 Key messages

# Euro area POLICY BRIEF

# December 2015

* Global activity remained subdued until 2015Q3. The December 2015 MPE continues to project a gradual strengthening until 2017 but worsened somewhat when compared to September, in particular for emerging economies. Global imports recorded a fall in 2015H1 and are expected to remain rather weak relative to GDP growth over the projection horizon. Risks remain tilted to the downside.
* Euro area HICP inflation increased slightly in October, interrupting the energy-driven downward path initiated in June. In the December 2015 MPE, inflation is projected to have an erratic behaviour in coming months before increasing gradually from 2016Q3 onwards. This increase is expected to proceed at a slower pace than envisaged in the September 2015 MPE but the level attained at the end of the projection horizon is unchanged (1.7%). Risks are considered to remain mostly on the downside.
* Euro area GDP slowed marginally in 2015Q3 likely on account of net exports. The December 2015 MPE reaffirms the expectation of a gradual recovery, increasingly supported by domestic demand. Bank lending continues to improve at a moderate pace. However, banks’ and firms’ funding costs developments have been less favourable lately. Risks to the outlook remain skewed to the downside.

Policy recommendation

* The euro area economic recovery has continued to proceed gradually but remains muted by past standards. Inflation has remained very low for some time and the return to levels close to 2% will be even slower than expected six months ago, mostly on account of less favourable developments in the external environment. HICP inflation is now projected to be 1.0% in 2016 and 1.6% in 2017 (1.5 and 1.8%, respectively, in June). These projections rest on technical assumptions that already incorporate financial markets expectations about further monetary policy easing. Moreover, the Eurosystem’s assessment of risks to the inflation outlook has become skewed to the downside over the last six months.
* The policy measures taken by the ECB since mid-2014 have provided some support to the euro area economy. However, the latest external developments and their impact on the balance of risks raise the question of whether the unfolding monetary accommodation is sufficient to achieve the objective. Although current inflation prospects are not as dreary as in last January, further action seems warranted. Not only the most likely path of future inflation has drifted away from the objective but also inflation expectations indicators suggest that agents are not yet incorporating a return of inflation to levels close to 2% in a relevant medium-term horizon. Among the policy options recently discussed in the Committees, an extension of the APP is favoured due to its likely impact on activity and, with more uncertainty, on inflation as well as to address remaining fragmentation issues. On the contrary, further cuts in policy interest rates are considered undesirable on the basis of a cost-benefit analysis. For a detailed discussion see the note “Further ECB’s monetary policy measures – a discussion”, November 2015.

Global

economy

Global activity (outside the euro area) remained lacklustre in 2015Q3, as GDP growth eased in the US (from 1 to 0.5% q-o-q) and in the UK (from 0.7 to 0.5%) and remained in negative territory in Japan (-0.2% for the second consecutive quarter). Growth momentum in emerging economies likely remained subdued, with still poor economic conditions in Brazil and Russia offsetting an upturn in some smaller emerging economies. Looking ahead, the December 2015 MPE continues to project a gradual strengthening of global activity, with growth outside the euro area projected to increase from 3.1% in 2015 to 3.9% in 2017 (Table 1). The projected acceleration is driven by resilient growth in advanced economies and a modest pick-up in emerging economies stemming to a large extent from the surpassing of recessions in Brazil and Russia. In China, activity is foreseen to continue to slow down gradually over the projection horizon (to 6.3% in 2017). Compared to the September 2015 MPE, global growth was marked down in both 2015 and 2016 (-0.1 and -0.2 p.p., respectively), reflecting a weaker outlook for emerging economies, but also less favourable prospects in major advanced economies in 2016. Global trade recorded a sharp contraction in 2015H1, a development not seen since the crisis (Chart 1). Import volume (outside the euro area) likely picked up in 2015Q3, but is expected to remain restrained in the near term. In contrast to recent years, the overall slowdown in 2015 is largely driven by a decline in imports in emerging economies. A number of factors likely contributed to this, namely falling domestic demand and exchange rate depreciation in Brazil and Russia (where sanctions also played a role) and the rebalancing of the Chinese economy (consumption and services are less import intensive than investment and industrial production). This might have also reduced China’s demand for commodities and negatively affected activity and imports in commodity producer countries. In 2016 and 2017, world imports (excluding the euro area) are projected to improve gradually, but at a pace clearly below than would have been expected on the basis of the historical relationship with GDP growth (Chart 1). Indeed, the global trade elasticity has been marked down further, reflecting the judgement that the high share of emerging economies in world trade together with cyclical (e.g. weak investment) and structural headwinds will continue to dampen import growth. In this context, euro area foreign demand projections were significantly revised downwards compared to the September 2015 MPE (Table 1). This reflects not only lower than previously envisaged growth in emerging economies, but also in other important euro area trade partners (e.g. UK and Switzerland). Risks to the outlook for global trade and activity remain tilted to the downside, more prominently for emerging market economies.

