 Key messages

# Euro area POLICY BRIEF

# October 2015

* Global growth likely remained subdued and uneven in 2015Q3. The latest IMF projections point to a somewhat weaker recovery in 2015 and 2016. Risks to the global outlook remain on the downside with increasing risks to growth in emerging economies, in particular China. A negative shock to domestic demand in China is not likely to derail the recovery in advanced economies (including the euro area) unless combined with adverse financial and confidence effects.
* In September, euro area inflation returned to negative ground driven by further falls in the energy component. The contribution of core goods and services prices has remained relatively stable over the last few months, but it is still premature to say that core inflation has reached a turning point. Risks to the euro area inflation outlook remain tilted to the downside. Longer-term survey-based inflation expectations are currently close to 2%, while market-based expectations broadly stabilised after the decline recorded in July/August, close to the extremely low levels reached in the beginning of 2015.
* Euro area GDP continued to increase in 2015Q2, on the back of domestic demand and net trade. Economic indicators for Q3 support the September MPE growth path. The uncertain situation in Greece, as well as protracted weak demand and low inflation are sources of downward risks. Euro area credit continues to improve gradually, as reported in the latest BLS, but overall conditions are still weak and heterogeneous across countries.

Policy recommendation

* Incoming data since the last meeting of the Governing Council point to a somewhat weaker outlook for euro area inflation over the policy relevant horizon with the balance of risks still tilted on the downside. The economic recovery appears to be proceeding broadly as expected, but slack remains large which may imply that domestic price pressures will remain muted for some time. In this context, further monetary policy measures may be needed to achieve a sustained return of inflation to levels close to 2%. Thus, a discussion about the suitable policy options is paramount to entrust the Governing Council with the means to act as soon as in December if needed (when the Eurosystem’s projections will be disclosed). Meanwhile, communication should continue to signal readiness to act and the ability to do so.
* Further policy options include both adjustments to measures already in place and announcing new ones. The choice should be guided by their effectiveness in providing additional monetary easing and in addressing remaining fragmentation problems. Given the uncertainty underlying the interpretation of the current prolonged episode of low interest rates and of low inflation, further policy support should focus on quantitative instead of interest rate-based measures. In particular, promises to keep interest rates low for long should not be pursued without being carefully pondered.

Global

economy

Global activity growth (outside the euro area) remained modest in 2015Q3. GDP likely grew at a steady pace in the US and the UK sustained by resilient domestic demand, in particular consumer spending, and improving labour market conditions. Despite this, the Federal Reserve kept interest rates unchanged in September in light of heightened uncertainty about the global economy and a slightly softer expected path for inflation. FOMC participants project inflation to be 0.4% in 2015 (‑0.3 p.p. than in June, largely reflecting lower energy and import prices) and to increase gradually to 2% in 2018. The outlook for growth and unemployment improved somewhat for 2015, but remained broadly unchanged in the medium term. Most participants continue to expect an increase in the federal funds rate this year. In Japan, the economy is expected to have rebounded in 2015Q3 as temporary factors that held down activity in Q2 fade, but available information for industrial production and exports cast some doubts about the strength of the recovery. In China, recent developments had a limited impact on the outlook for 2015/2016, but policy-related economic uncertainty increased markedly (Chart 1). In 2015Q3, China y-o-y growth pace was similar to the previous quarter (6.9%). The latest IMF forecasts (October 2015 WEO) point to a somewhat weaker recovery of the world economy in 2015 and 2016 than envisaged in the July Update, mainly due to lower growth in commodity exporters. Global growth (outside the euro area) is projected at 3.3% in 2015 and 3.9% in 2016. Activity is expected to pick up gradually in advanced economies, but growth prospects remain subdued. Activity in emerging economies is expected to slow down further in 2015 before picking up again in 2016, reflecting a normalisation of economic conditions in countries in distress (Russia, Brazil and some commodity exporters in Latin America). Growth in China is expected to decline over the forecast horizon (to 6.8% in 2015 and 6.3% in 2016, unchanged from July). World trade growth is projected to remain modest, as in the past two years. World trade (excluding the euro area) will continue to grow at a pace below or similar to that of GDP. The balance of risks to global growth remains on the downside with increasing risks in emerging economies. In particular, there is a risk of a sharper slowdown in China related to the transition towards more consumption-driven growth. Given the increased weight of China in the global economy, this would – all else equal – drag world GDP and trade down (Chart 2). In addition, a slump in final demand in China would also imply spillovers to other countries. The impact would be larger in China’s neighbours and in commodity exporters. The propagation to the euro area and the US could be fairly limited, despite the increase of exports to China in past years. The degree of exposure might be higher than the one suggested by trade links due to possible knock-on effects from weaker Chinese growth in other countries and indirect effects from financial contagion and confidence deterioration.

