Monetary Policy Review

Favourable developments and new concerns in the global economy

Monetary policy | 13 April 2017

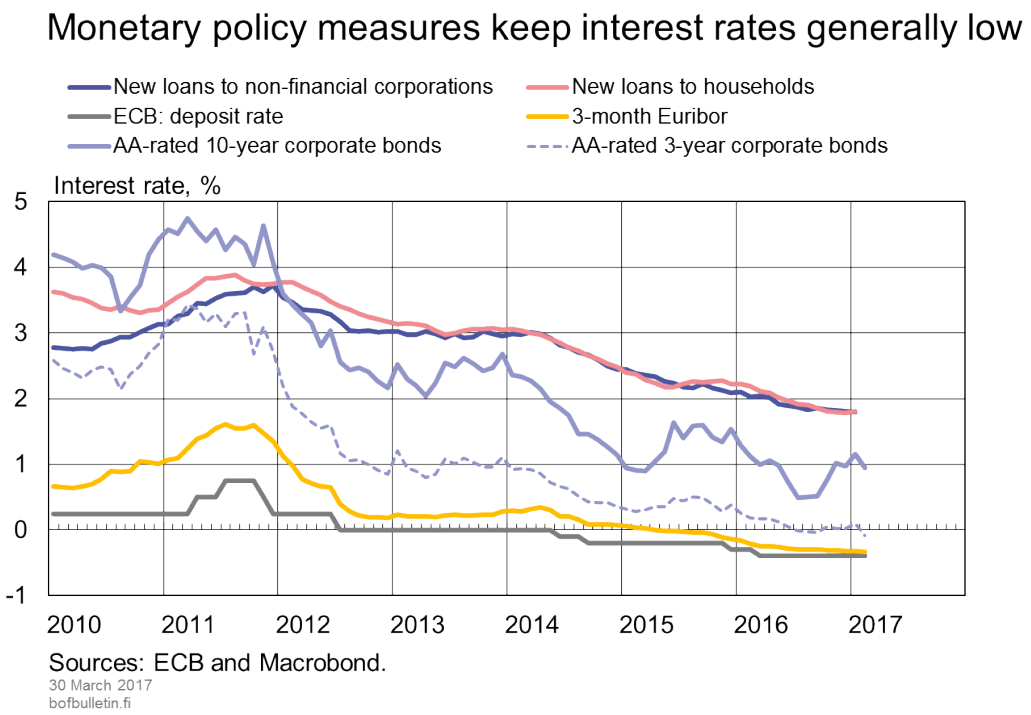
Global economic growth will strengthen from its 2016 level and continue at an annual pace of over 3% in the years 2017–19. Improvements in confidence in the United States and elsewhere will boost economic growth in the short term. Upside risks to US economic growth in 2018–19 could arise if the expected growth-enhancing measures of the new administration are fully implemented. At the same time, foreseeable increases in protectionism could considerably weaken global economic and trade growth.

Monetary policy continues to be highly accommodative

Euro area economic growth continues to be broadly based, yet inflation pressures remain modest. At its December 2016 monetary policy meeting, the ECB Governing Council decided to extend the

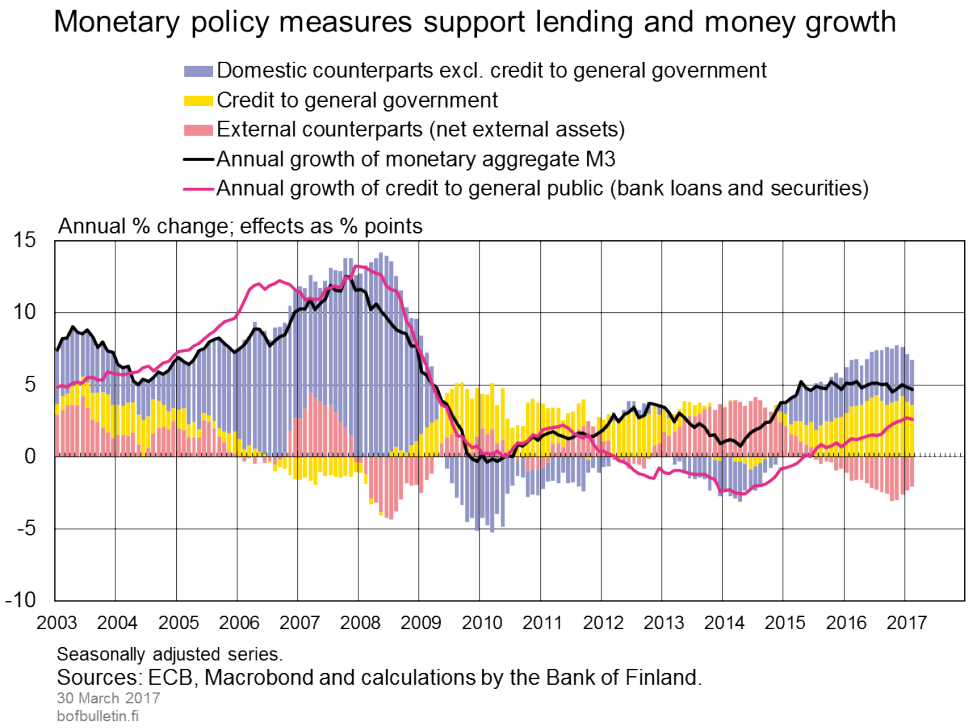
duration of the expanded asset purchase programme (EAPP) until the end of 2017. Purchases are intended to continue until there is a sustained adjustment in the path of inflation consistent with the inflation target. The Governing Council also decided that monthly purchases would again amount to €60 billion from April 2017. Should the outlook for economic growth again weaken or the financial market situation no longer contribute positively to inflation, the volume of purchases can be increased again. To ensure continued smooth implementation, the Governing Council decided to decrease the minimum remaining maturity for eligible securities in the public sector purchase programme (PSPP) from two years to one year and to permit purchases with a yield to maturity below the interest rate on the ECB's deposit facility.

Chart 1.



Policy rates remain at an historical low. The deposit rate paid to counterparts has been at –0.40% since March 2016. (Euro area money market undergoing huge changes). The Governing Council is not expecting to raise its key interest rates before the end of the EAPP. The last operation in the series of targeted longer-term refinancing operations (TLTRO II) launched by the Governing Council in March 2016 is in March 2017. These operations offer funding to banks on attractive terms, with a four-year maturity and at the interest rate on the main refinancing operations (currently 0.0%). For banks that have sufficiently expanded their lending to households and non-financial corporations (NFCs), the interest rate can be as low as the interest rate on the deposit facility prevailing at the time of the allotment of the operation. Overall, banks have borrowed EUR 740 billion in the TLTRO II operations.

Chart 2.

