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Can Euro Area Economic Growth Surprise in 2015?

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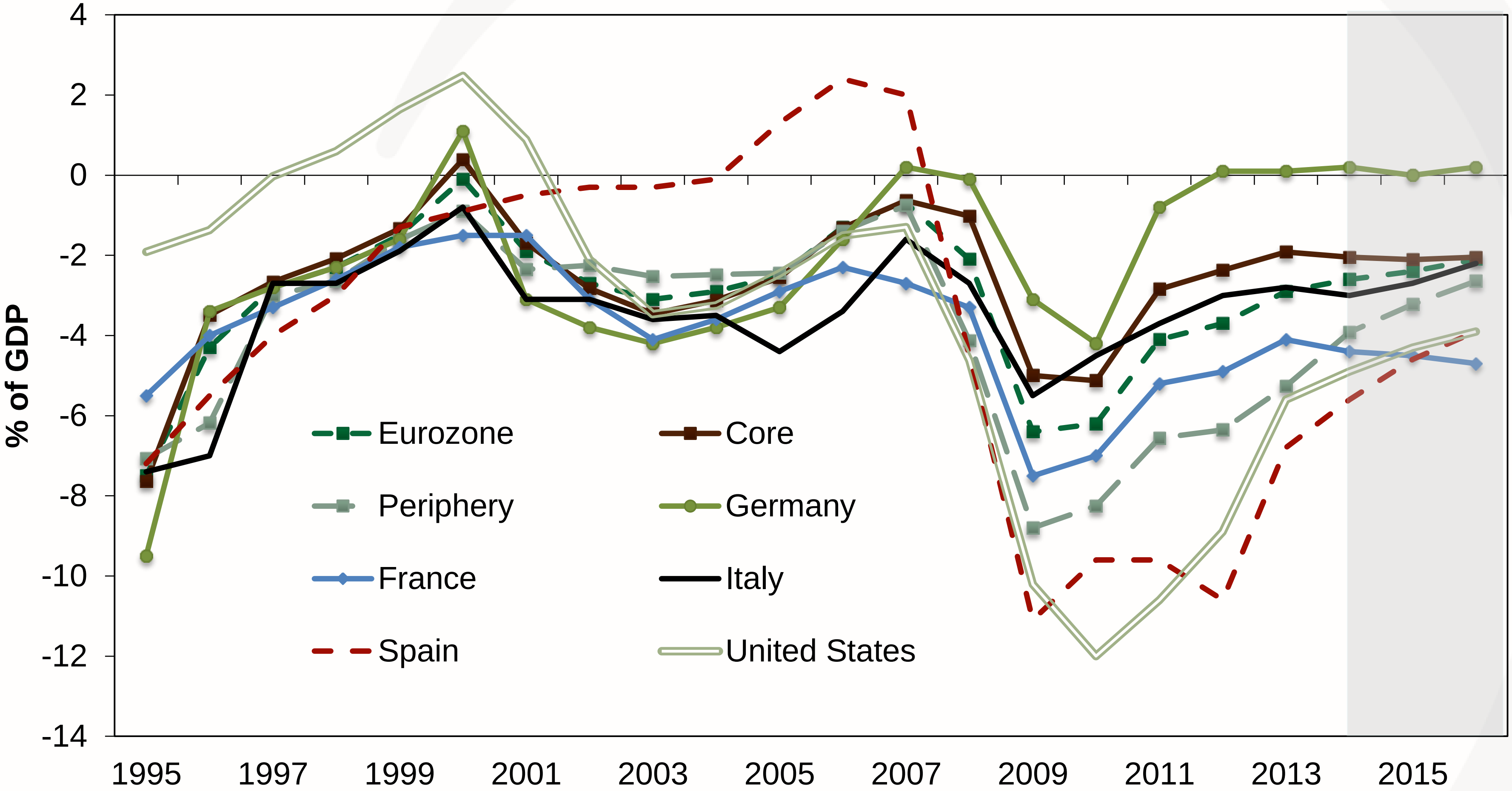
Have policies worked out six/seven years into the crisis?

- Weakness in **investment activity**.
- Steady decline in **potential growth** almost everywhere.
- High **unemployment**, especially among the youth (but DE).
- Need to absorb **macroeconomic imbalances**.
- Increased **poverty** and reversal of progress towards **social inclusion**, with potential **political risks** (all EA countries).
- Continuing **disinflation** (and risks of de-anchoring expectations and triggering deflation).
- Euro remains too strong for the state of the economy, also due to rising EA **current account surpluses**.

Additional (moderate) fiscal consolidation is unavoidable



Note: Core Euro area includes Austria, Benelux, Germany, Finland and France. Periphery Euro area includes Greece, Ireland, Italy, Spain and Portugal. Deficit data for Greece are not available for the period 1995-1999.
Source: Eurostat, US Department of the Treasury, Bureau of Economic Analysis, European Commission (forecasts)

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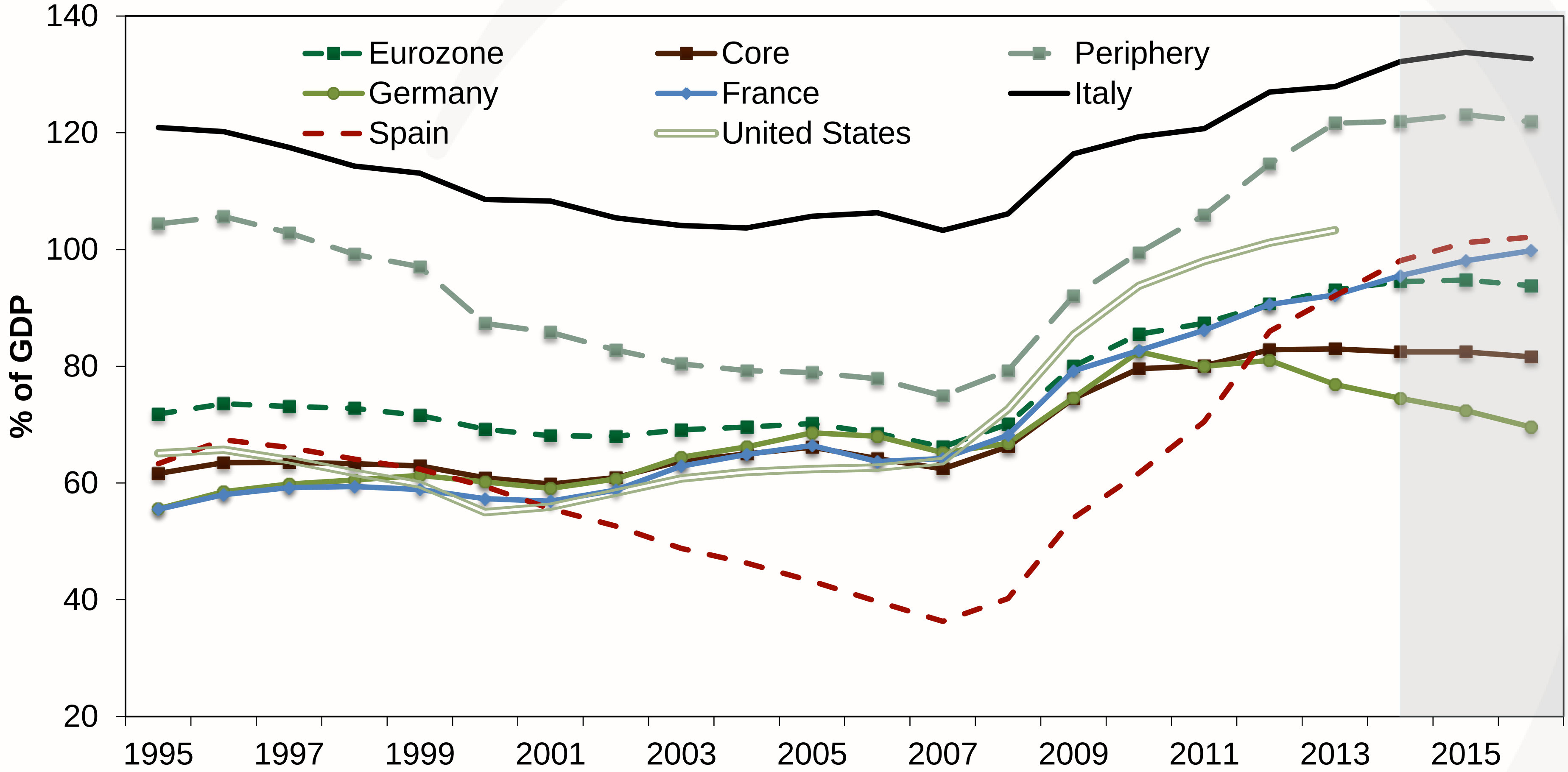
Public debt deleveraging has yet to start



