

Europe The Road Ahead

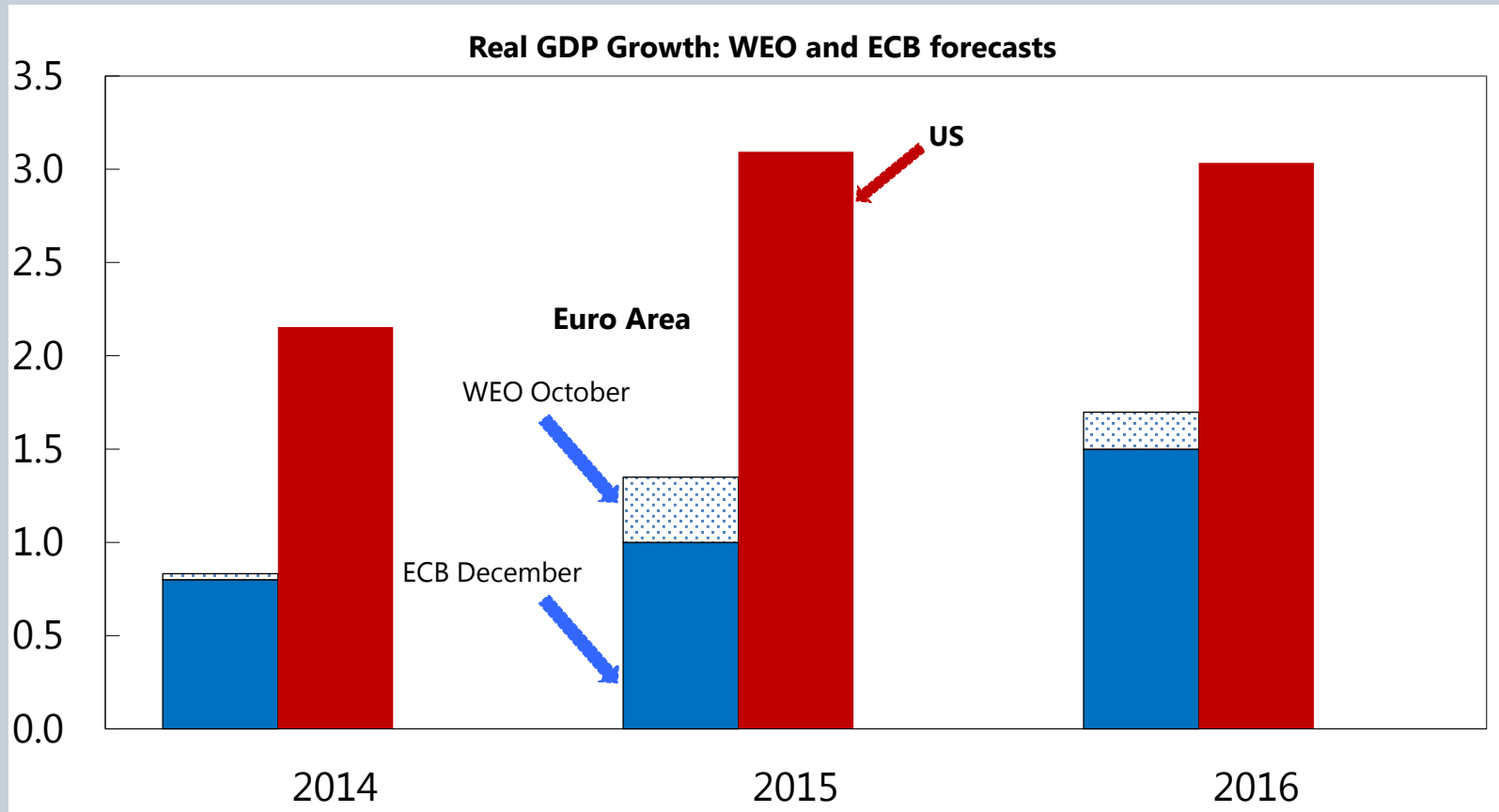


**JÖRG DEGRESSIN
DEPUTY DIRECTOR, EUROPEAN DEPARTMENT**

INTERNATIONAL MONETARY FUND

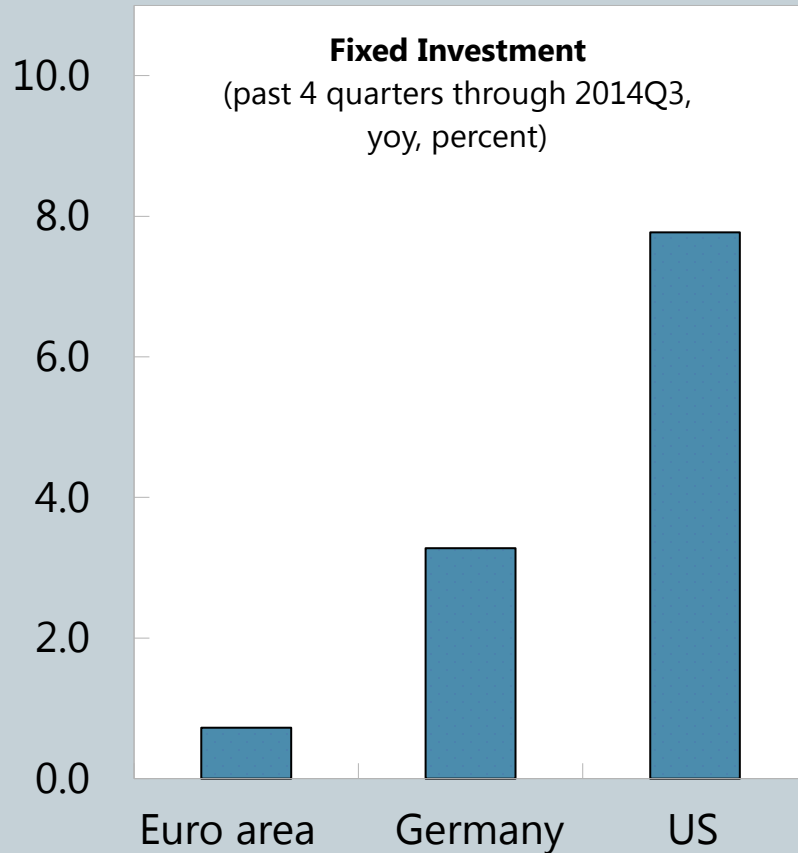
DECEMBER 2014

Only modest euro-area growth through 2016



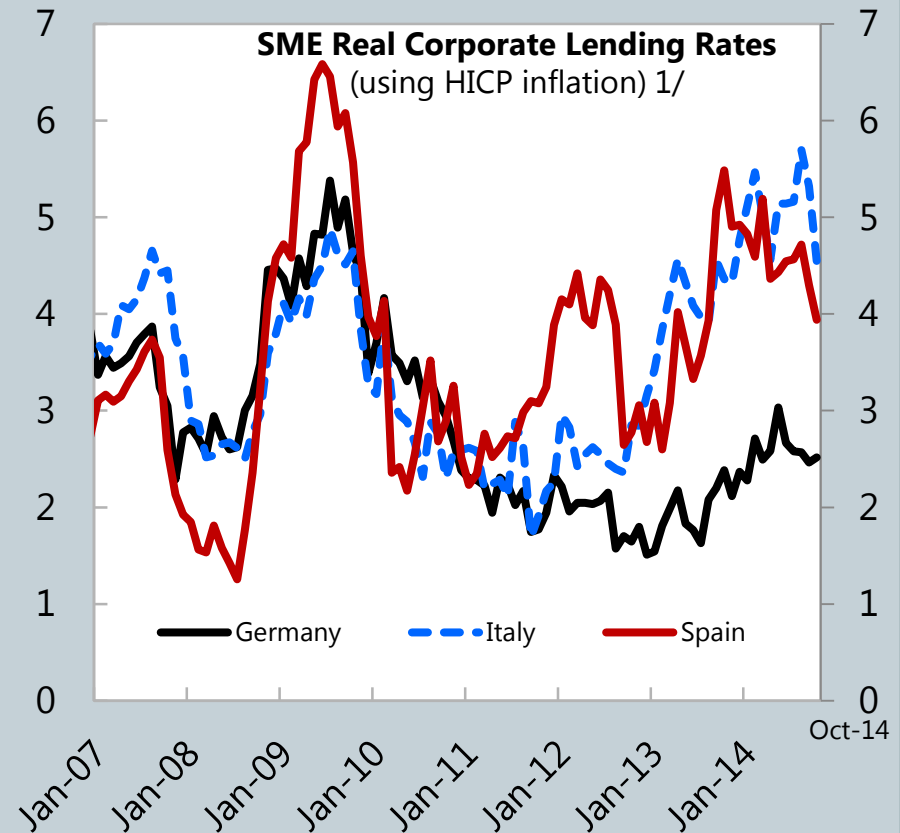
Low investment, also in Germany, has held back growth

