BANK OF FINLAND BULLETIN

BANK OF FINLAND ARTICLES ON THE ECONOMY

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Growth picking up but inflation remains subdued

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Global economic growth is broadly based and brisk in the current year. World trade, in turn, is experiencing a growth spurt. At the same time, inflation remains subdued. After an upward spike stemming from oil prices at the turn of the year, inflation has moderated again globally.

In 2016, global economic growth was still at its slowest since the financial crisis. The Bank of Finland forecasts global growth strengthening to 3.5% in 2017 and continuing at annual rates well above 3% through 2018–2019. There will also be a marked acceleration in global trade, following exceptionally weak dynamics in 2016.

Following the cyclical recovery in the global economy, slow potential growth in the advanced economies and economic restructuring in China will dampen the momentum of growth. The risks to global growth have eased, but remain tilted on the downside. However, there is potential for some positive alternative paths, should productivity growth accelerate and structural reforms continue.

Economic growth in the United States continues, even though expectations about stimulus measures have abated and the direction of economic policy is unclear. Chinese growth is expected to slow, albeit slightly later than forecast in the spring. The Chinese economy is expected to grow by 6% in 2018 and 5% in 2019.

China is the world's largest economy in terms of purchasing power-adjusted data, which means that it also has a significant impact on the global economy. In fact, the weight of advanced economies in the global economy has decreased. A stronger-than-forecast deceleration in China's debt-driven growth would weaken confidence globally and put a substantial brake on growth.

The European economy is expanding at a steady pace, and firm economic developments in the euro area will compensate for the somewhat moderating dynamics stemming from Brexit. Euro area GDP has grown at a rate of about 2% in recent years. Despite robust growth, core inflation has only very recently shown signs of a slight pick-up, supported by the ECB's monetary policy.

Investment in the euro area has rebounded, and employment has continued to grow for around the past four years. The global cyclical upswing also supports euro area growth. In addition to the economic upswing, structural reforms, too, have underpinned employment growth by raising the participation rate. Economic restructuring measures lend support to productivity growth, and therefore also longer-term economic growth. Therefore, there is potential for more positive economic developments than forecast.

The pace of structural reforms has slowed from the crisis years, however, and many euro area countries still lag behind the world's best-preforming economies. In addition, the euro area is still burdened by legacies from the financial and debt crises. Over the longer term, slow population growth and weak productivity performance dampen the euro area growth outlook.

Euro area financing conditions remain favourable

The ECB Governing Council has pursued strong monetary accommodation over the past few years. Key policy rates are exceptionally low. Since March 2016, the main refinancing rate has been 0.0%, the rate on the deposit facility –0.40% and the rate on the marginal lending facility 0.25%. In January 2015, the ECB Governing Council decided to launch an Extended Asset Purchase Programme (EAPP). The net asset purchases, at a monthly pace of EUR 60 billion, will run until the end of 2017, or beyond, if necessary, and in any case until there is a sustained adjustment in the path of inflation consistent with its inflation aim. The ECB Governing Council has announced that it will take a decision in autumn 2017 on the calibration of policy instruments beyond the end of the year. By the end of 2017, the Eurosystem balance sheet will include EUR 2,300 billion worth of securities purchased under the EAPP. Principal payments from maturing securities purchased under the EAPP will be reinvested, past the horizon of the net asset purchases.

The monetary policy measures will maintain accommodative financing conditions until there is a sustained adjustment in the path of inflation consistent with the price stability objective. While the growth outlook for the economy has improved, the price stability objective still lies far ahead, and, therefore, monetary accommodation will remain in place. Although the Governing Council does not expect interest rates to fall further, interest rates are, nevertheless, expected to remain at their present low levels for an extended period of time, and well past the horizon of the net asset purchases.[1]

The fixed-rate tender procedure with full allotment adopted during the crisis, together with the abundance of liquidity created by the securities purchases, has made the overnight interest rate Eonia closely shadow the ECB deposit rate (Chart 1). Interbank

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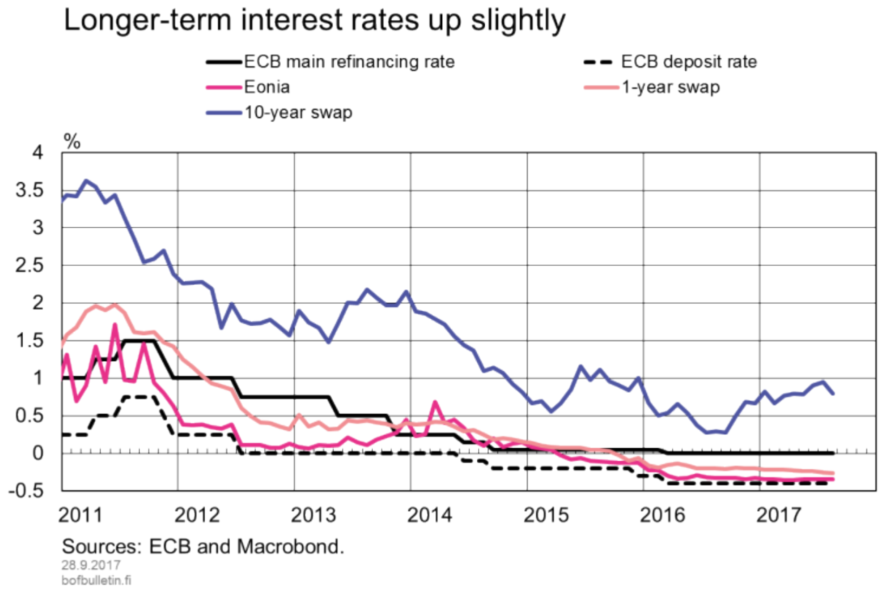
1. For closer details on the ECB's forward guidance and its effect on market expectations of interest rate developments, see Bank of Finland Bulletin 4/2017. Are market expectations in line with the forward guidance of the ECB?