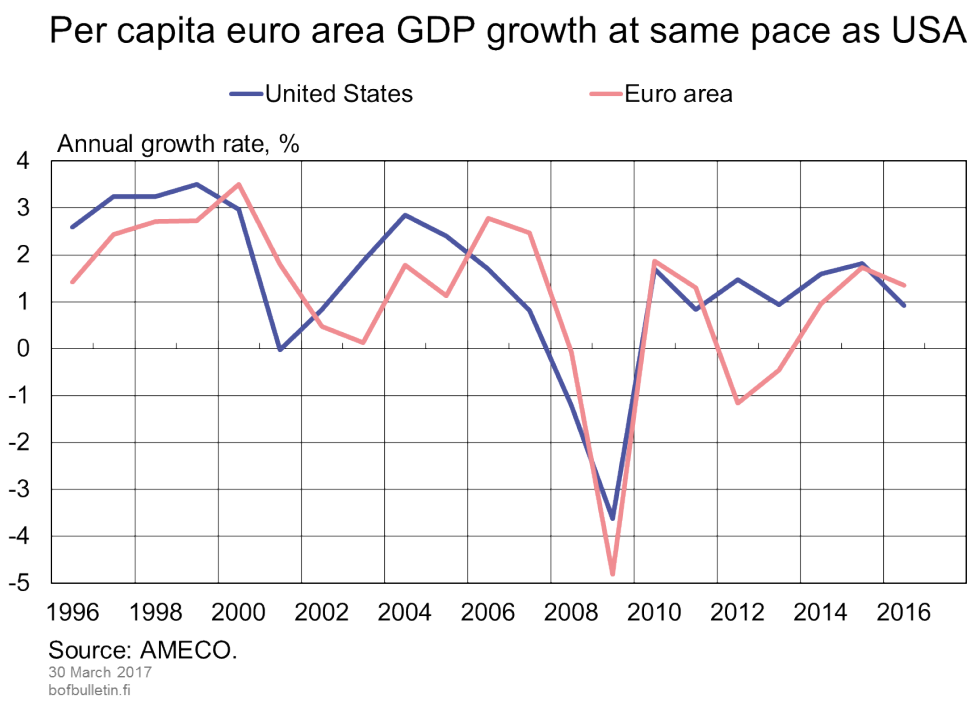


Monetary policy measures are keeping interest rates generally low and maintaining favourable financing conditions for the private sector. The accommodative monetary policy also underpins asset prices and rising inflation expectations, thereby lowering real interest rates. Government bond yields in the euro area have risen moderately since summer 2016, while remaining low on average.

Bank lending rates exceptionally low

Average rates on new bank loans continued to fall in 2016, with the average rate on loans to households falling more than that on loans to non-financial corporations. The average rate on new loans to households and NFCs was just under 2% at the start of 2017. The downward trend in the average rate on loans to NFCs would seem to have halted in the autumn of 2016. A tightening of credit standards for loans to enterprises in the fourth quarter of 2016 contributed to these developments.[1]

Chart 3.



Spreads in interest rates on new loans to NFCs between stressed countries (the GIIPS countries, i.e. Greece, Ireland, Italy, Portugal and Spain) and best-rated countries (here Austria, Belgium, Finland, France, Germany and the Netherlands) continued to shrink towards the end of 2016. In the GIIPS countries, the average rate on new loans to NFCs was 2.5% in early 2017 – nearly a percentage point higher than in the best-rated countries. In Greece, the average rate on new loans to NFCs was, at 5%, nearly 3 percentage points higher than in Italy or Spain. The lowest average rate (around 1.5%) on new loans to NFCs in early 2017 was recorded in the Netherlands and Luxembourg. In Finland, rates on new loans to NFCs averaged around 1.8% and were close to the euro area average. The cost of market-based financing for NFCs as measured by corporate bond yields remains low.

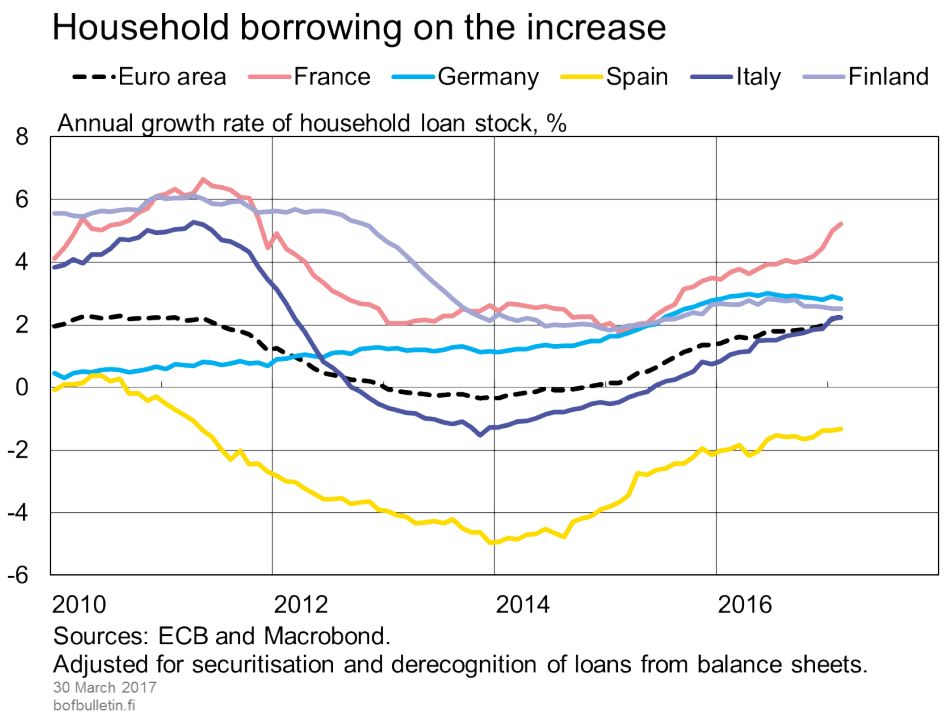
Average rates on loans to households fell more in best-rated countries than in the GIIPS countries during 2016, and the spread between the groups of countries widened by double-digit basis points. On new loans to households, the average rate was around 2% in the GIIPS countries and just under 2% in the best-rated countries. In the ECB Bank Lending Survey, banks expect credit standards to ease on both loans for house purchase and those for consumer credit. The dispersion of average rates on new loans to households across euro area countries was around two percentage points in early 2017. The average rate on new loans to households was highest in Ireland (around 3%) and lowest in Finland (around 1%).

Low interest rates underpin credit growth

The ECB's monetary policy stimulus lowers interest rates and provides support to credit growth. The effects of the EAPP are felt more broadly than just in the eligible sectors, as the sellers of securities must invest the money they receive in other assets. As yields on securities diminish, lending becomes increasingly attractive for banks. Although the negative ECB deposit rate increases costs for banks, it also encourages them to use the money market to smooth their liquidity fluctuations. The low interest rates increase demand for loans to households and NFCs, again supporting economic activity.

The availability of financing is linked to inflation developments, the real economy and financial stability. Growth in monetary variables usually also indicates an increase in real economic activity. A strong increase in lending (bank loans and banks' investments in securities issued by euro area residents), coupled with a simultaneous increase in money, is generally indicative of an increase in economic activity and, over a slightly longer term, in inflationary pressures. Conversely, if new loans are predominantly intended for the repayment of old loans and not for consumption or investment, monetary aggregates do not grow and no price pressures emerge in the economy. Of all monetary variables, the ECB consequently has its focus on credit growth.[2]

Chart 4.



Money growth[3] has recently been driven increasingly by the ongoing recovery in lending to the private sector and a reduction in long-term liabilities of the banking sector (lilac bars in Chart 4). The reduction of long-term debt is partly due to long-term deposits becoming less attractive, with low interest rates and compression of the term premium. The ECB's targeted longer-term refinancing operations have also served to replace other sources of long-term bank funding.