Investment recovery has lagged...



Source: HAVER Analytics

... and lending rates are only part of the story.

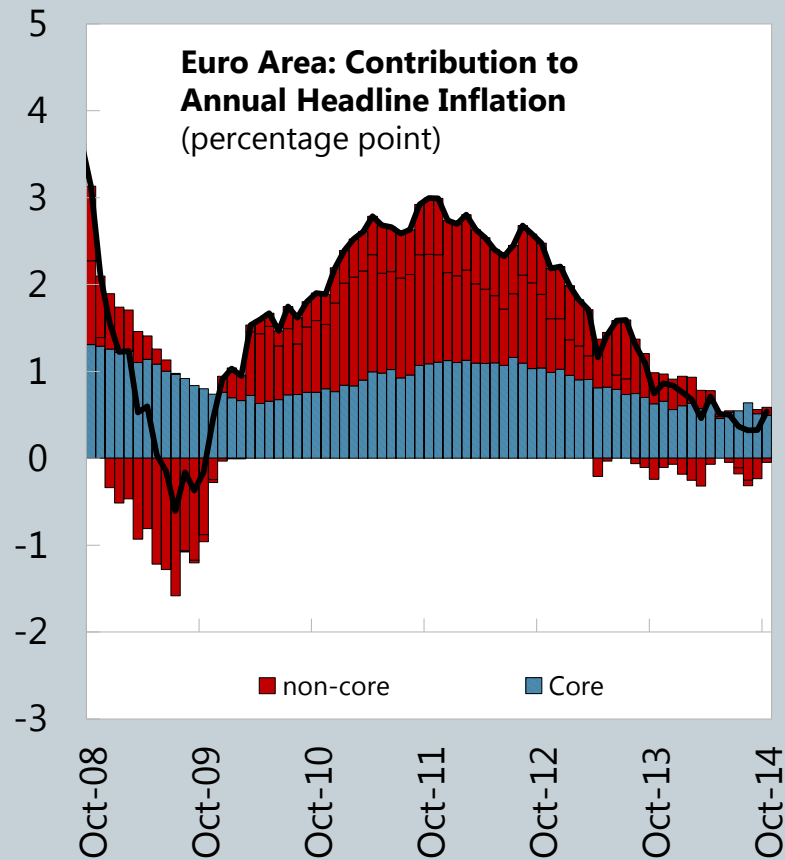


Note: spread is simple average of ESP and ITA over DEU.
1/ MFI lending to corporations under €1 million, 1-5 years. Ex-post real rates using HICP.

