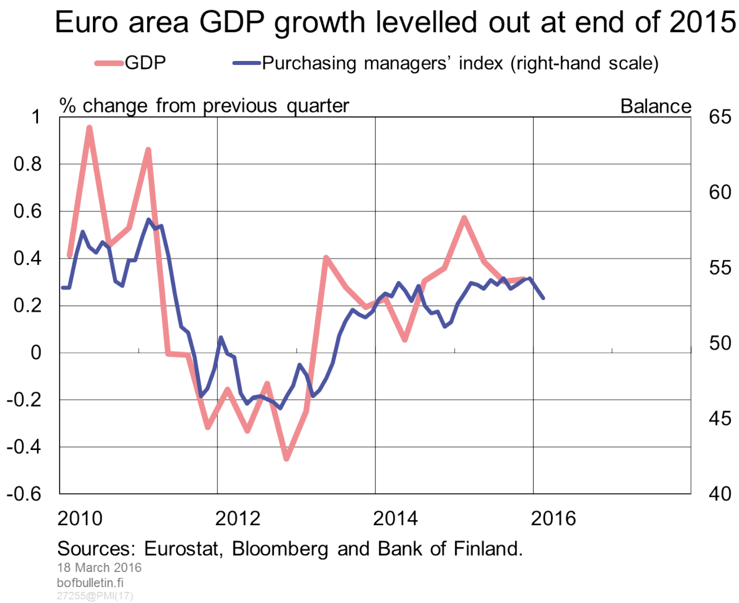
At the beginning of 2016, a new single crisis resolution framework came into force, emphasising the responsibilities of creditors in regard to troubled banks. The new framework will increase consistency and predictability in every EU country, thereby decreasing investor uncertainty over the longer term.

Although the introduction of the framework in January 2016 was no surprise to the markets, it may have contributed at least partially to the decline observed in banks' share prices in early 2016. Last year's bank restructuring measures adopted in Italy and Portugal also added to the uncertainty.

Growth of the real economy rests on domestic demand

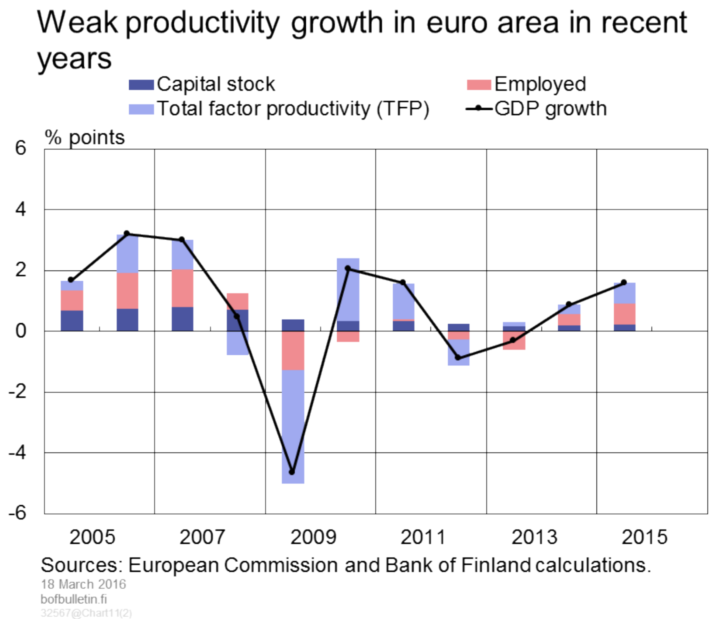
In the second half of 2015, GDP growth in EU22 countries (euro area, UK, Sweden and Denmark) fell slightly short of the Bank of Finland's September forecast, as growth in exports and investment was more sluggish than expected. This reflected a slowdown in the growth rate of emerging economies and global trade, as well as an increase in financial market volatility.

