Only very subdued growth in sight

12 Nov 2019 – Monetary Policy Review – International economy , Monetary policy

The global economic cycle entered a phase of slower growth in early 2018. At the same time, the United States began to step up its protectionist measures. By September 2019, it had already imposed substantial additional tariffs on some 70% of imports from China. The US-China trade war is widely reflected in the global economy. Industrial confidence worldwide has deteriorated steeply. Services sector confidence has also waned, if, at least so far, to a notably lesser degree. The trade war and political uncertainty are dragging down and postponing investment. Growth in global trade in goods has been at a complete standstill this year. Financial markets have been volatile but have avoided significant disruptions for the time being. The Bank of Finland estimates that, so far, the trade war has contributed to slowing global economic growth by about 0.7 of a percentage point.

Global economic growth has already waned notably, from over 3.5% in 2018 to about 3% this year. However, a further substantial contraction may still lie ahead, caused by uncertainties such as an escalation of the trade war and a wider spillover of its effects on the financial markets, a faster-than-anticipated moderation of the Chinese economy and Brexit.

Economic growth has also waned in the euro area, which is, however, not in recession. Growth has slowed to about 1% and is not forecast to pick up meaningfully in the immediate years ahead. The trade war and Brexit are increasing the risk of a recession. For euro area growth to strengthen, the external environment would need to improve and uncertainties diminish. At present, growth in the euro area has slowed the most in manufacturing-intensive economies such as Germany. There is no turn for the better visible yet for German manufacturing. The concern is that the weakness of euro area manufacturing activity would begin to be reflected on the labour market and in the services sector. There are already some slight signs pointing in this direction. Strengthening growth would, however, require this not to happen. The weaker cyclical conditions in the euro area are not reflected in euro area unemployment, at least thus far. The unemployment rate has already declined roughly to the level prevailing prior to the financial crisis.

In addition to growth, inflation in the euro area is similarly set to remain subdued in the immediate years ahead. The ECB's latest forecast projects that inflation will slow to 1% in 2020 and pick up to 1.5% in 2021. Core inflation, which reflects the medium-term price pressures within the economy, has remained at about 1% already for six years. Even though the ECB's latest forecast anticipates a gradual strengthening in core inflation to 1.5% in 2021, the forecast is subject to uncertainty. The decline in the unemployment rate and the pick-up in wage growth have not boosted core inflation for the time being. The weaker cyclical conditions will contribute to reducing price pressures further. In addition, inflation expectations have remained low relative to the ECB's target. The risk of deflation remains small, however, despite its recent slight increase. The weakening of the economic cycle and lower-than-target inflation expectations will prolong the period of low inflation in the euro area.

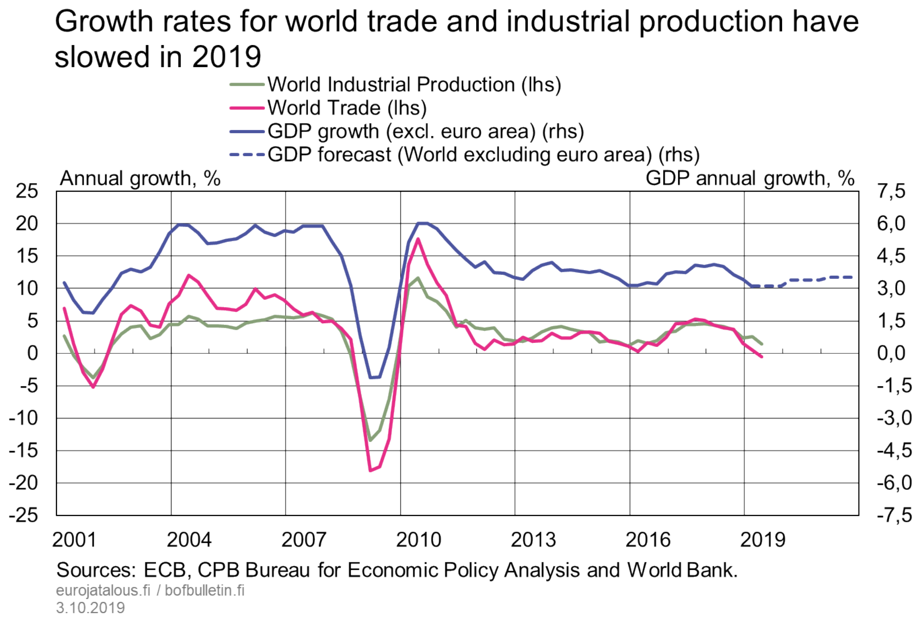
In this context, the Governing Council of the ECB decided at its meeting in September on a comprehensive package of monetary policy measures to provide further monetary policy stimulus and ensure that inflation moves towards the ECB's aim in a sustained manner. Financial conditions in the euro area will remain accommodative for an extended period and will also underpin investment, and hence the long-term growth outlook. Investment and productivity have continued to grow sluggishly in the euro area. Fixed business investment has so far recovered only slowly and has only recently reached pre-crisis levels. An extended period of accommodative financing conditions in the euro area means the period of negative nominal interest rates will continue.

The trade war between the United States and China has dampened world trade growth

During 2019, growth in world trade has moderated to around 3%. This is slower than the average rate between 2000 and 2018 (3.8%), and as recently as last year trade grew by 3.6% globally. According to the most recent projections, global growth is expected to accelerate only slightly and to remain close to 3% (Chart 1).[1] The latest OECD forecast from September predicts that the global economy will grow by 2.9% in the current year and by just 3.0% in 2020. The ECB September forecast (global, excluding euro area) and the updated IMF July forecast were slightly more optimistic, predicting growth will rise to around 3.5% in 2020.

1. IMF July forecast update, OECD September forecast and the ECB September forecast (global, excl. euro area).

Chart 1

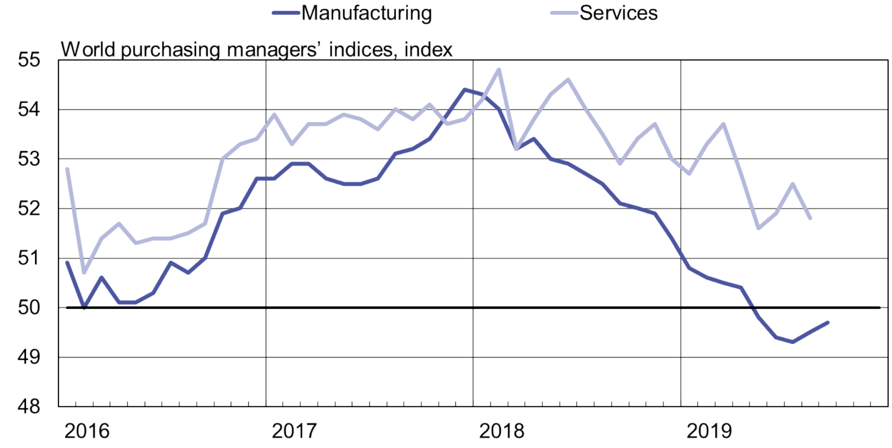


The trade dispute between China and the United States has further escalated since the spring. The tariff increases already cover a substantial proportion of China-US bilateral trade.[2] The dispute increases uncertainty about the future and is reflected in the current figures for manufacturing output and investment and, in particular, in bilateral trade flows between the United States and China. According to model simulations by the Bank of Finland, tariff increases currently in place will have a negative effect of around 0.7 of a percentage point on global growth.[3]

2. The tariff increases now cover roughly 70% of Chinese exports to the United States and 60% of US exports to China. General tariffs placed by the United States on washing-machines, solar panels, aluminium and steel are still in effect, apart for some individual countries that have been granted exemptions.
3. Read more about the effects of the trade dispute in: "The Trade war has significantly weakened the global economy".

Chart 2

Growth in services remained much more stable than in manufacturing



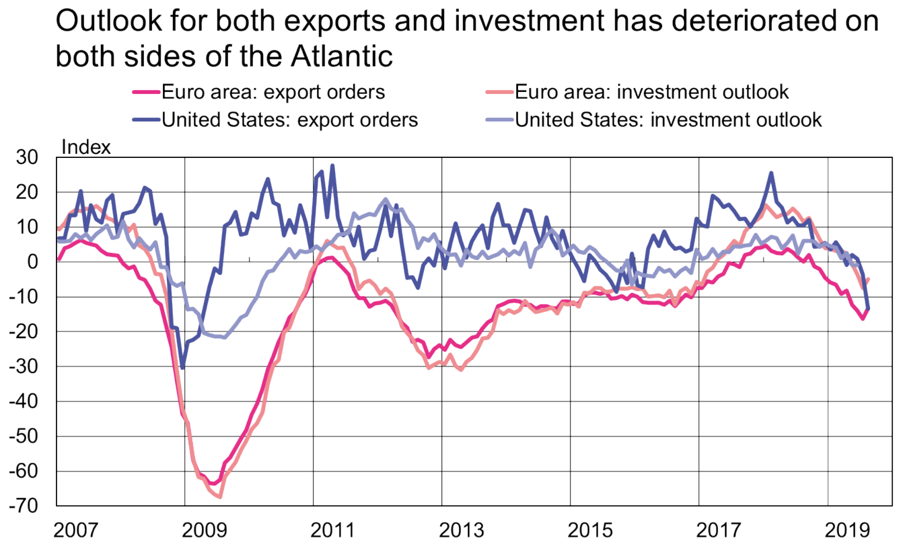
An index below 50 signifies that economic activity is decreasing.
Source: IHS Markit.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Growth in the manufacturing sector came to a standstill in the first half of 2019. The purchasing managers' indices (PMI) for manufacturing, used for anticipating future developments, has been on a downward trend for several months, pointing to a decline in industrial output (Chart 2). Protectionist measures and uncertainty about growth in the major economic areas have weakened the confidence climate and subdued global trade growth. Global growth in trade in goods has stagnated since the end of 2018. In the last few months, new export orders have further deteriorated. This suggests that global trade growth will remain subdued in the months ahead.

Despite the slow growth in manufacturing, the outlook for the service sector has so far remained relatively stable, as private consumption has kept rising. Positive developments on labour markets and in income growth as well as favourable financial conditions have continued to support this development. In the advanced economies, domestically produced market services account for around half of private consumption.[4] The longer the industrial slowdown persists, the more likely it becomes for employment to weaken, thereby increasing the risk of negative spillovers to the service sector through private consumption.