Source: HAVER Analytics

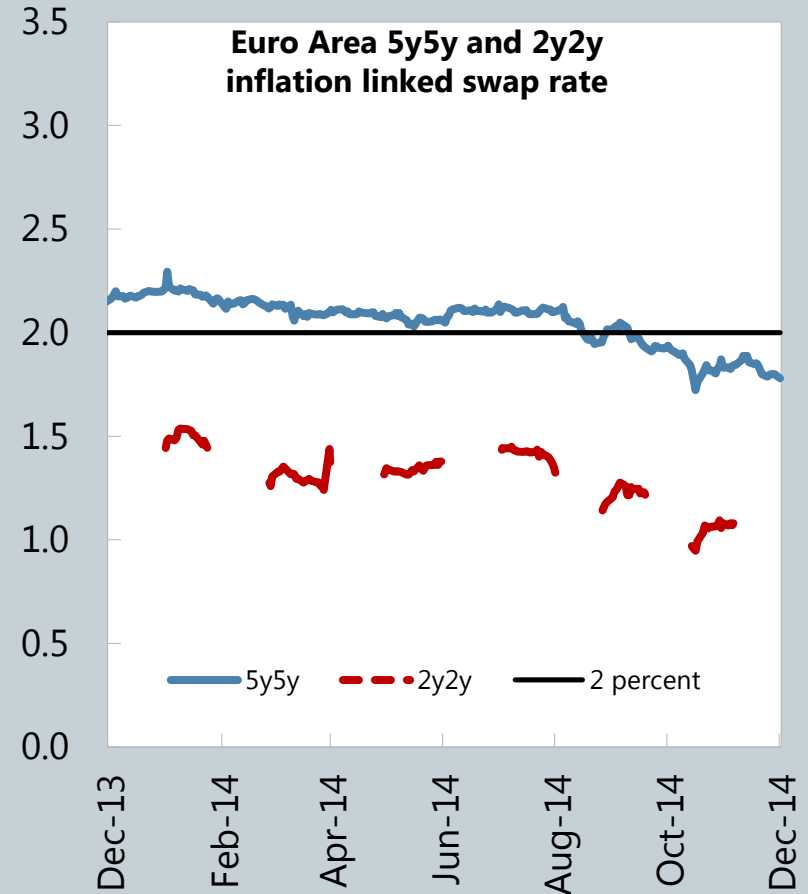
Inflation has weakened

Lately again driven by energy prices, but core inflation is also low...



Source: ECB, IMF IFS, Staff estimates

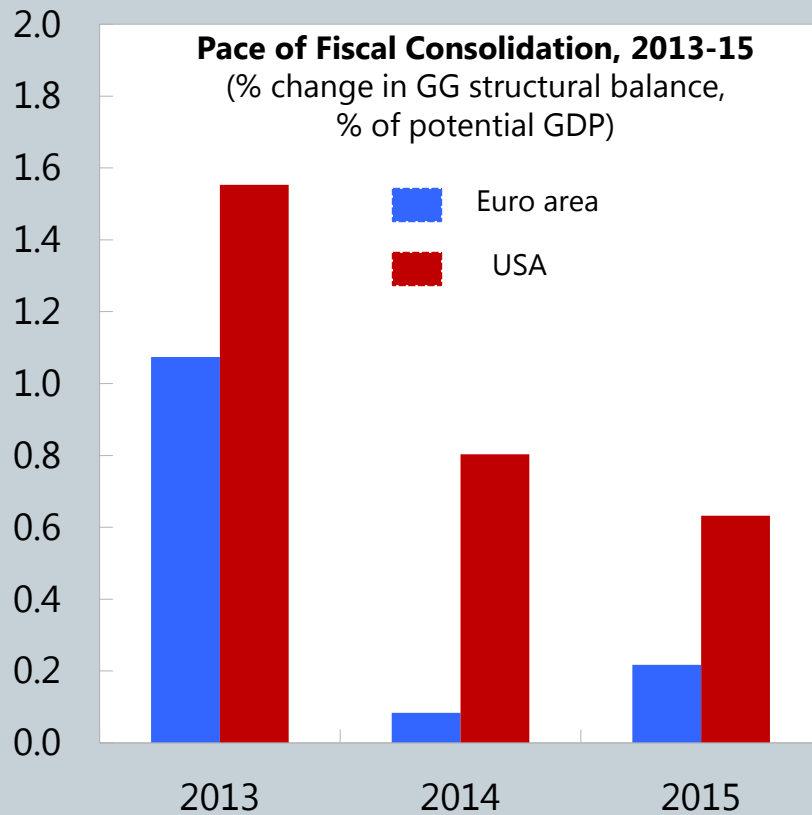
...and inflation expectations have further declined.