Chart 7



However, the internal fundamentals of the **euro area** economy have not changed during the past six months and continue to support growth. In 2008–2014, the heavy debt servicing burden of the private sector, tight fiscal policies and weak labour market developments dampened growth in domestic demand, but this dampening effect is now receding. However, in 2016–2018, euro area growth will rest on domestic demand more heavily than before. The outlook for export market growth has worsened, and the contribution of net exports to euro area growth will be negligible over the forecast period. Moreover, financial market turbulence at the beginning of the year has created uncertainty and tightened access to market-based equity financing and debt financing.

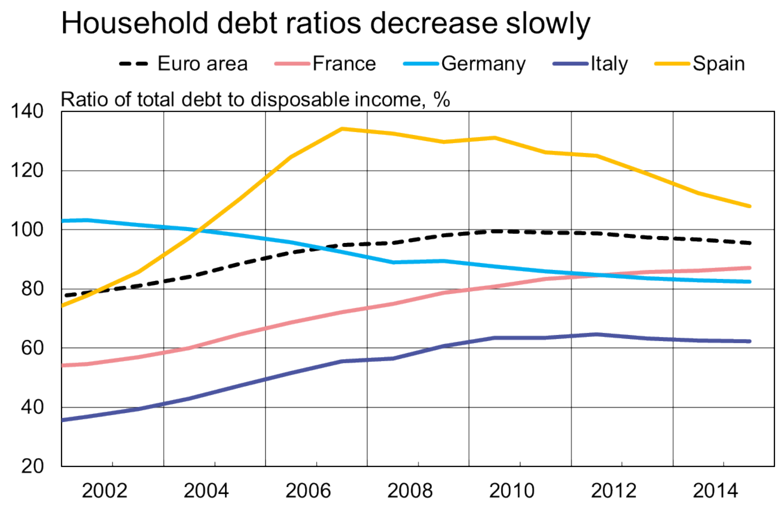
Chart 8



In 2015, of all components of aggregate demand, **private consumption** contributed most to euro area GDP growth. Its value has increased steadily since the beginning of 2014, as the employment situation has improved and the decrease in the prices of energy products has supported an increase in real disposable income. Growth in private consumption is expected to continue over the entire forecast horizon, reflecting a rising employment rate and persistently low interest rates.

Average annual growth in loans to euro area households strengthened steadily in the course of 2015. Nonetheless, the rate of this growth remains modest in comparison with pre-crisis levels, and the ratio of total household debt to disposable income continues to decrease slowly in the euro area (see Chart 9).

Chart 9



Sources: Eurostat and Macrobond.
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Of the large euro area countries, in Italy and France households' debt-servicing costs remain above their long-term average, which may limit growth in private consumption in the next few years. Especially in France, household indebtedness has been increasing continuously since 2002, although e.g. house prices have followed a downward path since 2012. In Germany, the household sector balance sheet has enough margin for manoeuvre for a further increase in private consumption in the coming years. Households' debt servicing costs are steadily decreasing in Germany, the loan stock is gradually growing and house price increases remain moderate. In Spain, balance sheet adjustment in the household sector is still ongoing and the stock of loans to households decreasing, albeit at a steadily decreasing pace.