Inflation

In October, euro area HICP y-o-y rate increased to 0.1% (-0.1% in September), reflecting increases in all components except processed food. This increase in headline inflation interrupted the gradual downward path initiated in June largely driven by more negative contributions from energy prices. Core inflation (excluding food and energy) rose from 0.9 to 1.1% in October, continuing its uneven upward profile. This notwithstanding, core prices remain subdued by past standards, having grown at or below 1.1% since 2013Q2 (Chart 2). Over that period, the output gap (measured as deviation of actual from potential GDP, as a % of potential GDP) has been narrowing at a relatively slow pace while remaining at quite negative levels. The fall of the unemployment gap (measured as difference between the unemployment rate and NAIRU) has proceeded faster but the gap remains positive and there are no indications of a pick-up in wage growth. Looking ahead, the December 2015 MPE projects an erratic behaviour of headline HICP inflation in the next months, reflecting developments in energy prices. This profile is partly shaped by base effects related to oil prices, which will be particularly large at the turn of the year and again after mid-2016. From 2016Q3 onwards, HICP inflation is projected to rise gradually, reaching 1.7% in the two last quarters of 2017. Core inflation is expected to present a steady upward trend over the projection horizon and stand at 1.7% in 2017Q4. In annual average terms, HICP inflation will increase from 0.1% this year to 1.0% in 2016 and 1.6% in 2017 (Table 1). Compared to the September 2015 MPE, headline inflation is projected to rise at a somewhat slower pace, especially in 2016. Note that as in the previous MPE, euro area inflation is being revised downwards (the cumulative revision amounts to -0.5 p.p. in 2016 and -0.1 p.p. in 2017), repeating the pattern observed throughout 2014. However, the factors behind these revisions are different (Chart 3). The revisions observed in 2014 both for one and two years ahead resulted mostly from a weaker outlook for HICP excluding energy, mainly on account of factors (other than assumptions) such as lower than projected wage growth. In the two latest MPE, revisions for 2016 are primarily driven by weaker energy prices while for 2017 revisions are again driven by HICP excluding energy but, this time, mostly due to lower external assumptions (foreign demand and indirect effects from lower oil prices). The December 2015 MPE projections for euro area inflation are broadly similar to those recently released by private forecasters and the European Commission. In turn, the latest OECD projections entail lower inflation, especially for 2017 (1.3%), reflecting not only weaker assumptions for oil prices but also lower core inflation. The balance of risks to the MPE inflation outlook is considered to remain on the downside, with key downside risks being lower external demand and a de-anchoring of inflation expectations. Longer-term euro area inflation expectations ‒ as measured by inflation-linked swaps 5-year rates 5-year ahead ‒ rebounded in the beginning of the year but a good part of those gains has been eroded during the summer. Notwithstanding some increase observed since end-October, expectations still stand at historical low levels.

Economic

activity

According to the Eurostat’s flash estimate, euro area GDP q-o-q growth decreased again slightly in 2015Q3 to 0.3% (after 0.5% in Q1 and 0.4% in Q2). Available information points to a continued positive contribution from domestic demand, notably from private consumption. In contrast, the contribution from net trade was likely negative. The economic recovery since the 2013Q1 trough has been proceeding at a rather modest pace by historical standards (Chart 4).[[1]](#footnote-2) In particular, export growth has been unusually weak while domestic demand has evolved more in line with previous recoveries. Despite the slower recovery in output, employment has been picking up at a relatively faster pace, mostly as a result of a more resilient than usual behaviour in the industry sector. Looking ahead, survey indicators in October/November stood in general slightly above their previous quarter averages, suggesting steady activity growth. The December 2015 MPE projects GDP q-o-q growth to stand at 0.4% in the next two quarters and to increase to 0.5% thereafter. According to these projections, the euro area will return to its pre-crisis GDP level in 2016Q1, i.e. it will take 32 quarters to reach the pre-crisis peak (compared to 15 and 19 quarters, respectively, in the US and the UK). In annual average terms, euro area GDP growth is projected to increase from 1.5% this year to 1.7% in 2016 and 1.9% in 2017 (Table 1), broadly in line with recent projections by private analysts and international organisations. Compared to the September 2015 MPE, the projection for 2015 was marginally revised upwards, mostly on account of past data, while the outlook for the next two years is unchanged. Nonetheless, domestic demand is now projected to have a stronger contribution to GDP growth, while exports were revised downwards. Employment is projected to grow at 1.0% per year in 2015-2017, above the September MPE projections (0.7/0.8%). Improvements in economic activity, fiscal incentives in some countries, wage moderation, past labour market reforms and a gradual, though limited, integration of refugees in the labour market should have a supporting role in employment developments. The balance of risks to the euro area growth outlook remains skewed to the downside, with external factors as key downside risks.

