1. Global economy and euro area

1.1 The global economy slowed further in 2019

Following a sharp deceleration in the second half of 2018, global economic growth remained sluggish in 2019 against the backdrop of the escalating trade dispute between the United States and China, some geopolitical tensions in the Middle East, and persistent uncertainty over Brexit. Annual average growth dropped to its lowest level since the great recession. The loss of momentum affected activity in most economic regions and was relatively marked in manufacturing industry, whereas services were more resilient. Factors specific to certain sectors, notably the motor vehicle industry, and to some emerging economies, as well as various structural forces such as weak productivity growth and population ageing, also inhibited economic dynamism. International trade weakened significantly, with a decline in trade having been observed in most of the major economies. Nevertheless, activity showed some signs of stabilising at the end of the year.

Table 1

GDP of the major economies

(percentage changes in volume compared to the previous year, unless otherwise stated)

				p.m. Contribution to world growth	*p.m. Share of world GDP[1]*
	2017	**2018**	**2019**	***2019***	
Advanced economies	2.5	2.2	1.7	*0.7*	*40.3*
of which:					
United States	2.4	2.9	2.3	*0.3*	*15.1*
Japan	1.9	0.3	1.0	*0.0*	*4.1*
Euro area	2.5	1.9	1.2	*0.1*	*11.2*
United Kingdom	1.8	1.3	1.3	*0.0*	*2.2*
Emerging economies	4.8	4.5	3.7	*2.2*	*59.7*
of which:					
China	6.8	6.6	6.1	*1.2*	*19.3*
India	7.2	6.8	4.8	*0.4*	*8.0*
Russia	1.6	2.3	1.1	*0.0*	*3.1*
Brazil	1.1	1.3	1.2	*0.0*	*2.4*
World	3.8	3.6	2.9	*2.9*	*100.0*
p.m. World trade[2]	*4.6*	*3.2*	*–0.6*	*–*	*–*

Sources: CPB, ECB, IMF.
1 According to the IMF definitions and calculated on the basis of purchasing power parities.
2 Average of exports and imports of goods and services. For 2019, change over the first eleven months compared to the corresponding period of the previous year.

A widespread slowdown

Compared to the previous year, annual GDP growth declined in almost all the main economies. In the advanced economies, it stabilised overall at a low level during the year, following the sharp slowdown at the end of 2018. In the United States, the expansion phase – the longest ever recorded so far – continued, supported by consumption and the fiscal stimulus approved in 2017-2018. However, it slackened pace owing to the worsening trade tensions and uncertainty surrounding US trade policy. Economic activity remained weak in the euro area, whereas it strengthened slightly in Japan, boosted by public and private consumption.

In the United Kingdom, GDP growth was both weak and volatile. Driven by stockpiling in anticipation of a possible departure from the EU without a deal on 29 March 2019, activity picked up in the first quarter of 2019 before growth dropped sharply thereafter. Overall, business investment was still undermined by the uncertainty surrounding Brexit, while household consumption proved more resilient, supported by job creation and wage rises.

In the emerging economies, growth gradually subsided. In the face of weakening domestic demand and prolonged trade tensions with the United States, China's economic expansion declined to its lowest level in three decades. Although consumer confidence remained strong, the high debt level and the rise in the debt service ratio seem to have curbed household consumption expenditure, in favour of savings. Since 2014, China has become the largest economy in the world, measured by purchasing power parities (PPP). On that basis, it represented 19.3 % of the global economy in 2019. In that same year, it moved into second place in terms of GDP valued at market exchange rates, with a weight of 16.3 %, behind the United States (24.8 %), but ahead of the euro area (15.4 %).

China became the second largest economy in the world in terms of GDP valued according to market exchange rates

At the same time, India's growth dropped to its lowest level in several years as a result of a significant fall in consumption. The economic slowdown also hit Brazil, Mexico and Russia. The economies of Turkey and Argentina, which had both entered recession in 2018, displayed a divergent picture. Supported by improvements in both financial conditions and access to credit, the Turkish economy began growing again. At the same time, the Argentinian economy continued to shrink, suffering from serious worsening of its financing conditions and rising inflation, factors which are denting confidence.

Mounting uncertainty

The weakness of worldwide economic activity is due largely to the heightened uncertainty, created primarily by escalating trade tensions between the United States and China, and to the widespread decline in manufacturing output. These two factors, which are closely linked, contributed to a marked fall in the growth of international trade. Yet there were some signs of stabilisation at the end of the year.

Following the tariff increases and retaliatory measures in 2018, there was a rise in both customs duties and the import base concerned during 2019. In May, the United States raised the customs duty from 10 % to 25 % on imports from China amounting to $ 200 billion, after having already imposed new tariffs on them in September 2018. In August, the American President also announced new taxes on Chinese imports worth $ 300 billion, so that almost all Chinese products would face new tariff barriers. China systematically responded to the US decisions by adopting retaliatory measures. However, from September onwards, tensions gradually eased with the prospect of a partial agreement between the two parties. China agreed to exclude a small number of products from its list of new tariffs and, following the actual conclusion of an agreement in mid-December, the United States partially revoked the tariff increases announced in the summer.

The new protectionism displayed by the United States over the past few years is largely due to China's industrial policies on subsidies, intellectual property rights, and technology transfer[1]. But those are not the only factors, as is evident from the increase in customs duties on steel and aluminium in the spring of 2018, or the threatened imposition of additional tariffs on motor vehicle imports.

1 See, for example, box 2 in the Annual Report 2018 or Buysse K. and D. Essers (2019), "Cheating tiger, tech-savvy dragon? Are Western concerns about "unfair trade" and "Made in China 2025" justified?", NBB, *Economic Review*, September.

While the US government has so far refrained from carrying out that threat, it has still not renounced it. In response to the French tax on digital services, it made new threats specifically targeting French products.

The United States has more generally become decidedly hostile to the international trade system, the operation of the World Trade Organisation (WTO), and global multilateralism. The uncertainty over trade policies is thus not confined to the dispute between China and the United States but also encompasses the future of the international trade system as a whole. Moreover, the friction between the United States and China is not just about trade and the divergences between their economic models; it is also about global technological and geopolitical leadership. Finally, the deterioration in diplomatic relations has also affected other countries. More particularly, during the summer, an open trade war erupted between Japan and South Korea, in which both countries tightened up their mutual export conditions.

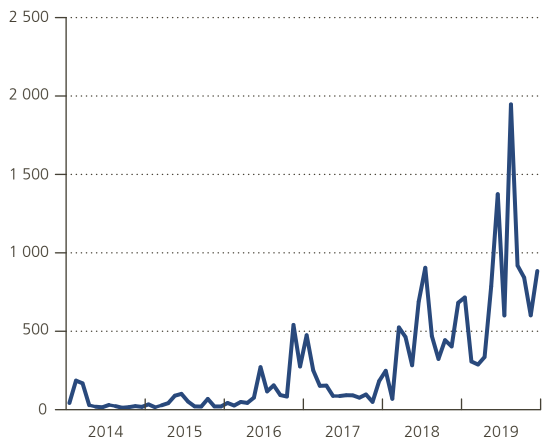
The uncertainties over international trade and the lack of political direction in the face of climate change have inhibited investment

The many concerns over the future of world trade and their impact on production – reallocations between countries and value chain adjustments – and on international trade have eroded business confidence.

Chart 1

Uncertainty over trade spiralled during the summer

(degree of uncertainty regarding US trade policy, index 2014 = 100)



Source: Refinitiv.

Firms have therefore become doubly cautious about investing, and that has depressed global demand for equipment and machinery. While China and the United States are currently the main countries affected by the new trade barriers, most other economies are also suffering, either as suppliers or owing to the deterioration in the general economic climate. Apart from the uncertainties concerning trade, sluggish investment is also a sign of the lack of clear political direction regarding the response to the global challenge of climate change. Despite international commitments on the part of governments, the adjustment plans are still in their infancy and there are still no definite policies aimed at implementing the energy transition.