4. OECD Economic Outlook Box 1.1., May 2019.

Chart 3

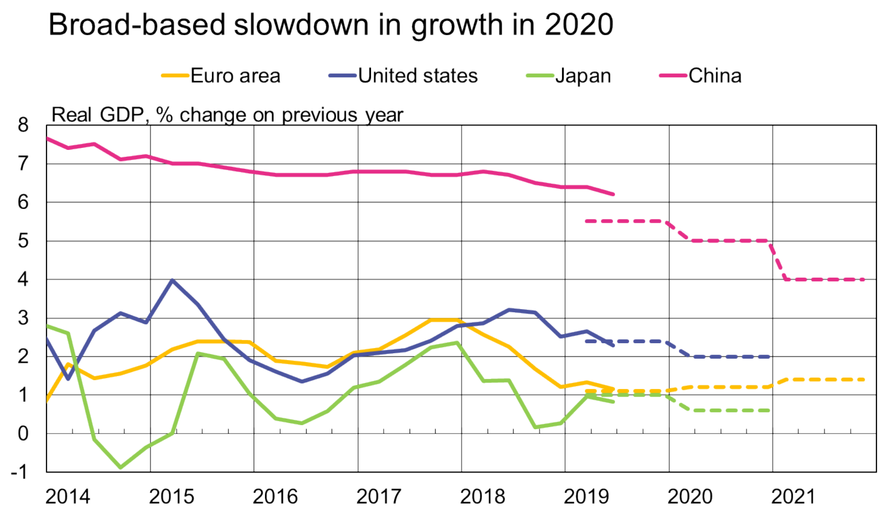


Sources: Conference Board, ISM, Eurostat and European Commission.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Leading indicators of investment have weakened noticeably (Chart 3). The growth in actual investment has also slowed during the first half of 2019, especially in the United States. In large investments, the time between when an investment decision is made and when it is ultimately realised and reported in statistics can be considerable. It is therefore likely that any broad signs of the current uncertainty and postponing of investments will be reflected in the statistics for actual investment with a time lag.

Growth weaker in all major economic areas

Chart 4



Sources: OECD, ECB and Bank of Finland (BOFIT).
Forecasts: BOFIT (China), ECB (euro area), OECD (US and Japan).
eurojatalous.fi / bofbulletin.fi
3.10.2019

The **United States'** short-term growth outlook has weakened somewhat compared with last winter, but the US economy is still expected to grow by more than 2% in 2019 (Chart 4). Industrial confidence as well as the outlook for investment and exports have declined substantially. One reason is the trade war and the uncertainty this has caused. Economic growth in the United States is bolstered by private consumption, having picked up after a poor winter season. Private consumption, in turn, is supported by strong consumer confidence, full employment and lower interest rates.

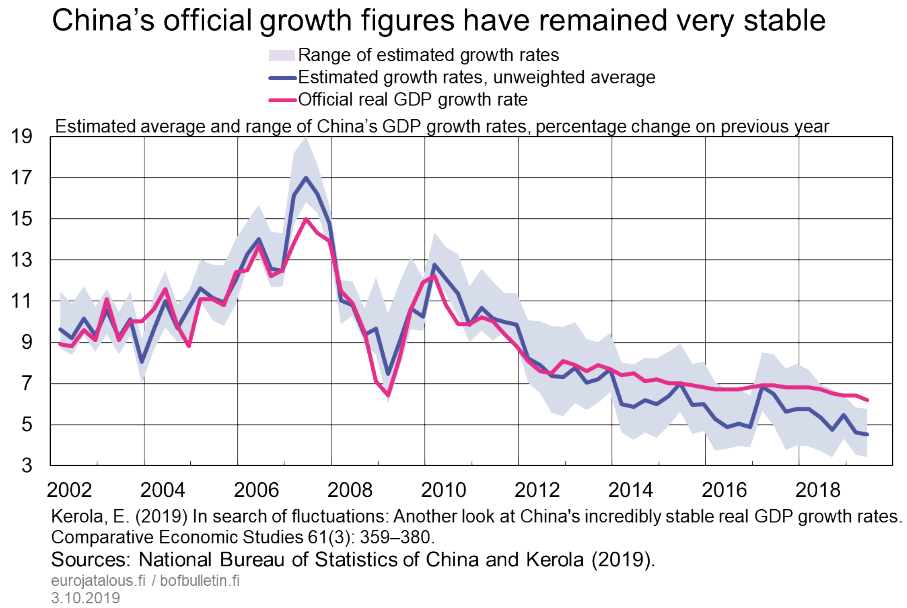
In early August, the United States raised the caps for discretionary government spending for 2020–2021 (Bipartisan Budget Act of 2019), essentially extending the fiscal spending measures introduced in 2018 over a longer period. Continuing the fiscal policy measures will improve growth in 2020 to some degree. However, in the years ahead, once the fiscal stimulus is over, economic growth in the United States is expected to stabilise at around 2%, in line with potential output.

By extending the fiscal policy measures, the United States' overall general government deficit will remain high for a longer period and increase government debt. The most recent OECD forecasts predict that the overall general government deficit will remain clearly above 6% of GDP in the immediate years ahead, and the general government debt will rise to around 113% of GDP in 2020. Large general government deficits also serve to support strong demand for imports, thus raising deficits in the trade and current accounts.

In 2019, the consumer price index (CPI) in the United States has largely remained significantly below 2%, mainly because the price of crude oil has been lower than in 2018. Core inflation has remained slightly over 2%. Unemployment has dropped below 4%, and annual wage growth, based on average hourly earnings, has remained above 3%. Full employment is helping to keep the inflation rate at around 2%, but subdued inflationary pressures and current developments in the global economy led the US Federal Reserve to lower its key interest rates in July and September.

China's growth is expected to slow in the years ahead largely due to domestic factors (see BOFIT Forecast for China). Economic uncertainty is increased by the growing trade tensions. China's imports have fallen from last year, and export growth has slowed substantially. Corporate willingness to invest has also suffered from the tariff increases imposed on each other by the United States and China and from the unpredictability of the situation. China has increased fiscal stimulus to support growth, further increasing the general government deficit. The biggest concerns relate to rapidly increasing indebtedness and the growing financial market risks.

Chart 5



The problems relating to China's growth figures also make it increasingly difficult to assess the current state of the global economy as a whole. In 2018, China accounted for more than a third of global growth. According to official statistics, China's economy is still growing considerably faster than the global economy as a whole, and growth has remained very stable (Chart 5). However, many alternative indicators and estimates suggest that in recent years the economy has grown more slowly than officially reported. The uncertainty surrounding China's actual growth increases the concerns relating to global growth expectations.

Japan's economy will continue to grow moderately in the years ahead, at around the potential growth rate of almost 1%. The Japanese population is ageing and declining at a brisk pace. As a result, while GDP growth may have been slow, when measured in terms of per capita GDP over the last ten years, it has actually accelerated faster than euro area growth and almost as much as in the United States. The shrinking working-age population is reducing the growth potential of the economy and weakening the dependency ratio. In order to curb high indebtedness and balance the public finances, Japan desperately needs measures to improve labour productivity and increase the foreign labour force. Inflation has remained subdued. The Bank of Japan has continued its highly accommodative monetary policy and also indicated that the will be maintained until the inflation target has been achieved in a sustained manner.

In the United Kingdom, the GDP growth rate fluctuated in early 2019 as the country was preparing for Brexit, originally due at the end of March. However, the UK's departure from the EU was postponed to the end of October. In the second quarter, the economy contracted and confidence indicators continued to decline. The UK's economic outlook for the years ahead depends on how the Brexit process progresses.

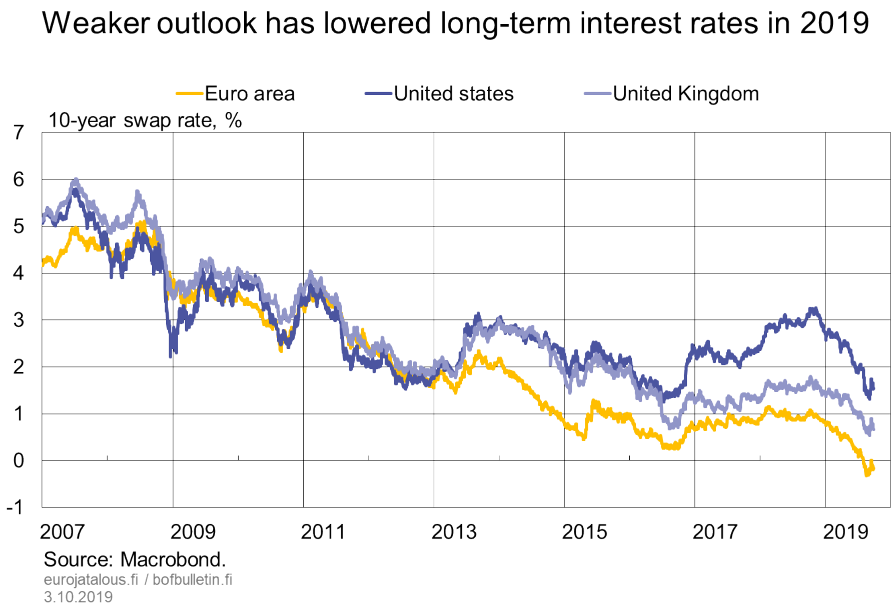
In Sweden and the other Nordic countries, economic growth has recently slowed slightly, in pace with the global economy. In Sweden and Norway, the GDP growth rate is currently around 1.5%, and in Denmark, close to 2%. Sweden's net exports are supporting growth, but domestic demand and investment growth have been poor. The depreciating Swedish krona has also had a negative impact on domestic demand.

The Russian economy has performed more weakly than anticipated in early 2019, and annual GDP growth is expected to be around 1%. According to the BOFIT Forecast for Russia, growth is expected to pick up in 2020 to close to 2%, largely due to public investment. Public investment alone will not boost the potential growth rate, and after 2020 growth will gradually slow.

Economic growth in **emerging economies** in 2019 has turned out to be significantly slower than anticipated. The slowing growth in China and the effects of the trade war on global value chains have slowed growth in Emerging Asia (excl. China). The economic outlook is also bleak for Latin America, where countries are suffering from their own economic policy problems. It is hard to see a clear and rapid improvement in the economic situation in emerging economies.