Monetary

and

financing

conditions

Euro area bank lending continued to expand in recent months, though growth remains low. In October, the annual growth rate of loans to the private sector was 0.8%, after a slight moderation in September largely on account of a momentary strong fall in loans to NFC in the Netherlands. Loans to NFC annual growth rose to 0.6% (compared to 0.2 and 0.1% in August and September, respectively) while loans to households continued their gradual upward trend, reaching 1.2%, the highest value since January 2012. Regarding euro area bank lending rates, the previous declining trend seems to have come to a halt in 2015Q3 in the case of loans to households (Chart 5). The interest rate on new loans to households increased again slightly in September to 2.99% (around 10 b.p. above the level in June). This increase was visible in various core countries, notably in Germany, while rates in peripheral countries continued to fall. In the case of euro area interest rates on new loans to NFC, there was an increase in September (by 10 b.p.) but it is still not clear if it denotes an inversion of trend. It is worth mentioning that the latest developments in the costs of funding of both MFI and NFC in the euro area have been less favourable than before, largely on account of an increase in their cost of market-based funding. Nonetheless, their nominal costs of funding remain at very low levels.

|  |  |
| --- | --- |
| **Chart 1** | |
| **World imports of goods and services (excluding the euro area)** | |
| **Contributions to q-o-q and annual growth** | **Elasticity of imports to GDP growth** |
|  | |
| Sources: ECB/Eurosystem and Banco de Portugal calculations.  Note: The trade elasticity is computed as the ratio between imports and GDP growth. | |

|  |  |  |  |
| --- | --- | --- | --- |
| **Chart 2** | | | |
| **Euro area – Prices, costs and measures of economic slack** | | | |
|  | | | |
| Sources: Eurostat and ECB.  Notes: The last quarter of core inflation (2015Q4) corresponds to the value observed in October 2015. The output gap is measured as deviation of actual GDP from potential GDP, as a percentage of potential GDP while the unemployment gap is equal to the difference between the unemployment rate and NAIRU estimates. The output and unemployment gaps correspond to the September 2015 MPE estimates. | | | |
| **Chart 3** | | | |
| **Euro area – Revisions of HICP inflation and components (in p.p.)** | | | |
| **Cumulative revisions in 2014** | | | |
| Year t+1 | | Year t+2 | |
|  |  |  |  |
|  | |  | |
| **Cumulative revisions in 2015H2** | | | |
| Year t+1 | | Year t+2 | |
|  |  |  |  |
|  | |  | |
| Sources: ECB/Eurosystem and Banco de Portugal calculations.  Notes: Cumulative revisions in 2014: March 2014 MPE to December 2014 MPE.  Cumulative revisions in 2015H2: September 2015 MPE to December 2015 MPE.  HICP revisions: decomposed into HICP excluding energy and Energy.  HICP excluding energy and Energy revisions: decomposed into those due to changes in projection assumptions (using the PUE) and those due to other factors. | | | |
| **Chart 4** | | | |
| **Euro area economic recoveries** | | | |
|  | | | |
| Sources: Eurostat, CEPR and Banco de Portugal calculations.  Note: The shaded area corresponds to maximum and minimum growth since the 1975Q1, 1982Q3, 1993Q3 and 2009Q2 troughs dated by the CEPR. In the latest recovery (trough: 2013Q1), data from T+10 onwards corresponds to the December 2015 MPE projection (dashed lines). | | | |

|  |
| --- |
| **Chart 5** |
| **Euro area - Interest rates on new loans to households** |
|  |
| Source: ECB.  Note: Peripheral countries include Italy, Spain, Portugal, Greece and Ireland. Core countries include Germany, France, Netherlands, Austria, Belgium and Finland. The composite interest rates are calculated by aggregating short and long-term rates using the monthly new business volumes. |