Another component of money growth is lending to general government (yellow bars in Chart 4). This item includes both bank loans to the general government sector (which have recently decreased) and securities purchases (which augment sellers' bank deposits) in the Eurosystem public sector purchase programme (PSPP) as part of the EAPP. Money growth is dampened by capital outflows (pink bars in Chart 4). Factors behind movements in this item include EAPP purchases of debt securities from outside the euro area where sales revenues have left the euro area.

Money growth in the euro area has been relatively stable, at an annual rate of around 5% since early 2015. In 2016, credit and money grew hand in hand. Credit growth occurs when banks increase their lending or buy debt securities issued by residents. Although the euro area banking sector's investments in private sector debt securities are at around EUR 2,000 billion currently, roughly four times higher than at the end of the 1990s, traditional bank loans still form around 85% of total credit to the private sector.

The annual growth of loans in the euro area continues to recover despite persistently large country differences. Total bank loans[4] to the private sector grew in late 2016 and early 2017 at a rate of just over 2%. The annual growth of bank investments in debt securities issued by the private sector picked up towards the end of the year and reached around 7% in early 2017.

Loan growth naturally also requires a willingness to borrow on behalf of private sector agents. According to the Bank Lending Survey, demand for loans from both households and NFCs remained strong in the fourth quarter of 2016, and this positive development seems to be continuing in 2017 as well.

Steady improvement in capital adequacy

Market confidence in European banks has recovered significantly over the past 6 months. Bank share prices have risen and spreads have remained narrow. Bank shares have benefited from expectations of growth-friendly measures and financial market deregulation by the new administration in the United States.

Improved economic outlook and the higher term premia will have a positive impact on bank

profitability over the longer term. However, the recent rise in share prices has diverted attention from several vulnerabilities related to banks' long-term profitability. According to ECB Banking Supervision (SSM), the profitability of euro area banks remains weak. In the third quarter of 2016, banks' average return on equity (ROE) fell significantly year-on-year to around 5.5%. The main factors behind weak profitability growth have been adverse developments in net interest income, fees and commissions as well as various structural issues.

In many euro area countries high levels of non-performing loans still weigh on bank profitability and hamper their ability to act as financial intermediaries to the real economy. This perpetuates lending differentials across euro area countries. The problem of non-performing loans is being addressed with new methods, but solving the problem will take time.

The European banking sector also suffers from excess capacity and inefficiencies. The sector is large relative to the economy, and in many core countries the number of branches is considerable. The large number of banks and increased competition for diminishing returns have contributed to weakening bank profitability. These profitability issues affect banks' ability to renew their business models to better respond to changing customer preferences and competition from outside the sector. There is a risk that weaker returns will hamper bank restructuring and further constrain their ability to provide funding to the real economy. Up to now banks' cost-to-income ratios have remained high regardless of cost cutting.

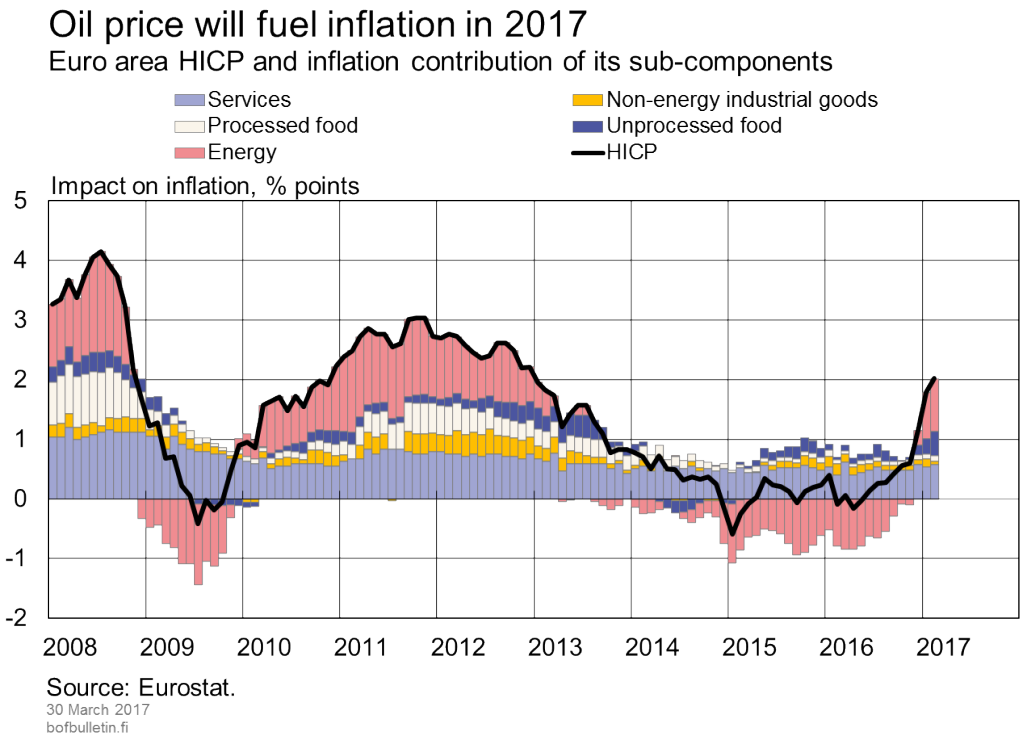
On the positive side, banks' capital adequacy in the euro area has been steadily improving since 2008 despite profitability issues, and it has almost doubled since the crisis. According to ECB data, banks' Tier 1 capital adequacy averaged 14.5% in the third quarter of 2016. For banks, completion of the regulatory initiatives currently under preparation would be key. This would reduce uncertainty about future capital needs and support lending. Ongoing discussion on deregulation perpetuates uncertainty. Any deregulation can lead to a build-up of vulnerabilities in the financial sector in the long term. Should risks related to economic developments or markets materialise, these vulnerabilities would weaken financial intermediation, which in turn would negatively impact on real economic developments.

Four years of uninterrupted growth in the euro area

Euro area GDP grew by 1.7% in 2016, driven by private consumption and investment. The rise in confidence indicators suggests growth will remain brisk in the early part of 2017. There has now been four years of uninterrupted growth. The internal fundamentals of the euro area economy have not changed during the last six months. They are supporting growth. Accommodative monetary policy will continue to keep the private sector's financing conditions relaxed and the debt-servicing burden moderate. Near-term fiscal policy will be broadly neutral and the labour