Source: Bloomberg

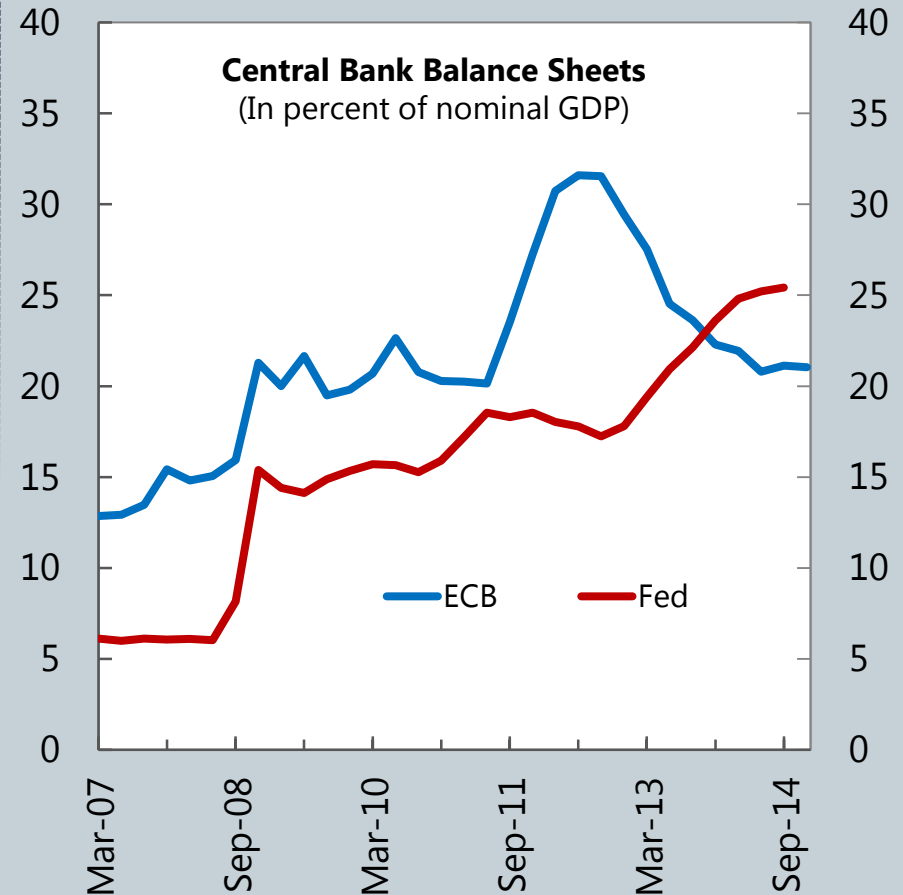
Demand support has been limited

Slower fiscal consolidation has helped the recovery. Hopefully not all the effects have been felt yet.



Source: Oct 2014 WEO

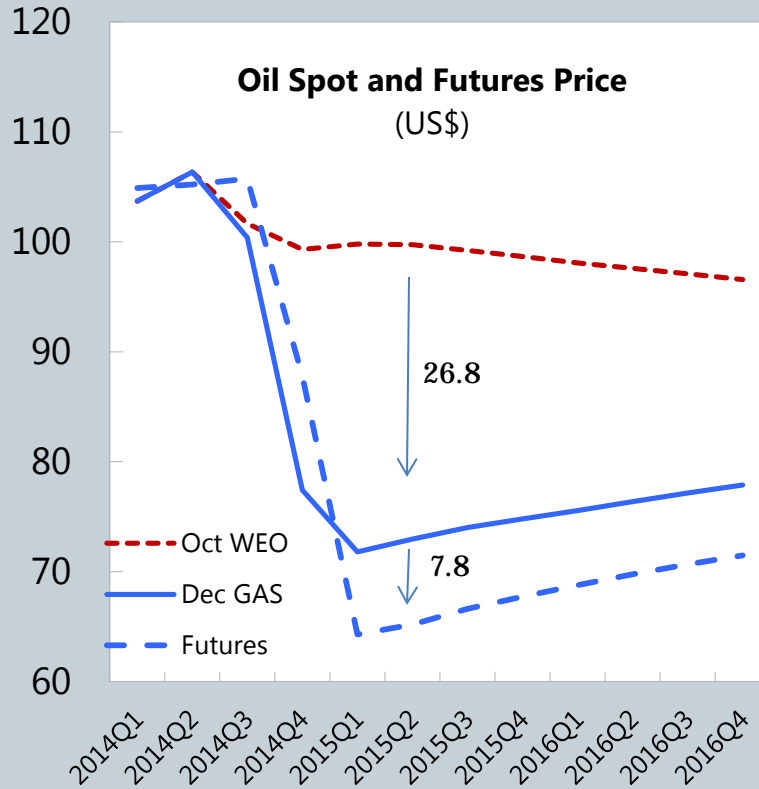
But the ECB balance sheet has been contracting.



Source: ECB, Bloomberg

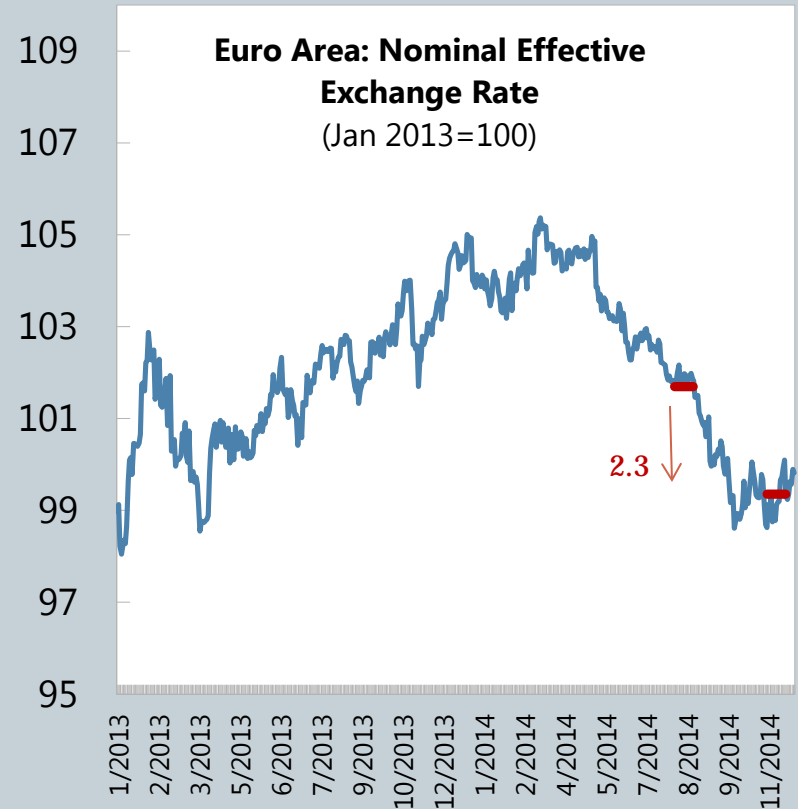
Oil and a weaker exchange rate should provide lift

Oil projections are much lower, mainly reflecting greater supply...