**Table 1**

|  |  |  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- | --- | --- |
| **Euro area − December 2015 Macroeconomic Projection Exercise** | | | | | | | | |
|  | Annual growth rates | | | |  | Revisions *vis-à-vis* September 2015 (a) | | |
|  | 2014 | 2015 | 2016 | 2017 |  | 2015 | 2016 | 2017 |
| **Prices and costs** |  |  |  |  |  |  |  |  |
| HICP | 0.4 | 0.1 | 1.0 | 1.6 |  | 0.0 | -0.2 | 0.0 |
| HICP excluding food and energy | 0.8 | 0.9 | 1.3 | 1.6 |  | -0.1 | -0.1 | 0.0 |
| HICP food | 0.5 | 1.0 | 1.1 | 1.5 |  | 0.2 | 0.1 | -0.2 |
| HICP energy | -1.9 | -6.7 | -1.6 | 2.4 |  | -0.3 | -1.1 | 0.1 |
| Unit labour costs | 1.1 | 0.9 | 0.9 | 1.2 |  | -0.1 | 0.2 | 0.1 |
| Compensation per employee | 1.4 | 1.4 | 1.5 | 2.1 |  | -0.2 | 0.0 | 0.0 |
| Productivity | 0.3 | 0.5 | 0.7 | 0.9 |  | -0.1 | -0.3 | -0.1 |
| Profit margin | -0.3 | 0.5 | 0.6 | 0.4 |  | 0.3 | -0.1 | -0.1 |
| *Effects of Government measures (p.p.):* |  |  |  |  |  |  |  |  |
| Administered prices (b) | 0.2 | 0.0 | 0.1 | 0.1 |  | 0.0 | 0.0 | 0.0 |
| Indirect taxes (b) | 0.1 | 0.1 | 0.1 | 0.0 |  | 0.0 | 0.0 | 0.0 |
| **Economic activity** |  |  |  |  |  |  |  |  |
| GDP | 0.9 | 1.5 | 1.7 | 1.9 |  | 0.1 | 0.0 | 0.0 |
| Private consumption | 0.8 | 1.6 | 1.9 | 1.7 |  | -0.1 | 0.2 | 0.0 |
| Government consumption | 0.8 | 1.4 | 1.2 | 1.0 |  | 0.7 | 0.4 | 0.3 |
| GFCF | 1.3 | 2.3 | 2.8 | 3.8 |  | 0.2 | -0.7 | -0.1 |
| Exports (c) | 4.1 | 4.8 | 4.0 | 4.8 |  | 0.4 | -0.8 | -0.4 |
| Imports (c) | 4.5 | 5.3 | 4.8 | 5.3 |  | 0.6 | -0.7 | -0.4 |
| *Contribution to GDP growth (p.p.):* |  |  |  |  |  |  |  |  |
| Domestic demand (exc. inventories) | 0.9 | 1.6 | 1.8 | 1.9 |  | 0.1 | 0.1 | 0.1 |
| Net exports | 0.0 | 0.0 | -0.1 | 0.0 |  | -0.1 | -0.1 | 0.0 |
| Inventory changes | 0.0 | -0.1 | 0.0 | 0.0 |  | 0.1 | 0.0 | 0.0 |
| **Labour market** |  |  |  |  |  |  |  |  |
| Employment (n. persons) | 0.6 | 1.0 | 1.0 | 1.0 |  | 0.2 | 0.3 | 0.1 |
| Unemployment rate (%) | 11.6 | 11.0 | 10.5 | 10.1 |  | -0.1 | -0.1 | 0.0 |
| **Public finances** |  |  |  |  |  |  |  |  |
| Government balance (% GDP) | -2.6 | -2.0 | -2.0 | -1.8 |  | 0.1 | 0.0 | -0.1 |
| Structural primary balance (% GDP) | 0.9 | 0.7 | 0.4 | 0.3 |  | 0.1 | -0.1 | -0.2 |
| Gross debt (% GDP) | 92.1 | 91.1 | 90.1 | 88.9 |  | -0.5 | -0.7 | -0.5 |
| **Assumptions and international environment** |  |  |  |  |  |  |  |  |
| Oil prices (levels in USD) | 98.9 | 53.8 | 52.2 | 57.5 |  | -2.7 | -6.9 | -5.6 |
| Non-energy commodity prices (USD) | -8.6 | -18.7 | -5.2 | 4.1 |  | 1.0 | -0.7 | -0.4 |
| EUR/USD exchange rate (levels) | 1.33 | 1.11 | 1.09 | 1.09 |  | 0.3 | -1.0 | -1.0 |
| Nominal effective exchange rate | 101.8 | 92.3 | 91.7 | 1.7 |  | 0.5 | 0.0 | 0.0 |
| 3-month interest rate (% p.a.) | 0.21 | -0.02 | -0.19 | -0.12 |  | -0.02 | -0.18 | -0.22 |
| 10-year bond yield (% p.a.) | 1.99 | 1.20 | 1.42 | 1.71 |  | -0.05 | -0.15 | -0.13 |
| World GDP (excl. euro area) | 3.7 | 3.1 | 3.6 | 3.9 |  | -0.1 | -0.2 | 0.0 |
| Euro area foreign demand | 3.3 | -0.1 | 2.7 | 3.8 |  | -1.6 | -0.7 | -0.3 |
| 1. Based on unrounded numbers. 2. Contribution to the HICP rate of change. 3. Includes intra-euro area trade of goods and services. | | | | | | | | |

1. In October 2015, the CEPR Euro Area Business Cycle Dating Committee declared that the trough of the recession that started after the 2011Q3 peak has been reached in 2013Q1. The trough signals the end of the second recession witnessed by the euro area after the crisis. [↑](#footnote-ref-2)