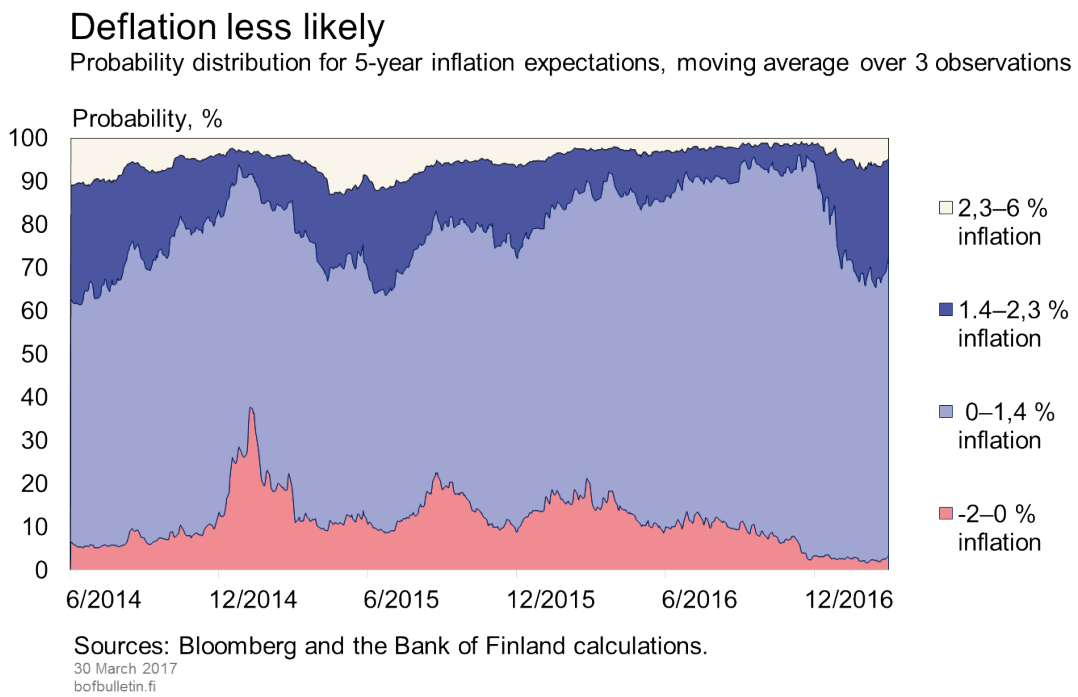
market will continue to improve. In these respects, the favourable trend is projected to continue in the immediate years ahead.

Chart 5.



Despite recent years' uninterrupted growth in the euro area economy, GDP growth in the past two decades has remained slower than in the United States. Per capita, however, the difference in GDP growth between the euro area and the USA is smaller. In 2015–2016, per capita GDP growth was actually stronger in the euro area. On the other hand, the euro area sovereign debt crisis is clearly evident also in per capita GDP growth, and in 2012–13, in particular, growth was slower in the euro area than in the USA.

Chart 6.

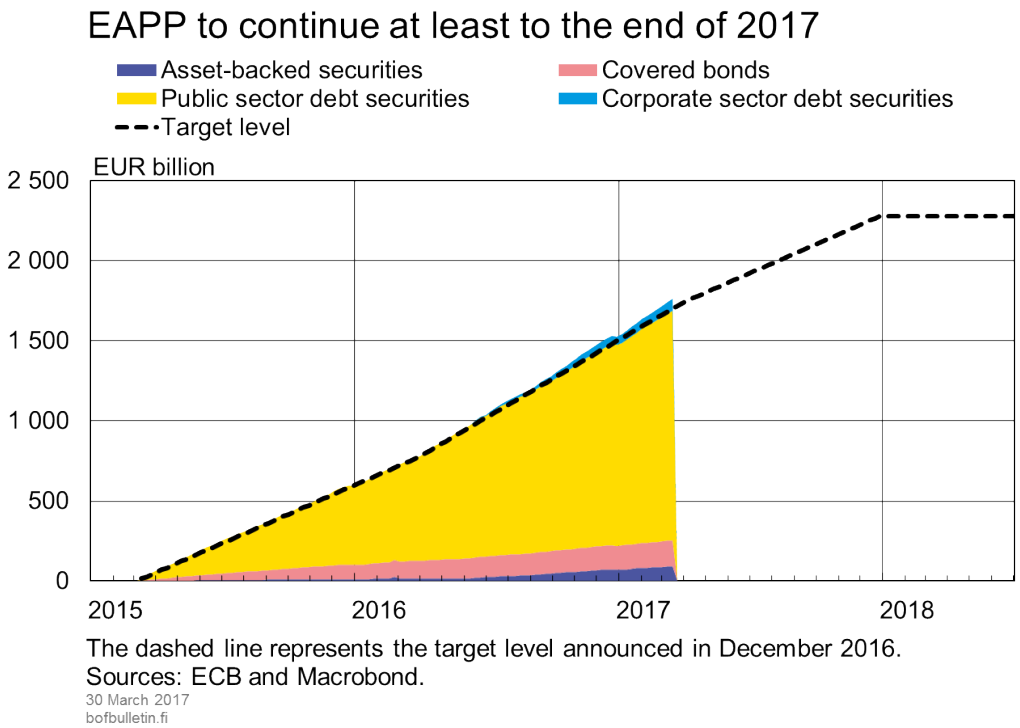


Domestic demand driving euro area growth

Private consumption and private investment were the components of aggregate demand that made the strongest contribution to euro area growth in 2015–2016. The composition of growth will be similar in the next few years. Public consumption will make a slight contribution to growth on average, but the contribution of net exports will be very modest.

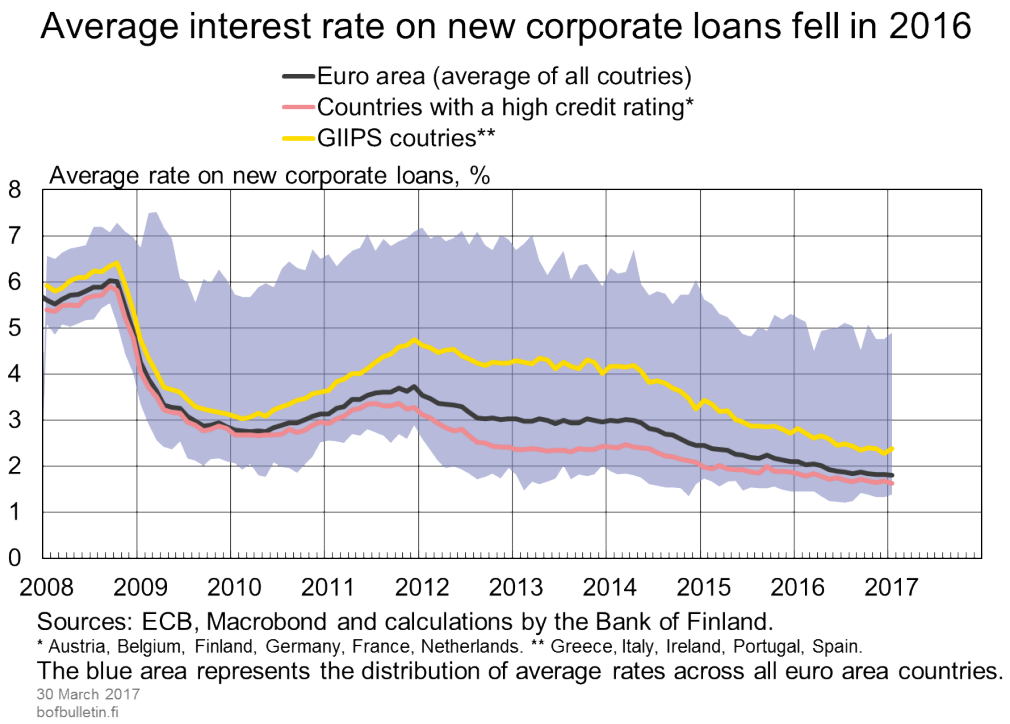
Private consumption will be bolstered by an increase in households' disposable income amid a steadily improving employment situation and higher labour income per employee. On the other hand, a slight acceleration in inflation will push down growth in real disposable income. The euro area unemployment rate has declined from a peak of 12% to slightly below 10%. Differences across countries are, however, still significant. Even though cyclical conditions will further reduce unemployment in the next few years, the euro area is beginning to approach structural unemployment levels. Decisive country-specific measures are still needed to reduce structural unemployment.