Decline in industrial output and world trade growth

The weakening demand for investment goods was reflected in industrial output, which declined on average in the advanced economies. This decline is also due to the contraction of activity in the motor vehicle industry, due to both supply disruptions and factors affecting demand. For instance, vehicle sales dropped in China following the expiry of certain tax incentives, while more generally, consumers demonstrated more reticence against the backdrop of rapid changes in technologies, regulations and transport habits. Output was disrupted in the euro area – and more especially in Germany – following the adoption of new emission standards.

The mounting trade tensions and global weakness of industrial output had a significant impact on the growth of international trade, which entered negative territory from the summer. While the decline in the volume of trade was widespread, the Asian economies most involved in world trade and value chains – headed by China – were harder hit. International trade suffered particularly from lower demand for motor vehicles, electronic products and capital goods, which are traded internationally to a considerable degree.

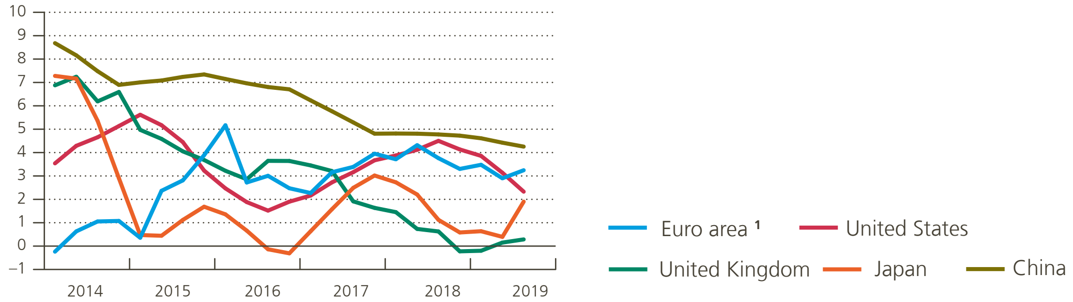
The sharp fall in Chinese imports is due in particular to a marked deceleration in the country's exports, but also to the still ongoing process of rebalancing its economy. The growing importance of domestic consumption at the expense of investment curbed

Chart 2

The heightened uncertainty depressed investment, manufacturing industry and international trade

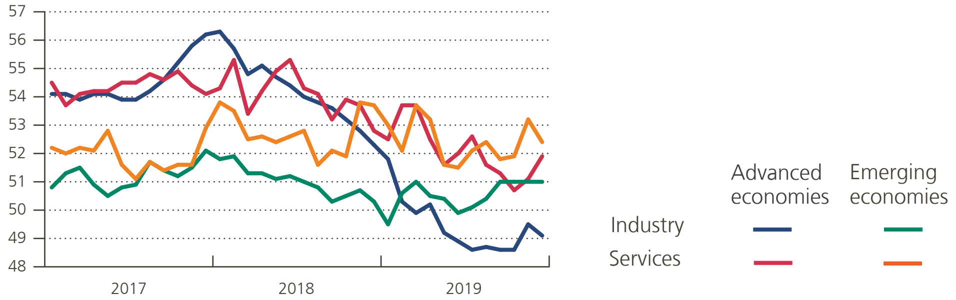
Investment

(quarterly data, moving averages over four quarters, annual growth rates)



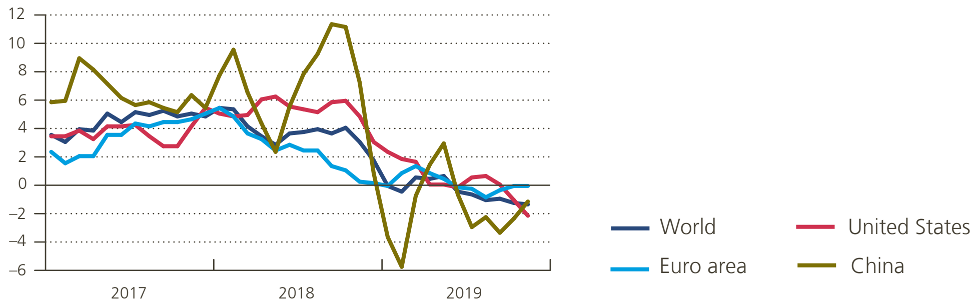
PMI indicators [2]

(monthly data)



International trade

(monthly data, annual growth rate, averages of imports and exports of goods and services)



Source: Refinitiv.

1 Excluding Ireland, where investment is volatile and closely linked to the activities of multinationals based in the country.

2 The PMI indices range between 0 and 100. A value of more than 50 indicates a rise in production, while a value of less than 50 indicates a fall.

demand for imports of investment goods and commodities. The desire to develop domestic production of inputs has a similar effect.

Some trade flows exhibited unaccustomed volatility during the year. That applies more particularly to Chinese exports, with certain goods being shipped in advance in order to avoid the American tariff increases. The United Kingdom saw a surge in imports at the beginning of 2019, ahead of the date initially planned for its departure from the EU, but it then subsided sharply.

In this context, and taking account of the weaker expansion – or even shrinking – of the working age population on account of demographic ageing, the unemployment rate continued to fall, sometimes reaching levels not seen for several decades. In the United States, unemployment thus declined to 3.5 % in December 2019, its lowest point since the end of the 1960s. A similar situation was apparent in the United Kingdom, while in Japan unemployment reverted to its level of the early 1990s, at just over 2 %. The buoyant labour markets generally encouraged wage rises in the advanced economies.

Buoyant services supported employment

While industrial output slowed considerably in 2019, that was not the case for services, which proved very resilient despite a slight slowdown. The dynamism of the tertiary sector, which represents a growing and dominant share of economic activity, supported job creation, household incomes and consumer confidence. In contrast to business investment, which was held back by increased wariness, consumption expenditure thus underpinned activity in general.

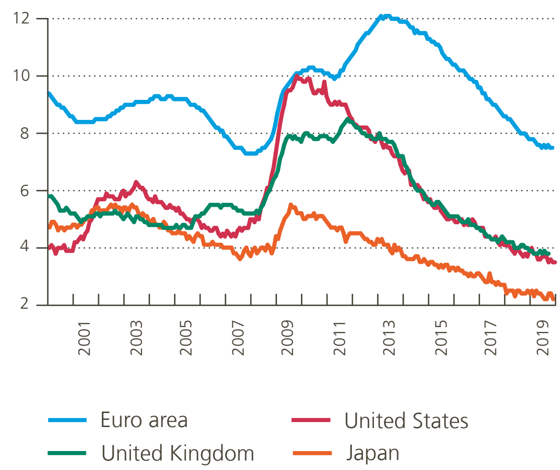
Weak inflationary pressure has led to further monetary easing

However, the wage rises were not reflected in prices, and the slowdown in economic activity was accompanied by a further weakening of the underlying inflationary pressure, combined with the absence of upward pressure originating from commodity prices. Inflation thus fell far short of its target in the advanced economies, while it reached historically low levels in a number of emerging economies. Argentina and Turkey, whose currencies have depreciated sharply in the recent period, were the exception in this respect, with relatively high inflation.

Chart 3

Further decline in unemployment rates

(monthly data, in % of the labour force)



Source : Refinitiv.

After surging strongly at the beginning of the year, oil prices subsided during the summer to less than US$ 60 per barrel of Brent, against the backdrop of a deteriorating global economic outlook. Following the attack on Saudi oil installations in September, the price per barrel suddenly jumped by about 10 % before falling again just as quickly. In the face of the easing of trade tensions between China and the US and the prospect of macroeconomic stabilisation, oil prices edged back up towards $ 70 by the end of the year. Prices of industrial and food commodities remained fairly stable overall through the year.

