Macro policy challenges for the euro area - article by Rolf Strauch

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“Macro policy challenges for the euro area”
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Following the easing of the Covid-19 pandemic, the global economy has faced a new shock. The war in Ukraine has resulted in a major geopolitical transformation, with widespread economic consequences. Commodity prices – particularly for energy and and food – have increased significantly since early 2022. Inflation is reaching new highs, not only in Europe, but also in the US and other parts of the world.

Major central banks embarked on a sharper than expected monetary policy normalisation, giving rise to recession fears and volatility in financial markets. Economic growth projections for the euro area have been revised downwards during the course of 2022. The most recent European Commission forecast (Summer 2022) predicts 1.4% growth for the euro area in 2023, 0.9 percentage points lower compared to the Spring Forecast.

The main downside risk to this forecast is linked to the duration of the war in Ukraine and its consequences for energy supply. Covid-19 also remains a significant risk; the possibility that the resurgence of the pandemic in Europe could cause renewed disruptions to the economy cannot be excluded. Lockdowns in China, supply-chain disruptions, and drought in Europe may also have an adverse effect on economic activity.

For the euro area, which is an energy importer, the increase in energy prices entails a transfer of income and wealth abroad. The deteriorating terms of trade has led to a real income loss, reaching magnitudes comparable with the major oil price shock of the 1970s. This loss amounted to about 2.5% of GDP up to the first quarter of 2022, the biggest terms of trade loss on record.

Although GDP growth in the euro area is decelerating, the region’s economy is demonstrating considerable resilience, which is based in particular on four elements.
First, historically low interest rates in recent years have had a positive effect on debt sustainability. The debt service in the public budgets - the main factor to assess debt sustainability - is at its lowest level in half a century in all euro countries, despite much higher debt levels. As average maturities on public debt have increased, debt service costs will remain low for some time, and higher market interest rates will translate only gradually into a higher effective interest burden for governments.

Second, the euro area's labour market has proven to be exceptionally strong. The unemployment rate is at an all-time low (6.6% in May 2022), thanks to labour market measure and buoyant demand during the pandemic and the recovery. Female participation in the labour force continues to increase, adding to an overall positive trend in labour participation.

Third, the banking sector has shown resilience in the current uncertain environment and is expected to withstand even a severe shock from an adverse macroeconomic scenario. Banks’ capital and liquidity positions are strong, and non-performing loans continued to decline.

Finally, the disbursement of Next Generation EU funds to EU Member States over the next few years will provide a unique opportunity to sustain the recovery, achieve a higher growth potential, improve medium-term fiscal positions and address risks of divergence.

These areas of strength will continue to bolster the euro area economy; however, effective policy measures are necessary to address the complex challenges. In the short and medium term, monetary policy actions aimed at reducing inflation should be accompanied by fiscal policy that includes temporary and targeted measures aimed at supporting exposed and vulnerable groups.

In the long term, the EU should make good on its commitment to cut its reliance on Russian fossil fuels by 2027 by accelerating the transition to renewable energy. The decarbonisation of the energy system, along with increasing energy efficiency will provide strong impetus to achieve Europe’s climate goals.

Furthermore, Europe needs to find ways to improve productivity. This is key to remaining competitive in the global economy and maintaining future economic growth. To that end, investment in innovation and the modernisation of our economies is essential, particularly through the implementation of digital technologies.

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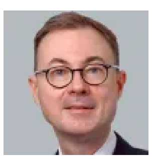

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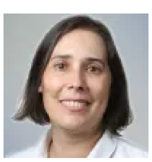

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