Chart 7.



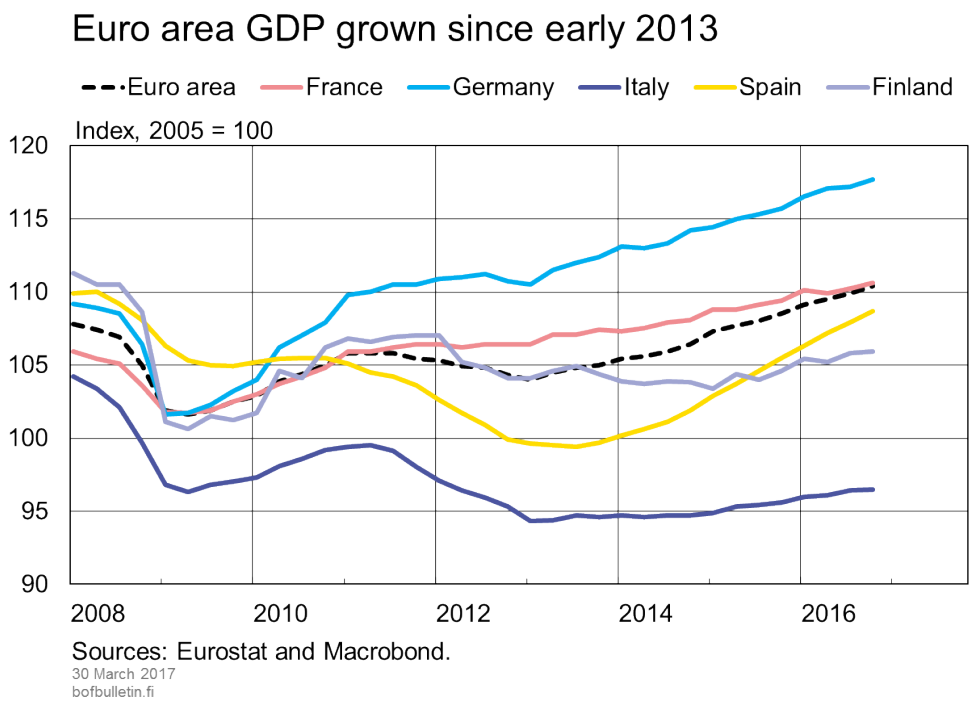
Accommodative financing conditions will boost household borrowing. Growth in the stock of loans to euro area households gathered momentum towards the end of 2016, and at the beginning of 2017 the household loan stock was up a good 2% year-on-year. Households' debt-servicing costs relative to income decreased in the euro area further in 2016, on the back of low interest rates. In France, household borrowing is growing notably faster than in the euro area on average, and at the same time interest rates on new loans to households have fallen faster than in the euro area on average. The brisk growth in new loans and renegotiations of existing loans have kept French households' debt-servicing costs (interest payments and repayment of capital) relative to income on a downward trend. In Germany, growth in household borrowing has remained considerably more moderate, and total debt relative to household income has remained stable. In Spain, households are still continuing to pay down their debts and the stock of household loans is contracting. In Italy, meanwhile, the household loan stock is growing, but debt-servicing costs relative to income have remained moderate.

Chart 8.



A pick-up in investment growth is a precondition for sustainable growth in the euro area. Private fixed investment begun to grow a few years ago, and the trend continued also in the latter part of 2016. However, the level of private fixed investment is still markedly below the peak prior to the global financial crisis. Investment growth in the next few years will be buttressed by the very low interest rate environment, the improved availability of finance, the need to renew the capital base after weak investment activity in 2008–2013 and the notably lower level of corporate sector indebtedness in certain countries.

Chart 9.



Accommodative financing conditions are also supporting borrowing by euro area non-financial corporations. At the beginning of 2017, the annual growth rate of the stock of corporate loans was around 2.5%.

Growth is still fragile, however: in January the corporate loan stock was 1% up on a year earlier. As in the case of households, debt-servicing costs relative to income have also decreased for the corporate sector.

The corporate sector is continuing to deleverage. Total corporate debt relative to GDP or value added contracted further during 2016. Euro area non-financial corporations' interest expenses and capital repayments relative to net income have declined further. Of the large euro area countries, corporate deleveraging has been by far the most notable in Italy and Spain. In France, the annual growth rate of the corporate loan stock markedly outpaces the euro area average. Although French corporations' total debt relative to GDP increased, debt-servicing costs relative to income decreased on the back of low interest rates. In Germany, growth in the stock of loans strengthened in the latter part of 2016 to figures well above the euro area average, but relative to GDP the total debt ratio remained stable and was clearly the lowest among the large euro area countries.

Among the large euro area countries, Italy's growth prospects are still muted

Germany's economy grew by 1.9% in 2016. The German economy is projected to maintain the strong growth momentum in the immediate years ahead, fuelled by private consumption and employment growth. Germany's economic fundamentals are in good shape: the economy is competitive, household indebtedness is at a moderate level and the unemployment rate ranks among the lowest in the euro area. With the lowest debt ratio among the large euro area countries, Germany has no need for fiscal consolidation over the forecast horizon.

The French economy grew by 1.1% in 2016. Growth slowed slightly from 2015, but was markedly brisker than in previous years. The pace of growth is projected to pick up in the next few years, underpinned by domestic demand and, notably, private consumption. Investments are also recovering. The economy continues to be supported by favourable monetary conditions. Fiscal consolidation will continue, at a moderate pace. Despite economic growth, unemployment in France will only decline slowly, as it is largely structural in nature. The effects of employment market reforms are not expected to materialise in the short term.

The Spanish economy has grown robustly since the turnaround in 2013. Already at the end of 2016, GDP reached about the same level as prior to the financial crisis. Growth is projected to continue at a stronger pace than the euro area average, but gradually moderating. Growth is supported by improvements in price competitiveness, structural reforms and the bottoming out of the housing bubble burst a few years ago. Favourable developments are also bolstered by accommodative financing conditions, reflecting the combined effect of monetary policy and consolidation in the banking sector. The continued brisk pace of growth will reduce unemployment and fuel inflation in the forecast period. The general government deficit is still large, however, and government debt has stayed around 100% of GDP.

The Italian economy has turned to growth in 2015 and 2016 after a long period of contraction. Growth has been relatively muted, however, in 2016, at slightly below 1%. The economy is projected to continue growing at a rate of around 1% in the immediate years ahead. Growth is supported by Italian government measures to improve the state of the banking system as well as the accommodative monetary policy and export growth. The phasing out of tax incentives for new recruitment has weakened employment developments, which is in turn reflected in the slight slowdown in consumption growth. If the employment situation does not improve or if export growth were to decelerate, economic growth may turn out to be even weaker than expected. Italy's muted growth prospects and the high government debt ratio (slightly over 130% of GDP) still give cause for concern.