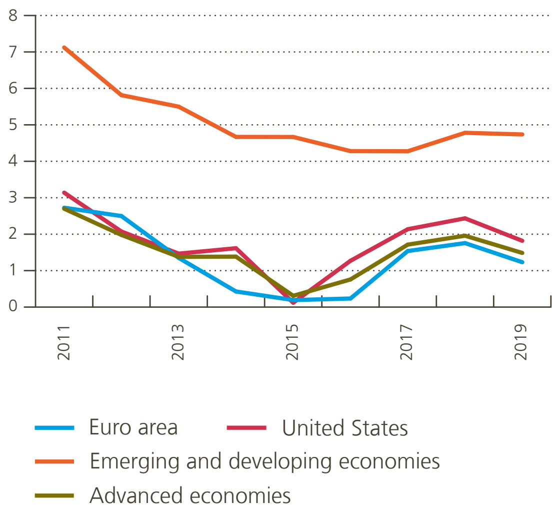
In an environment featuring weaker economic activity, increasing risks and declining inflationary pressure, monetary policies were adjusted in favour of a resolutely accommodative stance, both in the advanced economies and in the emerging countries. In particular, the US Federal Reserve adopted a more accommodative tone in its communication, before proceeding to introduce specific easing measures. For instance, in March 2019, it announced that, from September, it would end the reduction in its balance sheet which had begun in late 2018. It also cut its key interest rates on three occasions, namely in July, September and October. But after having restored the federal funds rate to a target range of between 1.75 % and 2 %, it stated that it would not consider any further reduction unless there was a marked deterioration in the economic outlook. As explained in more detail in chapter 2, at its September 2019 meeting, the ECB Governing Council cut the deposit facility interest rate and announced that it would resume its asset purchases. The central banks of China, India, Brazil and Russia, among others, likewise lowered their key interest rates last year. The Chinese monetary authorities also implemented targeted monetary easing in order to contain debt servicing costs and moderate the shortage of credit specifically affecting small firms. They are still striving to strike a delicate balance between promoting access to credit while keeping control over corporate debt levels, which have more than doubled since 2008.

In comparison with monetary policies, fiscal policies were not very expansionary in most economies. The United States and China were among the exceptions. Following the fiscal stimulus approved in late 2017 and early 2018, American fiscal policy became decidedly accommodative. Nonetheless, the economic benefits of this stance were relatively minor in a context of full employment, where the fiscal multiplier is usually small. The Chinese authorities

Chart 4

Decelerating inflation in the advanced economies

(percentage annual change in consumer prices)

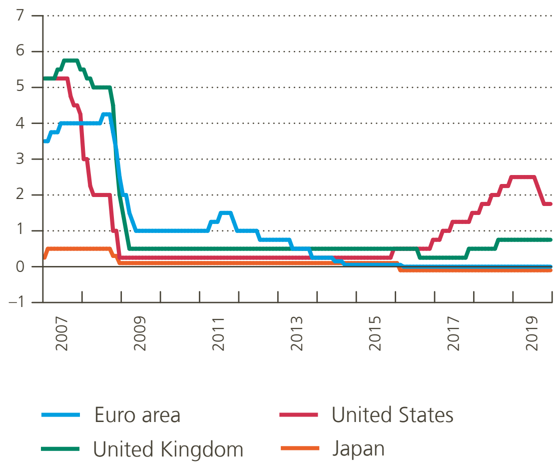


Source: IMF.

Chart 5

Monetary policies have been relaxed in the advanced economies

(main policy interest rates, in %)



Source: Refinitiv.

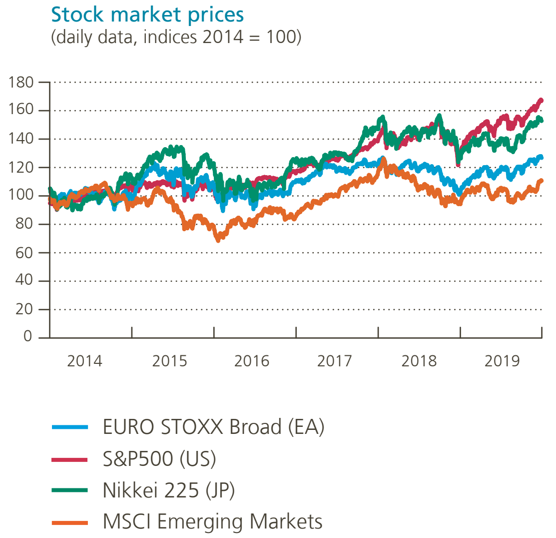
continued to support the economy, notably via investment in public infrastructure and tax cuts for households and businesses. In Japan, the government took various measures to counteract the expected negative impact of the rise in consumption tax – from 8 % to 10 % – with effect from 1 October 2019. These measures were more than sufficient to smooth household consumption before and after the tax increase, so that the latter's effects were much less marked than in 2014, when the tax rate had been raised from 5 % to 8 %. In December, Prime Minister Shinzo Abe also unveiled a new recovery plan amounting to 2.4 % of GDP (i.e. 13 000 billion yen, or more than € 108 billion).

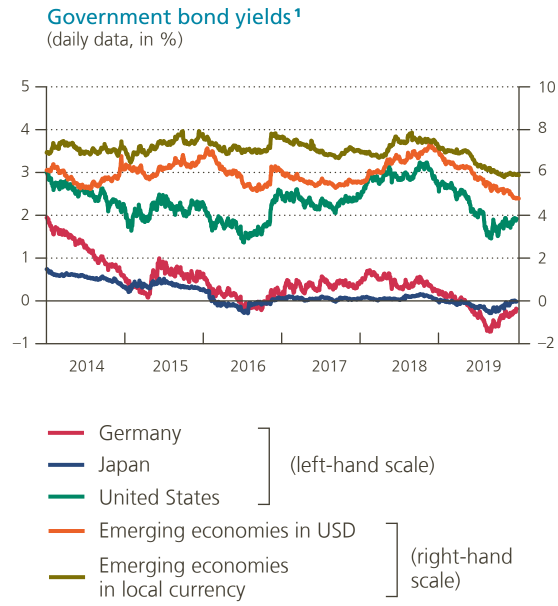
Financial markets under the combined influence of international trade and central banks

After optimism had been severely shaken at the end of 2018, it regained the upper hand and the equity markets enjoyed a strong revival at the beginning of 2019, especially in the advanced economies. Stock markets subsequently displayed a more erratic picture, sometimes depressed by the concerns relating to trade tensions, and sometimes bolstered by conciliatory communications on that

Chart 6

How the financial markets reacted to commercial and monetary policies





Source: Refinitiv.

1 Advanced economies: 10-year government bonds; emerging economies: JPM EMBI Global index (in US dollars) and JPM GBI index (in national currencies).

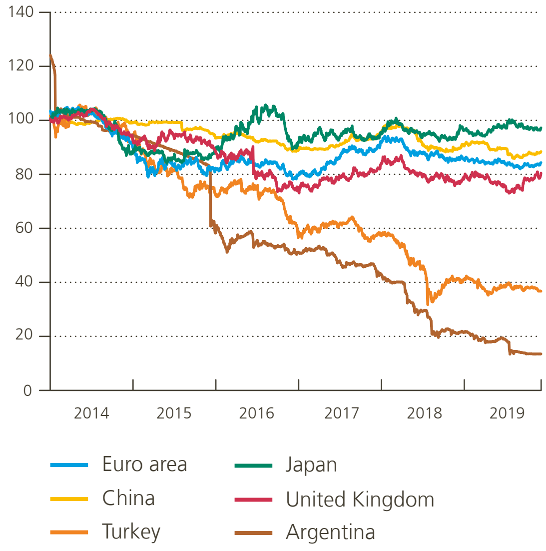
subject and the central banks' easing measures. Overall, the more accommodative monetary policy stance fostered an improvement in financing conditions in the advanced economies and, to a lesser degree, in the emerging economies. Sovereign bond yields also benefited from strong demand for less risky assets. Some long-term government bonds thus declined to historically low levels, occasionally entering very negative territory, as was the case in Japan and Germany. In the United States, the inversion of the yield curve during the summer temporary awakened fears of a deterioration in the economic outlook, or even a possible future recession. In the final quarter of the year, the apparent progress in trade talks and some reassuring signals indicating more encouraging economic prospects supported the equity markets and drove up sovereign yields.