Investment growth remains sluggish

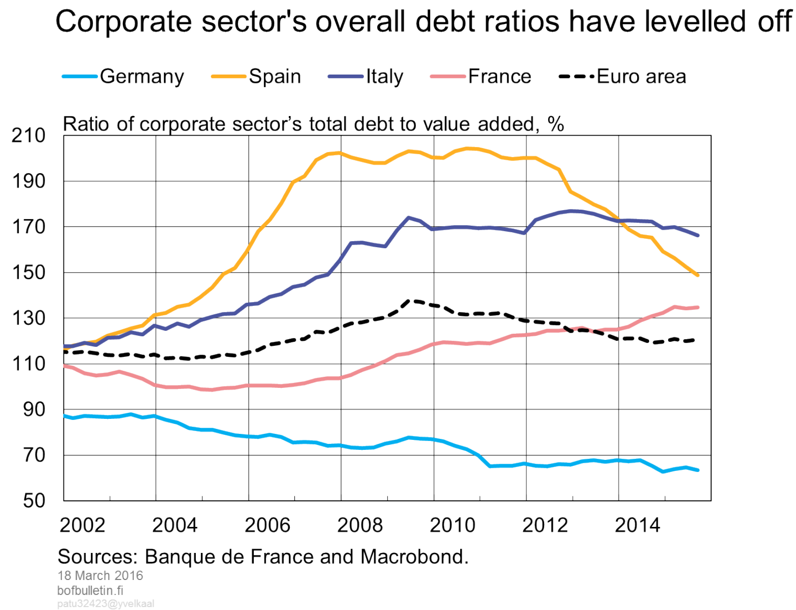
The value of **private capital investment** has increased in the euro area since the beginning of 2014. However, investment activity has recovered only slowly. It has been dampened by low profitability, often weak competitiveness and ample unused production capacity. Financial market uncertainty increased in the second half of 2015, and the beginning of 2016 saw a correction taking place, for instance on the equity markets. As a result, the pick-up in investment in 2016 is expected to remain weaker than anticipated. Looking ahead, however, the persistently low interest rate level should facilitate debt-servicing in the corporate sector and support investment growth.

The stock of corporate loans has displayed positive growth figures in the euro area since July 2015. At the beginning of 2016, however, differences between large euro area countries in the growth path of the corporate loan stock remained significant. In Spain, the annual growth rate of the corporate loan stock remains negative, but the contraction is bottoming out, although loan redemptions still exceeded loan drawdowns in 2015. Meanwhile in Italy, corporate loan growth returned to levels below zero in December. In France, in contrast, growth in the corporate loan stock has been much stronger than the euro area average.

All in all, the growth in debt financing slowed in the corporate sector in the course of 2015. In particular, the issuance of corporate bonds saw a decline towards the end of the year. For small and medium-sized enterprises (SMEs), access to finance from non-bank sources is still difficult in the euro area. Despite this, the results of euro area corporate surveys suggest that the availability of funding is now only a minor problem for companies of all sizes. Companies still consider lack of demand their most pressing problem.

In the euro area, the corporate sector's overall debt ratios (against value added) have remained almost unchanged from the year before, despite some variation across countries (see Chart 10).

Chart 10



In Spain, the progress of the balance sheet adjustment process remains rapid as the corporate sector continues to deleverage. Low interest rate levels and the pick-up in economic activity make it possible to reduce the share of non-performing loans and thereby improve Spanish banks' future lending capacity. In Germany, the overall corporate debt ratio has remained below the euro area average, although investment dynamics have been markedly stronger. In France, corporate indebtedness has increased alongside household indebtedness. Nonetheless, the ratio of debt-servicing costs to net corporate earnings shows a downward trend in France, and capital investment increased towards the end of 2015.

Situations differ across large euro area countries

Germany's GDP grew by 1.7% in 2015. The country's economic fundamentals remain solid, with strong competitiveness, moderate household debt levels and one of the lowest unemployment rates in the euro area. Thanks to a balanced fiscal position and the lowest debt ratio among euro area countries, German public finances are well equipped to accommodate the refugee crisis. In the next few years, the German economy will grow at a rapid pace 2%.

The **French** economy grew by 1.2% in 2015, indicating a clear improvement from developments in previous years. Growth is projected to pick up further over the forecast horizon, driven by private consumption, which in turn is boosted by an increase in households' disposable income, partly on the back of low oil prices. Favourable monetary conditions also support growth. Export growth is projected to be sustained, thanks to the depreciation of the euro, the ongoing improvement in the competitiveness of French industries and the improvement in the economic performance of Southern European countries important for French exports. Fixed capital investment is projected to gradually improve over the coming years. The high ratio of public expenditure to GDP has edged down, but fiscal adjustment is progressing sluggishly. The high unemployment is projected to persist.