Inflation

Euro area HICP y-o-y rate of change fell from 0.2% in July to 0.1% in August and to -0.1% in September, standing marginally below the September 2015 NIPE projections. The decrease was mainly due to further falls in the energy component (from -5.6% in July to -7.2% in August and to ‑8.9%). Compared to the NIPE, y-o-y rates of all the main aggregates except unprocessed food stood below the forecast in the past two months, especially energy. The HICP excluding food and energy has increased at a steady pace over the last few months, with the y-o-y growth rate standing at around 0.9%. Looking at a broad range of indicators of underlying inflation, it is noticeable that the decreasing trend observed since 2012 has been interrupted, albeit standing at historically low values (Chart 3). Inflationary pressures in the euro area remain muted. Pressures originating from the labour market remain contained as the y-o-y growth rate of unit labour costs stood at 0.8% in 2015Q2 (0.9% in Q1), with compensation per employee growth stable at 1.4%. Producer prices continued to fall up to August (y-o-y), even when excluding energy. Regarding external price pressures, after the considerable fall recorded throughout the summer months, the international price of oil did not change significantly on average up to mid-October, standing about 40% below the year-ago level. The mechanical update of the September 2015 MPE projections, based on the PUE and updated assumptions, implies downward revisions of euro area inflation over the projection horizon driven by a more appreciated euro exchange rate and lower oil prices, to 0.0% in 2015, 0.9% in 2016 and 1.4% in 2017. Recent forecasts for 2015/2016 by private analysts, the IMF (October WEO), the OECD (December Economic Outlook – preliminary) and the 2015Q4 SPF are slightly higher than the updated projections (at 0.1/0.2% in 2015 and 1.0/1.1% in 2016). For 2017, available forecasts point to an inflation rate in the range of 1.3-1.5%. Longer-term inflation expectations in the 2015Q4 SPF (4-5 years ahead) remained at 1.9%, slightly higher than the October Consensus. Inflation expectations implied in market instruments broadly stabilised after the decline recorded in July/August, close to the extremely low levels reached in the beginning of 2015.

Economic

activity

Euro area GDP q-o-q growth in 2015Q2 was marginally revised upwards to 0.4% (0.5% in Q1). Private consumption grew by 0.4%, a pace slightly below that of the previous quarter, but GFCF decelerated markedly from 1.4% to -0.5%, to a large extent due to the slowdown in construction. Net exports posted a positive contribution to GDP growth (0.3 p.p.), as exports accelerated and imports decelerated. Growth in Q2 turned out slightly higher than expected in the September MPE (0.3%) and the demand breakdown is broadly in line with the September forecasts, except for the weaker GFCF (0.4% growth in the MPE). Economic indicators available for Q3 suggest the maintenance of steady growth. The composite output PMI stood at roughly the same level as in Q2 while the European Commission economic sentiment indicator increased further. Confidence in industry remained at the same level as in the previous quarter, while confidence in services, in retail trade and in construction increased. In contrast, consumer confidence decreased in Q3, given deteriorating expectations concerning the general economic conditions and unemployment, but remains well above its 10-year average. Regarding the euro area labour market, employment increased by 0.3% q-o-q in Q2 (0.2% in Q1), while the y-o-y growth stood at 0.9% (0.8% in Q1). The PMI suggests an increase in Q3 at a broadly similar pace. In August, the unemployment rate remained unchanged at 11.0%, considerably above the average level since 1999 (9.5%). Recent forecasts by the IMF put GDP growth in the euro area at 1.5% in 2015 and 1.6% in 2016, only marginally revised downwards compared to the July Update. This compares with a MPE projected growth of 1.4% in 2015 and 1.7% in 2016. According to the IMF, contagion risks related to the situation in Greece remain a concern and risks from protracted weak demand and low inflation remain. Over the medium-term, there are also risks that potential output growth is lower than expected. Recent forecasts by the OECD and private sector analysts point towards 1.5% growth in 2015 and 1.7/1.8% in 2016.