Exchange rates largely mirrored the economic developments. The dollar appreciated slightly in relation to the euro, and more strongly in relation to the Chinese renminbi. The yen, and to a lesser degree the Swiss franc – two prime safe-haven currencies – appreciated somewhat against other currencies, while the pound sterling was highly volatile, fluctuating in response to the uncertainties and twists and turns concerning Brexit. It appreciated considerably against the euro from August, as the prospect of a negotiated withdrawal agreement gradually became clearer. The Turkish lira, which had fallen sharply in 2018, was more stable, in contrast to the Argentinian peso, which continued to tumble.

Chart 7

The US dollar appreciated a little against the euro

(daily data, exchange rate in relation to the dollar, indices 2014 = 100)



Source: Refinitiv.

1.2 Activity in the euro area was affected by the worsening global economic situation, but the labour market proved resilient

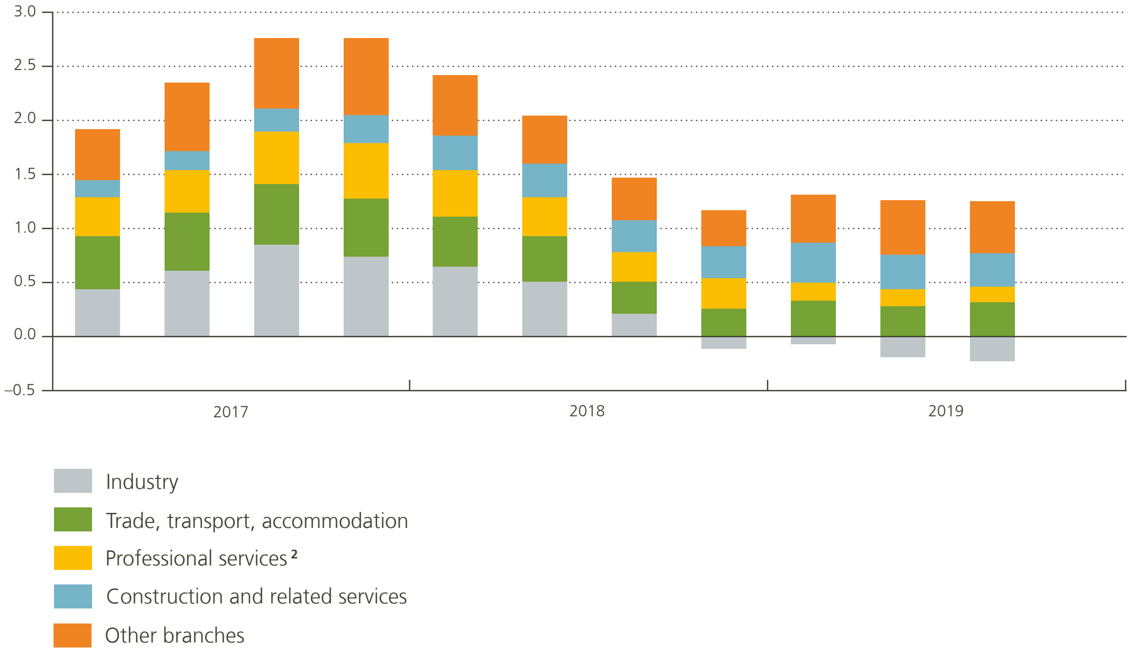
The slowdown in the global economy and international trade primarily affected manufacturing industry and exports

Economic growth in the euro area, which had fallen back to 1.9 % in 2018, dropped further to 1.2 % in 2019. The main factor in this weaker growth was the contraction in industrial activity. The decline was particularly marked in the motor vehicle industry, but other branches of manufacturing industry were also affected, albeit to a lesser extent. In addition, the expansion slowed down in some services branches, including those connected with industry, such as trade, transport and professional services, which together represent a large proportion of market services. On the other hand, construction and related services contributed more to the growth of

Chart 8

Activity in industry contracted in the euro area

(contributions of value added by branch of activity to the annual volume change in GDP[1], percentage points)



Source: Eurostat.
1 The sum of the contributions of the branches of activity does not correspond to the change in GDP. GDP is in fact equal to the total value added of those branches plus taxes on products (including VAT, excise duties and import duties) minus subsidies on products.
2 Professional, scientific and technical activities; administrative and support service activities.

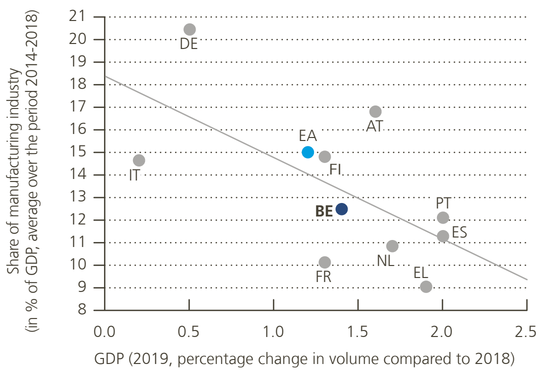
economic activity, driven by the low financing costs, the increase in household disposable income, and favourable weather conditions for construction work in the first quarter.

In 2019, GDP growth remained positive in all euro area countries, but slowed almost everywhere in relation to the previous year. It fell back sharply in Germany, to the lowest rate in the euro area except for Italy.

The weakening expansion of activity in the euro area is related to the slowdown in international trade and the decline in global growth, which depressed external demand for euro area products. More particularly, the cyclical slowdown in the United States, the persistent uncertainty over Brexit in the United Kingdom, and the less dynamic demand from China took their toll. The constant tension and serious

Chart 9

The euro area countries with substantial industrial activity were hardest hit



Sources: ECB, Eurostat, NBB.

uncertainty over trade policies specifically affected investment decisions worldwide, putting a heavy burden on industrial output and international trade. Industrial branches focused on exports thus paid a heavy price. In these circumstances, the relatively large share of industry in economic activity and the geographical and product specialisation of exports – which are usually advantages for the euro area, and especially for Germany – proved detrimental in 2019. The high degree of openness and close integration of the euro area's economy in global value chains have exacerbated the effects of this adverse change in the international environment.

Slackening global demand and technological and regulatory changes had an adverse effect on the motor vehicle industry

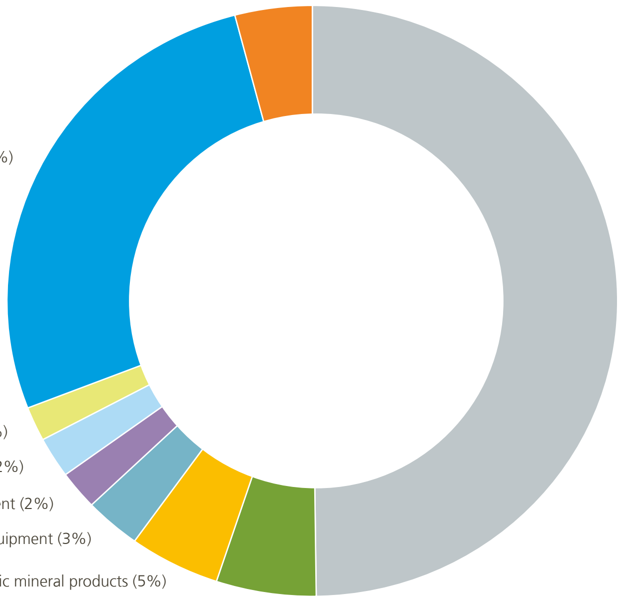
Nevertheless, the decline in industrial activity may also be due in part to a number of fundamental technological and regulatory changes in the motor vehicle industry. In the euro area, stricter emission tests for motorised vehicles were introduced in September 2018. The aforementioned decline in demand for such vehicles in China – following the reduction in tax incentives – also caused a drop in sales of cars. In addition, various specific factors affecting this branch, such as the introduction of low emission zones in many European cities, created much uncertainty, prompting consumers to adopt a wait-and-see approach. This mainly affected the German car industry, widely specialised in heavy-duty diesel vehicles, which are currently the most in doubt.