Sharp decline in long-term interest rates

Chart 6

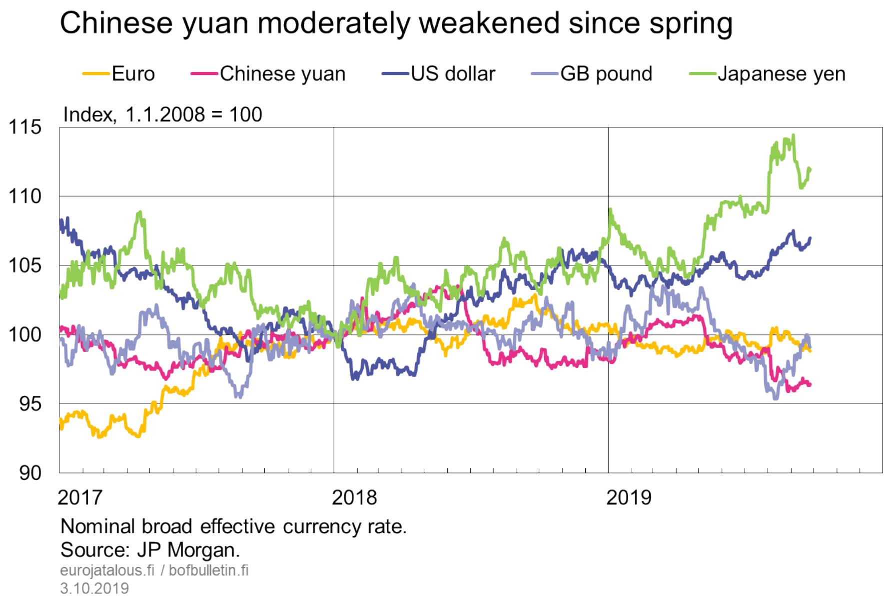


Compared with the beginning of the year, long-term interest rates have declined sharply due to the weaker economic outlook (Chart 6). The decline is attributable to both the increase in demand for safe havens and the decline in expected short-term interest rates.[5] At the beginning of the year, the financial markets were still expecting monetary policy in the major economic areas to tighten, and the United States, for example, was expected to continue its moderate interest rate rises. However, as the economic outlook has weakened, many central banks have eased their monetary policy. In the United

5. Read more [in Finnish] about declining long-term interest rates and the reversed interest rate curve in the Bank of Finland blog.

States, the Fed made its first interest rate cut in July, followed by a second cut in September. Likewise, in the euro area, the ECB lowered its deposit rate in September. In the United Kingdom, the Bank of England kept its key interest rate unchanged in September, but expectations of an interest rate cut have increased.

Chart 7



Global economic uncertainty has also boosted demand for safe havens on the foreign exchange markets, which is reflected particularly in the appreciation of the Japanese yen and the US dollar (Chart 7). The value of the pound sterling fluctuates in response to new information regarding Brexit. Since the trade war escalated, China has let its currency depreciate slightly.

Headline and core inflation rates in OECD countries have remained around 2% in recent months. Inflation has been subdued by the decline in oil prices that began in late April, bringing the barrel price back to around USD 60 in August, about 18% lower than a year ago. This shift is attributable to both demand and supply factors. Demand has weakened due to slowing economic growth and uncertainty caused by the trade war. On the supply front, OPEC and its allies have continued to cut production, but at the same time other countries, including the United States, have increased production. The attack on Saudi Arabia's oil plants temporarily raised the price of oil to almost USD 70 per barrel, but thereafter it quickly eased back down.

The ECB's comprehensive monetary policy stimulus package supports euro area inflation developments

Economic developments in the euro area have remained subdued and the difficulties experienced in the manufacturing sector, in particular, have persisted longer than previously anticipated. Inflation has fallen short of the targeted level of slightly below 2%, and inflation expectations have weakened further since the summer. In September, the ECB revised down its forecasts for both euro area GDP growth and inflation. The

Governing Council of the ECB assessed that the risks surrounding the euro area growth outlook were still tilted firmly on the downside.

For these reasons, the Governing Council decided at its meeting in September on a comprehensive package of monetary policy stimulus measures. The interest rate on the deposit facility was lowered by 10 basis points to -0.50% (Chart 8). The Governing Council adjusted its forward guidance concerning interest rates by stating that the key ECB interest rates were expected to remain at their present or lower levels until the Governing Council had seen the inflation outlook robustly converging to a level sufficiently close to, but below, 2%. This convergence must also be consistently reflected in underlying inflation dynamics. Previously, the Governing Council expected the key ECB interest rates to remain at their present or lower levels through the first half of 2020.

While the expectations about the future level of interest rates had previously been also dependent on a pre-defined point in time, they were now linked solely to the development of inflation. Thus, the ECB's forward guidance on interest rates shifted now to purely state-contingent forward guidance.

In addition to the lowering of the deposit facility rate, the Governing Council also decided to restart net purchases under the expanded asset purchase programme (APP) at a monthly pace of EUR 20 billion as from 1 November. The purchases will run for as long as is necessary to reinforce the accommodative impact of the key interest rates. The Governing Council expects the purchases to end shortly before it starts raising the policy rates. In addition, the Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period after it starts raising interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

The advantages of a negative central bank rate seem to have outweighed the disadvantages in the euro area.[6] To ensure the continuance of as smooth transmission of monetary policy as possible, the Governing Council took measures in September to ease the costs to the banking sector from negative interest rates. Namely, it decided to introduce a two-tier system for reserve remuneration in which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate. This exempt tier will be subject to a rate of 0%.[7]

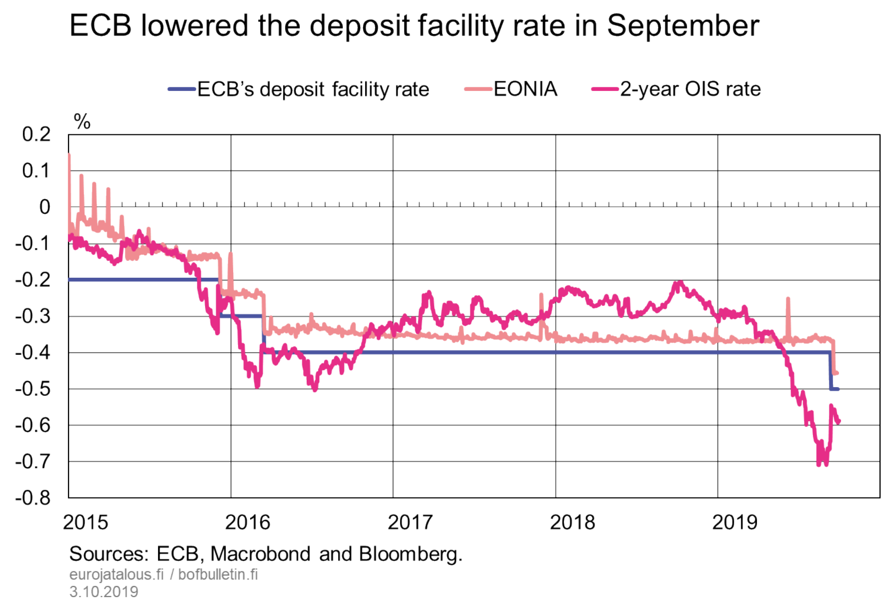
Furthermore, the Governing Council eased the modalities of the third series of targeted longer-term refinancing operations (TLTRO III) commencing in September by lowering the interest rate of the operations by 0.1 of a percentage point. The interest rate in each operation will be set, at most, at the level of the average rate applied in the Eurosystem's main refinancing operations over the life of the respective TLTRO. If banks increase their credit supply over a specific benchmark, the rate applied in the operations can be as low

---

6. For more information on the effects of negative interest rates in the euro area, see Slightly negative central bank interest rates ease financial conditions.
7. For more information on the two-tier system for reserve remuneration, see The Eurosystem's two-tiered deposit facility.

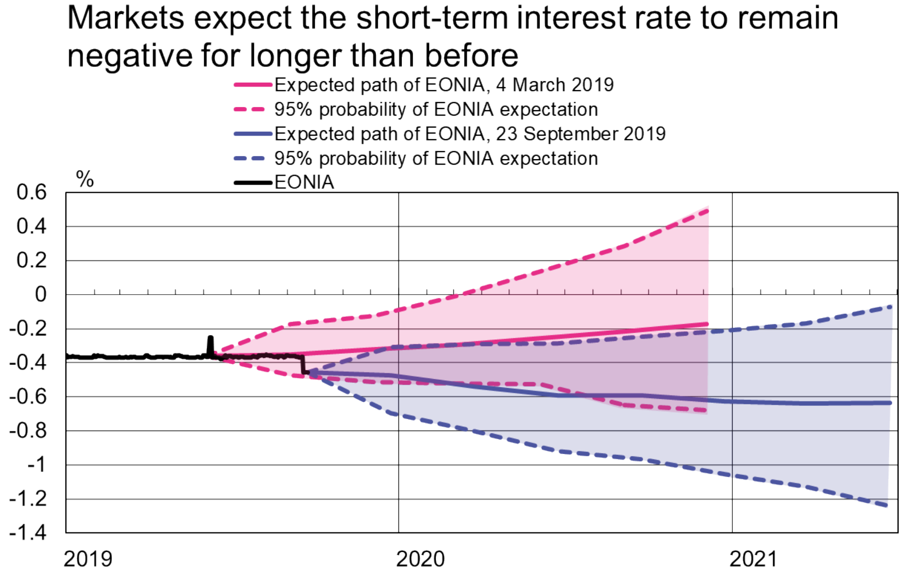
as the average interest rate on the ECB's deposit facility. In addition, the maturity of the operations was extended from two to three years.

Chart 8



As a reaction to weakening growth prospects, market expectations of interest rates have already been declining since the spring. The ECB's September decisions supported expectations of a prolonged period of low interest rates. The markets currently expect the short-term rate to remain negative for many years ahead (Chart 9). Based on market expectations, the return of the short-term reference rate to positive territory is now more unlikely than in the early part of the year.