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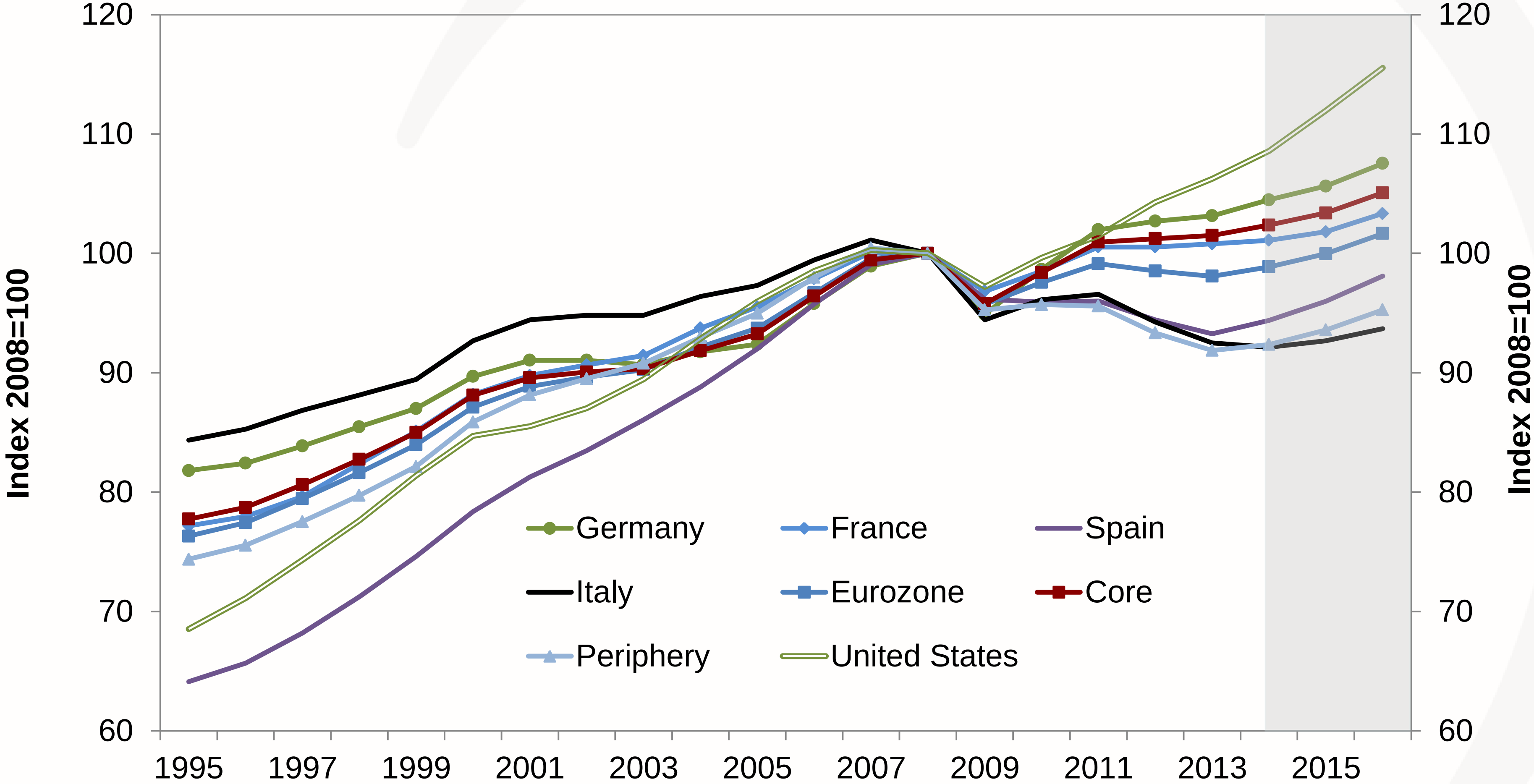
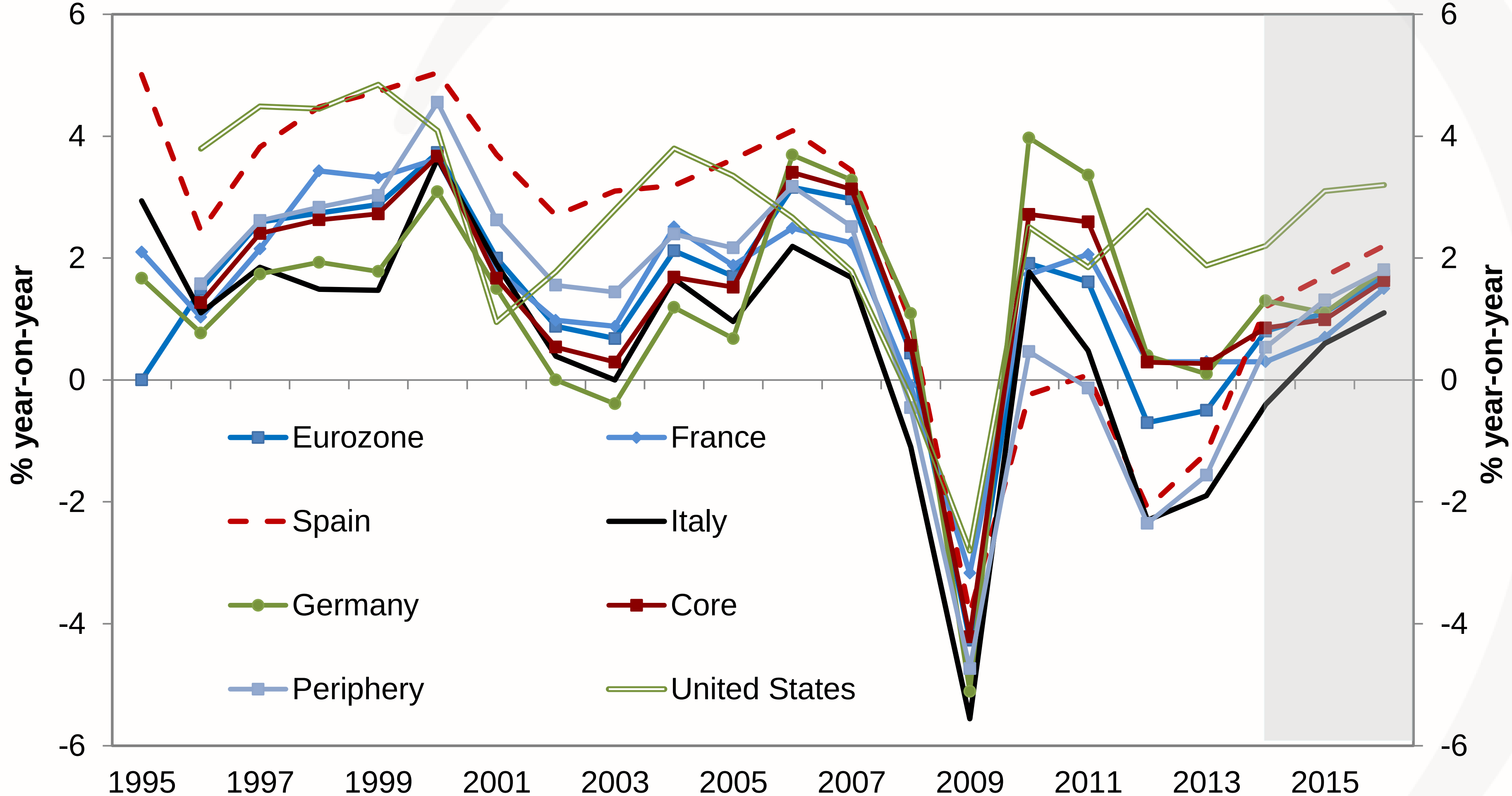
Any chance to recover GDP pre-crisis trend levels?



Source: Eurostat, BEA, European Commission (forecasts)

Or recover GDP growth potential?



Source: Eurostat, BEA, European Commission (forecasts)

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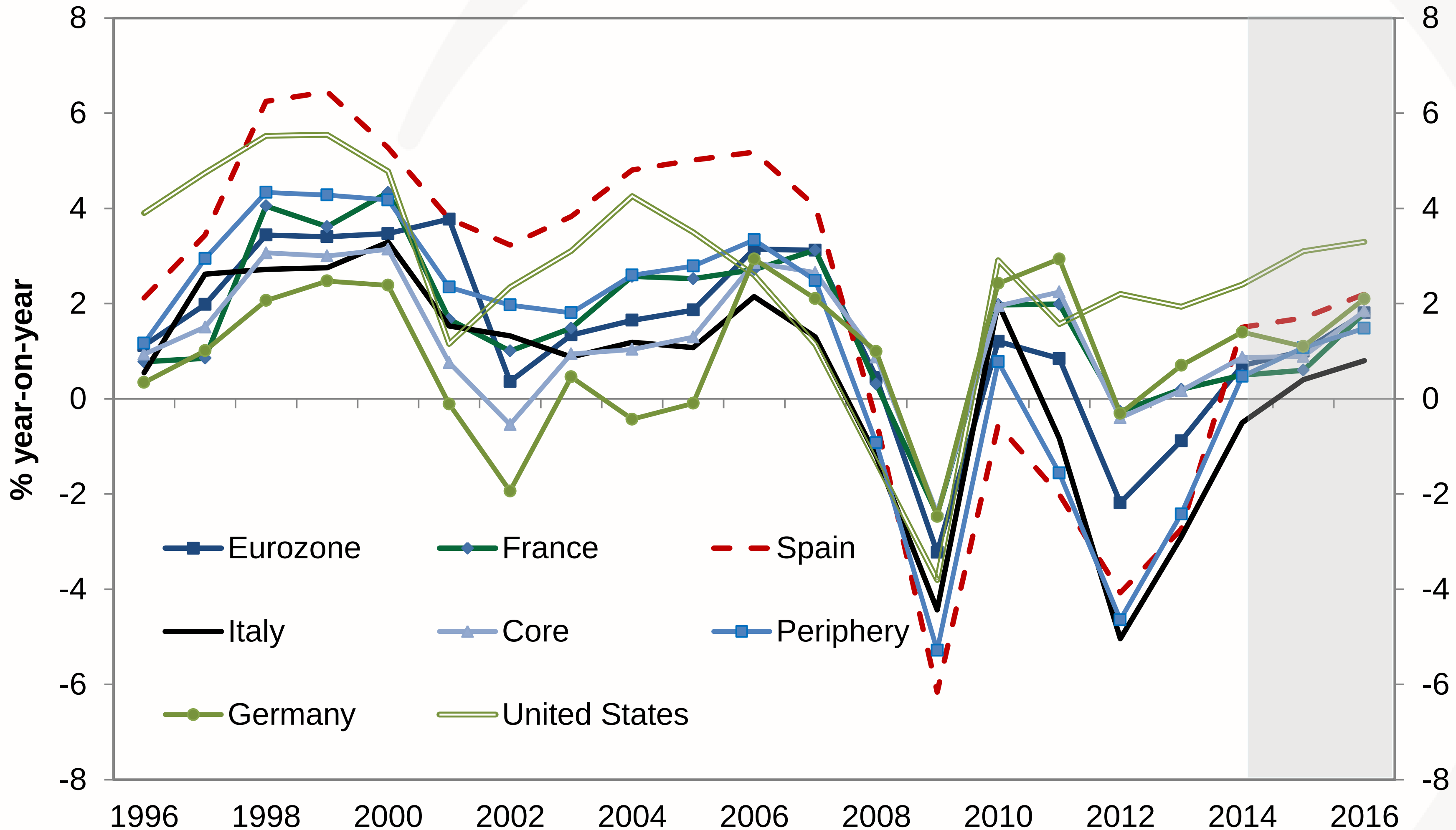
Domestic demand improving slowly even in core EA countries