The close integration of the motor vehicle industry in global value chains contributed to the spread of the malaise, both at geographical level – in euro area countries and elsewhere – and at branch of activity level – to other industries and certain branches of the services sector. The "transport equipment" branch is not the only one involved in value creation within

Chart 10

Various branches of activity contribute to the value added created in the euro area by motor vehicle production

(2015, in %)



Source: OECD.
1 This includes trade, transport, information and communication, and financial services branches.

the motor vehicle industry. In 2015, this branch of activity accounted for half the value added generated in the euro area which forms part of final global demand for motor vehicles. Yet, the other industrial branches also accounted for around 17 %, while several services branches, including trade, transport and financial services, represented more than a quarter of the total.

All this resulted in a further slowdown in euro area exports, though the deceleration was less pronounced than in 2018. That relative resilience is due partly to the fact that, in the first quarter, exports received a temporary boost from stockpiling in the United Kingdom in the run-up to the original Brexit date. In the first three quarters of 2019, average growth of exports of goods and services was particularly weak in Germany, whereas that country accounts for by far the biggest share of the euro area's total exports. On the other hand, euro area imports, which had slowed considerably in 2018, resumed an upward trend in 2019. However, this volatility is due partly to very large fluctuations in Irish imports, connected with the activities of multinationals in that country. Overall, the slowdown in exports coupled with the renewed strengthening of import growth resulted in a very negative contribution of net exports to GDP growth.

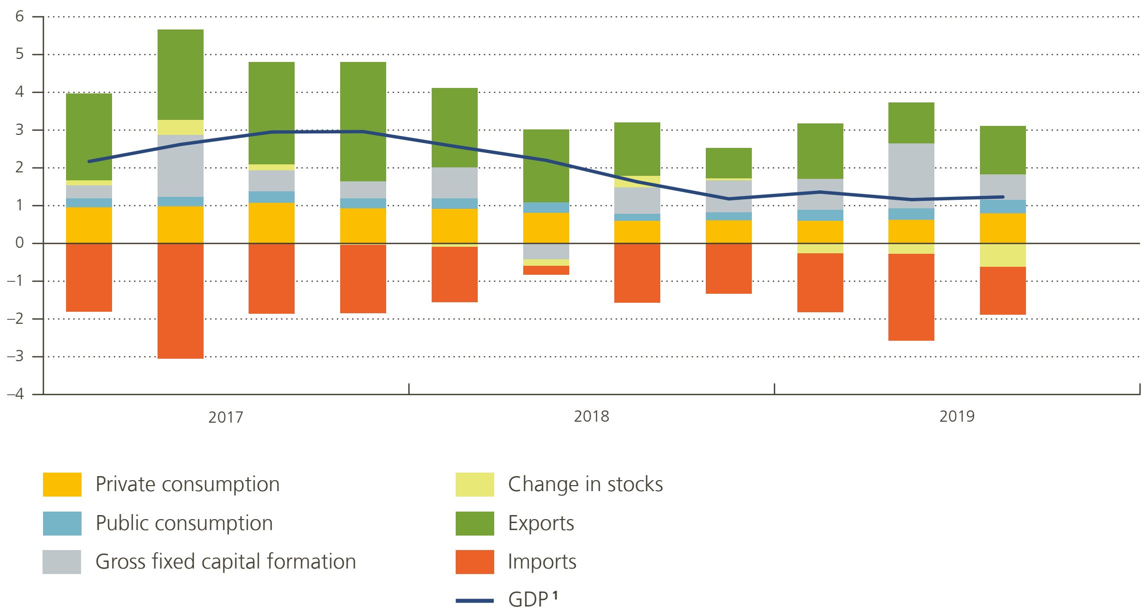
As for domestic demand, private consumption – which had been less dynamic in 2018 – continued to grow at more or less the same pace in 2019. This rise was due to the increase in household disposable income linked to the continuing expansion of employment and pay rises, and to consumer confidence, which has stood up well since the beginning of 2019. On the other hand, the household savings ratio has gradually risen over the past two years.

Investment bounced back during the first three quarters of 2019. Its contribution to annual GDP growth was considerably higher than in the previous year. However, that expansion is to a great degree due to substantial fluctuations in gross fixed

Chart 11

Net exports depressed GDP growth, but domestic demand continued to strengthen

(contributions in percentage points to the annual change in the volume of GDP, unless otherwise stated)



Source: Eurostat.
1 Percentage changes compared to the corresponding quarter of the previous year.

capital formation in Ireland, which are connected with the activities of multinationals and also distort the import statistics, as already stated. Investment in construction, in both housing and other types of building, including infrastructure, continued to grow, partly thanks to the low financing costs and weather conditions favourable to the construction sector in the first quarter, especially in Germany. Investment in machinery and equipment, though, recorded a smaller rise than in 2018.

Despite some shifts in its composition, GDP growth year-on-year remained fairly stable on the whole during the first three quarters of 2019, at the low level recorded at the end of 2018.

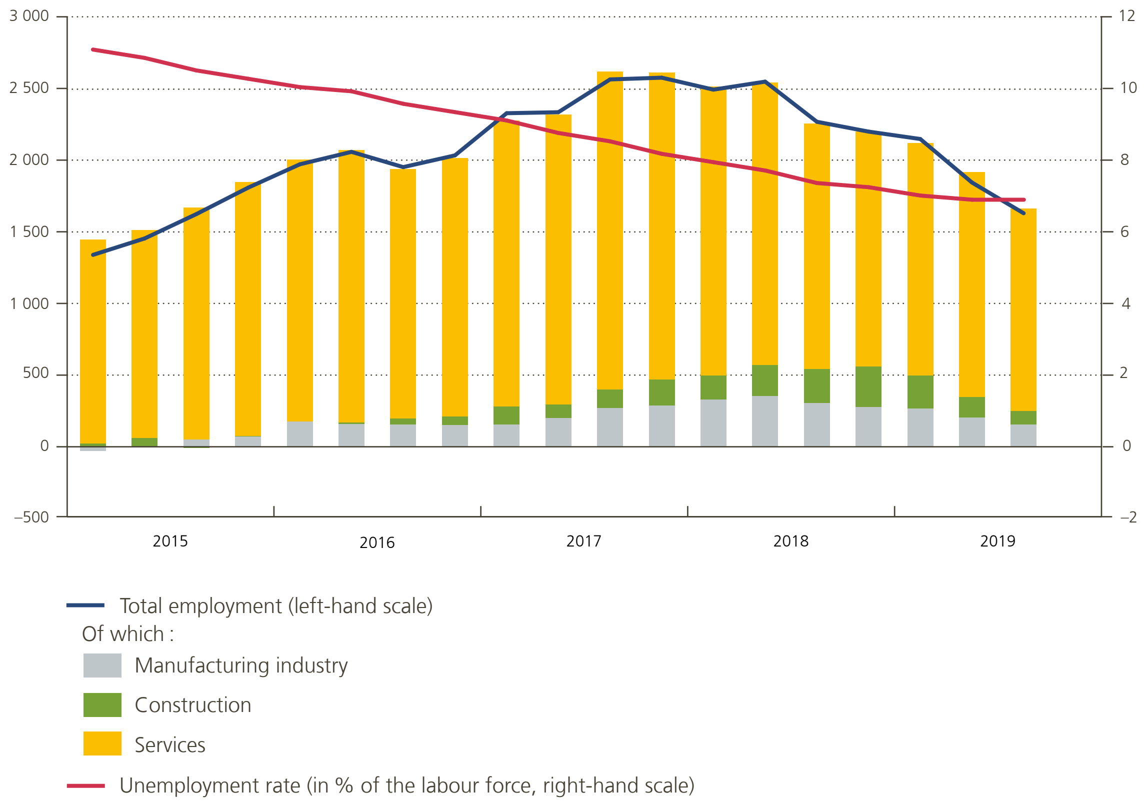
Yet the labour market remained dynamic

Despite the sluggish economic activity, the labour market continued to do well. At the end of the third quarter of 2019, more than 160 million people were in work in the euro area. Employment expanded by 1.1 % in 2019, though that growth was weaker than in the previous year. Construction and the manufacturing industry, in particular, saw a slower rise in the number of workers. In the services branches, which are by far the biggest source of jobs in the euro area, the slackening pace of employment growth was less pronounced, with professional services – which are closely linked to industrial activity – recording the biggest slowdown.