Chart 9



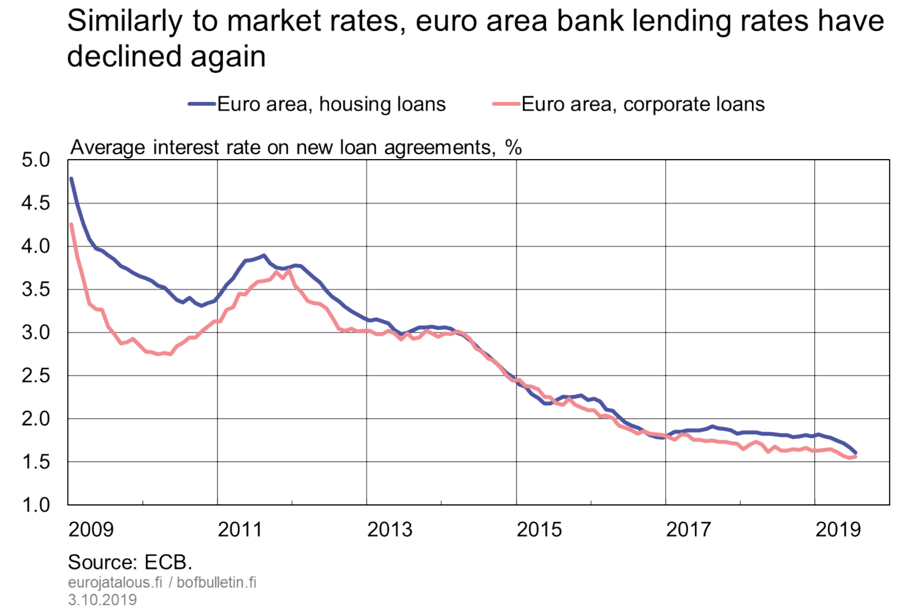
The solid lines reflect the path of EONIA expected by the markets and the shaded areas between the dotted lines contain 95% of the EONIA rates expected by the markets.
Sources: Bloomberg, Macrobond and calculations by the Bank of Finland.
eurojatalous.fi / bofbulletin.fi
3.10.2019

The Governing Council's September decisions provide a further monetary policy stimulus, as the euro area financing conditions will remain favourable for an extended period and hence underpin economic growth. The Governing Council also emphasised that, besides monetary policy stimulus, the euro area also needs economic policies that support economic growth.

The cut in interest rates has been transmitted as lower bank lending rates in the euro area

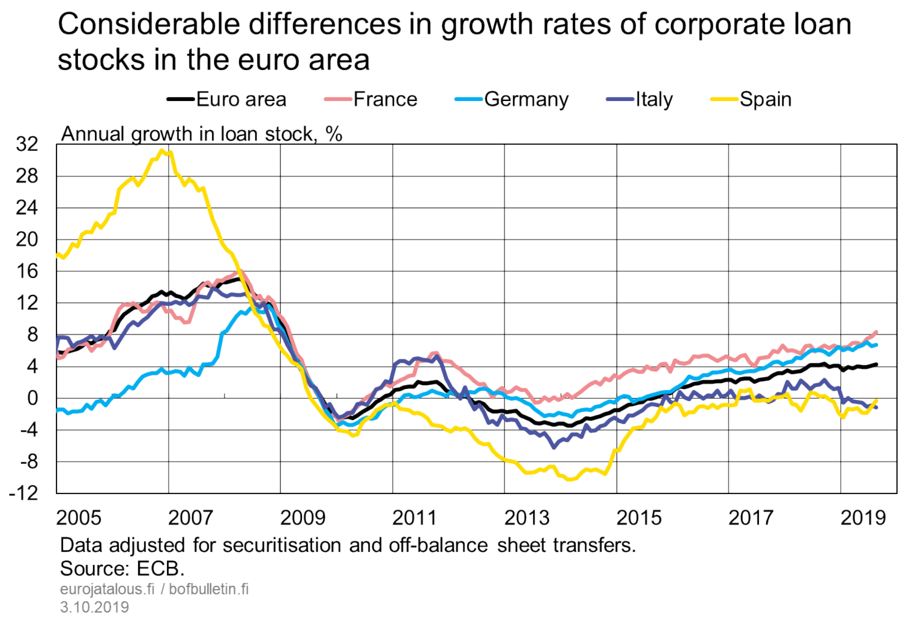
The weaker interest rate expectations have also led to a decline in interbank rates. The Euribor rates, which are widely used in the euro area as reference rates in bank loans to the private sector, fell notably from the early part of the year. This has been reflected in the average interest rates on new bank loans, which continued on the downward trend witnessed since the early part of summer 2019 (Chart 10). Before this, average rates had been fairly stable for a few years.

Chart 10



Country-specific differences in the average interest rates on new bank loans to non-financial corporations have narrowed further. However, the growth rates of loan stocks still diverge considerably (Chart 11). In Germany and France, for example, the corporate loan stock is growing at an annual rate of around 7%, while in Italy and Spain corporate loan stocks have continued to contract over the year. In the euro area as a whole, the average annual growth rate of the corporate loan stock has stabilised to close to 4%.

Chart 11



In Italy, the muted growth of the corporate loan stock is mainly due to the ongoing recovery of the banking sector, a protracted period of sluggish economic growth and uncertainties surrounding the economic outlook. In Spain, the main contributory factor is the property bubble that burst during the financial crisis and rendered the bulk of loans linked to the construction and real-estate sector worthless. Even though the economic conditions in Spain have already improved markedly, the banking sector is still struggling with a corporate loan stock that grew at a very rapid pace before the crisis. However, the fact that the annual growth rate of the corporate loan stock has remained negative does not mean that the situation is equally weak across all sectors. For example, the stock of loans to manufacturing companies in Spain has grown at a fairly robust pace for over two years already.

Profitability remains a challenge in the banking sector

The profitability of euro area banks weakened amid the turbulence early in the year. In the first quarter of 2019, the return on equity (ROE) of euro area banks was 5.8%, compared with 6.6% a year earlier. The uncertainties surrounding the global economy are also weighing on banks' short-term profitability prospects. Markets and banks anticipate only a slight improvement in ROE for the large euro area banks by 2020, to about 8%. In response to the subdued prospects, euro area banks' equity prices have experienced markedly weaker developments in the course of 2019 than broad market indices.

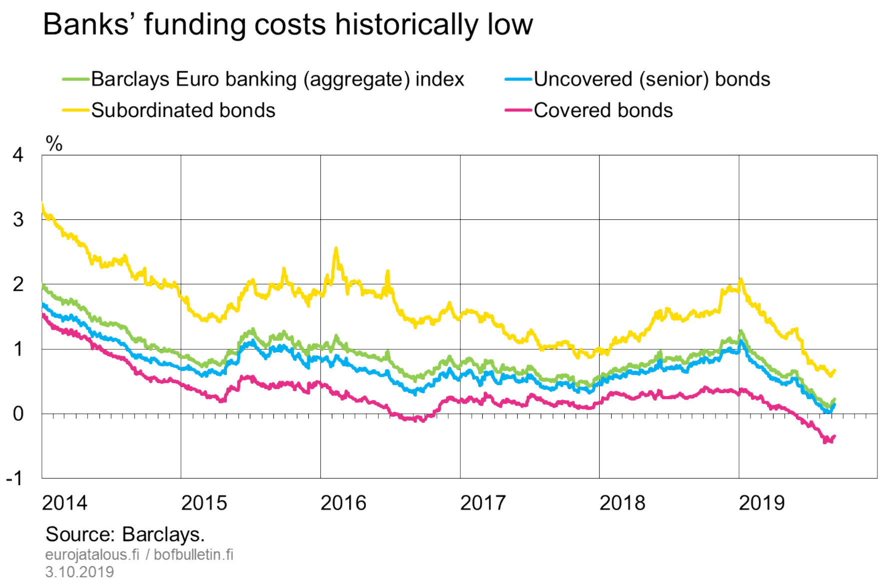
Euro area banks are particularly strained by long-term structural problems, and the subdued economic outlook may further emphasise these problems. Core banking business is still suffering from weak profitability. Growth in net interest income, which constitutes a key source of revenue for banks, has been muted amid persistently low interest rates and a flat yield curve. Net interest income has partly been supported by the return of credit growth to an upward trajectory. A problem, however, is that the growth rates of loan stocks diverge across the different euro area countries.

In light of revenue developments, one of the key challenges has been that banks have not sufficiently succeeded in compensating for their weak net interest income growth with other sources of revenue. Financial market uncertainties have eroded banks' net fee and commission income, in particular. In addition, euro area banks are still very locally oriented, which limits their ability to broaden their revenue sources. Cross-border banking activity has decreased in Europe since the financial crisis. The fragmentation and heterogeneity of Europe's capital markets provides a weak support against international competitors. In fact, competitors from the United States, which are backed by solid domestic capital markets, have increased their market shares in Europe, too. Weak profitability has weighed particularly on large euro area investment banks and banks specialising in corporate finance.

In many countries, banks that struggle with weak profitability are also strained by too heavy cost structure. There are many factors explaining banks' high costs, such as an extensive branch network or a large number of staff. Actually, bank profitability appears to be heavily dependent on banks' cost structure. Banks operating with a lighter cost structure can also adjust more easily to challenging market conditions. Going forward, banks must also respond to the challenges brought by major new trends, such as digitalisation. The related investments will put a considerable strain on banking sector profitability, especially in the short term.

From the perspective of banks' long-term profitability, completion of projects such as Banking Union and Capital Markets Union are of utmost importance. Similarly, efforts to promote the cross-border integration of the banking sector should also be stepped up.

Chart 12

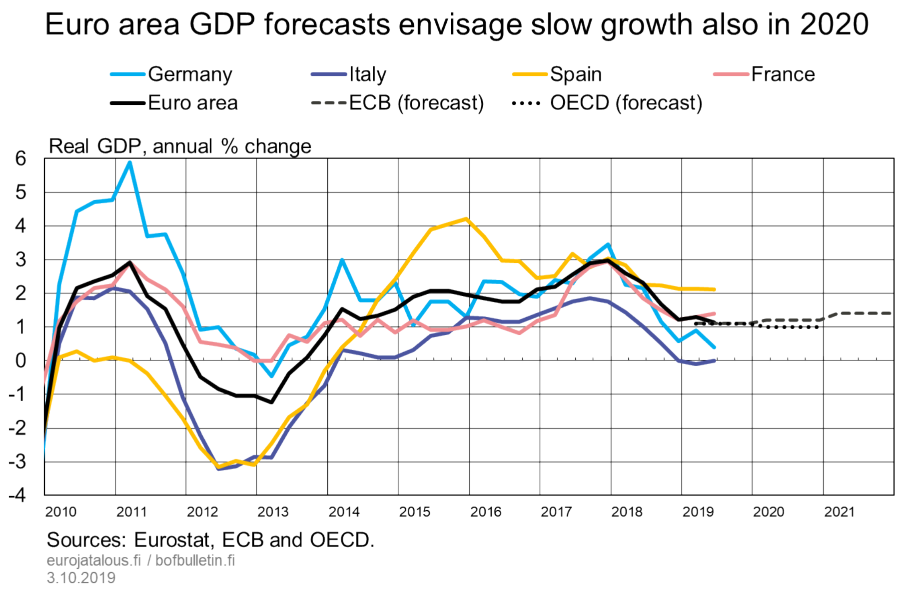


Over the past few years, the profitability of euro area banks has been supported particularly by declining loan losses. Lower loan losses and credit risks have contributed significantly to the profitability of banks, particularly in countries that bore the brunt of the sovereign debt crisis. The accommodative stance of monetary policy has supported banks in reducing problem loans on their balance sheets. In the first quarter of 2019, euro area banks still had some EUR 587 billion worth of non-performing loans on their balance sheets, which is almost 16% less than a year earlier. In proportion to the aggregate loan stock, non-performing loans accounted for 3.7% in the first quarter. Bank profitability also continues to be underpinned by low funding costs (Chart 12) as well as the ECB Governing Council's decisions September to introduce a two-tier system for reserve remuneration and ease the modalities of TLTRO operations.