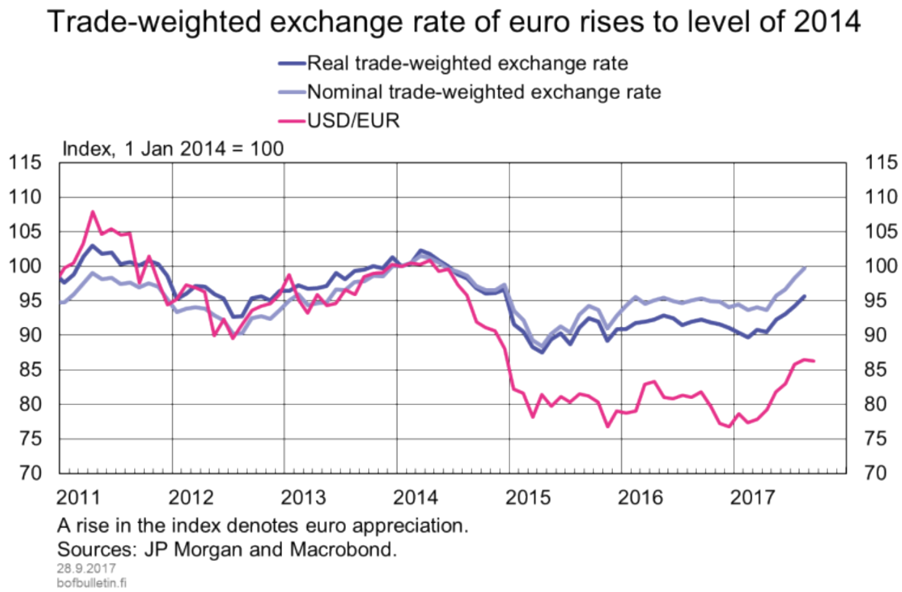
Euribor rates have remained very low during the course of 2017. However, longer-term interest rates have climbed far higher than before, with the spread between short-term and long-term interest rates having grown wider. The 10-year swap rate has risen a full ½ of a percentage point since October 2016 (Chart 1).

Chart 1.



The rise in longer-term interest rates reflects both an improvement in the economic outlook and a moderate strengthening of medium-term inflation expectations, as well as expectations of a gradual unwinding of the non-standard monetary policy measures. The improved outlook for the economy is also demonstrated by the marked appreciation of the euro since spring 2017 (Chart 2). The euro has appreciated notably against all major currencies, with the nominal exchange rate of the euro already largely in line with the level of early 2014, as measured by the broad currency basket. The stronger growth outlook and sizable current account surplus put upward pressure on the euro. The appreciation of the euro/dollar exchange rate is also underpinned by fading expectations of US stimulus measures, political uncertainty in the United States, and expectations regarding the Fed's monetary policy.

Chart 2.

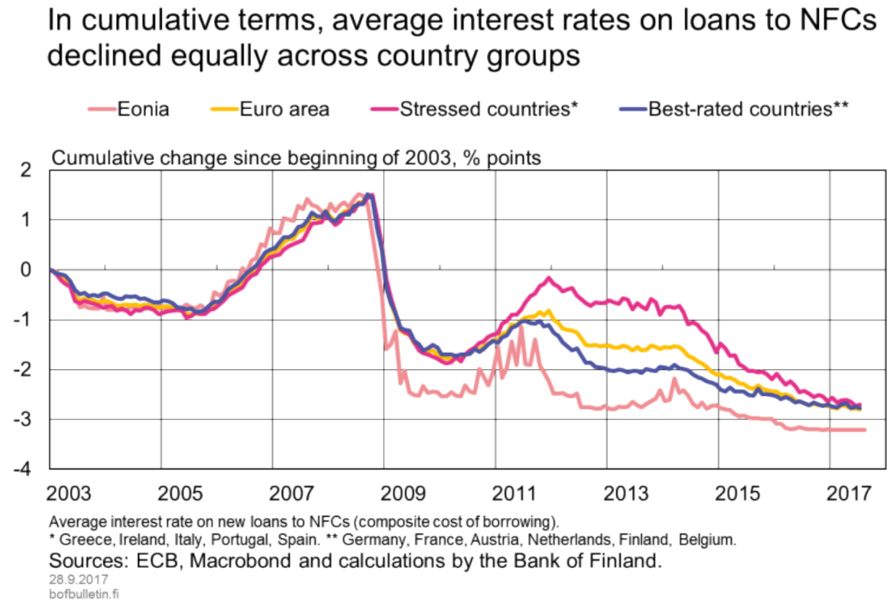


It is important for price stability that financing conditions in the euro area remain favourable. Although the ECB has not adopted an explicit exchange rate target, exchange rate fluctuations may have a significant effect on the inflation outlook and, by extension, on the stance of monetary policy. In addition to interest and exchange rates, asset price developments and access to funding also influence financing conditions. Access to funding, in particular, has eased notably in response to improvements in lending to non-financial corporations (NFCs) and households, and lower borrowing costs.

Better transmission of monetary policy to lending rates

Euro area monetary policy notably influences aggregate demand via the price of bank finance for households and NFCs, given that banks are the main source of funding for the private sector. Central banks usually influence banks' lending rates through policy rate changes. Banks' lending rates are, in turn, reflected in consumption and investment. During the financial and sovereign debt crises, the standard measures for influencing lending rates were insufficient and non-standard monetary policy measures were adopted, such as the Extended Asset Purchase Programme (EAPP). Over the years 2003–2009, the ECB was successful in steering the lending rates charged by banks (Chart 3). At the time, the changes in interest rates on new loans to NFCs mirrored the cumulative fluctuation of Eonia almost to perfection. If Eonia was down by one percentage point, corporate lending rates followed suit, both across the euro area as a whole and in individual euro area countries. This situation changed in 2009. Over the years 2009–2010, the average interest rate on new loans to NFCs in the euro area fell almost one percentage point below Eonia. The spread between euro area countries was at its widest in 2011. In the stressed countries (Greece, Ireland, Italy, Portugal, and Spain), the average rate on new loans to NFCs had, by the end of 2011, risen almost to the level of early 2003.

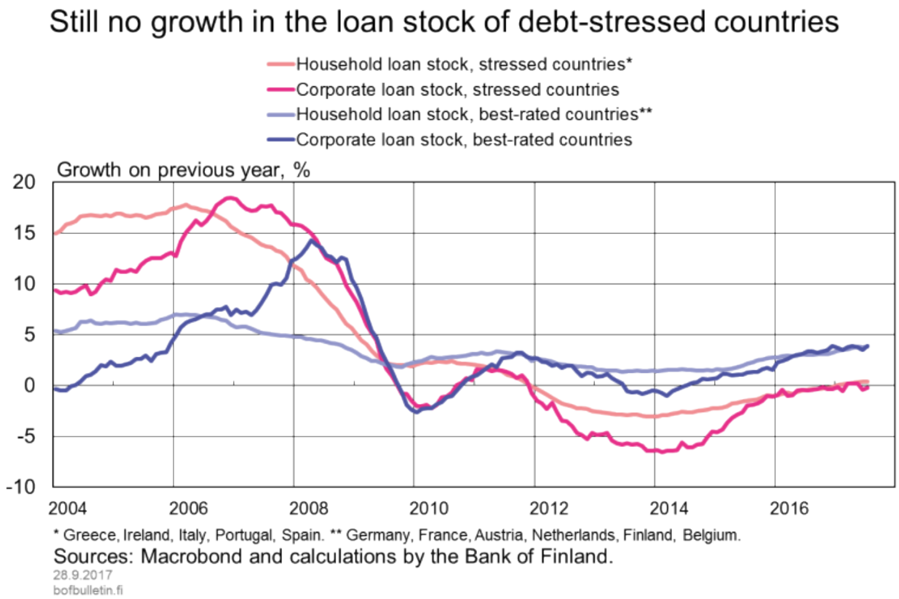
Chart 3.