In **Italy**, preliminary data suggests that GDP grew by 0.8% in 2015, having previously contracted for three consecutive years. Growth has been based on positive developments in exports and private consumption, but investment also increased in early 2015. Private consumption has been supported by improvements in employment and the resulting very high level of consumer confidence. Italy's GDP growth rate is projected to be around 1% over the next few years. Downward risks in Italy still relate to the banking system.

Spain's economy grew by 3.2% in 2015. Looking ahead, growth is expected to continue at a strong, albeit slightly decreasing pace. The unemployment ratio has declined to around 21%, having peaked at 27% in early 2013. Economic growth is supported by a significant easing of financing conditions and the improvement in employment. The ongoing growth, in turn, is leading to an improvement in the public finances, such that government indebtedness will edge down after peaking in 2016 (at approximately 100% of GDP).

UK will vote on EU membership

The **UK's** economy grew by 2.2% in 2015, and growth is projected to continue on a favourable path over the forecast horizon 2016–2018. The labour market situation has further improved, the employment rate has already clearly exceeded pre-crisis levels, and private sector confidence has remained strong. Although overall inflation hovered around zero in 2015 on the back of decreasing oil and commodity prices, service price inflation remained above 2% and underlying inflation also edged up during the year. The UK will organise a referendum on its EU membership on 23 June 2016, which is likely to increase uncertainty especially on the financial markets. Despite continued favourable investment developments and a positive outlook for industrial sectors, the biggest downward risks to the UK's economic outlook are exogenous and come from a potential weakening of global economic activity.

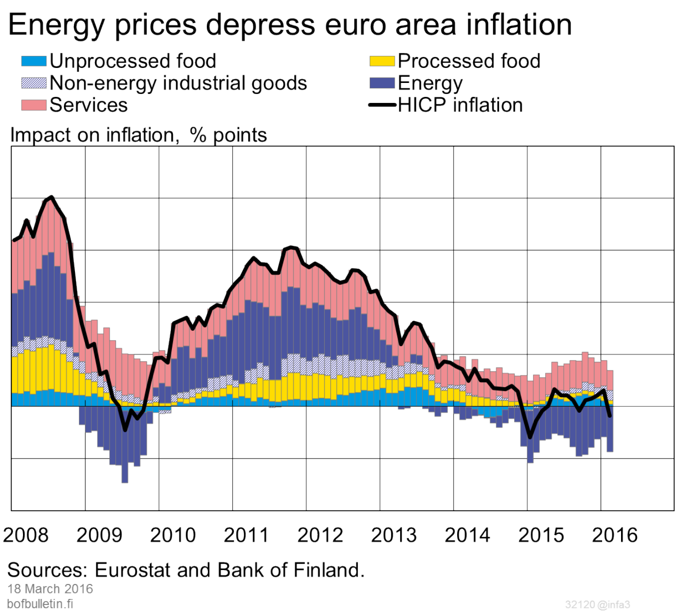
Sweden's economy grew by 4.1% in 2015, exceeding expectations, thanks especially to strong developments in private consumption and housing investment. Sweden's labour market displays positive developments, even if the unemployment rate will not decrease much over the forecast horizon due to recent immigrant inflows. Housing market developments and the related indebtedness remain the biggest risks to economic stability. The increase in house prices and household indebtedness are approaching worrying levels. Without new macroeconomic tools, Sweden's economic imbalance will keep growing, although the introduction of new macroeconomic tools may dampen growth in domestic demand over the short term.

In **Denmark**, the economy grew by 1.2% in 2015. Labour market conditions and real income have continued to develop favourably, strengthening growth in private consumption over the forecast horizon. The biggest downward risk relates to weaker than expected global growth, suggesting slower than expected growth in exports. On the other hand, following a reduction in labour market slack and a protracted deleveraging process, growth in private consumption may well exceed expectations.