Source: GAS, Staff estimates

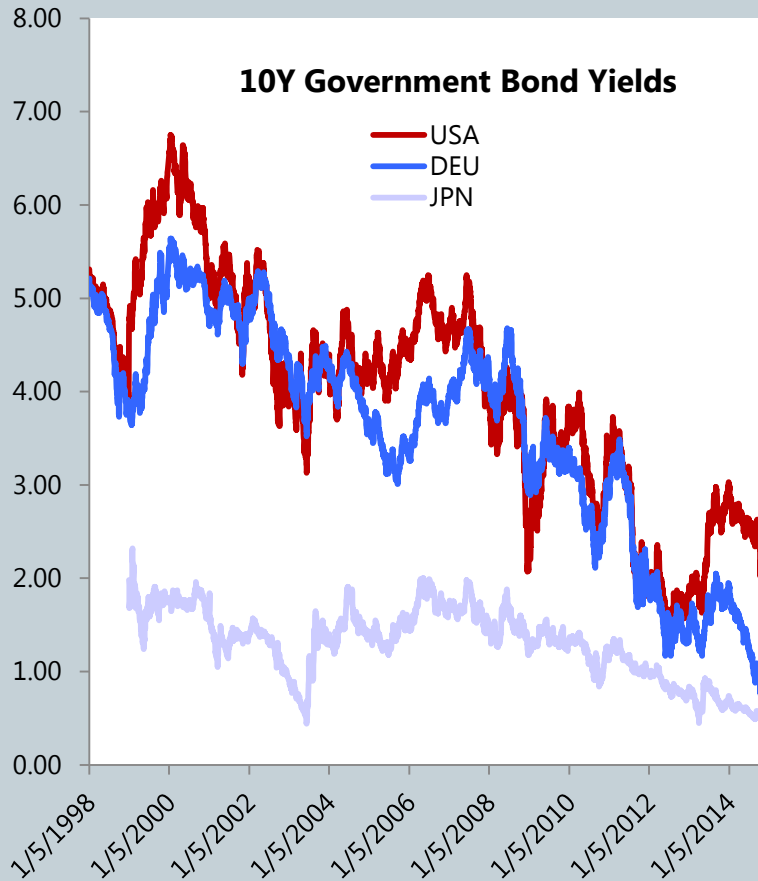
...and the nominal effective exchange rate has depreciated somewhat, limited by yen depreciation.



Source: WEO, Global Insight

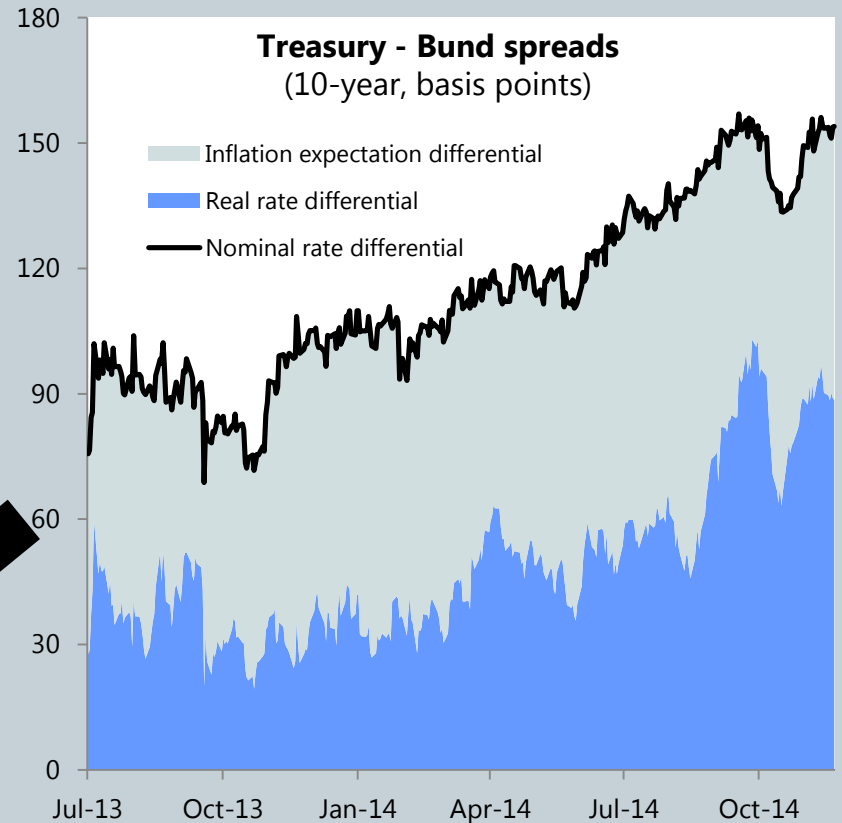
But bond markets are taking a downbeat view on medium-term euro-area prospects

The Bund has decoupled from the Treasury and has almost converged to the JGB.