Chart 12

Employment is expanding more slowly, but unemployment is still declining

(changes in thousands of persons compared to the corresponding period of the previous year, unless otherwise stated)



Source : Eurostat.

At the same time, the decline in unemployment which had begun in mid-2013 continued. In November 2019, job-seekers accounted for 7.5 % of the labour force, very close to the lowest figure of 7.3 % seen just before the crisis. The improvement was fairly widespread in the euro area countries. Unemployment also continued to fall in the countries hardest hit by the crisis, in some cases being partly due to reduction in the size of the labour force. In Italy, the unemployment rate declined again, dropping below 10 % in the course of 2019, while it continued to hover around 15 % in Spain and Greece. In these two countries, youth unemployment is still very high. The contrast with some other euro area countries remains stark : in Germany and the Netherlands, for example, the unemployment rate fluctuates around a mere 3 %.

While labour market shortages are still significant, they have not worsened. In Germany, the Netherlands, Belgium and Austria, in particular, the proportion of unfilled vacancies has remained considerable, exceeding 3 %. That applied mainly in the construction and services sectors. In the manufacturing industry, shortages were smaller and, in 2019, the number of firms considering the availability of labour to be a constraining factor declined.

Labour market shortages are still significant but are no longer increasing

Various factors explain why the labour market situation is still relatively positive despite the weakening economic growth. For instance, the labour market generally takes time to respond to a deterioration in the economic situation, as firms are cautious about cutting their workforce in view of the costs involved in redundancies and staff recruitment, while it is uncertain how long the economic slowdown will last. Similarly, the difficulty of finding people with the required skills in some branches is possibly part of the reason why firms retain their staff, since there is no guarantee that they will be able to re-employ the workers they need once activity picks up.

Wages are still rising while inflation remains low

Labour costs are, in principle, a key determinant of prices. According to the Phillips curve model, there is a negative correlation between unemployment and inflation which is attributable to wages. For example, if unemployment is particularly low, workers can negotiate higher wages and that (ultimately) may drive up the prices of the goods and services that they produce.

As a result of the persistent tightening of the labour market, positive wage growth continued in the euro area in 2019, although the pace stabilised during the year. Labour costs per person continued to rise by more than 2 % on an annual basis. Unit labour costs increased at a similar rate, as productivity per worker stagnated. Among the large economies, it was mainly Germany where unit labour costs continued rising ; they increased by an average of around 3.5 % compared to the previous year.

In 2019, as at the end of 2018, the increase in unit labour costs was also reflected in higher prices of domestic value added which includes net indirect taxes and margins as well as wages. That transmission became a little more marked since, in the euro area, it was no longer curbed by firms wishing to limit their profit margins.

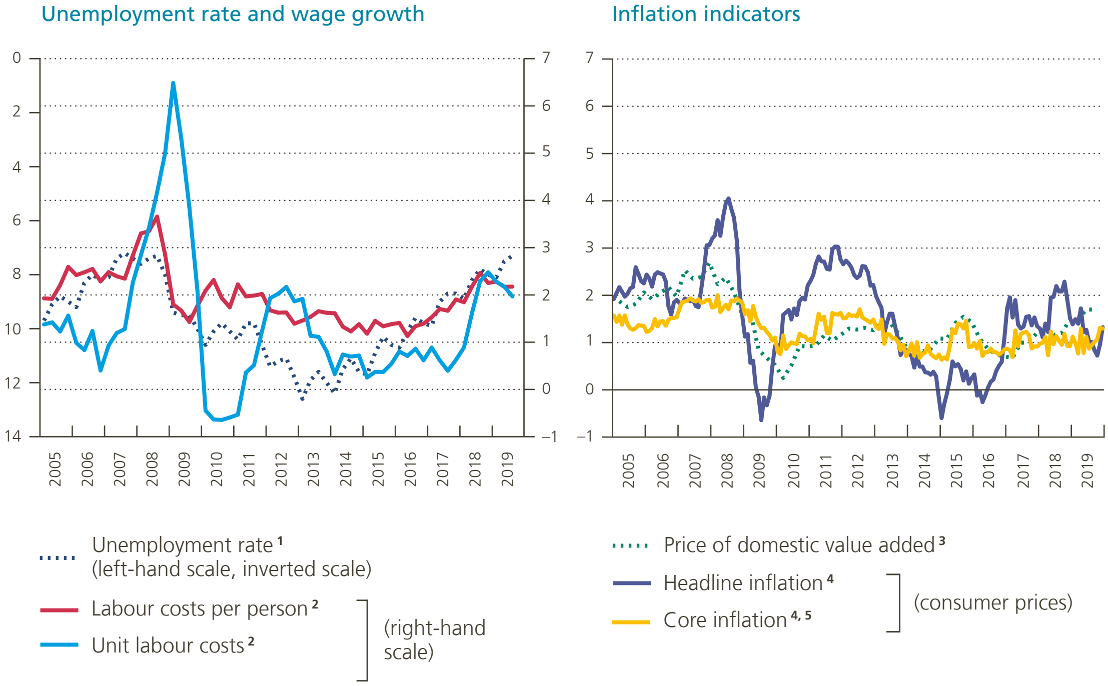
Since 2017, however, the rise in the price of domestic value added has not been mirrored in consumer prices, which traditionally form the basis of the indicators of total and core inflation. Two factors may account for that.

First, many of the goods and services consumed by euro area households are imported. Also, a fall in the prices of these imports may offset the rise in the prices of domestic production in the consumer price indices. Such an effect is, in principle, particularly relevant for headline inflation, which is typically influenced heavily by changes in the price of energy, that being a component imported mainly from the rest of the world. The decline in energy prices in 2019 is in fact the main reason why headline inflation dropped below 1 % during the year, whereas it had averaged 1.8 % in 2018. Also, the baskets used to calculate the consumer price indices do not include part of domestic value added. That applies, for example to investment, including investment in the construction sector, where prices have maintained a strong upward trend since 2017 and continued to drive up the prices of domestic value added in 2019.

In this context, there was again barely any increase in core inflation in 2019 in the euro area. Viewed over a longer period, it has already stagnated at around 1 % since the end of 2013.

Chart 13

Higher labour costs are not always reflected in a permanent rise in consumer prices



Sources: ECB, Eurostat.
1 Percentages of the labour force.
2 Percentage changes compared to the corresponding quarter of the previous year.
3 Change in the GDP deflator (in other words, the ratio between GDP at current prices and GDP at constant prices), percentage changes compared to the corresponding quarter of the previous year.
4 Percentage changes compared to the corresponding month of the previous year.
5 Headline inflation, excluding energy and food.

Fiscal policy was eased slightly

The budget deficit of the euro area as a whole edged upwards slightly in 2019, from 0.5 % of GDP in 2018 to 0.8 % of GDP. That increase reflects divergent budgetary developments between euro area countries. For instance, the budget surplus expanded in Greece, while the deficit contracted in Spain and Portugal. Conversely, Germany recorded a smaller surplus while Belgium and France saw their deficits increase. In France, the budget deficit came to 3.1 %, but that is partly due to non-recurring factors.

Interest charges declined further in the euro area countries. On the other hand, in some countries, notably Germany, Belgium and Italy, the budgetary outcome suffered from the impact of less favourable economic conditions. In the euro area as a whole, the fiscal stance was slightly expansionary: the structural primary budget surplus was down by about 0.3 percentage point of GDP.

The gross public debt ratio in the euro area as a whole peaked at 95.1 % of GDP in 2014. The subsequent downward trend persisted in 2019, to 86.4 % of GDP, representing a further decline of 1.5 percentage points in the space of a year. The debt ratio was down in most euro area countries, although it increased by 1.4 percentage points in Italy, bringing the debt to 136.2 % of GDP. As in 2018, Italy was the only euro area country where the snowball effect – i.e. the impact on the general government debt ratio of the difference between nominal GDP growth and the implicit interest rate on the public debt – pushed up the debt burden; the implicit interest rate there was higher than the (modest) nominal economic growth. Greece once again recorded the highest public debt ratio in 2019, at 175.2 % of GDP, although that was substantially lower than the previous year's figure.