Source: Eurostat,Oxford Economics, European Commission (forecasts)

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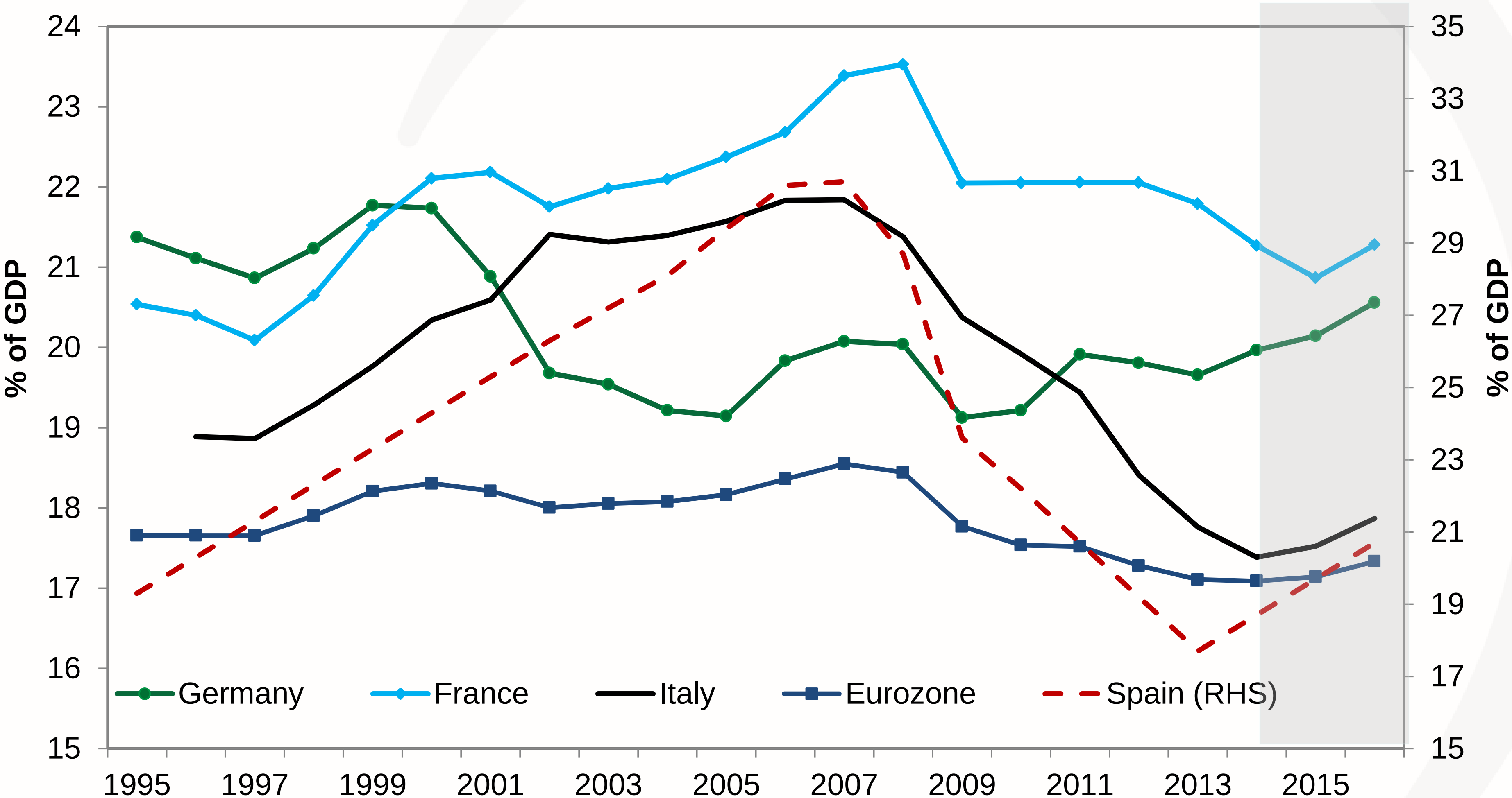
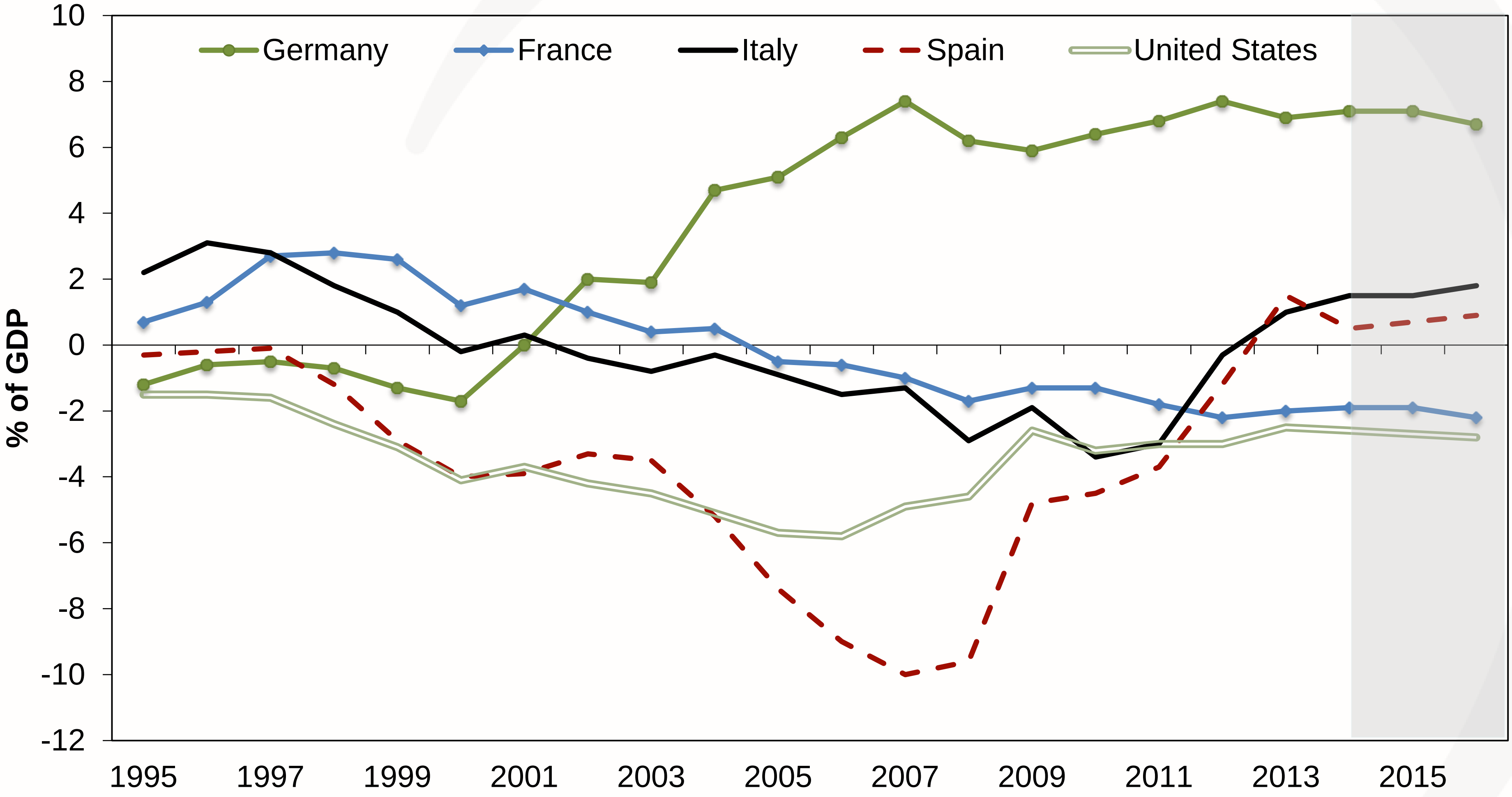
Investments for growth: the challenge to reverse current trends