Euro area domestic demand struggling against industrial sector weakness

GDP growth in the euro area has remained subdued since the second half of 2018. In 2018, it was still 1.9%, but this year it has slowed to around 1% (Chart 13). The slowdown reflects, in particular, the decline in net exports.

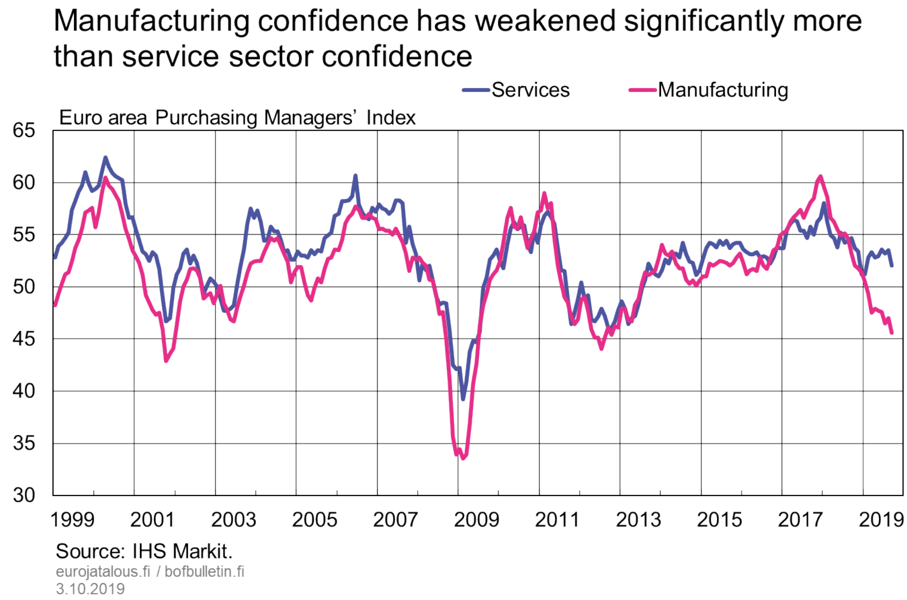
Chart 13



GDP growth in the euro area in 2019 is thus expected to be lower than previously anticipated, and projections for growth in 2020 have also recently been revised downwards. According to the ECB's projections, euro area growth is however expected to recover slightly by 2021. The September 2019 ECB staff macroeconomic projections for the euro area foresee annual real GDP increasing by 1.1% (June projections: 1.2%) in 2019, 1.2% (June: 1.4%) in 2020 and 1.4% (1.4%) in 2021. According to the European Commission's June forecast, GDP will grow by 1.2% in 2019 and by 1.4% in 2020. These projections are, however, subject to a significant downside risk. The OECD projections published in September foresee a stronger slowdown in euro area GDP growth than the projections by the ECB and the Commission. The OECD expects GDP to grow at a rate of 1.1% in 2019 and 1.0% in 2020.

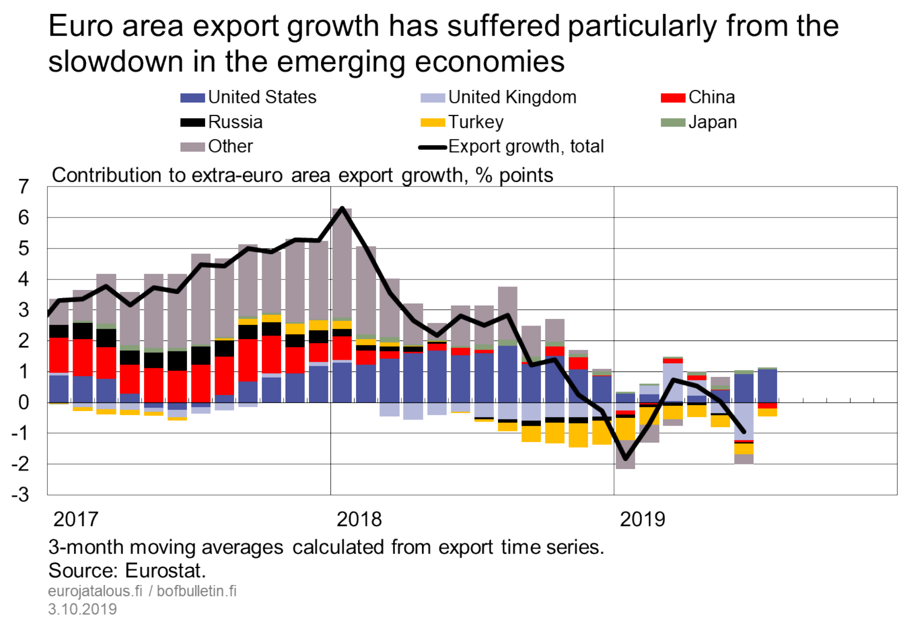
Growth has been supported by solid private consumption, which has been bolstered by an improvement in the employment situation and an increase in disposable household income. Accommodative financing conditions and the mildly expansionary fiscal policy stance will continue to support private consumption. Solid private consumption is reflected in an improvement in retail trade from the previous year and in the purchasing managers' index for the service sector, which has remained at levels that signal growth.

Chart 14



In contrast, the purchasing managers' index for manufacturing has fallen in 2019 to levels that signal a decline in activity. This type of strong divergence in the manufacturing and service sector purchasing managers' indices is exceptional in the euro area (Chart 14). The outlook for manufacturing has suffered from weak export demand and the uncertainty caused by trade tensions. In addition, sector-specific factors have burdened manufacturing output, particularly in Germany. The latest confidence indicators point to a continued decrease in euro area export orders, which does not promise a rapid improvement in manufacturing output.

Chart 15



Euro area export growth has stagnated since the end of 2018 and has suffered particularly from the slowdown in the emerging economies. Export demand to particularly China, Turkey and Russia has been weak (Chart 15). The uncertainty triggered by Brexit has been reflected as a shrinking of exports to the United Kingdom, even though preparations for the assumed Brexit date at the end of March boosted export volumes temporarily. The euro area's three most important partners for goods trade are the United States, the United Kingdom and China. In all these economies, growth is expected to slow in the immediate years ahead, and it is therefore hard to foresee a positive turn in the outlook for euro area exports.

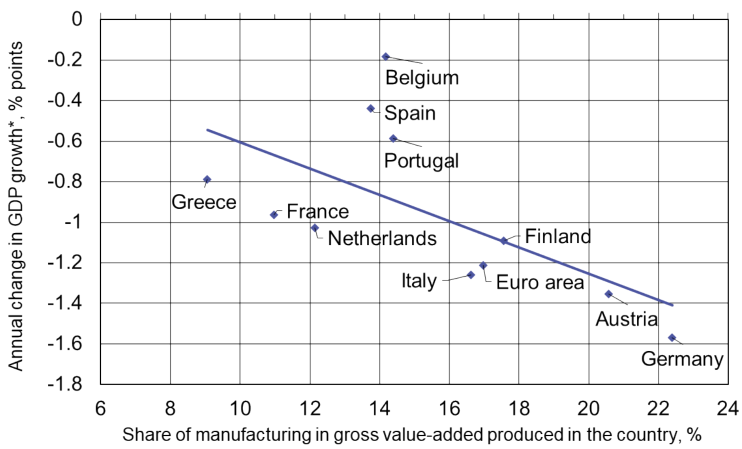
In the second quarter, fixed business investment was growing by 2.5%, year-on-year. The rate of growth was, however, slower than in previous quarters. The weakness of exports and manufacturing is dampening the outlook for fixed business investment, and leading indicators of investment have declined further in recent months. In addition, the capacity utilisation rate has declined in the past year.

Manufacturing-intensive Member States have suffered most from the shrinkage in world trade

Manufacturing output has been subdued throughout the euro area. The importance of manufacturing to the economy does, however, vary considerably between Member States. The share of manufacturing in the gross value added produced in the country is the largest in Germany and Austria, whereas in, for example, Greece, France and the Netherlands, the share is significantly smaller. In Finland, the share of manufacturing in gross value added is close to the euro area average.

Chart 16

Economic slowdown most pronounced in manufacturing-intensive economies



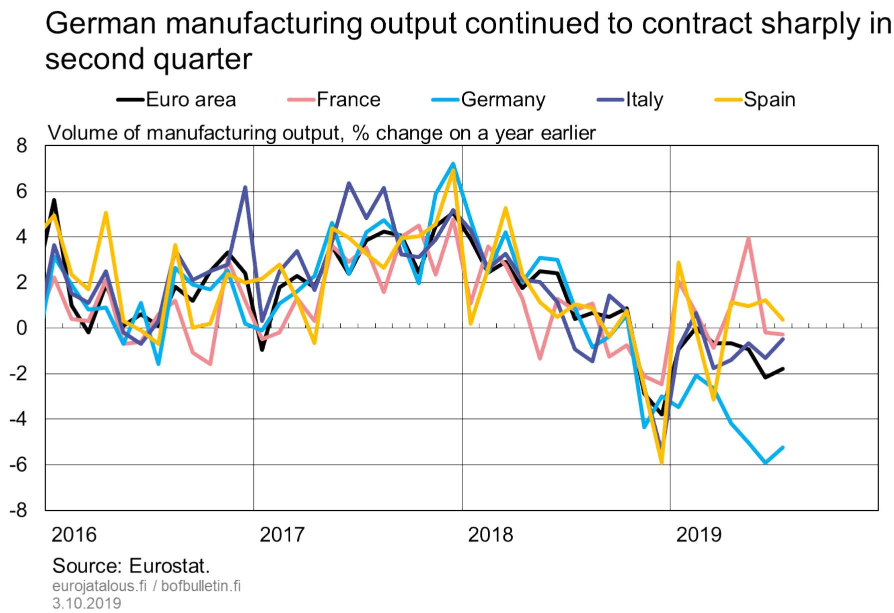
*Annual change in GDP growth in the period 2018H1–2019H1.
Sources: Eurostat and calculations by the Bank of Finland.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Differences in the share of manufacturing have been reflected in the economic slowdown witnessed in the current year. This is reflected in Chart 16: the higher the share of manufacturing, the stronger the decline in GDP growth compared with the early part of 2018. Due to the strong link between euro area manufacturing output and exports, the decrease in export demand, partly in response to the trade disputes, will at least initially hit hardest the manufacturing-intensive Member States.