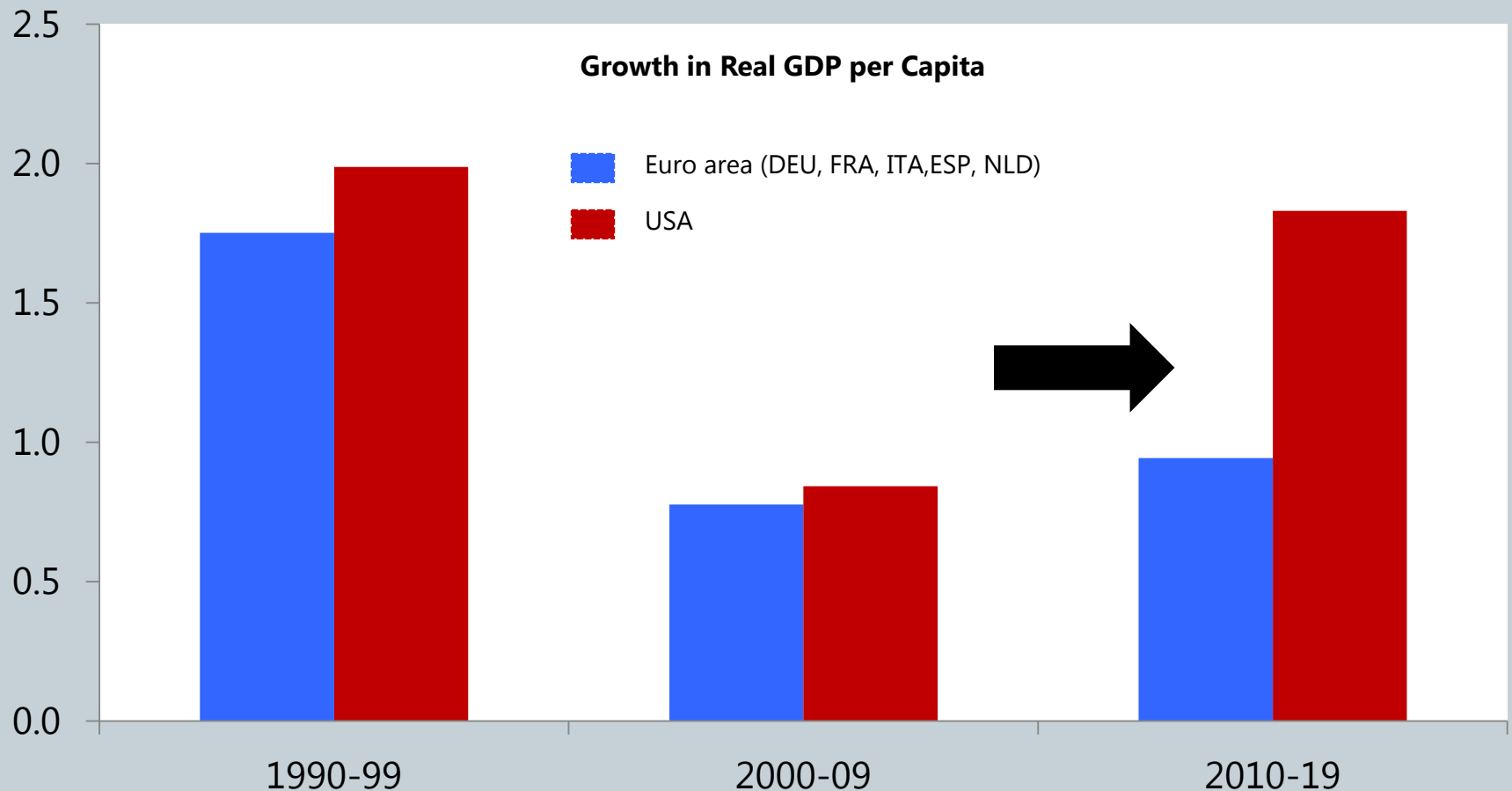
Source: HAVER Analytics

Most of the opening of the differential appears to reflect "real" rather than "nominal" factors.



Source: Bloomberg

For the first time, a major long-term growth gap is projected to open up relative to the US



Why is that so?



- **Structural rigidities?**
- **Macroeconomic policies?**
- **Monetary union?**

If policies have contributed, why?



- **Different diagnoses?**
- **Self-interest?**
- **Coordination failures?**

Fund advice:

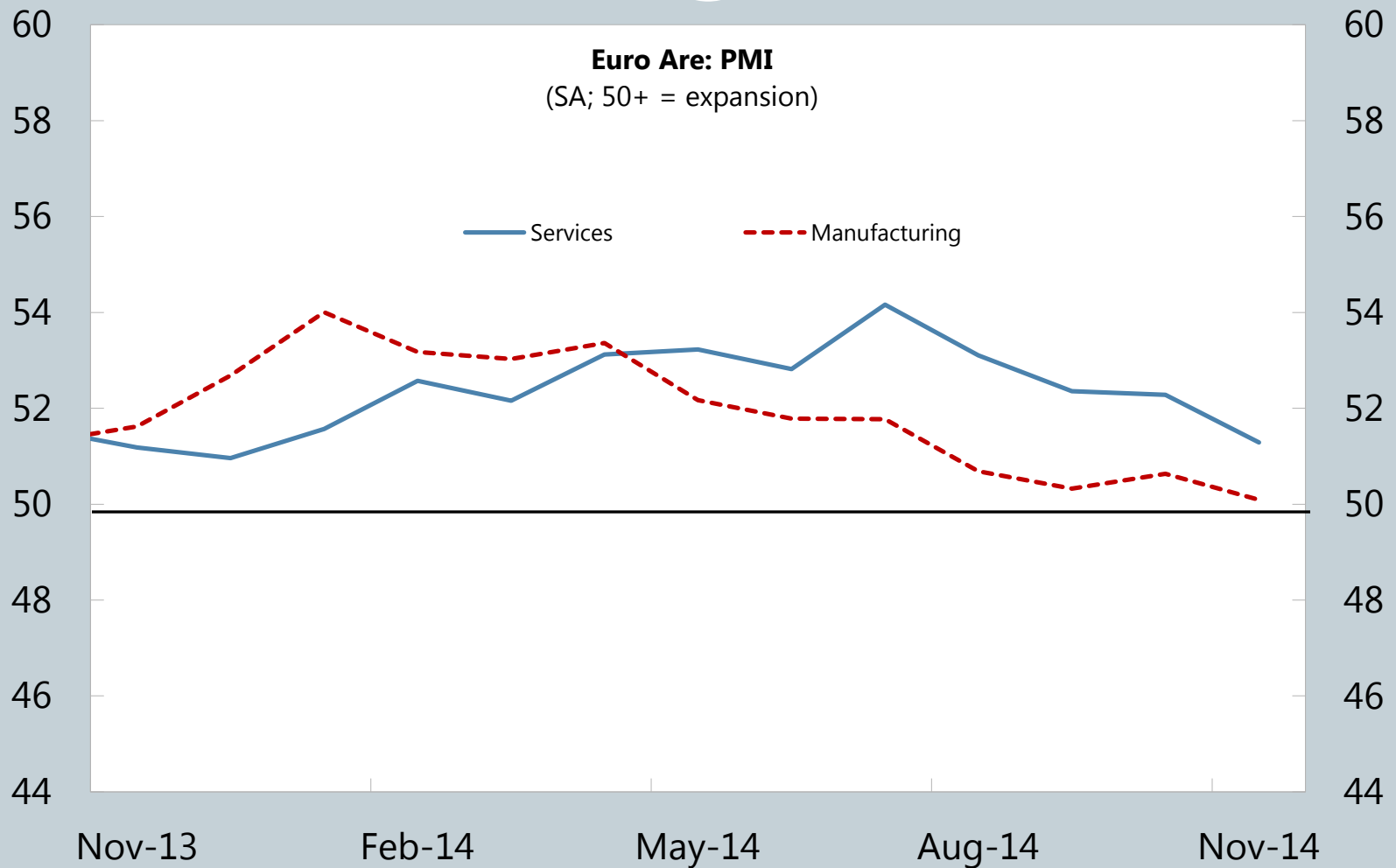


- **Sovereign QE if low inflation persists**
- **More accommodative fiscal policy**
 - More investment or tax cuts in economies close to MTO
 - Use of SGP flexibility for those appreciably below MTO
 - European investment initiatives
- **Structural reforms**
- **Stronger monetary union**