Oil prices main cause of sluggish inflation

Inflation developments in EU22 countries (euro area, UK, Sweden and Denmark) have been sluggish. In 2015, the annual average rate of inflation in the euro area was zero, the lowest outcome since the start of Monetary Union. After a dip in January 2015, inflation picked up and was in May nearly one percentage point higher, only to slow down during the summer back to levels close to zero. After standing at –0.1% in September, the rate increased without pause towards the end of the year and stood at 0.3% in January 2016. Inflation was again negative in February (–0.2%). Inflation was also zero in the UK, 0.7% in Sweden and 0.2% in Denmark.

Chart 11



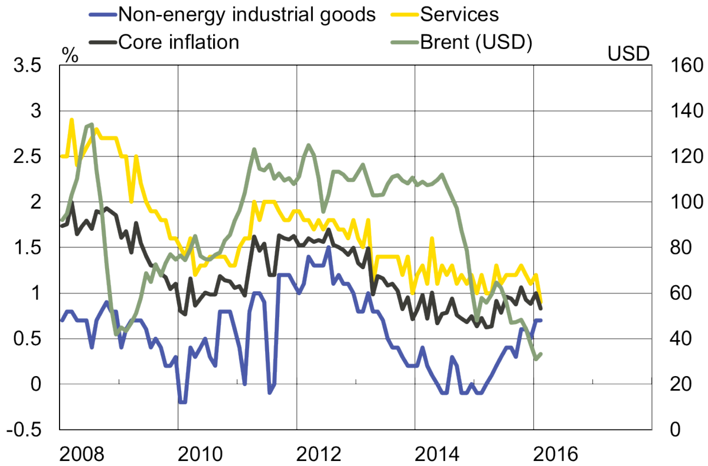
The low inflation rate mainly reflected developments in oil prices, which decreased further in the course of 2015. After a modest recovery during the spring, oil prices in US dollars fell again from USD 65 per barrel to USD 30 per barrel. The lowest prices, USD 28 per barrel, were seen in January 2016, but in the course of February and March oil prices have recovered to levels close to USD 40.

The fall in oil prices has a direct impact on the prices of energy products, which make up some 10% of the consumer price index. However, the impact of changes in oil prices are relative: the lower the oil price, the smaller the impact of a 50% oil price fall on the prices of energy products. In addition, especially for transport fuels, fixed taxes constitute a large share of the price, which dampens the impact on consumer prices. In 2015, energy components pushed down consumer price inflation by 0.7 of a percentage point on average.

Changes in oil prices also have an indirect but immediate effect on the economy more broadly. Lower energy prices push down production costs and the prices of end products. This impact can be observed in underlying inflation – that is, inflation which excludes the contribution of energy and food prices. Compared with consumer price inflation, underlying inflation has remained more stable in the euro area, standing close to 1% towards the end of 2015. As regards the main components of underlying inflation, services prices have remained almost unchanged despite the fall in oil prices, and the prices of non-energy industrial goods rose markedly in the course of 2015. In February 2016, however, underlying inflation decreased by 0.2 percentage points to 0.7%, which implies that the immediate indirect effects of lower oil prices are starting to be reflected in consumer prices. It should be noted, however, that an observation based on a single month is surrounded by considerable uncertainty.