Weakness of the German economy has persisted for longer than expected

The growth prospects for the four largest economies in the euro area continued to diverge during the summer. In Spain, GDP growth has remained robust, and in France, too, GDP is growing at a stable rate. Italy's growth prospects have remained unchanged at very weak levels since late winter. The weakness of Germany's manufacturing output became more pronounced during the summer (Chart 17). Germany is an economy with a high degree of manufacturing intensity and openness,[8] which makes it more dependent on exports and more sensitive to the structure of global trade than other countries. Difficulties in the German car industry may also reflect more extensively on the euro area economy, due to the sector's high degree of global integration and the fact that developments in the sector start to show rapidly in the orders received by subcontractors.[9]

Chart 17



Sluggish growth in the **German** economy has a significant effect on the performance of the euro area economy, both directly based on its large weight, and indirectly via economic relationships. Germany's GDP contracted slightly in the second quarter, compared with the first quarter. This was particularly due to the weakness of exports. In the early part of the year, developments in German investments were still favourable. Investment continued to grow in the manufacturing sector, but the construction sector witnessed a significant drop in investment. Private consumption has been supported by

8. In Germany, the share of foreign trade (exports + imports) in GDP is over 60%, compared with some 40% in the other large euro area countries.

9. For discussion of Germany's car industry see the BoF blog [in Finnish only].

the still good level of employment (unemployment rate 3%) and wage growth. Real net wages grew in the second quarter by 4.8%, year-on-year. Consumer confidence in Germany has, however, declined since March. German GDP growth seems to be set to reach some 0.5% in 2019, which is only one third of the growth recorded in 2018. There is heated debate in the country on whether, in the name of fiscal stimulus, budget deficits should be allowed. The IMF, too, has encouraged the German authorities to use the available fiscal space to bolster potential growth.[10]

Italy's economic growth was modest throughout the first half of the year, and GDP growth in 2019 is expected to be close to zero. In 2018, the economy still grew by nearly 1%. Industrial output has contracted for several consecutive months – albeit clearly less than in Germany. Growth in private consumption has slowed. The situation of the Italian economy has been complicated by political uncertainty – which nevertheless decreased in September with the formation of the new government. Italy's problems nevertheless remain, namely high unemployment, weak competitiveness and a large general government debt (over 130% of GDP).

France's GDP is expected to grow in 2019 and 2020 by some 1.3%, i.e. only slightly slower than in 2018. The Macron administration is trying to speed up its economic reforms that were slowed down by the 'yellow vest' protests. France increased public spending as a concession to protesters. This acts now as fiscal stimulus. In France too, general government finances have been in deficit for a long time, and the general government debt-to-GDP ratio is approximately 100%.

Spain, the fastest growing large euro area country in recent years, has succeeded in maintaining a pace of growth higher than that of the others also in the first half of 2019. GDP growth for the year is expected to reach a good 2%. The Spanish economy is protected by its smaller dependence on exports and the smaller weight of manufacturing in GDP. In Spain too, general government finances are still in deficit, but the deficit has shrunk year after year, and the general government debt-to-GDP ratio has slowly decreased.

Euro area investment rate persistently low

Estimates of growth in euro area potential output have decreased slightly in the course of 2019, to 1.4%. Developments in labour productivity, in particular, have been weak in the euro area. According to the study described in one of the theme articles, slow productivity growth might be due to the weakening of innovation and postponement of the adoption of new technologies by companies, reflecting weaker aggregate demand (Euro area productivity growth could slow further in the event of a downturn).

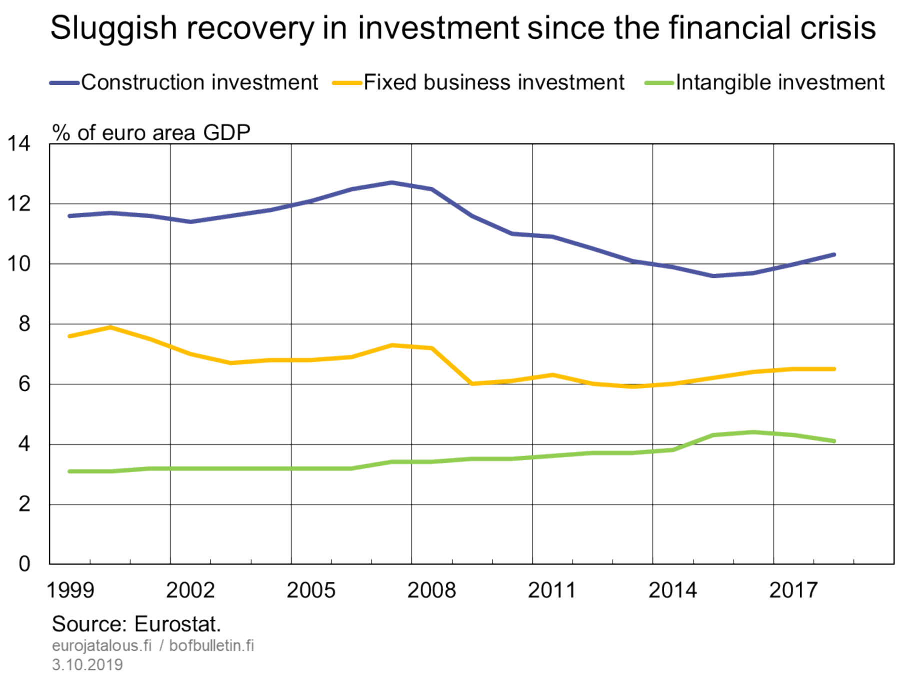
The contraction in the working-age population has been compensated by the ongoing rise in the labour force participation rate, particularly among older cohorts. The decrease in the working-age population is, however, likely to strengthen towards the mid-2020s. In the absence of new reforms to support the participation rate and economic growth, the balanced rate of growth in the economy is therefore expected to slow as a result of

10. IMF article IV consultation with Germany, July 2019.

population ageing. The Governing Council of the ECB stressed in September the importance of implementing structural policies to boost euro area productivity and potential growth.

Compared with pre-crisis levels, the savings rate in the euro area is still high and investment rates are markedly lower. The current account surplus has remained stable, at 3%. While the current account surplus provides a buffer against population ageing and potential economic shocks, it may also signal weak incentives for investment and a low level of investment opportunities. As a result of the higher savings rate and low level of residential investment in the larger euro area countries, household debt ratios have declined steadily in recent years.

Chart 18



The investment rate in the euro area is notably below the levels of the early post-millennium years. Construction investment, in particular, has been sluggish, and its share of euro area GDP is only slightly higher than at its historical trough in 2015 (Chart 18). Construction activity is particularly subdued in Spain and Italy.

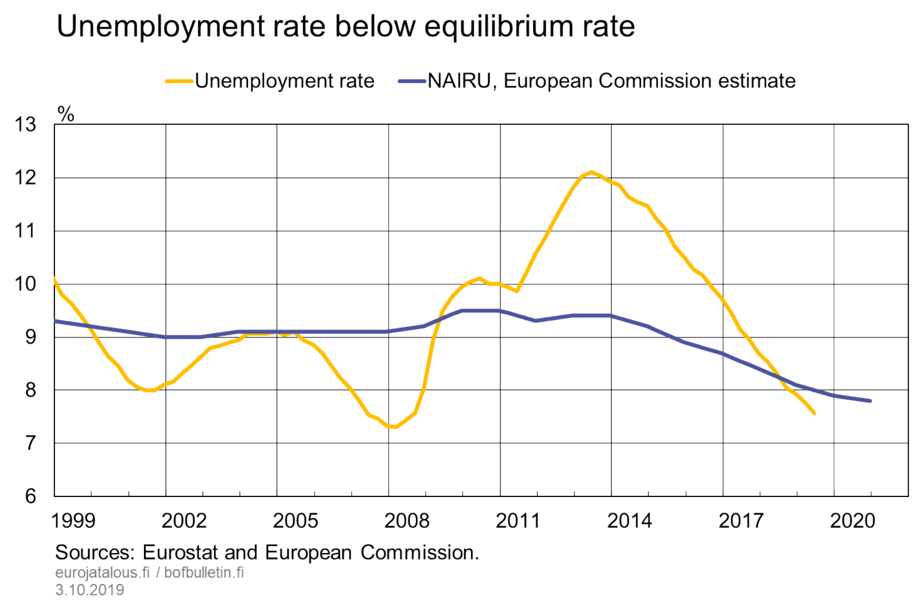
Fixed business investment started to recover slowly only in 2015 and its share of total output is still smaller than before the crisis. The recent weakening of the growth prospects for investment may weigh on investment rates in the future. Of the large Member States, only in Spain has the share of fixed business investment risen above pre-crisis levels. In Spain, the recovery of fixed business investment reflects the strong performance of the manufacturing sector, which has been supported by structural changes implemented during the financial crisis. The share of intangible investment in total output has continued to grow steadily and is now notably higher than before the crisis.[11]

Growth has been sustained by the still positive labour market situation

Unemployment in the euro area has already dropped close to historically low pre-crisis levels. In July, the unemployment rate was 7.5%. This reflects, in particular, the decline in the unemployment rate in Germany to a record low of 3%. In contrast, of the large euro area countries, the rate of unemployment is still well above pre-crisis levels in Spain and Italy. The pace of decrease in unemployment has, however, slowed in 2019, and in some Member States, e.g. Belgium, the unemployment rate has remained more or less unchanged.