Brexit negotiations get underway

The United Kingdom has announced that it will submit its notification of withdrawal from the EU in March 2017. The withdrawal notification will trigger the official exit negotiations of Article 50 of the Treaty on European Union. The negotiations have a two-year deadline.

Prime Minister Theresa May stated in January 2017 that UK was striving for a 'comprehensive, bold and ambitious' free trade agreement with the EU. Since it usually is a long-term process to negotiate free trade agreements, uncertainty about the future will continue for a prolonged period, and some kind of transitional agreement for the time between the UK exit and ratification of a new agreement would surely be in the interest of both parties.

In 2016, GDP growth in the United Kingdom was around 2%. Since the referendum, sterling has depreciated around 10% on a trade-weighted basis, which has pushed up export prices and fuelled inflation to about 2% at the beginning of 2017. The Bank of England has announced that it is ready to raise interest rates, should inflation accelerate excessively. The pick-up in inflation dampens growth in real household incomes and consumption. Investment activity and – due to the lower exchange rate – exports have been weak. The outlook for investment is strained by uncertainty over the coming negotiations. GDP growth is projected to be below 2% in 2017 and around 1½% in the immediate years ahead.

Sweden's GDP grew by slightly over 3% in 2016. The output gap is assessed to have closed during 2016, and GDP growth is therefore expected to ease slightly. Sweden's economic growth is projected to remain at about 2½% in the next few years. Inflation has remained moderate relative to economic growth, enabling the Riksbank to maintain its expansionary monetary policy stance. The looming housing bubble and rapidly increasing household debt remain the greatest downward risks to stable economic developments.

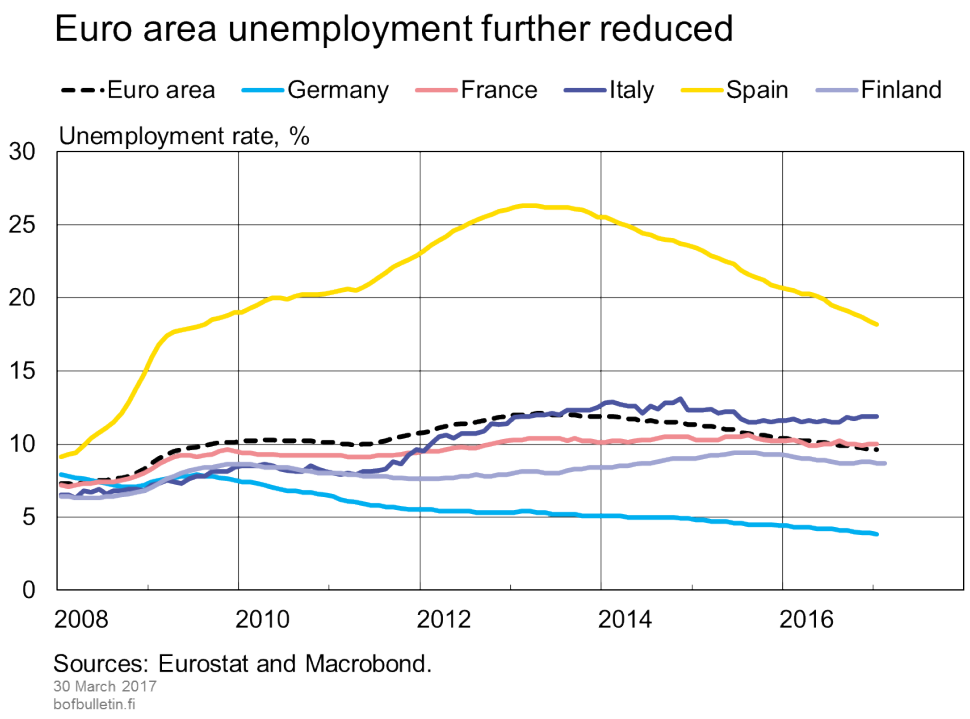
In Denmark, the economy grew by about 1% in 2016. The Danish economy is close to full employment and inflation has remained very low. Growth in real incomes has boosted private consumption. Fuelled by domestic consumption, growth will strengthen in the coming years to about 1½%.

Oil price impact fuels inflation – core inflation slower

Euro area inflation picked up towards the end of 2016, following a protracted period of low inflation. In 2016, inflation averaged only 0.2%, but in December it accelerated to 1.1%, and at the beginning of 2017 it reached levels close to 2%.

The rapid pick-up in inflation is due mainly to the price of oil, the direct effects of which are reflected in inflation via two channels. On one hand, the steady rise in the oil price from the trough of 2016 will push up costs. On the other hand, changes in the price of oil are reflected in inflation also mechanically, via the base effect (Temporary factors have fuelled euro area inflation). The price of oil is now significantly higher than at the beginning of 2016. As inflation is measured as the year-on-year change in prices, the base effect caused by the low price of oil a year earlier has a significant upward impact on inflation. Even if the price of oil were to remain at the current level and not continue to rise, the oil price base effect will be reflected in inflation throughout the current year. Based on oil futures prices and various expert assessments, the price of oil will stabilise to levels close to USD 55 per barrel in the immediate years ahead. If the price of oil remains stable, the oil price base effect, stemming from the energy component and pushing up consumer prices in 2017, will dissipate at the beginning of 2018.

Chart 10.



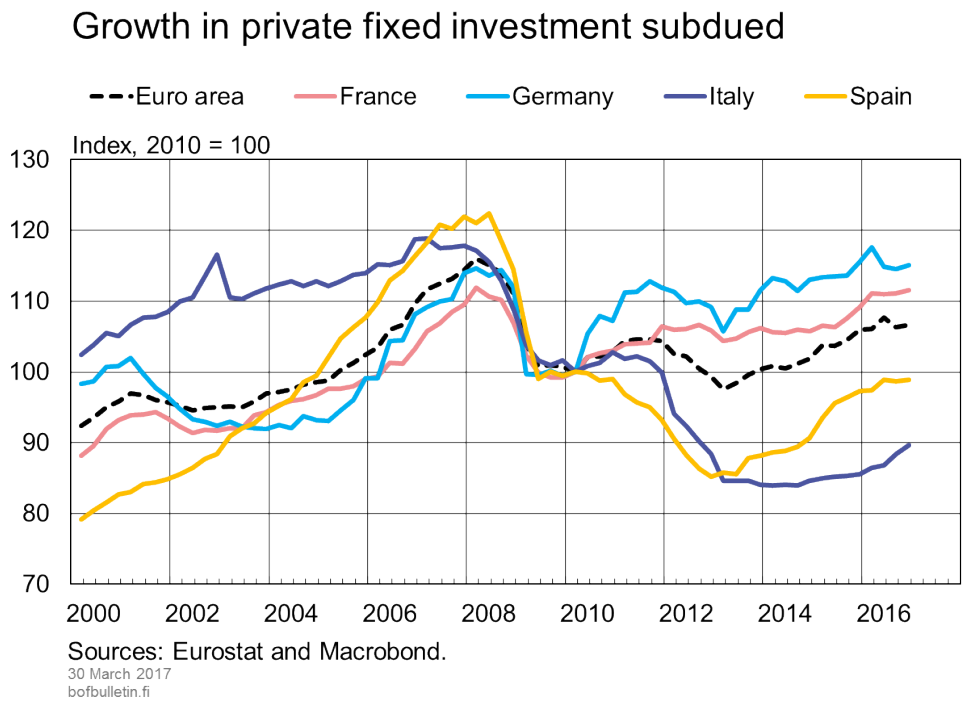
Changes in the price of oil usually cause only temporary fluctuations in inflation ('Frequency of rising and declining prices in the euro area'). Assessments of the medium-term outlook for inflation should be accompanied by an examination of core inflation (inflation excluding the prices of raw materials and food), which reflects longer-term price pressures internal to the euro area. For the past three years, core inflation has persisted at levels slightly below 1%, whereas the average rate since the introduction of the euro has been close to 1.5%. Core inflation has been dampened by moderate wage developments in the euro area in recent years, and there are still no

signs of a pick-up in wage inflation. A more broadly based transmission of the rise in fuel and energy prices to consumer goods prices would weaken consumers' purchasing power and could therefore lead to higher wage demands. A temporary acceleration in inflation, due to a rise in the price of oil, and leading to wage increases is referred to as a second-round effect. At least so far, however, the temporary rise in inflation has not been transmitted to wage inflation and made the pick-up in inflation a more permanent phenomenon.