Supplemental Slides

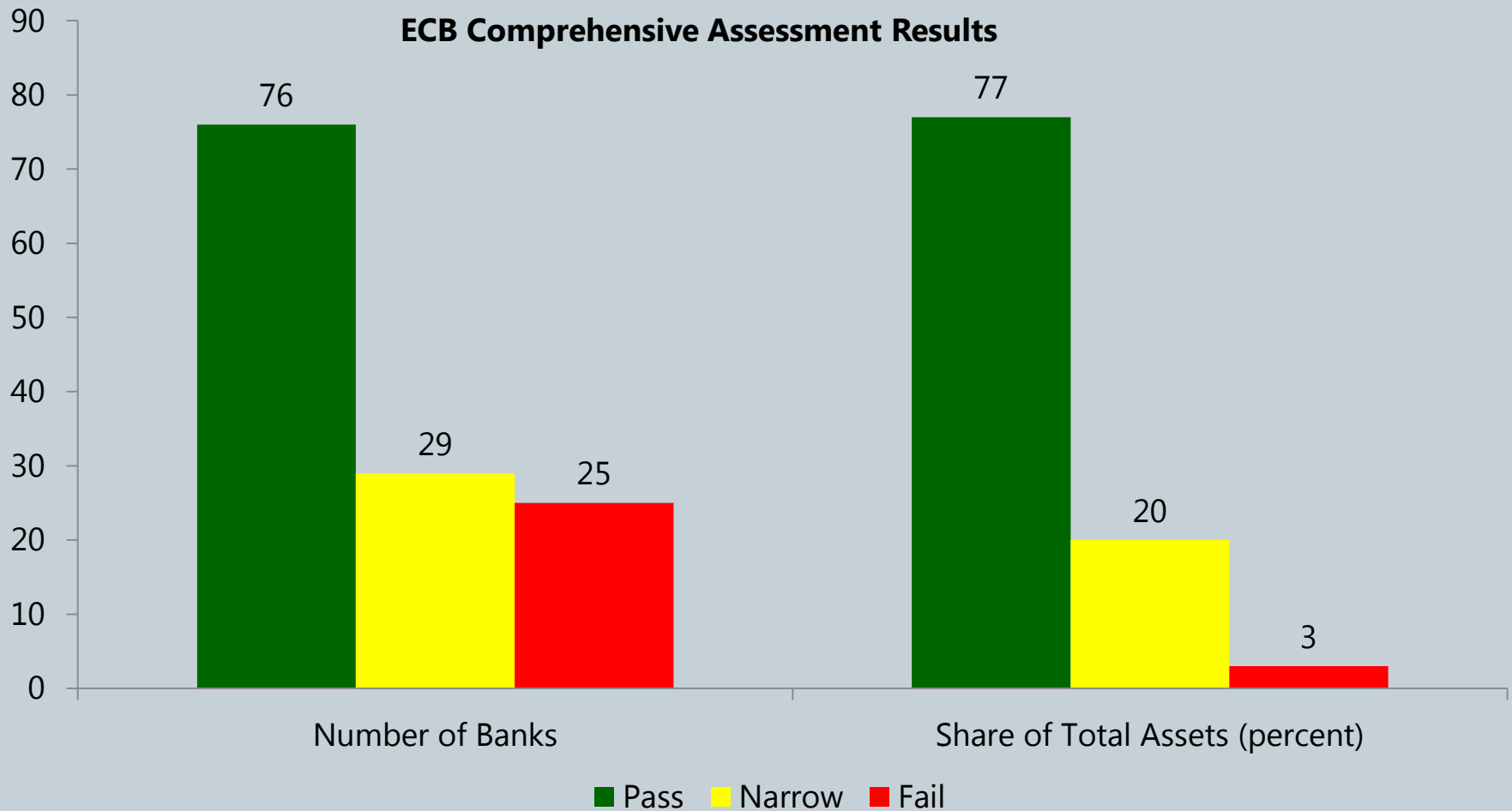
Since then, confidence has fallen



ECB Comprehensive Assessment



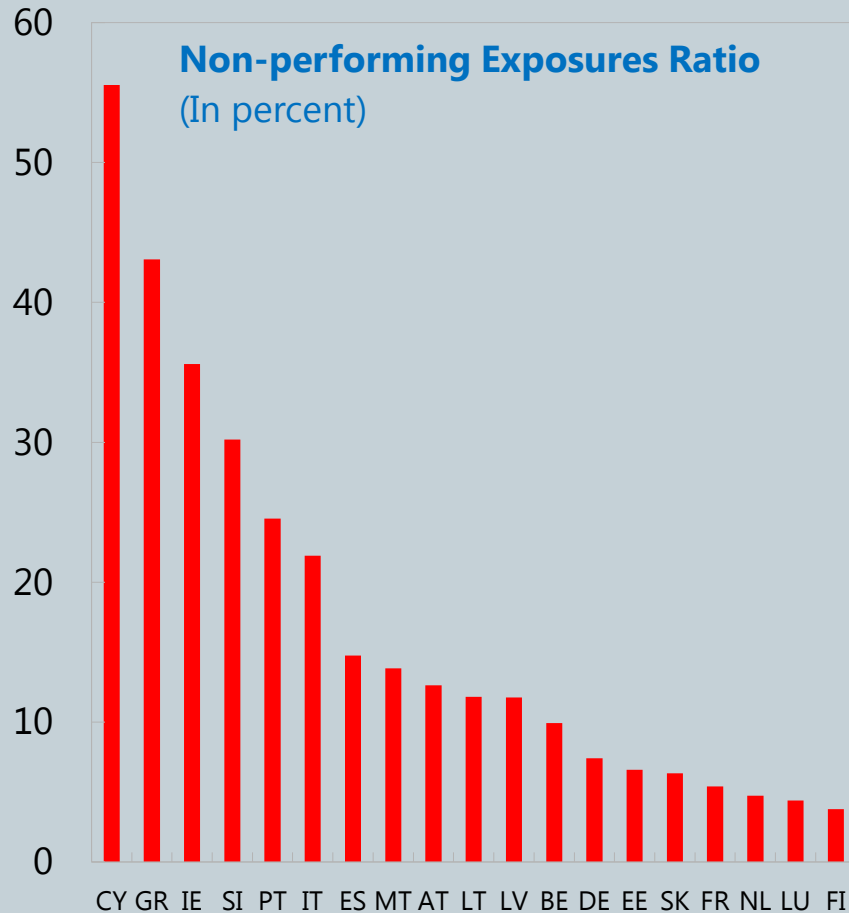
ECB Comprehensive Assessment Results



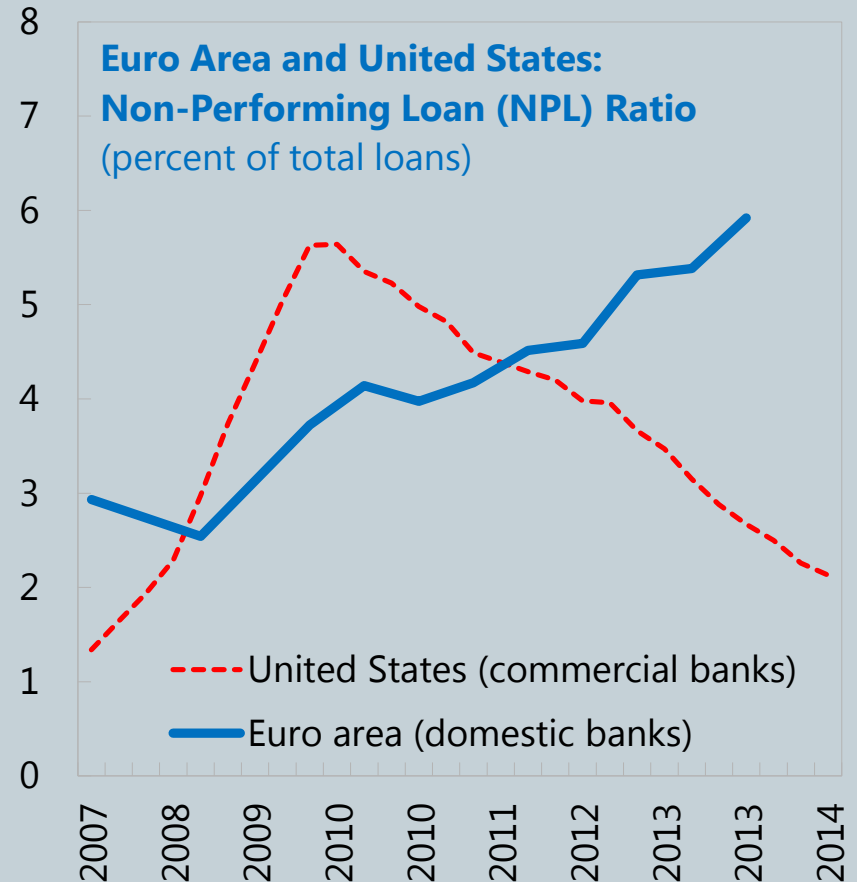
Source: ECB, EBA, Staff estimates. Narrow pass is a CET1 ratio between 5.5 and 7 percent under the adverse scenario.

Repairing Balance Sheets

Non-performing exposures have reached high levels in some countries.



Share of non-performing loans has yet to reach its peak while it has been declining in the United States.



Source: ECB, EBA, FRED, Staff estimates.