Chart 12

Lower oil prices begin to affect underlying inflation in the euro area



Source: Eurostat.
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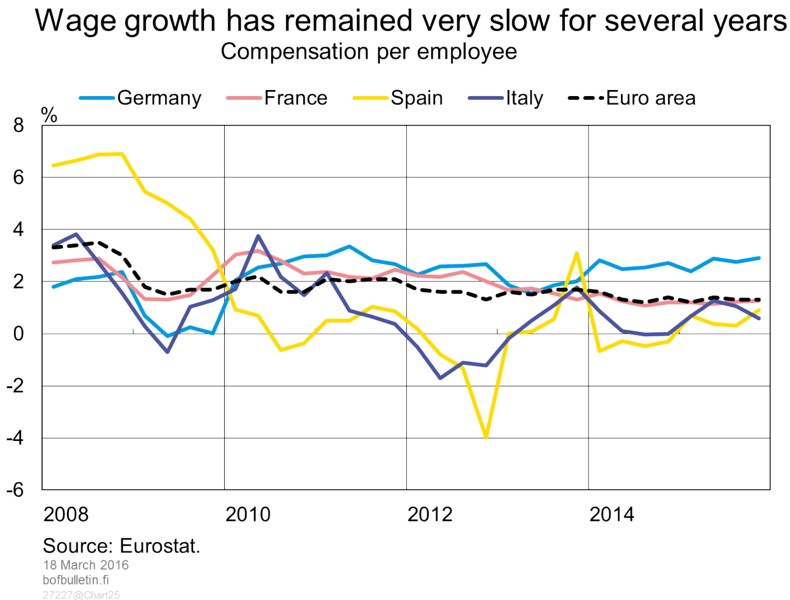
More than oil prices, sluggish underlying inflation reflects weak developments in euro area wages. Wage growth has remained very slow for several years in the euro area. Wage inflation has been dampened in particular by developments in Spain and Italy, where adjustment measures have been taken, but wage growth has decelerated in France, too. Among large euro area countries, only Germany has seen somewhat positive wage developments. The deceleration of wage inflation in the euro area in recent years has reflected a weakening of productivity, which constrains possibilities for wage increases.

Chart 13



The immediate effects of oil price changes are one-off by their very nature. Lower oil prices push down the general price level, but the change has no lasting impact on inflation (as measured by the change in consumer prices over 12 months). Even if oil prices were to remain permanently at current levels of USD 30–40, instead of increasing, the inflation effect of the price fall would disappear after one year.

Therefore, as such, changes in oil prices are not a concern over the price stability-relevant medium term. On the contrary, low oil prices increase consumers' purchasing power and consumption in the euro area, promote economic growth and thereby, ultimately, push up inflation.

However, the fall in oil prices may also have longer-lasting, indirect effects that manifest themselves via inflation expectations.

Oil price developments reflected in inflation expectations

The anchoring of longer-term inflation expectations to the objective of price stability is of paramount importance. As the price of oil crashed towards the end of 2014, inflation expectations also weakened, and longer-term inflation expectations have remained at lower levels. The recent fall in oil prices to around USD 30 has further depressed inflation expectations, and long-term expectations (five-year rate five years ahead) have now reached historic lows. This is worrying, as changes in oil prices should not affect long-term inflation expectations, which rather reflect views on inflation developments over the economic cycle. The weakening of market-based inflation expectations may, however, also result from the fact that spreads on inflation-linked swaps have increased. Survey-based (SPF) long-term inflation expectations have remained broadly stable.

According to the Bank of Finland's forecast, the EU22 inflation rate will be only 0.2% in

2016. Thereafter, inflation is projected to increase to 1.2% in 2017 and reach 1.6% in 2018.

The projected increase in inflation will be dampened by the (gradually waning) impact of oil price developments. Oil prices are estimated to have nearly bottomed out and, on the basis of futures prices, they should start slowly increasing. The increase in inflation will remain moderate over the entire forecast horizon, as EU22 countries still experience a clearly negative output gap which, according to IMF calculations, will close only slowly. Moreover, wage developments and the short-term outlook for wages are both moderate.

The pick-up in inflation will be further supported by the sustained accommodative monetary policy stance and the resulting low exchange rate for the euro. Moreover, the downward trend in EU22 countries' unemployment rates continues, and the capacity utilisation rate has gradually increased.