Inflation is expected to remain moderate in the immediate years ahead, as there is still slack in the euro area economy. According to various estimates, output is still below potential, i.e. the output gap is still open. An open output gap means that there is unutilized resources in the economy. Subsequently there is only modest upward pressure on wages, and hence prices. As a result, core inflation is expected to pick up only slowly as the output gap closes gradually in the immediate years ahead.

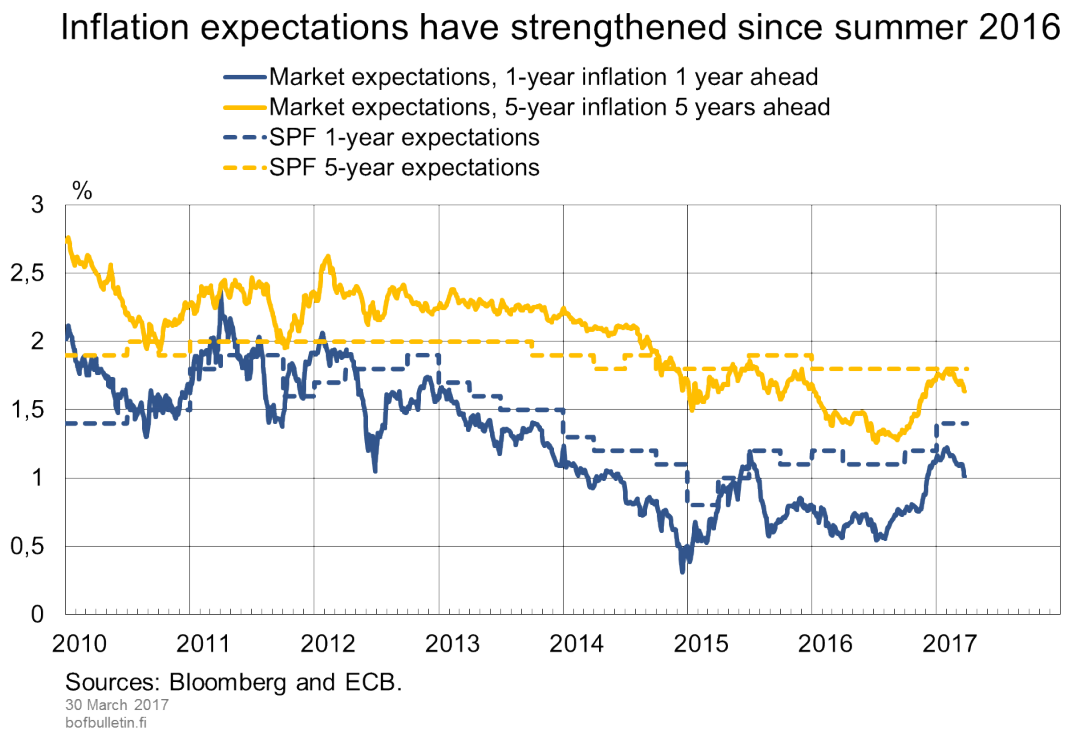
The moderate rate of inflation also reflects the ongoing low level of inflation expectations. From the perspective of the objective of price stability it is, however, positive that inflation expectations have risen significantly from the exceptionally low levels of summer 2016. The increase has been broadly based and has been reflected in inflation expectations derived from market information, and more recently also in surveys of professional forecasters. The rise in short-term inflation expectations largely reflects the higher price of oil and the recent brisk pace of actual inflation. More relevant is, however, the increase in market-based longer-term expectations that extend over the business cycle. This shows that economic agents' perception of inflation developments has strengthened and that there is a smaller risk of divergence in inflation expectations from their anchor, i.e. the ECB's price stability objective. (Have market inflation expectations strenghtened?)

Chart 11.



The improvement in inflation expectations and recent developments in inflation have alleviated the threat of deflation in the euro area. A dampening of inflation expectations may give rise to a self-reinforcing spiral in the price mechanism, which will eventually slow the rise in prices. The probability of negative inflation, derived from market information, has, however, decreased since summer 2016, and is now virtually non-existent. Even though inflation is expected to remain moderate in the medium term there is also a higher probability that the inflation rate will exceed 2%.

Chart 12.



Overall, the outlook for euro area inflation has improved in the past six months. Oil price developments will fuel inflation significantly in 2017, but as the base effect fades away the rate of inflation will level off slightly. There is still unused capacity in the economy and wage developments are moderate, and core inflation will therefore rise at a slow pace. The positive outlook for the economy, the closing of the output gap, the sustained accommodative monetary policy stance and the improvement in inflation expectations will gradually push up inflation closer to the price stability objective.

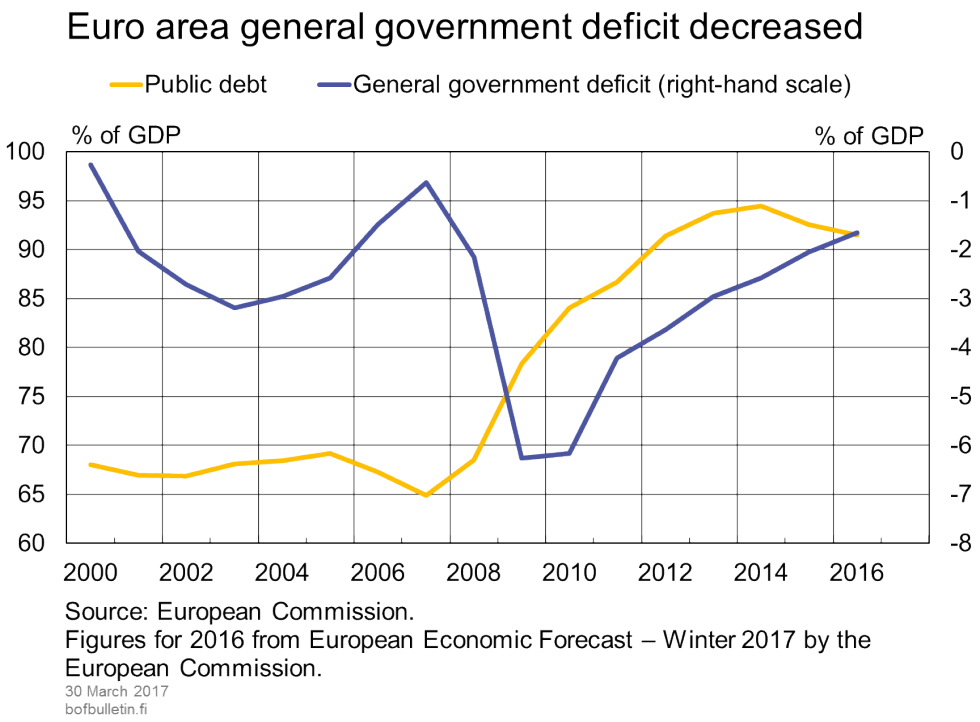
Slow reduction in euro area general government debt