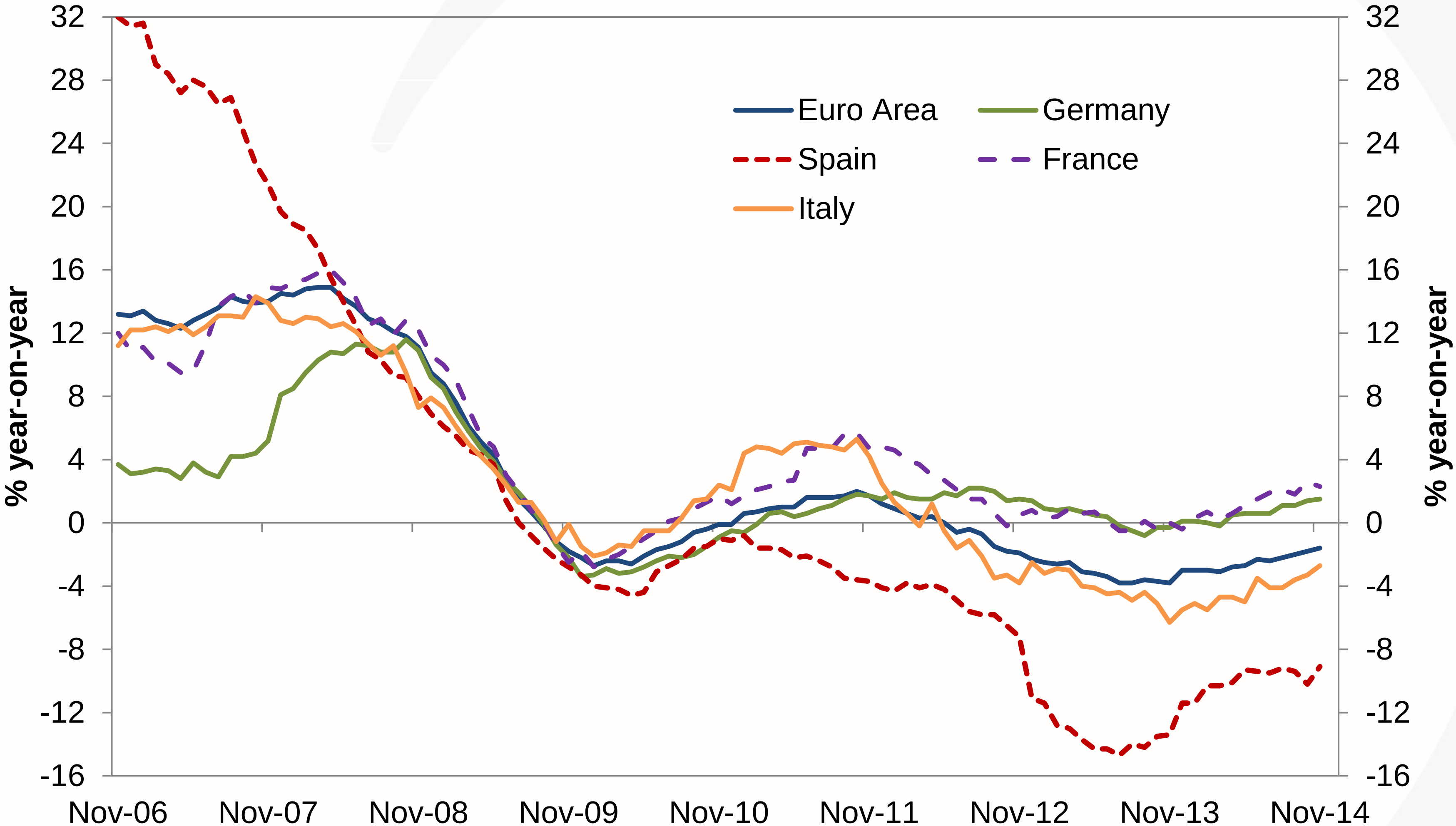
Source: Eurostat, European Commission (forecasts)

Policy mix leading to current account surpluses



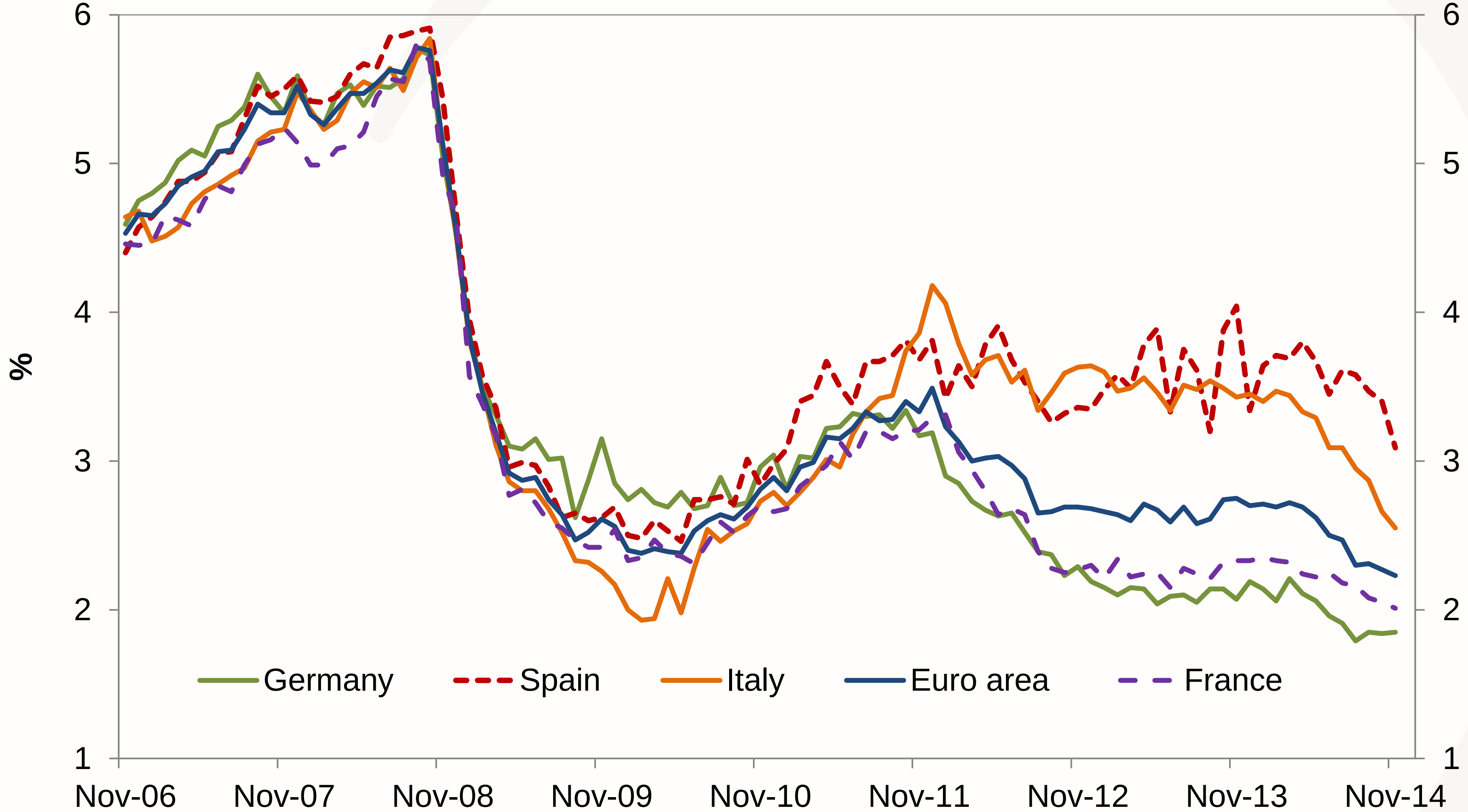
Note: Euro area data are not available in the period 1995-1998.
Source: Eurostat, ECB, IMF, European Commission (forecasts)