Monetary

and

financing

conditions

Bank lending in the euro area has been improving but remains very weak. The annual growth of MFI loans to the private sector reached a trough in 2014Q1 and has been steadily increasing since then. This reflects an improvement in both loans to NFC and to households. In August, lending to the private sector increased by 0.8% (0.7% in July).[[1]](#footnote-2) After having fallen for more than 3 years, loans to NFC recorded the second increase in a row in August (0.4% in annual terms after 0.3% in July), mainly due to the expansion in short-term loans. The annual growth rate in loans to households was broadly stable in the euro area (1.0%) and in most euro area countries. The maintenance of still weak credit growth, namely to NFC, should be seen against developments in economic activity, as growth in real MFI loans to NFC tends to lag that of GDP (Chart 4). In fact, the weak recovery in real lending seems broadly in line with that of real activity. Still, differences exist across countries. Among major euro area countries, in France real credit is growing strongly when compared to GDP developments. In order to assess the level of credit, one can look at the credit-to-GDP gap. Until 2015Q1, and with the notable exception of France, credit-to-GDP gaps continue negative in many euro area countries and the euro area as a whole (Chart 5). While for the euro area as a whole the decreasing trend has already reversed, in peripheral countries the gap continues to widen. Regarding euro area MFI interest rates on new loans, they have been showing a decreasing trajectory and the dispersion has been falling, in contrast with the trajectories seen at the time of the sovereign debt crisis especially in the case of NFC. But dispersion still remains high. For NFC loans, the spread in rates between core and peripheral countries is close to 60 b.p., below the maximum of around 180 b.p. registered in mid-2013, but still above the levels seen prior to crisis. In August, interest rates on new loans stood at 1.8% in loans to NFC and at 3.0% in loans to households (compared to around 3.5% and 4.5% at the end of 2011, respectively). The 2015Q3 BLS confirms the message of improving bank credit market in the euro area. Credit standards on loans to NFC eased further and loan demand also increased relative to the previous quarter. The improvement was mostly on account of loans to SME. Pressure from competition from other banks continues to be the main factor explaining the easing in credit standards, followed by risk perception on sector or firm. The increase in demand was related to the general level of interest rates and also to firms’ financing needs. Credit standards on loans for house purchase or for consumption remained virtually unchanged relative to Q2, while demand increased further. Similarly to loans to NFC, pressure from competition from other banks led to an easing in credit standards and demand was mostly driven by the general level of interest rates, but also the housing market prospects. Banks continued to report a broadly positive impact of the APP on their financial situation, especially on the market financing conditions. The additional liquidity is reported as being used firstly for granting loans to enterprises and consumer credit. Moreover, banks report that the APP has contributed to an easing in terms and conditions for these types of loans.

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| **Chart 1** |
| **China’s growth outlook** |
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| Sources: Aspen Publishers, Consensus Economics, The Economist and Baker, Bloom and Davis – “Measuring Economic Policy Uncertainty” at [www.PolicyUncertainty.com](http://www.PolicyUncertainty.com).  Note: Monthly GDP forecasts correspond to the average of Blue Chip, Consensus and The Economist. |

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| **Chart 2** |
| **How important is China?** |
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| Sources:BP, IMF, OECD, United Nations, World Bank and Banco de Portugal calculations.  Note: Latest data for world industrial production: 2013. The share in world trade is the sum of China’s exports and imports of goods as a percentage of world total. Metals: aluminum, copper, lead, nickel, tin and zinc. Non-oil commodity exporters: Chile, Australia, South Africa. Oil exporters: Saudia Arabia, Brunei, Russia. The indicator shown in the chart on the right measures the valued added generated in each exporting country that is finally absorbed in China, as a percentage of total domestic value added of the exporting country. By measuring trade in valued added terms it allows for the exclusion of the import content of exports and thus better illustrates the impact of final demand in foreign markets on domestic output. |
| **Chart 3** |
| **Euro Area HICP underlying inflation measures** |
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| Sources: Eurostat, SDW and Banco de Portugal calculations.  Note: The shaded area represents the range between the minimum and maximum of the following underlying inflation indicators: 10% and 25% trimmed means, standard deviation weighted indicator, HICP excluding food and energy, HICP excluding unprocessed food and energy, and the first principal component of three different HICP item disaggregations (subindices, main aggregates and an intemediate aggregation level). |

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| **Chart 4** |
| **Real growth of euro area MFI loans and GDP** |
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| Sources: ECB, Eurostat and Banco de Portugal calculations. |

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| **Chart 5** |
| **Credit-to-GDP gap in the euro area** |
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| Source: BIS and Banco de Portugal calculations.  Note: Calculated as the HP filtered (or cyclical component) ratio of total credit to the non-financial private sector over nominal GDP (with a lambda of 400 000). The starting point is different for each country depending on the availability of data. Last available point: 2015Q1. |

1. In the August release, the ECB implemented a methodological change on loans adjusted for sales and securitisation that allows taking into account, on an ongoing basis, stocks and repayments of derecognised loans. As a result, adjusted flows and growth rates are in general lower. For the 12 months up to July 2015, the growth rates of loans to the euro area private sector, households and non-financial corporations have been revised downwards, on average by 54 b.p., 77 b.p. and 41 b.p., respectively. [↑](#footnote-ref-2)