In the most acute stages of the sovereign debt crisis, fluctuations in the Eonia were no longer reflected in the normal way in lending rates throughout the Monetary Union. With a view to enhancing the transmission of monetary policy, the ECB Governing Council in summer 2014 decided on measures to support lending, and in January 2015 on the adoption of an Extended Asset Purchase Programme (EAPP) to maintain price stability. Currently, the decline in interest rates is almost equal to the fall in the Eonia rate by a full 3 percentage points since 2003. In addition, the gap between the two groups of countries has almost been closed. In cumulative terms, the decline in average interest rates on new loans to NFCs in the stressed countries has been nearly equal to that witnessed in the best-rated countries. Presently, the average interest rate on loans to NFCs is 2.2% in the stressed countries and 1.6% in the best-rated countries. When the spread in interest rates between the countries was at its widest, the corresponding average interest rates were 4.3% and 2.4%, respectively.

This examination is merely indicative, as the transmission of monetary policy may, at the same time, have been influenced by e.g. regulatory changes and financial market and economic restructuring. It is, however, obvious that there has been a marked improvement in monetary policy transmission since the crises. The ECB's Bank Lending Survey (BLS) also found that credit standards have been further eased for corporate and housing loans alike.

Chart 4.

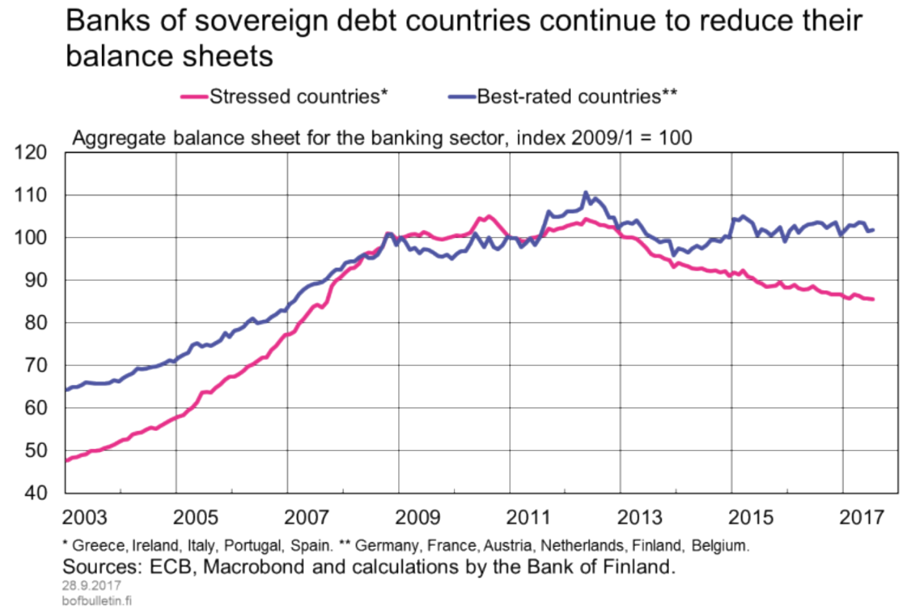


Private-sector loan stock continues to contract in some euro area countries

Euro area stocks of both corporate and household loans are currently posting marked growth (around 2.5%). However, the pace of lending growth still diverges across countries (Chart 4). In some euro area countries, growth in the corporate loan stock has already hit double digits (e.g. Malta and Slovakia), whereas in others the loan stock is set to contract further (e.g. Greece, Ireland, and Portugal). Of the large euro area countries, France has recorded the strongest annual growth in the household loan stock (6%). In Germany and Italy, growth has been broadly in line with the euro area average. However, the household loan stock continues to contract in Spain, Ireland, Greece, Portugal, Cyprus and the Netherlands.

The differences in lending growth across the euro area are also reflected in balance sheet developments for the banking sector as a whole (Chart 5). Indeed, developments in the banking system balance sheet tell the story of the financial crisis. The pre-crisis period was marked by robust lending growth. This growth was particularly strong in the countries that were in the end hardest hit by the crisis. The aggregate size of the banking sectors of Greece, Ireland, Italy, Portugal, and Spain doubled over the years 2003–2008.

Chart 5.



With the onset of financial crisis, growth came to a standstill, lending growth slowed and banks began to adjust their balance sheets. Capital adequacy was also improved through balance sheet contraction. In the best-rated countries, banking sector balance sheets have already expanded beyond the levels recorded in early 2009. By contrast, banking sector balance sheets continue to shrink in stressed countries.

Lending barely profitable, but banking sector outlook is brighter

The profitability outlook for euro area banks is currently brighter than in recent years. Bank share prices have mainly risen, while risk premia on bank bonds have remained low. According to the Single Supervisory Mechanism (SSM), return on equity (ROE) for euro area banks was 7.1% in the first quarter of 2017, against 5.1% a year earlier. The profitability improvement in the early part of the year is related above all to economic expansion and favourable financial market developments. At the same time, the monetary accommodation pursued by the ECB has kept banks' funding costs at a historical low. Investor confidence in the sector has revived in step with a moderate pick-up in inflation expectations and a wider yield spread. Together with the improvement in economic outlook, this also points to an improvement in the medium-term outlook for banks' results.

The revival of investor confidence is also reflected in the special resilience of bank share price performance to various negative market shocks and political risks. For example, the resolution measures of June 2017 conducted under the auspices of the Banking Union and by Italy and Spain met with a positive response on the financial markets. The minor effects of the measures on other banks are seen as a sign of the banking sector's stronger resilience to problems and of investor confidence in the Banking Union's Single

Resolution Mechanism (SRM). The improvement in capital adequacy has also contributed to banks' higher shock-absorption capacity. According to the ECB, banks' average Tier 1 capital ratio measuring original own funds stood at 14.8% in the first quarter of 2017, while it had still been in the region of 10%, on average, in 2010 before the escalation of the euro area sovereign debt crisis.