Contraction in credit growth: some stabilisation in sight



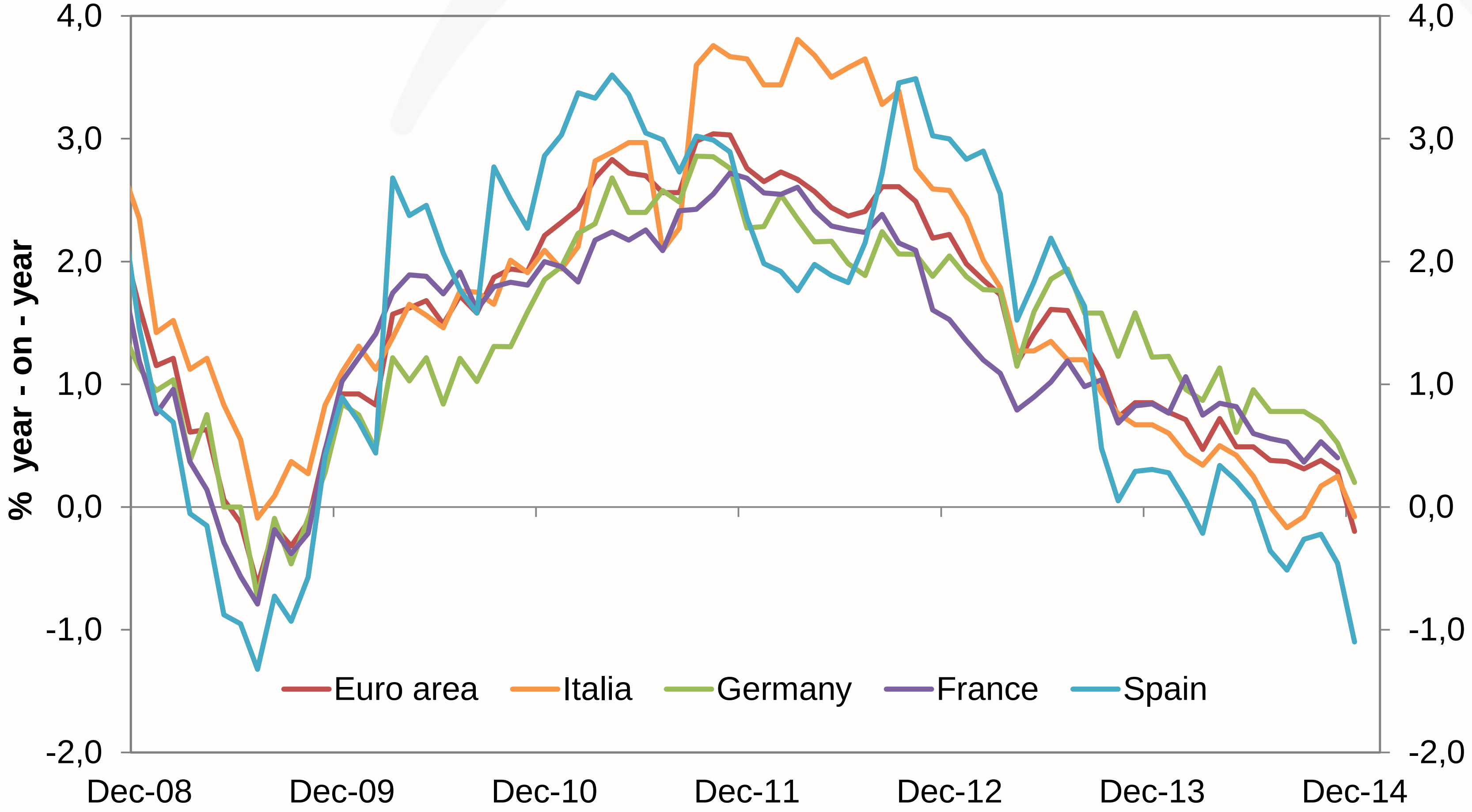
Source: ECB

Cost of credit: the gap has started to narrow



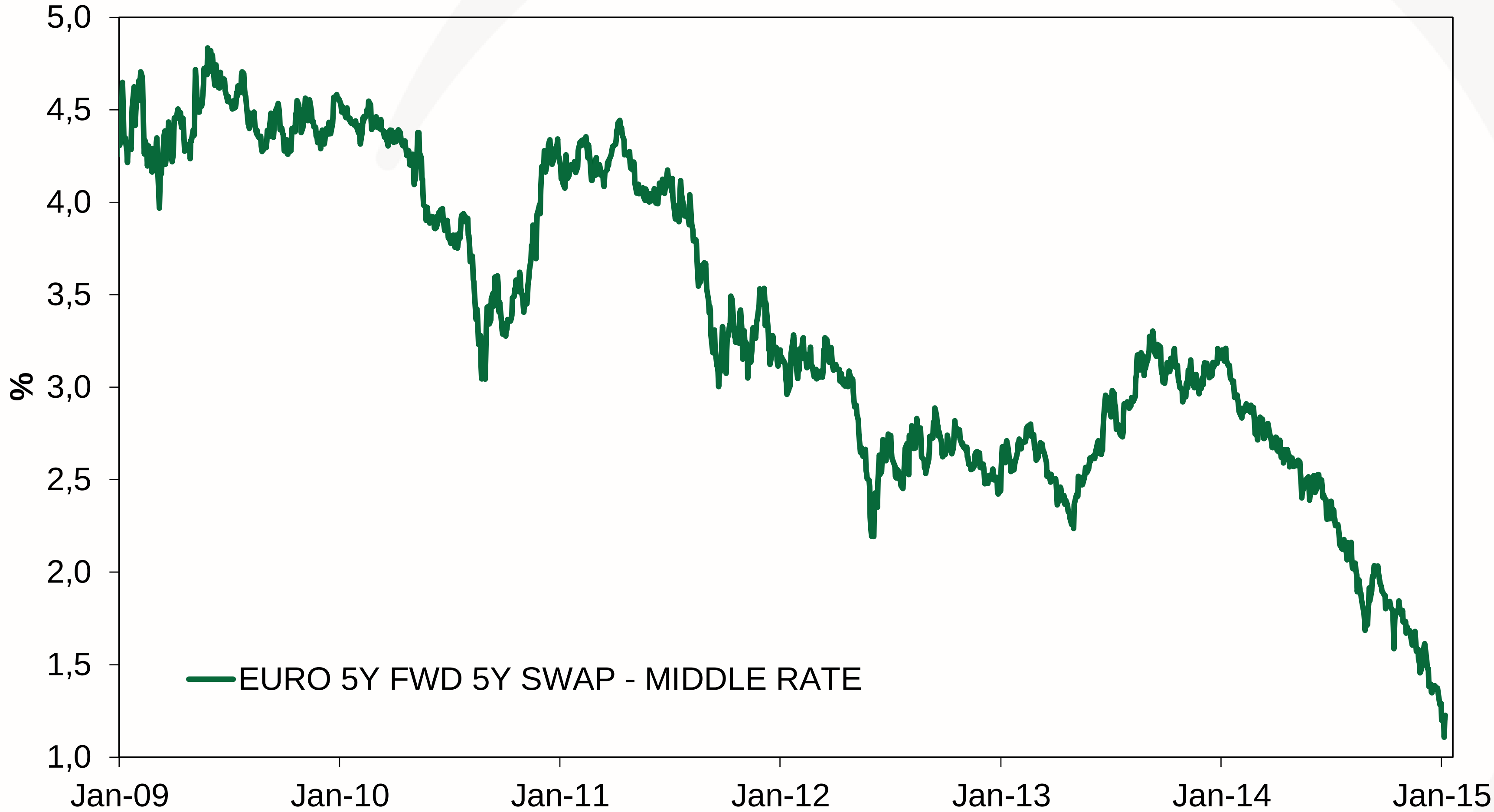
Source: ECB

Disinflation continues (with non-negligible risk of deflation)



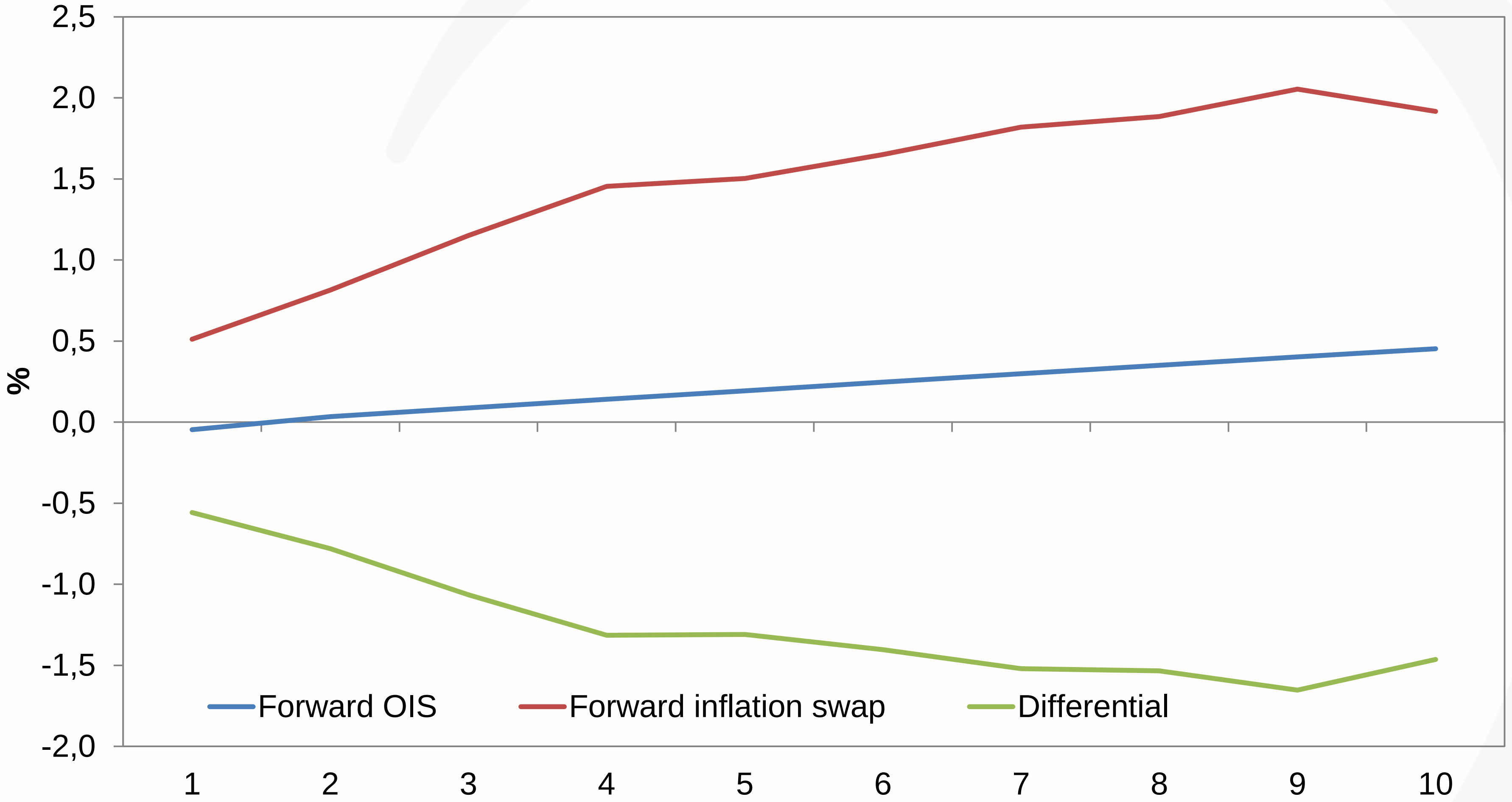
Source: Eurostat

Inflation expectations have declined sharply



Source: Thomson Reuters Datastream

Is secular stagnation already priced in?