According to current estimates, the unemployment rate is already slightly below e.g. the NAIRU[12], i.e. equilibrium unemployment, as estimated by the European Commission (Chart 19). According to the ECB, unemployment is projected to decline further, despite the deceleration in activity. On the other hand, the deceleration of economic activity may be reflected in unemployment rates slowly, as, in the event of a deterioration in demand, companies first reduce the number of hours worked and use labour market flexibilities, for example the time credit system. Germany is in fact already witnessing a slight decrease in the number of hours worked per employee, following the upward trend in 2018.

Chart 19



The employment market has thus far been supported by the increase in the labour participation rate, particularly among older cohorts. The participation rate of 15–64-year-olds has already climbed to the level of the United States, i.e. close to 75%. Due to population ageing, future improvements in employment will require labour

11. The rise in 2015 and 2016 reflects Ireland's exceptionally large R&D investment, which levelled off in 2017 and 2018.

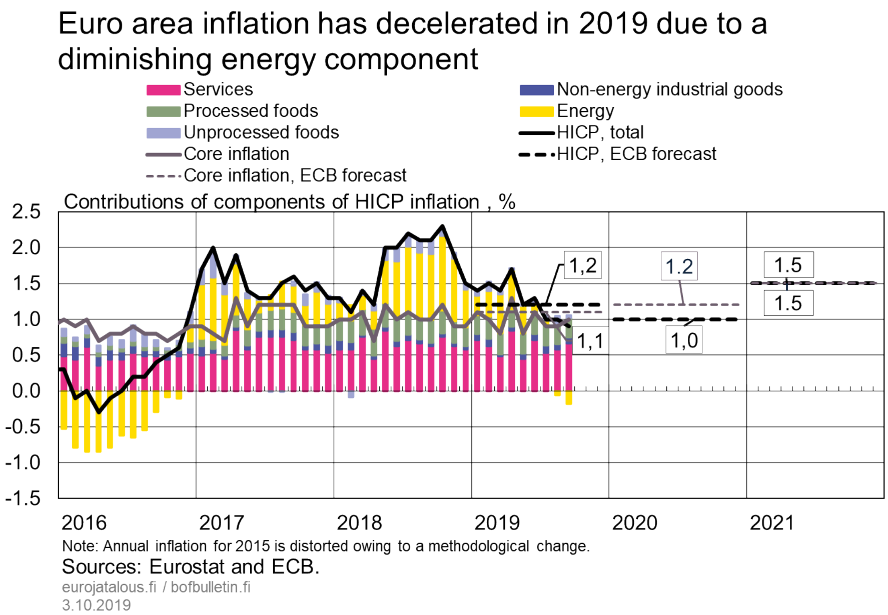
12. NAIRU refers to the non-accelerating inflation rate of unemployment.

market reforms that would support the labour market participation of young people, in particular. The participation rate of the young is still below pre-crisis levels.

Inflation outlook dampened by expectations shortfall

The pace of rise in prices in the euro area has decelerated since the 1.8% recorded in 2018. During summer 2019, headline inflation slowed to 1%. The decline in inflation is almost entirely due to a slowdown in energy price growth, largely attributable, in turn, to developments in the oil price. Annual growth in the price of oil has turned notably negative in 2019, significantly reducing the energy component's contribution to headline inflation (Chart 20). The ECB’s September 2019 macroeconomic projections predict headline inflation of 1.2% in 2019, 1.0% in 2020 and 1.5% in 2021.

Chart 20

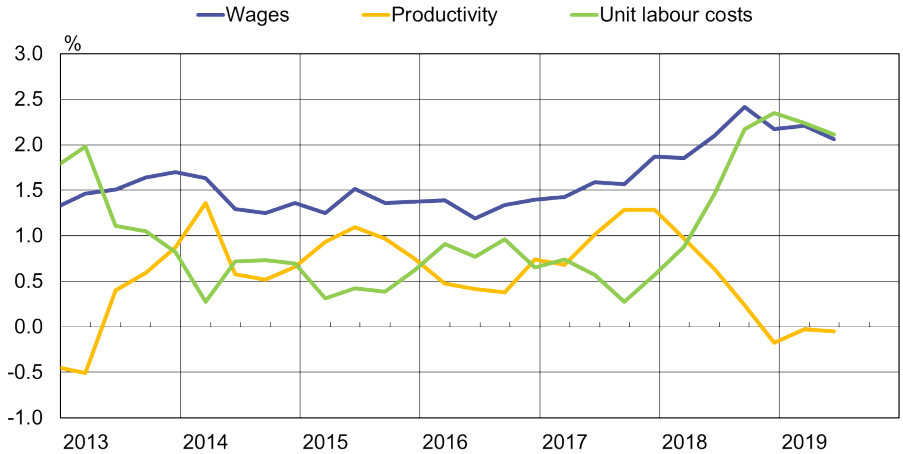


Core inflation in the euro area has stood at an annual rate of about 1% for six years now. Core inflation, which omits the effects of changes in energy and food prices, reflects the euro area's domestic cost pressures. The ECB’s September projections forecast core inflation picking up slightly, from 1.1% in 2019 to 1.2% in 2020, and again to 1.5% in 2021.

Wage inflation has gathered pace in recent years. Wage growth does not give rise to inflationary pressures, however, when labour productivity increases at the same time, as a higher wage bill then corresponds with a larger quantity of goods produced. This can be measured by unit labour costs. As wage inflation started to pick up in the euro area, labour productivity also increased at first, leaving little room for price pressures to build up (Chart 21). The sharp cyclical decline in productivity at the turn of 2018/2019 resulted in a substantial rise in unit labour costs. Unit labour costs are expected to level out, however, as soon as productivity growth begins to normalise. Indeed, the rise in unit labour costs has so far remained absent from inflation, with firms having instead lowered their profit margins for the time being.

Chart 21

Unit labour cost growth has accelerated as productivity growth has declined



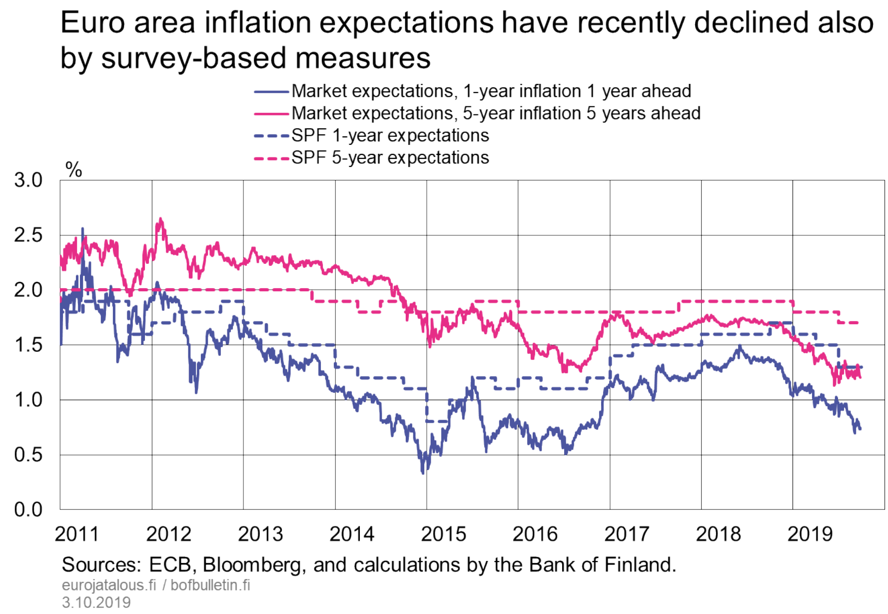
Source: ECB.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Capacity utilisation in the euro area is approaching full capacity, and this is contributing to an accumulation of cost pressures. Unemployment is below the NAIRU, and the output gap, which reflects the difference between measured aggregate output and its potential level, has closed according to various estimates.

Euro area inflation expectations have been steadily declining for a year now, in terms of both market-based measures and survey-based measures (Chart 22). Short-term inflation expectations have fallen in response to the deteriorating cyclical outlook and one-off shocks, such as movements in the price of oil. By contrast, longer-term inflation expectations reflect how economic agents perceive inflation in the long term, extending over business cycles. Accordingly, longer-term market-based measures reached historical lows during the summer and still remain very low.

Similarly, longer-term measures based on the ECB's Survey of Professional Forecasters (SPF) are also lower than ever before, although remaining appreciably above market-based measures. The fall in longer-term inflation expectations is troubling, as muted expectations can eventually lead to a self-perpetuating cycle of low inflation.

Chart 22



The probability distribution for expected inflation can also be derived from market information. This distribution has recently skewed towards lower levels of inflation, which reflects the aforementioned decline in market expectations. Since the summer, the odds of inflation falling below 1% have increased markedly, but the probability of deflation has not significantly increased.

Overall, the near-term outlook for euro area inflation is muted, with inflation projections having been widely downgraded. Euro area inflation is set to remain well below 2% in the medium term. In 2019 and 2020, inflation will be constrained by oil price base effects, barring significant developments in the oil price. Inflation will gradually accelerate towards the end of the forecast period, but will remain moderate. Inflation will be supported by continued robust labour market developments. It would be of paramount importance, however, for inflation expectations to rise to ensure the sustained convergence of inflation towards the ECB's inflation aim of below, but close to, 2%.