Banks' profitability performance nevertheless continues to be overshadowed by many structural and cyclical risks. In Europe, growth in retail banking has remained lacklustre. Due to the low level of interest rates and feeble growth in loan stocks, banks are finding it difficult to meet their operational costs in their retail business, i.e. bank loans. Although growth in banks' other income has been encouraging in the early part of 2017, many banks are still struggling to find other sources of income to offset the decline in net interest income. Furthermore, harsher competition between banks and the increasing role of new players – e.g. in the field of payment services and asset management and in certain credit segments, such as the retail credit market – may further impair the ability of banks to earn additional income in the future.

In addition to suffering from structural problems, euro area banks are also troubled by a substantial amount of non-performing loans on their balance sheets. According to the Single Supervisory Mechanism (SSM), non-performing loans of euro area banks amounted to EUR 865 billion in the first quarter of 2017, which is 9% less than a year earlier. This positive trend notwithstanding, large amounts of non-performing loans continue to erode the profitability of some banks and contribute to upholding the differences in lending volumes between euro area countries. The market expects European banks to clear their balance sheets of bad loans worth at least EUR 80–90 billion in the current year.[2] The large amount of non-performing loans makes it necessary to continue the measures designed to reduce bad loans, thus strengthening confidence in the banking sector, supporting banks' access to funding and improving their future lending capacity.

Given current developments in banking income, the profitability outlook for euro area banks is likely to remain constrained in the immediate years ahead, while still being brighter than over the past few years. Future profitability will also depend on banks' efforts to adjust their operations to reflect changes in the operating environment and stricter regulations, as well as on economic developments. To improve their long-term profitability, many banks are rethinking their operations and strategies. Banks are optimistic about the cost savings to be gained especially from automation and digitalisation. That said, IT investment and digitalisation initiatives have also significantly added to banks' costs, and therefore cost-to-income ratios for euro area banks have remained persistently high. Due to the high expense of reform projects, there is a risk that less profitable banks that are struggling with old problems will not be able to renew themselves.

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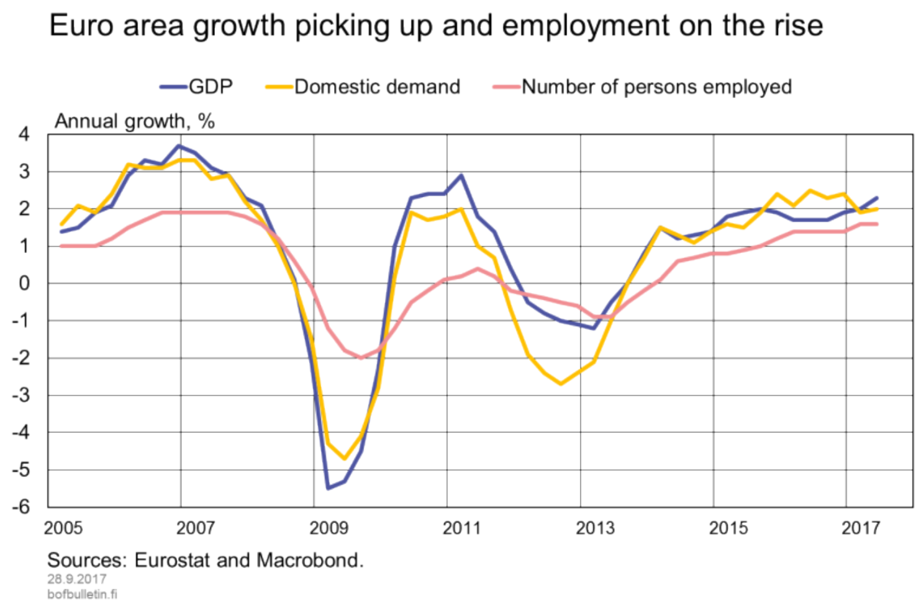
2. In addition to the restructuring of Spanish and Italian banks undertaken in spring 2017, market expectations are also driven by a range of supervisory initiatives, including the forthcoming IFRS 9 update, the ECB's guidance to banks on non-performing loans (issued in spring 2017) and the 2017 Transparency Exercise of the European Banking Authority (EBA).

Euro area economy growing, supported by monetary policy

Confidence in the euro area economy has remained solid throughout 2017. All key confidence indicators predict robust growth to continue into the upcoming quarters (Chart 6).

Chart 6.



Private consumption and investment have been the main components of aggregate demand contributing to economic growth in the euro area in recent years. The composition of growth is expected to remain largely unchanged through the immediate years ahead. Public consumption will make some contribution to growth on average, but the contribution of net exports will be very modest.

Employment has now seen four years of uninterrupted growth. In the first quarter of 2017, euro area employment was up by 1½% from a year previously. By country, employment growth has been widespread, although this can be partly attributed to fiscal measures. Unemployment fell to 9.2% in the second quarter, reaching its lowest level since early 2009.

Private consumption will be bolstered in the euro area by an increase in households' disposable income amid a steadily improving employment situation and higher labour income per employee. At the same time, a slight increase in the rate of inflation will temper growth in real disposable income.

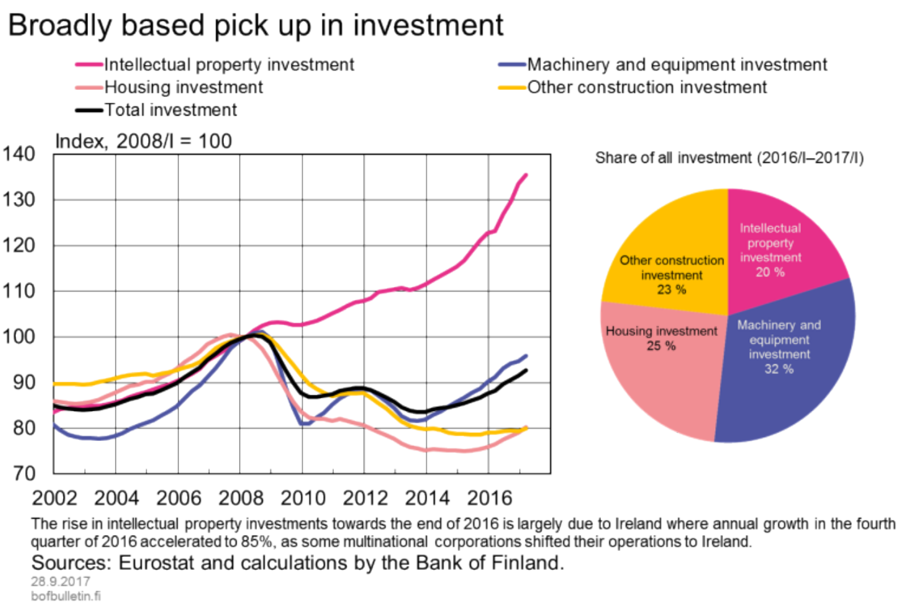
Household indebtedness relative to income has fallen in the euro area by a few percentage points from the levels reached in 2011 and is now at approximately 95% of disposable income. Debt-servicing costs relative to income have continued to fall in the major euro area economies. Germany and Spain, in particular, have seen their debt service ratios (i.e. interest expenditure and loan amortisations as a percentage of net income) fall under their long-term averages. France, however, is a notable exception, in that its debt service ratio has remained approximately 10% above its historical average. France is also the only country out of the major economies whose growth in total household debt has accelerated faster than growth in available income.