Source: Bloomberg

Where do we get growth from?

- **Lack of aggregate demand:** Is the current policy mix a correct stance for the Euro Area?
- **Supply-side reforms:** what can be done to strengthen them? How can we provide incentives for reforms within the existing fiscal framework?
- Are European **fiscal rules** appropriate for the current economic environment? Can we overcome the moral hazard issue?

Does it make sense to allow flexibility for structural reforms?

- Structural reforms increase **potential growth** over the medium-long run and thus lower the **structural part of the deficit**.
- Structural reforms often imply either near-term recessionary effects or need to compensate losers with **a negative impact on public accounts**.
- What really matters is **long-term sustainability of debt**: supporting reforms makes sense also from a fiscal point of view.

Juncker's Plan: investment for growth?

- Important for the **long-term prospects** of the EU economy.
- What can be done by the **private sector** and what instead can only be done by governments (or a supranational institution)?
- Unlikely to provide strong **support to the economy over the near term**, but could support **confidence**.
- Focus on the **quality of public investment**.

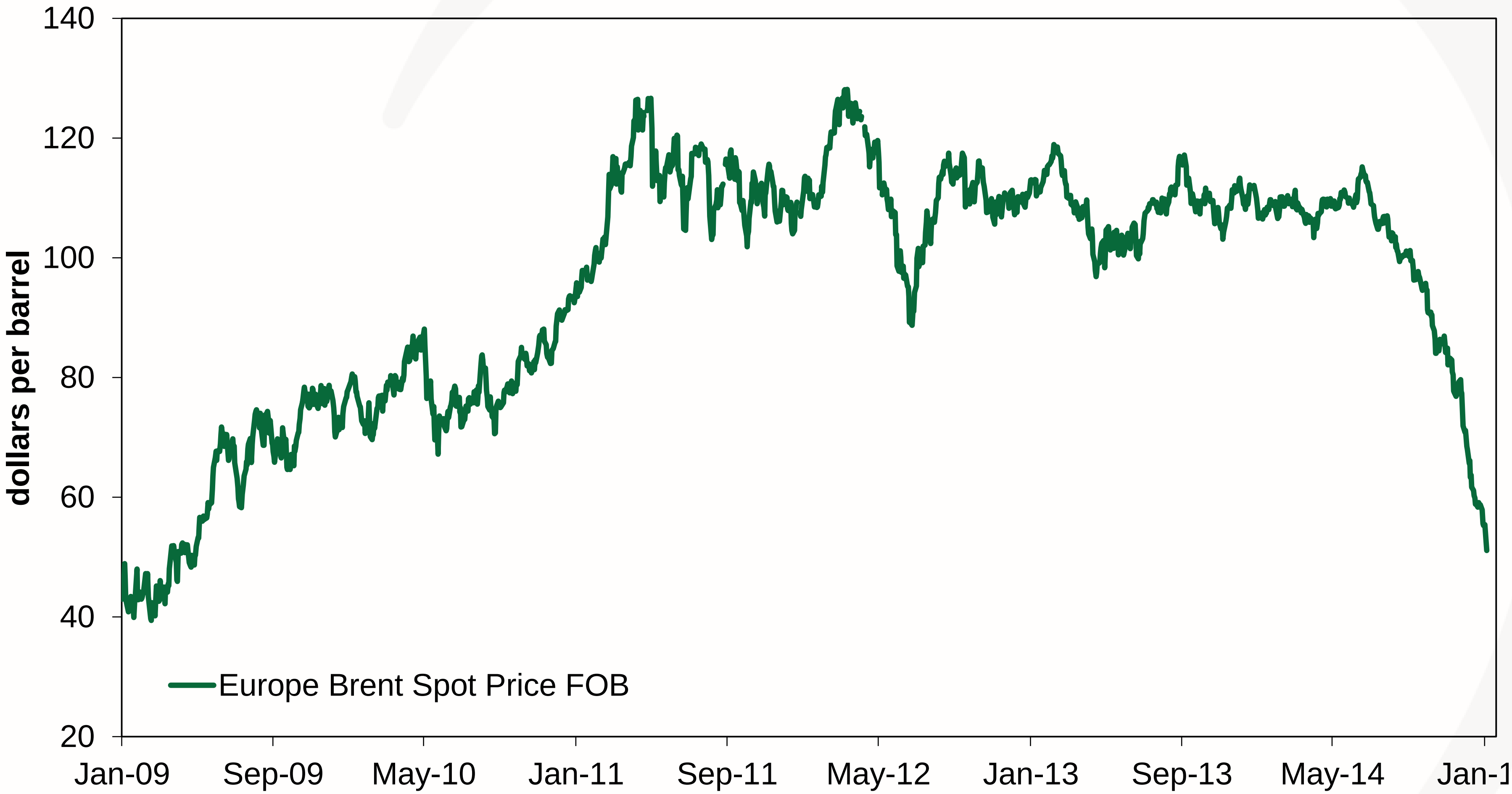
What's the way out?

- Need for more integrated **common and country-specific structural policies** to support long-term growth, employment and social cohesion.
- EU Member States are engaged in fiscal consolidation and efforts to reduce macroeconomic imbalances, which inevitably have near-term negative effects on demand: **need for fine-tuning and flexibility linked to structural reforms.**
- The **transmission mechanism of monetary policy** is still not working properly. Need for further action to bring **inflation back on target soon.**

ECB about to launch a major QE? Will it work?

- It must be **large enough**.
- It has to be **politically acceptable**.
- Tradeoff between **market neutrality** and **ECB capital keys**.
- It is likely to involve also **private sector assets**.
- ECB to decide very soon.

Oil prices to the rescue? an underrated boost to the economy

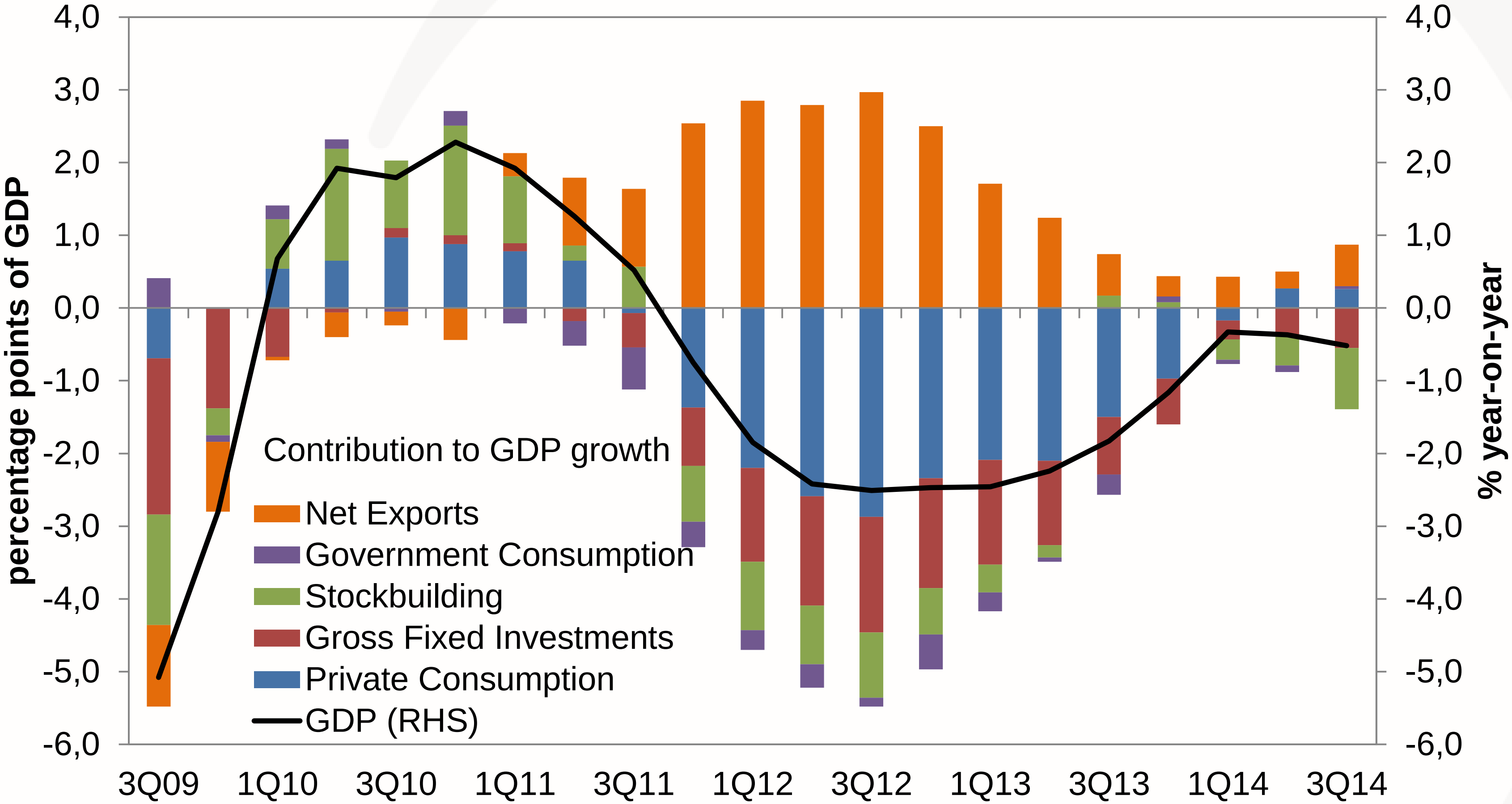


Source: EIA, Thomson Reuters

Can fears about Grexit derail the recovery?