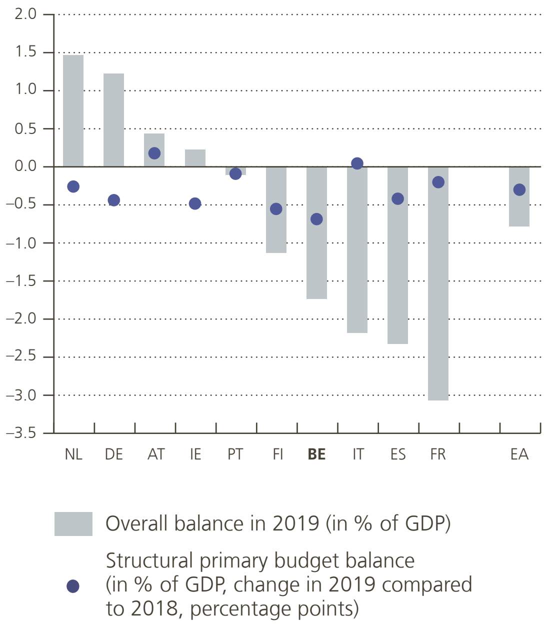
At the end of 2019, no EU Member State was subject to an excessive deficit procedure under the corrective arm of the Stability and Growth Pact (SGP), as the Ecofin Council decided in June to close the procedure which it had launched in respect of Spain. That situation is in sharp contrast to what was seen during the crisis years, when most of the countries in the euro area at that time were involved in such a procedure. Consequently, the surveillance of the public finances of all Member States now takes place under the preventive arm of the SGP. On that basis, the Member States' public finances are assessed according to the medium-term objective (MTO), a reference value for the structural budget balance specific to each country, which is consistent with sound and sustainable public finances.

Some of the countries pursuing an expansionary fiscal policy had scope to do so while others did not

In a limited number of Member States, notably Germany, the Netherlands and Luxembourg, the structural balance exceeded the MTO. Those countries therefore have budgetary scope which could be used to adopt an expansionary fiscal stance. Germany used this scope to fund the implementation of coalition agreement measures, such as bigger tax allowances or higher child benefits and retirement pensions. As a result, its structural primary budget surplus declined by 0.4 percentage point of GDP in 2019. However, in a number of euro area countries, the structural budget balance remained below the MTO, so that an effort is still needed to attain that target. Those countries therefore have no real fiscal space but some of them, such as Belgium, Spain and France, nonetheless pursued an expansionary fiscal policy. Italy's fiscal stance was fairly neutral.

Chart 14

Most euro area countries pursued a slightly expansionary fiscal policy



Sources: EC, NBB.

The euro area's current account ended 2019 with a surplus of almost 3 % of GDP, slightly lower than the outcome in previous years. A current account surplus of this size shows that the euro area saved more than it invested, driving down the "equilibrium" or "natural" interest rate of the euro (see box 1). The sheer size of the current account surplus of the euro area as a whole reflects the systematically large surpluses recorded by some countries, particularly Germany and the Netherlands, combined with smaller deficits in countries where the deficit had often been substantial before the crisis. Among the latter countries, some – like Spain and Italy – have already recorded a surplus for several years. Since last year, Belgium's surplus has turned into a deficit.

After having risen continuously from 2010 to 2017, the euro area's current account surplus dipped slightly below the previous year's level in 2019. Leaving aside the volatility of the Irish current account, this fall masks some rebalancing between the current accounts of the euro area countries, as the German and Dutch current account surpluses declined, while Spain and Italy recorded an increase in their surpluses, and the deficit was reduced in Greece. It remains to be seen whether this heralds the start of a more symmetrical rebalancing process in the euro area that also involves the Member States which have systematically recorded large current account surpluses. In any case, the reduction in the current account surplus in Germany is in line with the accelerating wage growth of recent years and more extensive use of the budgetary scope in 2019. The Netherlands likewise pursued a slightly expansionary fiscal policy last year.

BOX 1

Extremely low interest rates: a global, structural phenomenon

The persistence of extremely low or even negative interest rates is cause for concern. It gives rise to anxieties (will we soon have to pay the banks to look after our savings?) and explanations some of which are well-founded, others less so. To obtain a clearer idea, this box sets out the concepts involved and summarises the state of the debate on the causes of the phenomenon in the world and in the euro area.

What is an interest rate?

The interest rate represents the "price of time". It measures the remuneration for the patience shown by any economic agent who, by choosing not to spend, delays the immediate gratification derived from consumption or renounces the future gains expected from a productive investment. A high price of time therefore encourages everyone to postpone expenditure. Conversely, a fall in the interest rate encourages earlier spending.

If there is a price, there must be a market where supply and demand equalise at an equilibrium price. On this "loanable funds" market, savings (the supply of funds) finance the borrowings (demand for funds) of economic agents wishing to spend more than their income (a household purchasing a car or investing in housing, a firm building a factory, the State building a motorway, etc.). Loans are raised either directly, e.g. on the bond market, or indirectly via the banking system. At any time, the interest rate corresponds to the level at which the supply of loanable funds is equal to the demand, taking all agents together. For example, a sudden rise in savings (supply of funds) driven by fears of recession will drive down the interest rate, thus encouraging borrowing (demand for funds), so that equilibrium is restored.

The role of inflation

The elementary mechanism described above disregards a key consideration in the choice between spending today or tomorrow: the loss of the currency's purchasing power due to inflation. As a "tax" on time, inflation encourages earlier spending in order to avoid that loss. The interest rate mentioned above therefore has to take account of that tax. This "economically relevant" rate which informs decisions on saving and borrowing is called the real interest rate.

This real interest rate differs from the rates advertised by the banks or published in the press, because the latter take no account of the "inflation tax". In this case, we refer to nominal interest rates. The real interest rate is obtained simply by subtracting from the nominal interest rate the inflation effects likely to be incurred by postponing expenditure for a given period.

This is precisely where central banks play a fundamental role in the economy, by announcing an inflation target and promising to take the necessary steps to achieve it. With this "price stability" target, they therefore inform economic agents of the probable level of the "inflation tax". It is easy to see that widely fluctuating inflation would be just as detrimental to the agents' decisions on spending as if VAT rates or income tax rates were suddenly to become unpredictable. Like any tax, inflation needs to be moderate, stable and predictable in order not to disrupt the functioning of the economy.

In the euro area, price stability was defined as an annual inflation rate "below, but close to, 2 % in the medium term". A slightly positive inflation rate is generally considered desirable, notably to avert the risk of triggering a runaway deflationary spiral [1]. Defining the target in the medium term also obviates the need for the central bank to constantly adjust its monetary policy in response to temporary events, such as energy price shocks.

Monetary policy and the inflation target

To ensure that inflation is moderate and predictable, the central bank tries to stabilise economic activity at levels close to the potential level of full employment. Contrary to what one might think, that is not the maximum possible level of production but the level beyond which wages and prices would rise faster than the central bank's target figure. Conversely, production below the potential level would create unemployment and exert undesirable downward pressure on prices and wages.

Since the real interest rate is the relevant lever for influencing spending, economic activity and employment, it is crucial for the central bank to know the level of the real rate at which supply and demand for loanable funds are in balance, while maintaining activity and employment close to their potential level. This "equilibrium" or "natural" real interest rate (also known by the English abbreviation r^* – pronounced as r-star) is the compass by which monetary policy is steered. Although r^* cannot be observed, its properties are known and it can be estimated on the basis of existing data.

The art of monetary policy consists in stabilising inflation around its target via the real interest rate and the latter's influence on spending and economic activity. Thus, if inflation is constantly expected to fall short of its target, that is often the sign of an economy operating at below its potential. The central bank then tries to stimulate activity by cutting the real interest rate below its "equilibrium" level. Conversely, when inflation is constantly expected to exceed its target, the central bank restrains activity by raising the real interest rate above its "equilibrium" level. Although controlling inflation and stabilising economic activity often go hand in hand, this "divine coincidence" [2] is not guaranteed. For instance, a lasting increase in production costs which is not due to a cyclical upturn in the economy – e.g. an increase caused by an upward trend in energy prices – reduces the full employment potential, forcing the central bank to raise the real interest rate in order to curb inflation at the expense of a fall in activity.