Increased corporate investment in the euro area

The corporate sector is responsible for more than half of the fixed investment within the euro area. As firms have improved their balance sheets in the years since the financial crisis, internal finance is used to fund an increasingly large share of investment. As a result, an upturn in corporate sector profits and available income has also resulted in an upsurge in investment. Nevertheless, as of the first quarter of 2017, investment had not yet returned to the levels reached before the onset of the financial crisis (Chart 7). This is mainly due to construction investment alone accounting for almost half of all fixed investment. Housing and other construction-related investments collapsed during the crisis and still remain approximately 20% below their 2008 levels.

Immaterial investment (e.g. investment in R&D or computer software) did not experience a similar decline during the crisis and has actually increased by over 30% since 2008. Immaterial investment has grown from 12% of total corporate investment in 1995 to more than 20% by the beginning of 2017.

Chart 7.



According to SAFE (Survey on the Access to Finance of Enterprises), the ECB's semi-annual survey measuring access to corporate finance, the half-year period ending in March 2017 saw the fewest corporate loan rejections since the onset of the financial crisis. Firms also reported improved revenues, stable product development cycles and rising costs. According to a corporate survey issued by the European Commission, only a fifth of manufacturing companies reported their output to be limited by inadequate demand. This is in stark contrast to the worst phase of the financial crisis, when 60% of respondents reported that production was constrained by demand. Instead, the availability of labour has become an issue for 10% of manufacturing companies, the highest reported level since early 2008. The outlook for the construction sector is largely analogous to that of the manufacturing sector, except that the former is still plagued by the financial crisis' impact on the availability of finance.

Companies expect demand for labour to increase across all sectors (services, construction, industry and retail) in the third quarter of the year and maintain a positive outlook on employment. Confidence indicators and purchasing managers' indices also remain positive across all sectors, and industrial order books are at their highest since before the financial crisis.

Furthermore, the corporate sector is continuing to deleverage. Corporate debt relative to value added has dropped by 10 percentage points since 2009 and currently stands at 120%. Similarly, companies' debt service ratios (i.e. interest expenditure and loan amortisations as a percentage of net income) have clearly improved in the large euro area economies, most notably in Italy and Spain. The corporate sector has in fact become increasingly financially self-sufficient since the financial crisis. According to SAFE, the reasons for corporate deleveraging include a desire for higher credit ratings and improved balance sheets going into the future.

Overall, the outlook for non-financial corporations has improved in the past year. Growth in private fixed investment will be buttressed by the very low interest rate environment, improved availability of finance, the need to renew the capital base after years of weak investment activity, and the lower level of the capital ratio for corporate sector debt. It appears that the recent upswing in the corporate sector has resulted in a virtuous circle, as growth expectations foster an appetite for investment and recruitment.

Current account surplus historically large

Many euro area economies ran large current account deficits leading up to the financial crisis. The significant deficits of the GIIPS-countries[3] have eased in response to consolidation measures and reforms (Chart 8). Currently the Netherlands, Germany, Slovenia and Malta all have exceptionally large current account surpluses. In fact, in 2016 as many as 13 out of 19 euro area countries ran current account surpluses. Consequently, the aggregate current account surplus of the euro area has reached approximately 3% of GDP, while it was close to zero before the crisis. This development can be explained by low commodity prices (most notably oil) and the continued low rate of investment. In addition, exports have been bolstered by the depreciation of the euro from its peak values.

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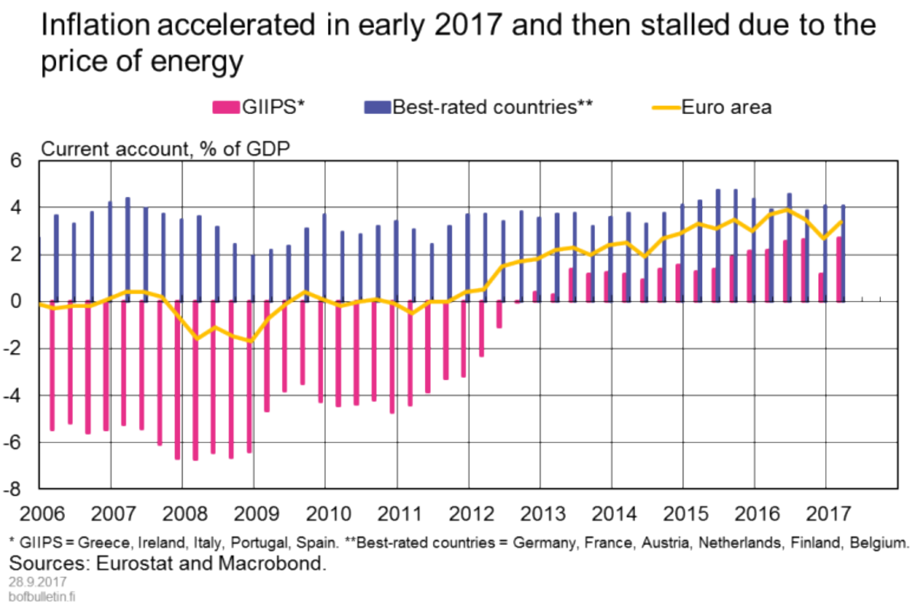
3. Greece, Italy, Ireland, Portugal and Spain.

Chart 8.



Cost-competitiveness can be harnessed to steer the external balance of the economy and boost employment. Cost-competiveness indicators have shifted across the euro area in recent years and reflect well the policies that each Member State would need to adopt to balance their current account. Germany, who runs a large trade surplus, has experienced the largest hike in costs when measured by unit labour costs. Cost developments have been modest in Portugal, Greece, Spain and Cyprus, whose economies are all still recovering from the financial crisis. Finland, in turn, has experienced the largest drop in unit labour costs out of all of the euro area economies.