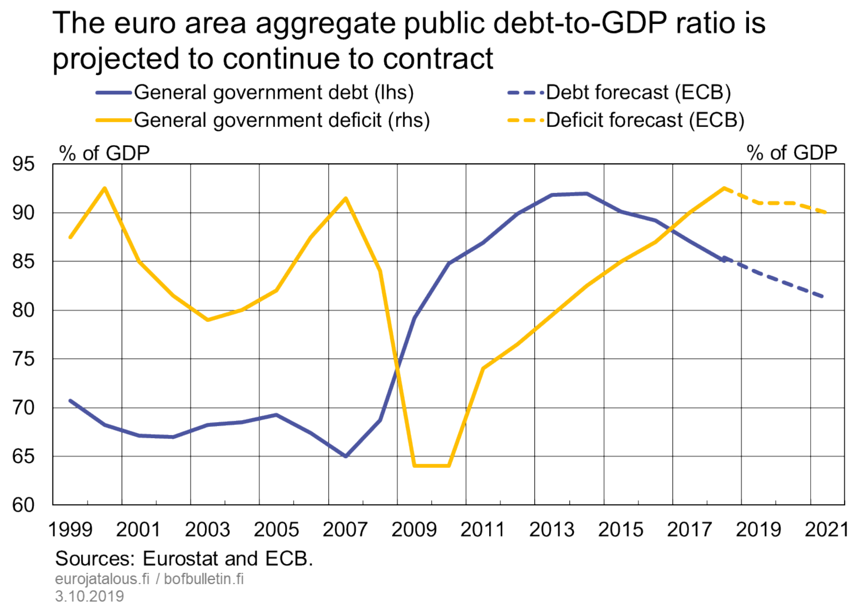
Euro area fiscal stance mildly expansionary

The aggregate fiscal stance for the euro area is forecast to be mildly expansionary in 2019, and the aggregate general government deficit ratio is expected to increase from 0.5% of GDP in 2018 to slightly below 1% of GDP in 2019 (Chart 23). The fiscal stance is currently contributing some support to the expansion of economic activity in the euro area. At the press conference[13] following its monetary policy meeting in September, the Governing Council of the ECB stressed that governments with fiscal space should act in an effective and timely manner to pursue growth-supporting measures. On the other hand, in countries where public debt is high, governments need to pursue prudent policies that will create the conditions for automatic stabilisers to operate freely.

13. Watch the introductory statement to the press conference following the ECB Governing Council's September monetary policy meeting.

The euro area aggregate public debt-to-GDP ratio is projected to gradually decline from its current level of about 85% of GDP. Yet significant differences still persist with respect to each country’s level of public debt. In France and Spain, general government debt stood at almost 100% of GDP in 2018, while Italy and Germany had public debt-to-GDP ratios of 130% and about 60%, respectively. These differences are expected to remain sizeable, as, of the large euro area economies, only Germany's public debt is shrinking.

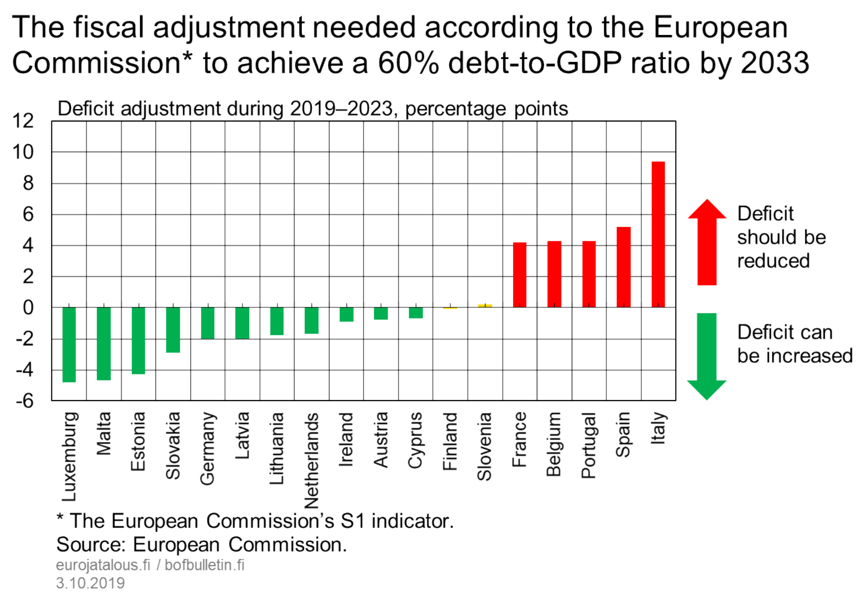
Chart 23



A sustainable level of general government debt allows for effective countercyclical fiscal policy. One measure of the sustainability of public debt over the medium term is the European Commission's S1 indicator (Chart 24). This shows the additional fiscal adjustment required to reach a 60% public debt-to-GDP ratio, as stipulated in the Growth and Stability Pact, by 2033. By this measure, only Germany and the Netherlands would appear to have meaningful fiscal space when looking at the euro area's large economies. By contrast, Italy, Spain and France would each have to narrow their fiscal gaps over the next few years to achieve a 60% public debt-to-GDP ratio. [14]

14. This is based on the European Commission's S1 medium-term fiscal sustainability indicator as outlined in its 2018 Fiscal Sustainability Report. The S1 indicator is by itself, however, only one measure of risk to medium-term fiscal sustainability and should not be taken as a policy recommendation.

Chart 24



The fiscal adjustment needed according to the European Commission* to achieve a 60% debt-to-GDP ratio by 2033

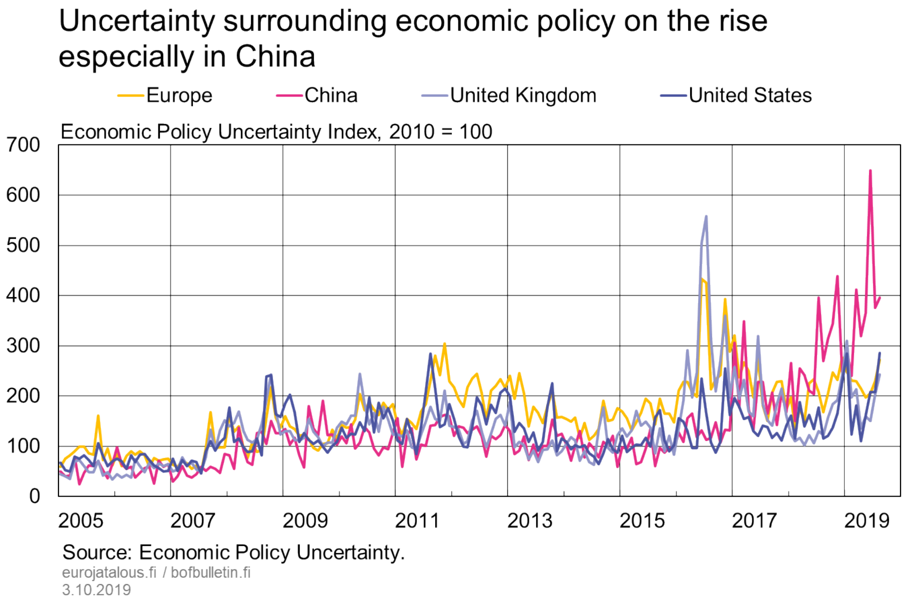
* The European Commission's S1 indicator.
Source: European Commission.
eurojatalous.fi / bofbulletin.fi
3.10.2019

Several euro area countries face prominent long-term fiscal sustainability risks relating especially to population ageing. According to an assessment by the Commission, high-level fiscal sustainability risks are associated with Belgium, Spain, Italy and Luxembourg. In addition, ten Member States face medium-level risks. Fiscal sustainability assessments are heavily influenced by growth forecasts and projected yields on long-term sovereign bonds.

Growth risks skewed to the downside on account of trade war and Brexit

Some of the risks identified in earlier forecasts relating to trade war escalation, the slowing of the Chinese economy and the United Kingdom's withdrawal from the EU have already materialised to an extent. The Economic Policy Uncertainty index has risen markedly over the course of the year (Chart 25), and the balance of growth risks remains tilted on the downside.

Chart 25



The United Kingdom's new withdrawal date from the European Union is set for the end of October. The odds of a no-deal Brexit may have increased, although according to the law the Government is required to seek an extension to the withdrawal date if a divorce deal fails to win support in Parliament. A no-deal Brexit would prove highly disruptive to the economies of the United Kingdom and the remaining EU Member States. The impact would be significant especially for the Republic of Ireland, but also for other key trading partners of the United Kingdom. The impact for any given country will depend on its external trade volume, its supply-chain crossovers, and its financial connections. An orderly no-deal departure would entail adopting World Trade Organization rules for foreign trade. Under this scenario, the remaining EU area's aggregate real GDP would decline by 0.3–1.5% in the long term, depending on the impact assessment and compared with a situation where the United Kingdom would not leave the EU.[15] In the case of a disorderly departure, this outlook would be further exacerbated by financial market disruption. Nevertheless, different assessments suggest that most of the decline in aggregate output caused by a no-deal Brexit would fall on the United Kingdom. In the Bank of England's worst-case scenario of a disorderly no-deal withdrawal, the United Kingdom's real GDP would contract by about 5.5% in the short term.[16] Overall, impact assessments suggest that the negative impact on GDP in EU countries would, on average,

15. The National Bank of Belgium's January 2019 report on different impact assessments published during the past two years. The results are based on seven different impact assessments: link.
16. The Bank of England's Brexit calculations from November 2018: https://www.bankofengland.co.uk/report/2018/eu-withdrawal-scenarios-and-monetary-and-financial-stability that were updated in September 2019: https://www.bankofengland.co.uk/-/media/boe/files/letter/2019/governor-letter-to-chair-of-tsc-re-updated-brexit-scenarios.pdf?la=en&hash=2E567C985959FCF2D80A4F803A7D17392E2855DE. In September 2019 the impact on GDP was estimated to be 2 percentage points smaller than in November 2018, largely owing to various sectors successfully preparing for a no-deal scenario. In terms of severity, the Bank of England's calculations are at the high-end of different impact assessments. For instance, the OECD's latest calculations, published in September 2019, estimate a no-deal withdrawal as having a 2% smaller effect on GDP in the immediate following years than the Bank of England's baseline forecast.

be about 10–30% of that suffered by the United Kingdom.

The trade dispute between the United States and China escalated further during the summer and has already had a clear impact on economic developments (The trade war has significantly weakened the global economy). It would appear that the trade dispute is set to drag on, threatening to increase the barriers to international trade.[17] The rise of protectionist policies weakens growth conditions and may in the worst case even precipitate severe financial market disruption.

There are already signs of the trade dispute affecting the Chinese economy, which has also been weakened by domestic issues. The weakening of the economy together with a worsening debt problem means that episodes of market disruption may become more frequent. A sharp decline in Chinese growth could have considerable effects on the global confidence climate, on commodity prices and international trade, and on global growth. A slowdown in China would also exacerbate issues in other emerging economies.

Tags

euro area, global economy, inflation, monetary policy

17. The economic impact of protectionist measures has been estimated in the following articles, among others: Bank of Finland Bulletin (1/2019) Alternative scenarios linked to the global impact of US fiscal and trade policies, published 3 April 2019; Bank of Finland Bulletin (4/2018) Trade policy tensions casting shadow on economic horizon, published 18 October 2018, and ECB (2018) Implications of rising trade tensions for the global economy, ECB Bulletin 3/2018.