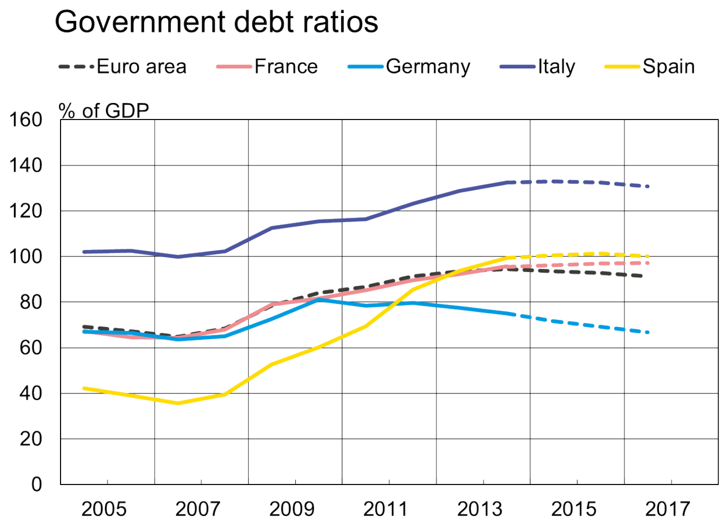
Refugee crisis – a question mark for fiscal policy

The financial crisis resulted in a sharp increase in euro area government deficits. Thereafter, fiscal balances have gradually improved as a result of discretionary fiscal measures and improved cyclical conditions. In 2015, the euro area government debt ratio decreased for the first time since 2007.

The overall general government deficit is projected to decrease in 2016 and stand at levels close to 2% of GDP. This rather favourable trend is likely to continue also in the next few years, and the deficit ratio is projected to decline to around 1% in 2018. There are, however, significant differences between countries.

Among large euro area countries, Germany's and Italy's debt ratios will improve in 2016, whereas Spain will not see an improvement before 2017. In France, the debt ratio keeps increasing, albeit very slowly. These forecasts are, however, very uncertain, in particular for countries with slow growth and a high debt ratio.

Chart 14



The figures for 2015–2017 are based on the Commission's forecast.
Sources: European Commission and Macrobond.
18 March 2016
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The state of, and outlook for, the public finances are affected by the prevailing level of interest rates, cyclical conditions and discretionary fiscal measures.

Interest payments on government debt are decreasing, as countries can substitute maturing debt securities with new debt securities with lower yields. During the turbulence of the sovereign debt crisis, some euro area countries were obliged to issue debt securities with sometimes very high yields.

The general government primary balance will improve mainly on the back of favourable cyclical conditions. In previous years, the euro area general government primary balance improved following fiscal consolidation measures. Although expense cuts are still being introduced, in some euro area countries they are being counterbalanced by a partial repealing of past tax increases. Despite the fact that many euro area countries are still far from reaching the 60% of GDP threshold for government debt ratios, as required by the Stability and Growth Pact, a clear easing of fiscal policies from previous years' levels has taken place since 2015. Certain countries are seeking to move from adjustment towards growth and employment-enhancing structural reforms which can, to some extent, be used to replace adjustment measures in accordance with the fiscal policy rules for the euro area.

Euro area fiscal policies are also being eased by the increase in public expenditure resulting from the refugee crisis. According to IMF estimates[3], however, this impact will be relatively small at the EU level in 2016 (some 0.1% of GDP). In individual countries, the impact may be far more pronounced. In Germany, for example, the IMF estimates it to be around 0.3% of GDP. However, these estimates are surrounded by a significant degree of uncertainty.

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3. See https://www.imf.org/external/pubs/ft/sdn/2016/sdn1602.pdf.

In order to enhance implementation of the fiscal policy rules, and as suggested by President of the Commission, Jean-Claude Juncker in his Five Presidents' Report on the development of EMU, the European Commission decided in October 2015 to establish an independent advisory body, the European Fiscal Board (EFB)[4]. It is meant to become fully operational in the course of 2016. This new body is tasked with assessing implementation of the fiscal policy rules, especially its consistency, as well as serious cases of infringement and the appropriateness of fiscal policy stances. The European Fiscal Board is also meant to cooperate with national fiscal councils.