Growth outlook improved for large euro area economies

Germany experienced strong economic growth in the first half of 2017, bolstered by consumption and investment in both the public and private sectors. Housing investment has increased fairly strongly, and industrial and public investment are both also on the rise. The German economy is projected to sustain its growth into the immediate years ahead, fuelled by private consumption and increasing employment. Germany's economic fundamentals are in order: the economy remains cost-competitive, household and public debt are at moderate levels, and unemployment ranks among the lowest in the euro area. On the back of a general government surplus and the lowest debt ratio among the large euro area countries, Germany is well-equipped to support its economy via fiscal measures if required.

France's economy is expected to show improved signs of growth in the current year, up from its 2016 level of around 1%. Domestic demand spurred growth in early 2017. Growth is also projected to remain relatively strong into the next few years, on the back of private consumption and investment. The economy is also being supported by a strong increase in lending, owing to low bank lending rates. The new French Government has set a target of keeping its fiscal deficit within the margins of the Stability and Growth

Pact (i.e. at most 3% of GDP). High structural unemployment makes unemployment fall more slowly, an issue that upcoming labour market reforms will attempt to tackle.

Italy saw faster GDP growth than projected in the first half of 2017, and growth forecasts for the year have accordingly been revised up to a good 1%. This notable increase in growth can be explained by an upswing both in investment activity and exports as well as an unforeseen boost in private consumption owing to improvements in employment. Employment is indeed on the rise; however, this has not been accompanied by a decrease in unemployment, as the recent positive development stems from a higher participation rate. This is Italy's third consecutive year of GDP growth following an extended period of recession.

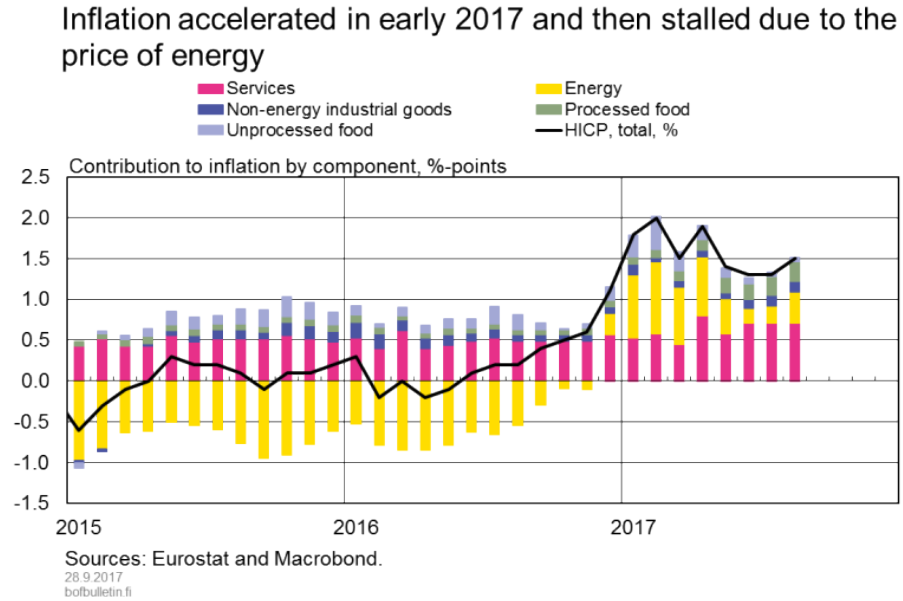
The **Spanish** economy has grown robustly since the turnaround in 2013. Already in early 2017, GDP reached the same level as prior to the financial crisis. Growth is projected to continue at a stronger pace than the euro area average, but gradually moderating. Economic growth is supported by structural reforms, improved price-competitiveness, a moderate rise in house prices and favourable financing conditions. The ongoing brisk pace of growth will lower unemployment and boost inflation. This positive trend will work to improve the state of the public finances, but the ratio of public debt to GDP still remains around 100%.

Inflation still subdued despite cyclical upswing

The euro area enjoyed brisk growth in the first half of 2017; the output gap, which measures the level of unused capacity in the economy, is expected to close sooner than previously forecast in the spring. However, the rate of inflation is not displaying signs of sustained acceleration.

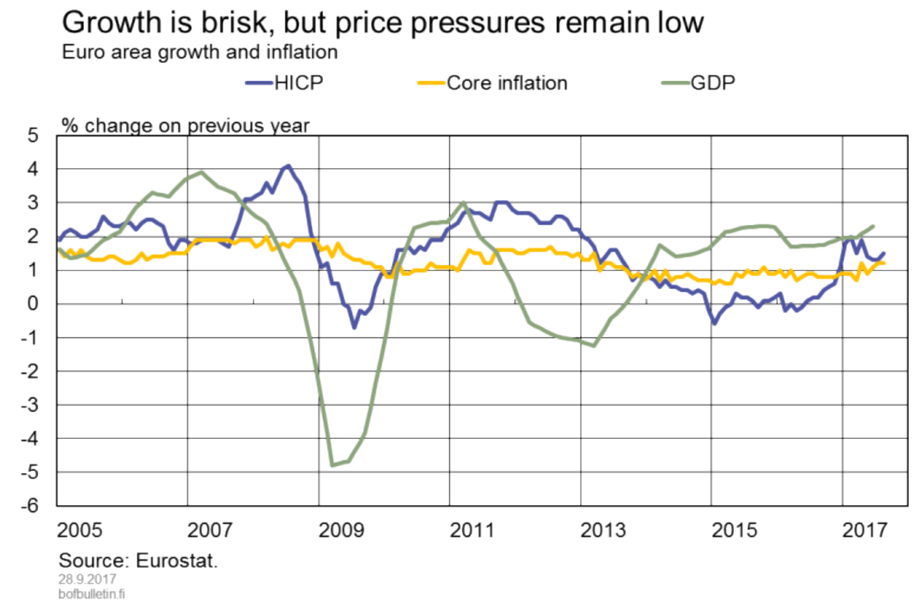
In the beginning of the year, inflation was primarily driven by the base effect of energy prices, i.e. the increase relative to the reference period of the previous year. The price of oil increased by approximately 70% from January 2016 to January 2017, significantly spurring consumer price inflation in the first quarter. The energy component's effect on euro area inflation was on average approximately 0.8 of a percentage point between January and April. The base effect weakened further on in the year, and inflation slowed. In August, euro area consumer price and core inflation (the latter of which excludes energy and food prices) stood at 1.5% and 1.2%, respectively.

Chart 9.



