THE ECONOMIC SITUATION IN THE EURO AREA
LOWER GROWTH AND LOWER INFLATION

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CVII REUNIÓN DE GOBERNADORES DE BANCOS CENTRALES DEL CEMLA

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GLOBAL GROWTH IS WEAKENING, PARTICULARLY IN THE EURO AREA

Against a background of increasing policy uncertainty and weakening trade growth, the global economy is experiencing a slowdown. The weakening has been particularly intense in the euro area where the manufacturing sector is experiencing a contraction.

Sources: IMF and IHS Markit
THE SLOWDOWN AFFECTS LARGE COUNTRIES

- Economic growth in 2018 was well below of expectations in large countries (except Spain) and GDP growth forecasts for 2019 have been revised notably.
- In addition to external factors, a combination of specific factors exerted a more protracted effect than foreseen - new emission standards, social tensions in France and fiscal policy uncertainty in Italy.

Source: IMF
WITH DIVERGENCES BETWEEN SECTORS

Sources: European Commission (EC) and IHS Markit (PMI)
THE EURO AREA IS PARTICULARLY EXPOSED TO GLOBAL TRADE MODERATION (I)

- Exports have slowed significantly, contributing to weaker than expected growth in the euro area.

Sources: WTO, CPB and Eurostat
(a) Global imports excluding euro area trade
Across countries, Germany and Italy are the two major economies which exhibit the biggest vulnerability to non-euro area markets (particularly to other EU members).

Source: Eurostat
PRIVATE INVESTMENT AND CONSUMPTION ARE ALSO SUFFERING

- Weakening exports combine with other domestic factors (production difficulties in industry, social unrest in France and policy uncertainty in Italy) to hinder economic growth in the euro area.

**EURO AREA: INVESTMENT AND EXPORTS**
(year-on-year- growth)

**EURO AREA: INVESTMENT AND EXPORTS CORRELATION**
(year-on-year- growth)

**EURO AREA: PRIVATE CONSUMPTION AND EMPLOYMENT**
(year-on-year- growth)

Sources: Eurostat and Datastream
INFLATION REMAINS SUBDUED...

- Inflation continues to surprise on the downside
- Long-term inflation expectations have fallen to fairly low levels, which is an important cause of concern.

**EURO AREA. HICP**
(year-on-year- growth)

**LONG-TERM INFLATION EXPECTATIONS**
IMPLIED INFLATION 5 YEARS AHEAD 5 YEARS

Sources: Eurostat, Datastream and ECB
...AS INCREASING LABOR COSTS DO NOT PASS THROUGH INTO HIGHER INFLATION AMID FALLING PROFIT MARGINS

- Labor costs increases did not result into higher inflation, as firms reduced their profit margins.

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**EURO AREA**

**USA**

**JAPAN**

Source: Datastream
The expansionary phase is expected to continue at a more moderate pace, while inflation will remain subdued.

- After some temporary factors fade out, the expansionary phase in the euro area is expected to continue, supported by favorable financial conditions, increases in employment and wages and a more expansionary fiscal policy in some countries.

- On the external side, monetary policy accommodation in major central banks and fiscal stimulus in China could contribute to a recovery of global growth in the second half of 2019.

- Inflation will remain subdued in the medium term.

### Table: MPE March 2019 vs. BMPE December 2018

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<thead>
<tr>
<th></th>
<th>MPE March 2019</th>
<th>Difference from BMPE December 2018</th>
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<tbody>
<tr>
<td><strong>REAL GDP</strong></td>
<td></td>
<td></td>
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<tr>
<td></td>
<td>1.9</td>
<td>1.1</td>
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<td><strong>HICP</strong></td>
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<td></td>
<td>1.7</td>
<td>1.2</td>
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<td>Excluding energy and food</td>
<td>1.0</td>
<td>1.2</td>
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SUBSTANTIAL INTERCONNECTED RISKS EXISTS (I)

i. Global weakness of manufacturing and trade tensions (cars, agricultural products, aerospace industries)

ii. Uncertainty surrounding the Brexit outcome

iii. Vulnerabilities in emerging markets and a more intense slowdown in China;

Sources: Banco de España, Bank of England, IMF, NIESR and UK Treasury
iv. Political uncertainty particularly in Italy, could derail growth. Sovereign yield spreads in Italy remain high. The economic recession and uncertainty over the Italian fiscal outlook could activate the sovereign-bank feedback loop and trigger adverse confidence effects on other countries.