Balance sheet resilience under test

Euro area faces both external and internal risks

The most important external risk facing the euro area relates to a broad-based strong slowdown of the global economy, which would dampen both growth and inflation in the euro area. Such a development could be triggered if strong adverse effects resulting from the sharp decline in oil prices were to be compounded with an abrupt standstill of growth in China. The sharp and protracted fall in oil prices has deeply distressed countries, such as Russia, which are dependent on oil production. The concern is that more countries end up in a similar situation, which would also be conducive to greater political uncertainty. Moreover, several companies whose business relies on oil and other commodities are struggling to service their debt, and some have already gone bankrupt.

The situation is aggravated by the high level of USD-denominated private sector debt in several emerging economies. In countries whose currencies have depreciated, exports in commodities generate more income in the domestic currency. At the same time, however, the value in the domestic currency of foreign-denominated debt increases as the currency depreciates. A crisis in countries with high levels of foreign-denominated debt and heavy reliance on the production of commodities might have unforeseen consequences.

The risk is that the protracted fall in oil prices and the sharp slowdown of the global economy will have nonlinear effects, as the balance sheets of highly indebted economies can no longer bear the ever-weakening situation. In several countries the high levels of public and private sector indebtedness already mean that balance sheets cannot withstand a heavy shock. Once the buffers have been exhausted, the consequences may be greater than expected. In such a situation, the adverse effects on economic growth and inflation could be broad-based and surprisingly heavy, in which case even financial stability could be jeopardised. In a worst-case scenario, this could mean a ‘third wave’ of financial crisis.

Unresolved problems may halt recovery

The recovery in the euro area economy is still fragile. Public sector indebtedness remains considerable, and in some countries the banking sector struggles to cope with the high level of non-performing loans. Greece's financial problems persist, and economic activity

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4. See http://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX:32015D1937.

remains very sluggish also in Portugal and Italy.

At the beginning of 2016, the financial markets became increasingly concerned about the state of the banking sector. Attention was focused, in particular, on a few large banks which had reported heavy losses. In Europe, the strong reactions were partly explained by the new bail-in rules which had entered into force at the beginning of the year. As the rules increase creditor involvement, investors may be more prone to react when problems are revealed. However, the fall in bank share prices was broad-based across regions and different types of banks.

Despite improvements in many respects, the protracted nature of the crisis is visible in a number of ways: the growth outlook is dampened by persistently sluggish capital investment and high levels of long-term and youth unemployment. Several countries have seen changes in their government, which gives rise to concerns about a receding pace of reform and backward steps on the necessary adjustment path. Hence, the euro area crisis is not yet fully over, and an escalation in the situation could halt euro area recovery. Political uncertainty in Europe is also compounded by the upcoming referendum, to be held on 23 June, on the UK's membership of the EU. An exit of the UK from the EU would have adverse consequences for the whole of Europe.

The refugee crisis represents a new shock to the fragile situation of the euro area and could, at worst, jeopardise the area's recovery, should the scope and adverse effects of the crisis increase. Already now, the number of refugees Europe has had to cope with has been a shock, and its effects are surrounded by a high degree of uncertainty.

To ensure successful reception and integration of refugees and positive long-term effects, the number of arrivals should be reasonable and evenly shared among EU countries. Under such circumstances, the resulting pick-up in public spending would create a positive impact on growth over the short-term and the increase in the working-age population would impact growth positively over the long term.

If refugee inflows continue to be unevenly shared and focused on certain countries which already consider the situation to be challenging, sentiment may deteriorate, with unforeseen consequences. Sentiment is being affected, among others, by side-effects of the refugee situation, such as human trafficking and fears of terrorism. If the refugee crisis were to escalate and lead to a suspension of the functioning of the Schengen area and to ever greater restrictions on free movement across borders, the result would be an increase in growth-hampering uncertainty. A strong increase in the number of refugees, combined with an uneven allocation of refugees or a tighter closure of borders, would increase uncertainty regarding the EU's future. The attractiveness of Europe as a place to invest will decrease if common solutions cannot be found to common problems.

Tags

economic growth, global economy, inflation, monetary policy