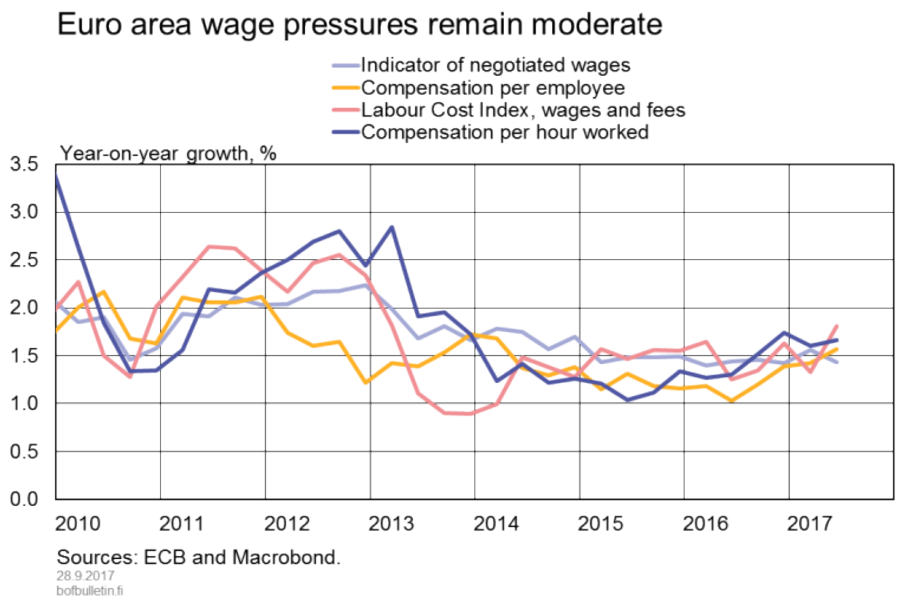
The euro area's external price pressures, both those stemming from global inflation and those stemming from commodity prices, remain moderate. The recent appreciation of the euro will also offset inflationary pressures that a possible increase in euro area import prices might otherwise induce. The euro area is a large internal market unto itself, and as such, exchange rates only have a limited impact on import prices and are slow to affect consumer prices. Insofar as the euro's appreciation reflects the improved growth outlook of the euro area, the impact of the currency's appreciation on inflation will decrease even further. On the other hand, should the appreciation of the euro stem from factors exogenous to the euro area, inflationary pressures might be tempered to a greater extent.

Chart 10.



Core inflation, which measures internal price pressures affecting the euro area, has hardly increased at all. A relatively high unemployment rate and labour market reforms in several countries have together kept wage pressures low. Growth in labour costs in the euro area has been slower than before the global financial crisis. This might not, however, be a consequence of the crisis itself, but could instead be the result of improved efficiency on global markets for factors of production. Increased competition, digitalisation and the easy transferability of know-how together mean that companies are better equipped to optimise their supply chains. This optimisation can be interpreted as an increase in the elasticity of demand for factors of production (e.g. labour and capital). In a situation like this, workers might accept increasingly moderate pay rises in order to keep their jobs. It is very likely, then, that wage pressures in the euro area have been subdued due to these very factors.

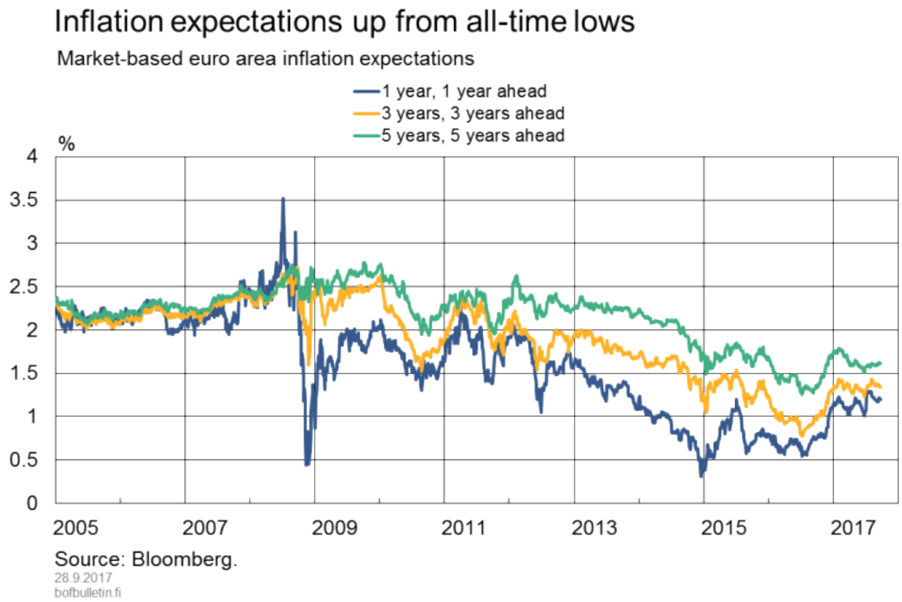
Chart 11.



The improved condition and positive outlook of the euro area economy, do, however, create the necessary backdrop for an increase in demand and, consequently, growing wage pressures, as long as unemployment slowly decreases and unused production capacity is brought back into play. Yet, there is a concern that even considerable improvements in the real economy might not translate into higher inflation, at least to the extent previously expected. There have been signs of this in the major economies, where inflation has remained lower than expected despite the growth in the economy.

From the perspectives of monetary policy and the price stability objective, the essential long-term inflation expectations are still relatively low. At the same time, surveys by professional forecasters still put long-term expectations at approximately 2%. Overall, inflation expectations project that euro area inflation will not pick up significantly and that adjusting the rate path towards the price stability objective will take time.

Chart 12.



Currently, inflation is expected to slow again at the beginning of 2018 due to transient factors. After this, it is expected to accelerate gradually. Even though the acceleration of inflation is still characterised by uncertainty, sustained economic growth will support rate paths adjusting to the price stability objective in the years ahead.

Structural reforms ease the challenges from an ageing population

Even though euro area economic growth has recently gained momentum, it has still remained moderate since the financial crisis. This has reflected slow population growth in the euro area and weak productivity performance in all the largest euro area economies. In recent years the working-age population (15–64-year-olds) has grown at a subdued pace in the euro area, and has even contracted in many euro area Member States, including Spain and Italy, which are among the largest countries. Sound economic structures impact on employment and productivity growth positively, thereby easing the adverse economic effects of an ageing population. At the same time, sound economic structures contribute to strengthening the effectiveness of monetary policy by raising the natural rate of interest[4], improving monetary policy transmission and reducing economic rigidities.