Source: Datastream
THE ECB MONETARY POLICY

- In December 2018, the ECB ended net asset purchases under the APP.
- Monetary policy remains very accommodative: reinvestments of APP portfolio, enhanced forward guidance and new TLTRO.

Source: ECB
MARCH ECB GC: EXPECT OFFICIAL INTEREST RATES TO REMAIN AT THEIR PRESENT LEVELS AT LEAST THROUGH THE END OF 2019…

- Also relevant is the recent deterioration of the macro and inflation outlook, which have led markets to revise downwards their expectations of the future interest rates. The first increase (+10bp) is expected in July 2021 (27 months ahead).
- The pace of the expected increase of the interest rates is slower than the one anticipated by the markets in the beginnings of previous cycles of interest rate increase in the Eurozone and USA.

Source: ECB, Federal Reserve and Datastream. The left panel displays the OIS forward curve for the euro, which contains both an expectation term and a term premium.
... AND ANNOUNCED A NEW TLTRO (III) PROGRAM WITH A MATURITY OF TWO YEARS

- These new credit operations should help to preserve favorable bank lending conditions and the smooth transmission of monetary policy.
- In the absence of the program, the balance sheet of the Eurosystem would shrink by more than 700 bn.

**BANK LOANS INTEREST RATES**

**TLTROs (*)**

**EUROSYSTEM. EXCESS LIQUIDITY (**)**

* TLTRO holds for Targeted Longer-term Refinancing Operations

** Holdings of central bank reserves (current accounts and deposit facility) in excess of reserve requirements.
THE ROLE OF FISCAL POLICY IN THE SLOWDOWN

- Fiscal policy, particularly public investment would be able to provide some support for demand in those countries with fiscal space whose economic situation is significantly worsening (Germany).
- However, the euro area’s current institutional architecture is not conducive to a coordinated budgetary action by its member countries.

![Graph showing fiscal space and impact on GDP](image)

Source: European Commission and Eurosystem
THE EURO AREA FACES IMPORTANT CHALLENGES

• Domestic uncertainty is high and could weaken growth, particularly in Italy.

• In the high-debt countries, public debt loads are leaving insufficient fiscal space to respond to possible shocks, while productivity gaps remain wide, retarding per capita income convergence. Potential growth is low and structural reforms are needed to improve resilience.

• Although some steps towards a genuine Economic Monetary Union have already taken in recent years, the architecture is still incomplete and vulnerabilities remain. Further progress to complete the Banking Union is a priority:
  • Further progress on risk reduction
  • Creation of a common European Deposit and Insurance Scheme (EDIS)
  • Deliver on the Capital Markets Union initiatives
APPENDIX
1. **Interest rates**: The Governing Council now expects the key ECB interest rates to remain at their present levels **at least through the end of 2019**

2. **Reinvestment**: without changes, with the exception of updates in forward guidance
   - “The Governing Council intends to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time past the date when it starts raising the key ECB interest rates”

3. **TLTRO-III**: a new series of quarterly targeted longer-term refinancing operations
   - will be launched, **starting in September 2019 and ending in March 2021**, each with a maturity of **two years**
   - counterparties will be entitled to borrow **up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations** over the life of each operation
   - TLTRO-III will offer **incentives for credit conditions to remain favorable**
   - **Further details on the precise terms of TLTRO-III** will be communicated in due course

4. **Full allotment**: The Eurosystem lending operations will continue to be conducted as **fixed rate tender procedures with full allotment** for as long as necessary, **and at least until** the end of the reserve maintenance period starting in March 2021