The escalation of the financial crisis in 2008 and the euro area sovereign debt crisis that followed were reflected in a protracted weakening of public finances in the euro area. Only in 2015 did the euro area general government debt ratio pass its peak (approximately 94% of GDP in 2014) and begin to decline. The debt ratio is expected to continue to decline in the immediate years ahead. Among large euro area countries, only Germany's debt ratio is expected to decrease notably, whereas in France, Italy and Spain, the general government debt-to-GDP ratio will remain more or less unchanged in the immediate years ahead.

Over the past few years, the decrease in the euro area general government deficit has been sustained mainly by the improved cyclical conditions and smaller interest payments. The overall

general government deficit continued to decline in 2016 and stood well below 2% of GDP. In the period since 2000, the deficit has reached levels below 2% only in 2006 and 2007, which were very favourable years. The deficit is expected to continue to decrease significantly in 2017, but in subsequent years at a slower pace. The size of the deficit differs from country to country: Germany has a budget surplus, whereas the other large euro area countries continue to record significant deficits.

Chart 13.



In addition to cyclical conditions, the current state of and outlook for the public finances are also affected by the prevailing level of interest rates and discretionary fiscal measures. Of these factors, cyclical conditions are currently the most important factor improving the euro area public finances. The prevailing level of interest rates is still very low, particularly in the shorter maturities, but also in longer maturities. Interest payments on government debt are therefore expected to remain moderate in the immediate years ahead. The importance of discretionary fiscal measures aimed at consolidating the public finances has been minor since 2014. The near-term fiscal policy stance for the euro area is expected to be broadly neutral. Towards the end of the forecast period, however, there will be growing pressure to tighten fiscal policy in many euro area countries, due to the stricter requirements imposed by the Stability and Growth Pact as a result of the closing of the output gaps.

Discussion has continued as to the appropriate fiscal stance for the euro area. In its

Communication[5] adopted in November, the European Commission proposed that based on the current cyclical conditions for the euro area, the fiscal stance should be expansionary and that a fiscal expansion of up to 0.5% of GDP is desirable for 2017. At the same time, the Commission noted that Member States have to make good on their commitments to the Stability and Growth Pact. In the Commission's view, Member States that have more fiscal space to act should, however, in their own policies, also take more account of the euro area aggregate fiscal stance. This should be done particularly in connection with public investments that strengthen the growth fundamentals. The Eurogroup nevertheless concluded that a broadly neutral aggregate fiscal stance in 2017 strikes an appropriate balance, although it also stressed the importance of a growth-enhancing composition of budgetary measures. In the current economic situation, determined implementation of structural reforms is more important than fiscal expansion. This would improve the longer-term growth outlook for the euro area.

Risks still predominantly on the downside

The main risks to the euro area growth and price outlook can be divided into risks to the international economy and internal euro area and EU risks. Although the risks to the US growth outlook are on the upside, risks overall are still predominantly on the downside. The forecast for the international economy is presented in a separate forecast box [Link: 'Forecast for the global economy'].

Risks to the international economy

The risks related to the aspirations of the new US administration are on the upside. The new administration aims for infrastructure investment, tax reforms and reductions and deregulation. Fiscal stimulation as well as deregulation may boost US growth in the immediate years ahead. Because no detailed information is yet available on these plans, not to mention decisions, from the forecast point of view this is still just an alternative scenario of accelerating growth and inflation.

If the plans for public investment in infrastructure come through, they will improve the growth prospects for the output potential of the whole economy. However, any higher-than-predicted growth may prove short-lived if the measures of the new administration do not increase the longer-term growth potential. Deregulation in some areas of the economy may improve the growth of output potential, but again, the short-term growth effects of financial market deregulation are overshadowed by the growing risks to financial stability in the longer term. In addition, the US administration has not so far specified how possible fiscal consolidation could be achieved. An alternative scenario of a possible fiscal stimulus by the new US administration that is partially financed through a border adjustment tax is presented in Box 'Scenario based on US

economic policy plans' [Link].

The downward risks to the international economy relate to increased limitations to free trade and a more rapid decline in China's debt-driven growth than anticipated.

Possible protectionist measures by the USA and other countries form a negative risk to the growth outlook over the next few years. The new US administration has brought customs duties and trade policy agreements into the centre of the debate. Experiences with the negative effects of customs duties on world trade do not support such measures. Against this background, the US administration will scarcely aim for any significant increase in customs duties, but it is setting out to renegotiate agreements with its trading partners to achieve more favourable positions from its own point of view. One alternative to increased customs duties has been the border adjustment tax, which would have an import-reducing and export-enhancing effect.

Chinese growth risks are still on the downside. China's growth is debt-driven, which exposes it to risks from financial market disruptions. The profitability of Chinese banks is also weak and the country's shadow banking system is vulnerable to financial market disturbances.

Internal euro area and EU risks

The short-term economic effects of the upcoming UK departure from the EU (the Brexit) have been smaller than expected. However, due to the Brexit much uncertainty is related to the longer-term outlook for both the UK and the EU, because the effects of the departure depend on, among other things, the progress and final results of the negotiations. Although the Brexit referendum as well as other unexpected political events of recent years have not disrupted the euro area growth, this will not necessarily remain unchanged.

The euro area is still recovering from the financial and debt crisis, as evidenced by the fact that there are persistent concerns about the condition of the banking sector and the outlook for the public finances in certain countries. The large amount of nonperforming assets in euro area banks is still a problem in several countries (Cyprus, Greece, Italy and Portugal). Cypriot and Greek banks are in the most difficult position, as their nonperforming assets approach 40% of the banks' risk-weighted assets. Portuguese and Italian banks also still have a lot of nonperforming assets (about 15–20% of their risk-weighted assets). There is still a great deal of uncertainty as regards the economic outlook for Greece. The publicly reported EU and IMF disagreements on the sustainability of the Greek public debt have once again raised the question of the difficult situation of Greece. The rating of Portuguese government debt as investment grade is also still hanging by a thread.

Notes

1. Further information is available in the January 2017 Bank Lending Survey published by the ECB. ↑
2. Excessive credit growth and related threats to financial stability are currently addressed mainly with macroprudential tools. ↑
3. The broad monetary aggregate (M3) comprises currency in circulation and bank deposits but also money market fund shares/units and certain securities (those bought by euro area residents from banks in so-called repurchase agreements as well as marketable debt securities of up to 2 years' maturity). ↑
4. Adjusted for loan sales and securitisation. ↑
5. European Commission Communication (2016). Towards a positive fiscal stance for the euro area. COM(2016) 727, 16 November 2016. ↑

Keywords

economic growth, global economy, inflation, monetary policy