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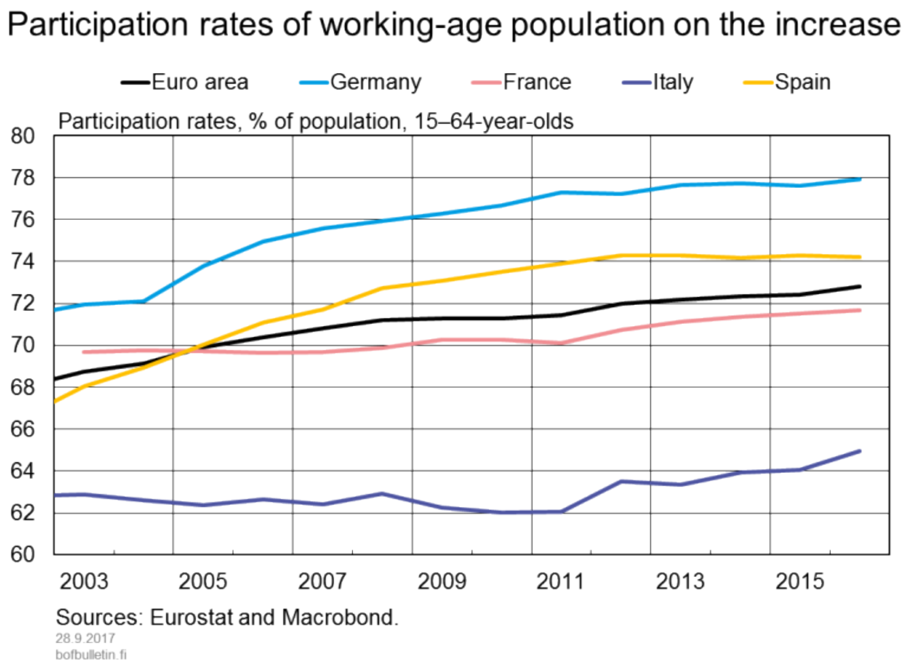
4. The natural rate of interest is the real interest rate that brings the economy into equilibrium and would prevail if output were at its potential level, i.e. in a situation where the economy is in neither an upswing nor a downswing. The equilibrium would lead to stable inflation over the long term.

Chart 13.



Structural reforms have considerably raised the participation rate (the sum of the number of persons employed and unemployed relative to all persons aged 15–64) in the euro area, which mitigates the effects of the contracting working-age population on economic growth. The euro area participation rate for 15–64-year-olds has risen by over 2 percentage points in the past ten years. The participation rate has increased in all the largest Member States, and also particularly in the Baltic States and Malta. The positive development reflects primarily more active labour participation by women aged 50–64. This has been supported by pension reforms, higher educational levels and the improved health situation of the population (Chart 13).

Deregulation and easing the conditions for business activity support productivity and economic growth. In this respect, structural reforms have been a vital condition for economic stimulus packages granted to euro area crisis countries. The reforms implemented are reflected in the World Bank's Doing Business[5] indicators which have improved relative to 2010 for Spain, Italy, Greece, Portugal and the Baltic States.

All in all, several euro area countries still lag far behind the world's best product and labour market structures. There are also considerable differences between euro area Member States. Nevertheless, progress with the implementation of reform measures has slowed since the crisis years. Structural reforms could still further improve the functioning of the economy and monetary policy transmission in the euro area.

5. The indicator aims at measuring the ease of doing business on the basis of 11 indicator sets essential for carrying out business operations.

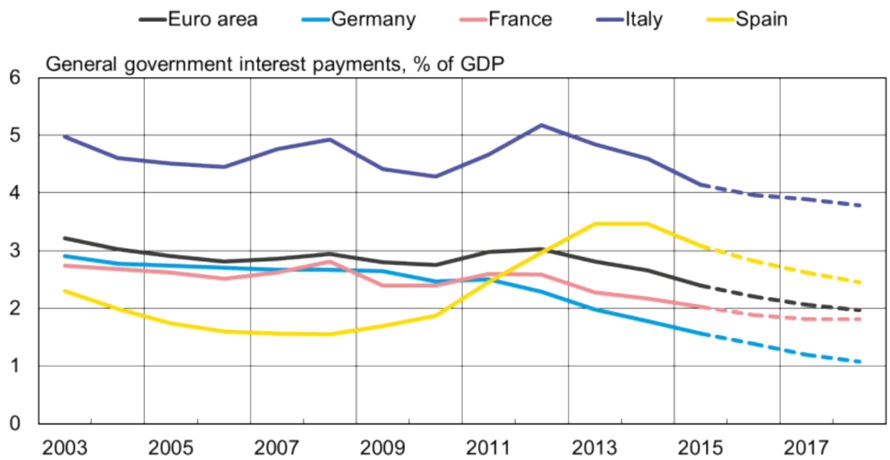
General government finances improving slowly in the euro area

The euro area general government debt ratio, which reached its peak (around 92% relative to GDP) in 2014, declined to around 90% in 2016 and is expected to continue on a gradual downward trend. However, the significant differences in debt ratios across euro area countries are not disappearing. In France, Italy and Spain, the level of public sector debt is expected to remain roughly unchanged in the next few years, while in Germany the debt-to-GDP ratio is set to decline notably.

The general government headline deficit ratio for the euro area is expected to fall somewhat in the current year, from 1.5% of GDP in 2016. Even in 2016, the headline deficit was quite low by historical standards. Similar to public debt-to-GDP ratios, euro area countries appear to remain divergent also in terms of the size of their deficits. In Germany, general government finances will remain in surplus, while the other large euro area countries will post significant deficits.

Chart 14.

General government interest payments in euro area declining



The figures for 2016–2018 are from the European Commission's spring 2017 Economic Forecast.
Source: European Commission.
28.9.2017
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The fiscal situation in the euro area has improved in the past couple of years due to cyclical conditions and declining interest payments. Of these two factors, cyclical conditions are the more important. Nevertheless, falling interest payments have also notably boosted the public finances. The prevailing level of interest rates is still very low. Interest payments have contracted because maturing longer-term loans carry higher interest rates than the new loans taken out to replace them (Chart 14).

The third factor impacting the state of and outlook for the public finances – discretionary fiscal measures – has no longer been an important element in stabilising euro area general government finances in recent years. The fiscal policy outlook in the euro area has remained roughly unchanged from spring 2017, and the fiscal stance in the immediate years ahead is expected to remain broadly neutral.

Even though the public finances will improve in the near term because of low interest rates and economic growth outpacing the rate of potential growth, the general government debt-to-GDP ratio will remain high. Under less favourable conditions, high debt ratios could cause significant problems for certain euro area countries. Therefore, in making decisions on fiscal policy, countries should also prepare for less favourable times. From the perspective of maintaining confidence on the financial markets, this is all the more important for countries with high levels of public debt.

Tags

ECB, employment, inflation, monetary policy