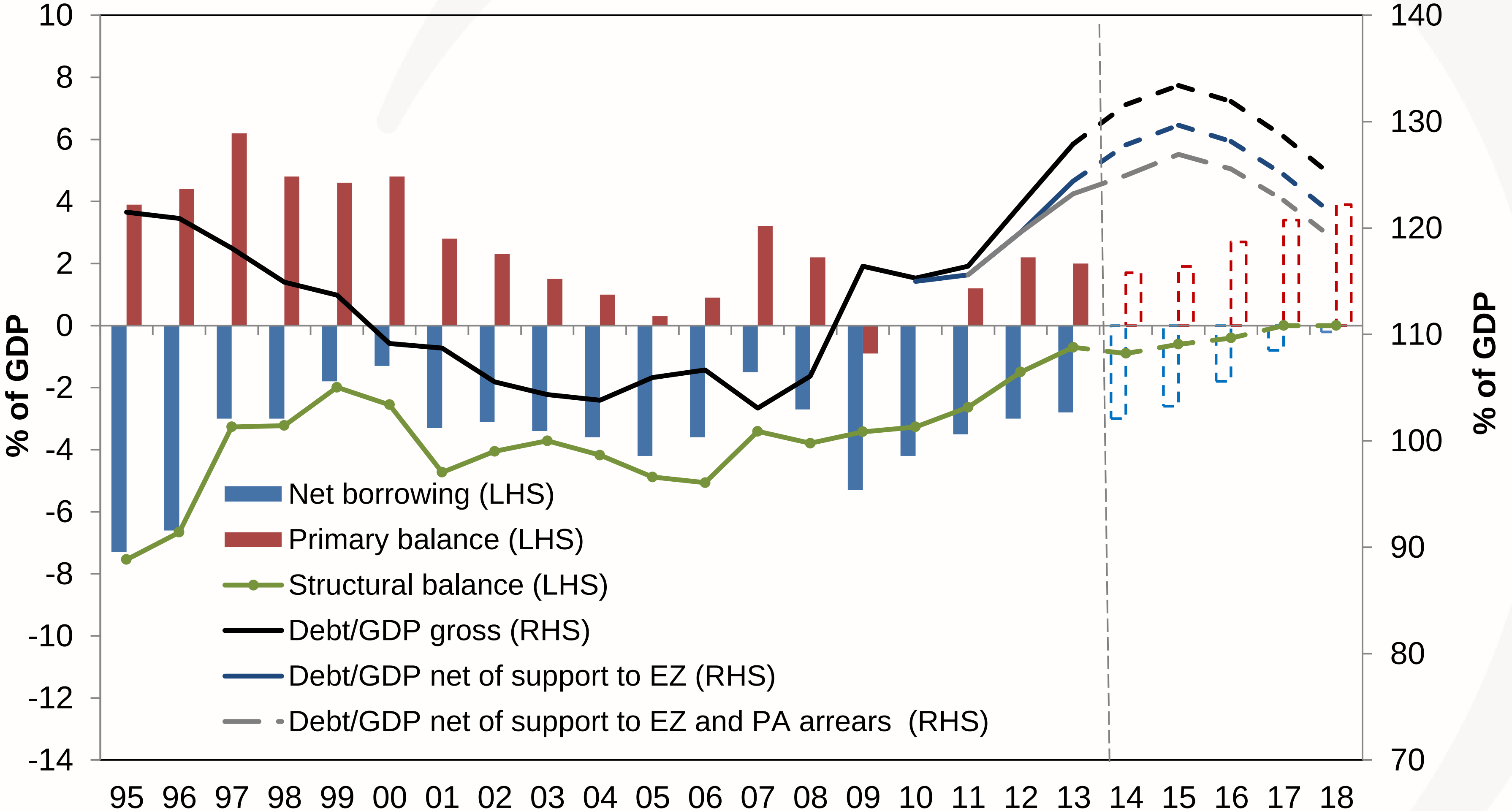
- Need for a compromise solution soon. A **long period of uncertainly** would jeopardise the recovery.
- Exit by one country would sharply increase the so-called **redenomination risk** priced by investors and would effectively end monetary union as it stands.
- Lesson: political tensions within the Euro Area cannot continue for long. Need to move quickly towards **fiscal and political union**.

A very slow recovery for now; any surprise in 2015?



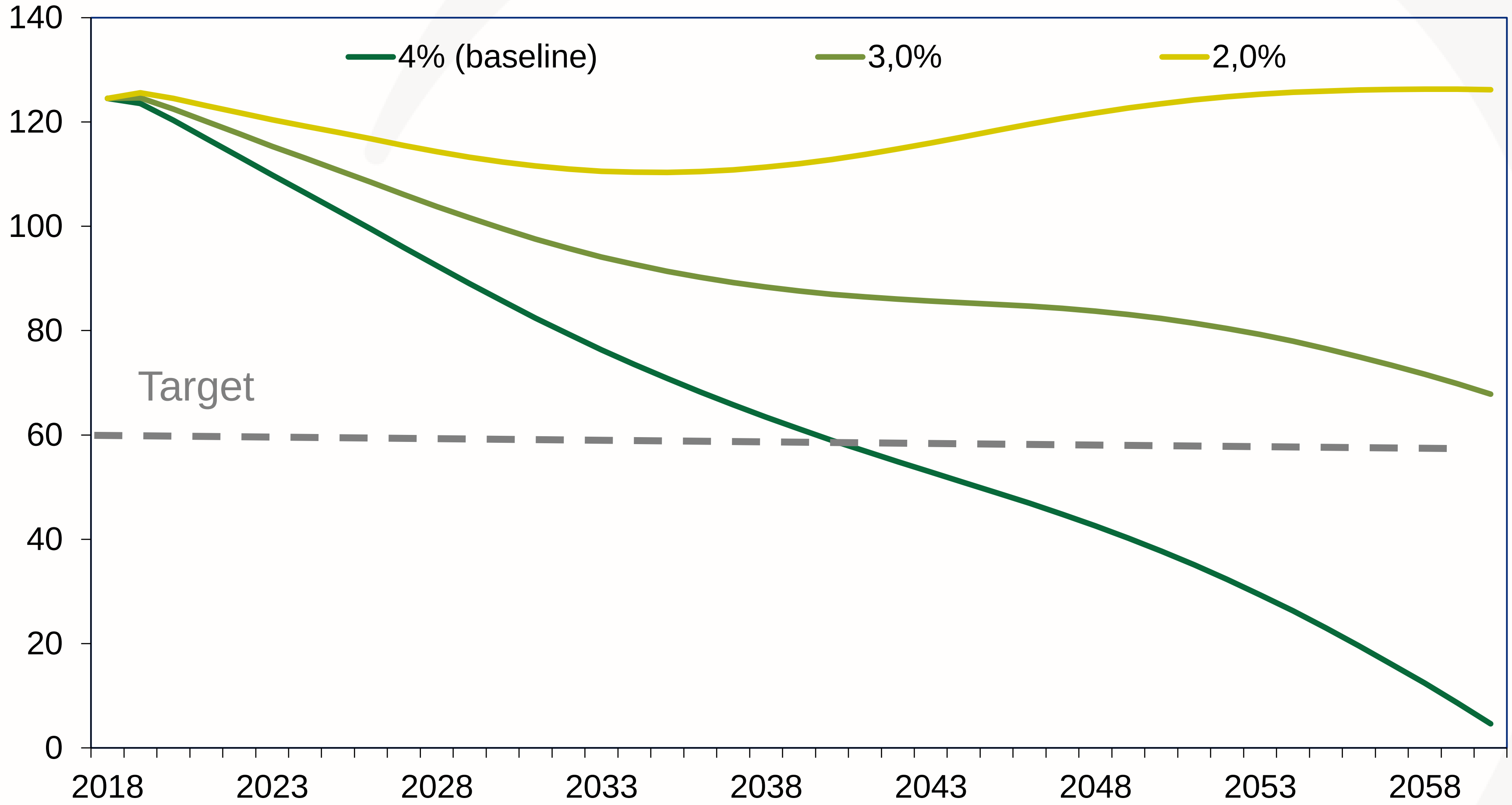
Source: ISTAT

Toward large primary surpluses and zero structural balance



Source: ISTAT, ESA 2010. Data for public debt are coherent with ESA 2010 from 2010.