It should be noted that central banks can only exert direct influence on nominal interest rates. However, real interest rates follow suit once economic agents' inflation expectations become sufficiently stable ("firmly anchored" in the central bankers' jargon).

1 Deflation – a steady decline in prices – tends to be self-perpetuating because the expectation of future price reductions prompts agents to postpone their expenditure, further depressing demand and driving prices down. For more details, see the definition of price stability as viewed in the euro area, https://www.ecb.europa.eu/explainers/tell-me-more/html/stableprices.fr.html.

2 This term is generally attributed to Olivier Blanchard and Jordi Gali (see Blanchard O. and J. Galí (2007), "Real Wage Rigidities and The New Keynesian Model", *Journal of Money, Credit, and Banking*, supplement to v. 39, 35–66), who use it specifically to describe the situation in which the central bank can stabilise economic activity and inflation simultaneously.

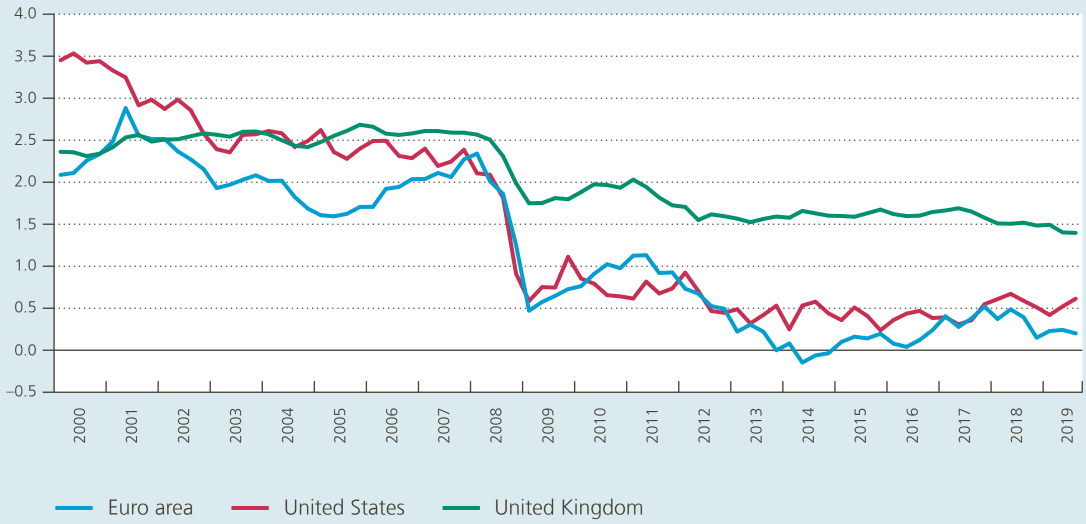
Determinants of the equilibrium interest rate

While central banks may claim to have some influence on nominal and real interest rates, the same is not true of the equilibrium interest rate, which reflects aspects of the economic situation over which monetary policy has no control. For economies open to capital inflows and outflows, such as the euro area, the equilibrium interest rate depends largely on the global interplay of supply and demand for loanable funds. As shown in the chart below, the estimates of *r** available for the euro area, the United States and the United Kingdom have tended to fall since the early 2000s, and the 2008-2009 crisis only accelerated that decline.

There are many reasons for this decline, and they include factors which simultaneously boost savings while curbing investment. The principal factors include population ageing in the West and in East Asia (China, South Korea, Japan) and, in some countries, the marked worsening of income inequality. Individuals tend to save more as they approach retirement age, while the wealthiest households exhibit

Equilibrium interest rate (*r): United States, United Kingdom and euro area**

(in %)



Source: calculated according to Holston K. *et al.* (2017), "Measuring the Natural Rate of Interest: International Trends and Determinants", *Journal of International Economics,* 108, supplement 1 (May): S39–S75.

a higher propensity to save their surplus income. Firms adjust their investment plans in line with the prospect of less dynamic markets, smaller productivity gains – another structural trend in many advanced economies, liable to depress the equilibrium interest rate – and generally lower growth. For many large firms, low investment combined with the persistence of comfortable profit margins and stable dividends has automatically boosted savings, prompting them either to support their own share prices by large-scale repurchases or to stimulate demand for low-risk or risk-free assets even further.

Higher risk perception has probably also stimulated precautionary saving and discouraged some investment plans, further weakening the already modest growth prospects. In particular, the crises in 1997-1998 and 2008-2009 were a sad reminder of the exorbitant cost of financial crises, encouraging many countries to save more, either to rectify unsustainable external deficits or to accumulate substantial reserves to cope with the effects of a future external crisis. In demographic terms, the longevity risk – the risk of living longer than expected during active life – remains a threat to the financial viability of retirement systems which are already under stress. More recently, heightened geopolitical risks, the growing uncertainty about economic policies themselves (e.g. the emergence of trade disputes), and ever more evident climate risks have done nothing to reverse that trend.

In the euro area, the excess loanable funds in relation to borrowing needs is particularly pronounced, a reality expressed in the region's current external surplus (as opposed to the US external deficit) and which accentuates the downward pressure on the equilibrium interest rate of the euro. Although part of the euro area's savings serve to meet the needs of economic agents outside the region (the financial corollary to the current external surplus), the underlying reasons behind the rise in saving were reflected in growing demand for risk-free assets, such as the government bonds of certain euro area countries. In the face of this stronger demand, the supply of this type of asset was limited by the rapid improvement in the public finances of major issuers such as Germany and by persistent doubts concerning the soundness of other major issuers such as Italy. That contributed to a marked fall in nominal bond yields, which are now negative or zero up to long maturities in several countries.

Monetary policy when the equilibrium interest rate is close to zero

The decline in the equilibrium interest rate to a level close to zero is a constraint on monetary policy since it considerably reduces the scope available to the central bank for stimulating activity. Largely negative real interest rates are then necessary, and in principle, in a context of very low inflation, that requires negative nominal interest rates. However, the zero nominal interest rate on banknotes limits that possibility, and it is only the costs and risks associated with holding large quantities of banknotes that create some scope for cutting nominal interest rates below zero and keeping them there.

As with any remedy applied in heavy doses over long periods, there is always the possibility of unwelcome side effects:

1. In the long run, such an incentive to incur debts could lead to financial excesses. It could permanently impair the balance sheet quality of firms, individuals, and even governments, thus making it particularly difficult to restore interest rates to normal.

2. The search for higher yields compresses risk premiums, thus weakening the market signals informing investors of borrowers' solvency. This "sight navigation" may lead to ill-considered risk-taking.

3. The reduction in the margins made by financial intermediaries on their lending activities affects their profitability and could ultimately threaten the quality of their balance sheet.

4. The remedy itself could become ineffective, as negative nominal interest rates could destabilise the loanable funds market instead of helping to rebalance it. If precautionary motives dominate decisions

on saving, the desire to maintain a safety buffer could actually cause the agents to step up their saving still further (rather than reducing it) in the event of a fall in interest rates.

5. Negative nominal interest rates could create a feeling of unfair redistribution, in which virtuous savers pay a tax that benefits reckless debtors.

In conclusion, the emergence of very low or even negative nominal interest rates reflects general structural developments (demographics, flagging growth, higher risks, growing income inequality) which monetary policy cannot influence but which, in a low inflation context, oblige policy-makers to cut nominal interest rates to unprecedentedly low levels. The sole intention here is to bring inflation back towards its target. However, it shows the limits of the conventional approach to monetary policy and highlights both the usefulness of non-standard monetary measures, which offer some influence over longer maturities in the yield curve, and the importance of getting other economic policy instruments to contribute more towards maintaining activity at close to its potential level and increasing the economy's potential.