Debt/GDP falls with a primary surplus at 3% only



Source: Update of the Economic and Financial Document 2014, September 30, 2014

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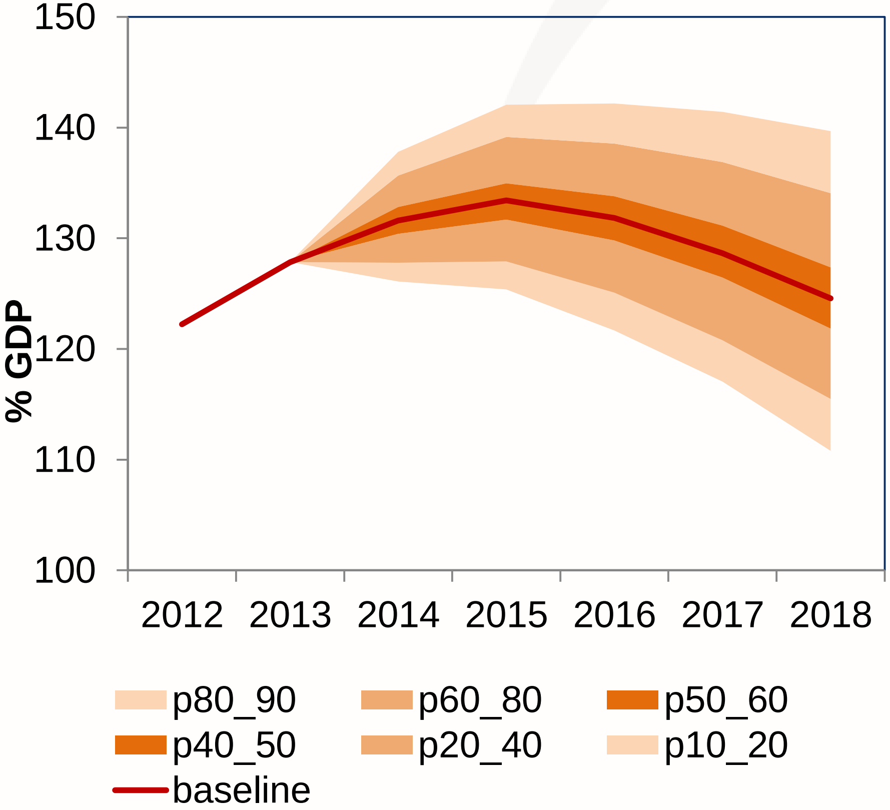
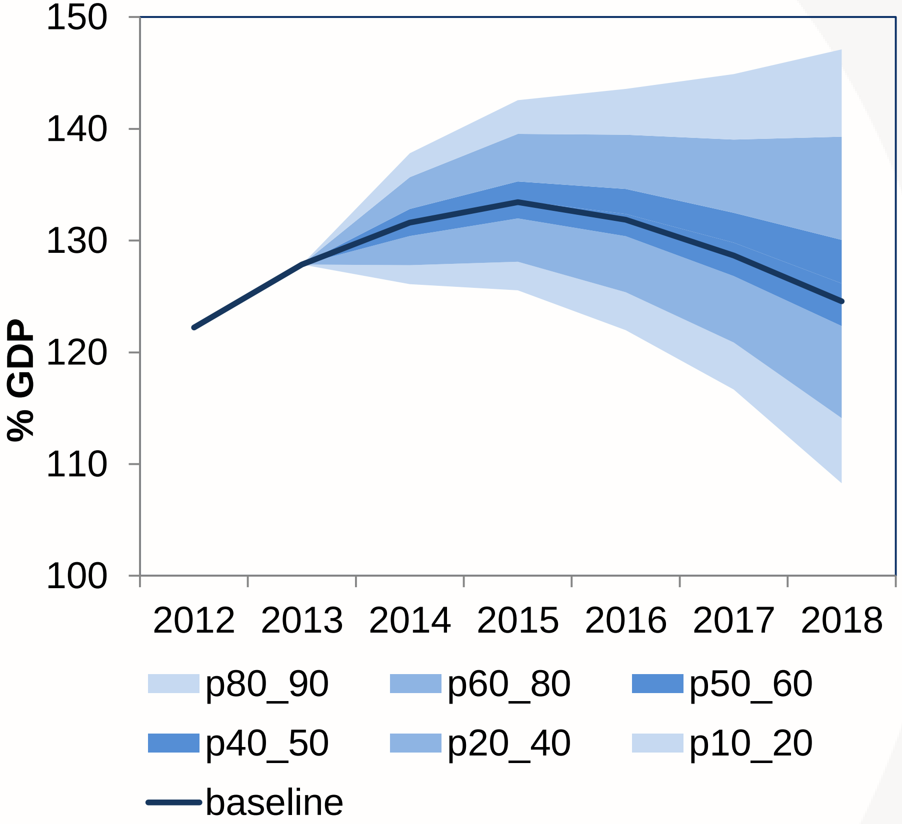
Debt/GDP trend robust to GDP and interest rates shocks

Temporary shocks

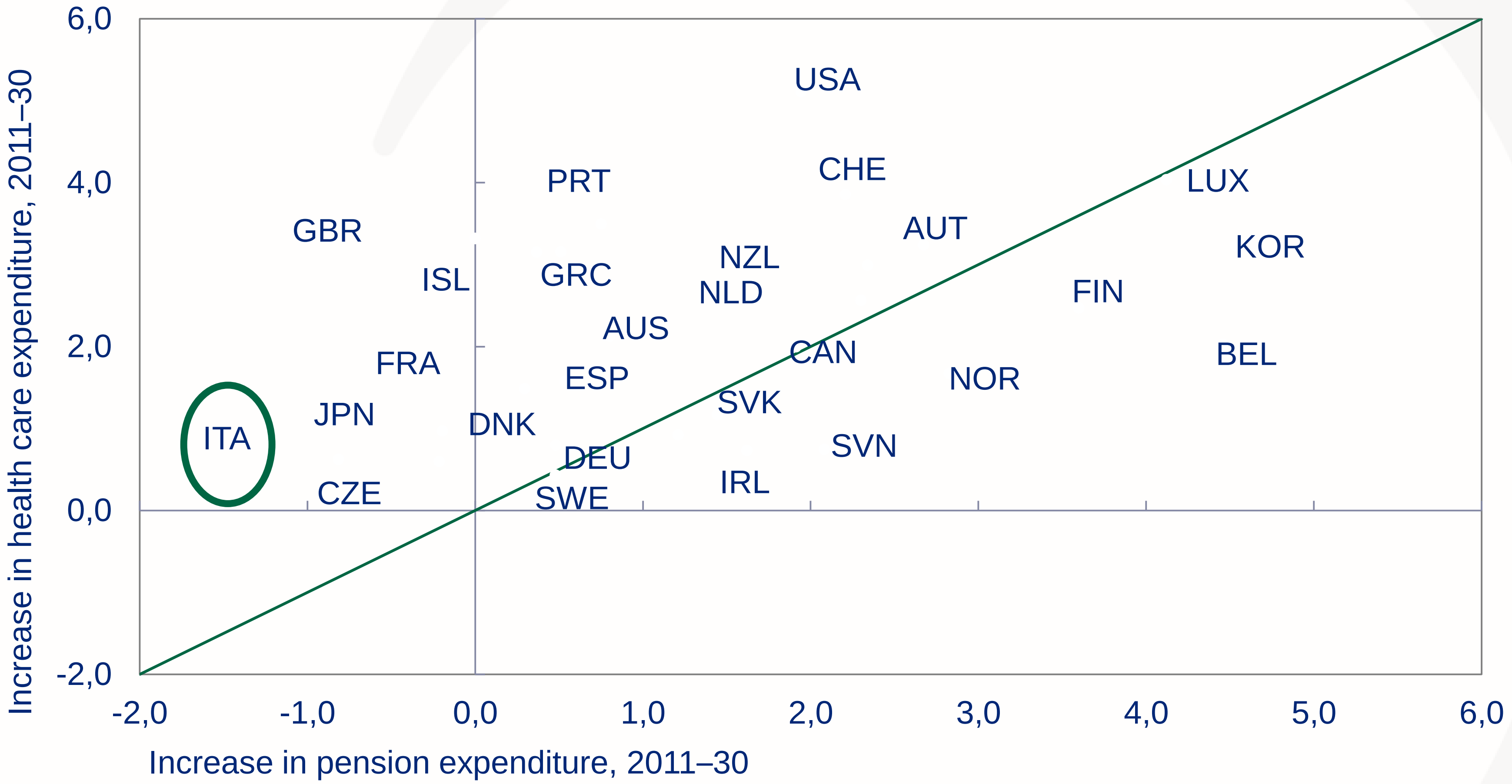


Permanent shocks



Source: MEF. Stochastic projections of the debt/GDP ratio based on historical volatility of short and long-term interest rates and nominal growth rates by using Monte Carlo simulations on 1990-2013 data. The fan chart reports distribution percentiles.

Lower age-related expenditure than in most other countries



Source: IMF World Economic Outlook, Autumn 2013

Best policy for an indebted country in a severe recession?

- Many targets: balancing public finance objectives, supporting the economy, respecting fiscal rules and maintaining credibility in financial markets.
- But one priority: **structural reforms** to boost confidence and change expectations of economic agents and investors, although the actual effects can take time to bear fruits.
- The ultimate goal must be **sustainable economic growth and prosperity**.

Italy's key reforms, completed or under way

- **Institutional reforms:** new electoral law, end to bicameralism, simplification of the multilayer governance.
- **Labour market reform:** further flexibility in hiring, labour law reshuffling and simplification, 'Youth Guarantee'.
- **Tax system:** reduction in the tax wedge, a more equitable, transparent, simplified and growth-oriented tax system.
- **Speeding up of payments of the public administration**: new regulatory and monitoring framework, electronic invoicing.

Italy's key reforms, completed or under way

- **Privatisation programme:** State-owned/local gov't companies and real estate assets to improve efficiency and reduce debt.
- **Spending review:** reducing procurement costs, increasing efficiency and cutting unproductive public spending.
- **Investment framework:** alternative financing especially for SMEs, incentives for large-scale infrastructure investment; extra budget leeway for public investment at local level.
- **Public administration:** digitalisation and modernisation, open data, transparency, red tape reduction, fight against corruption.

Euro Area: Stimulus in the pipeline and far less headwinds

- Much more gradual **fiscal consolidation**.
- Financial fragmentation and tight **credit conditions** gradually diminishing. Return of confidence to the banking sector. **ECB's QE** to reduce risk of deflation and support economic activity.
- Delayed effects of **structural reforms** to the fore.
- Halved **oil prices** are a shot in the arms.
- **Bottom line: there could be positive surprises from Euro Area growth in 2015.**