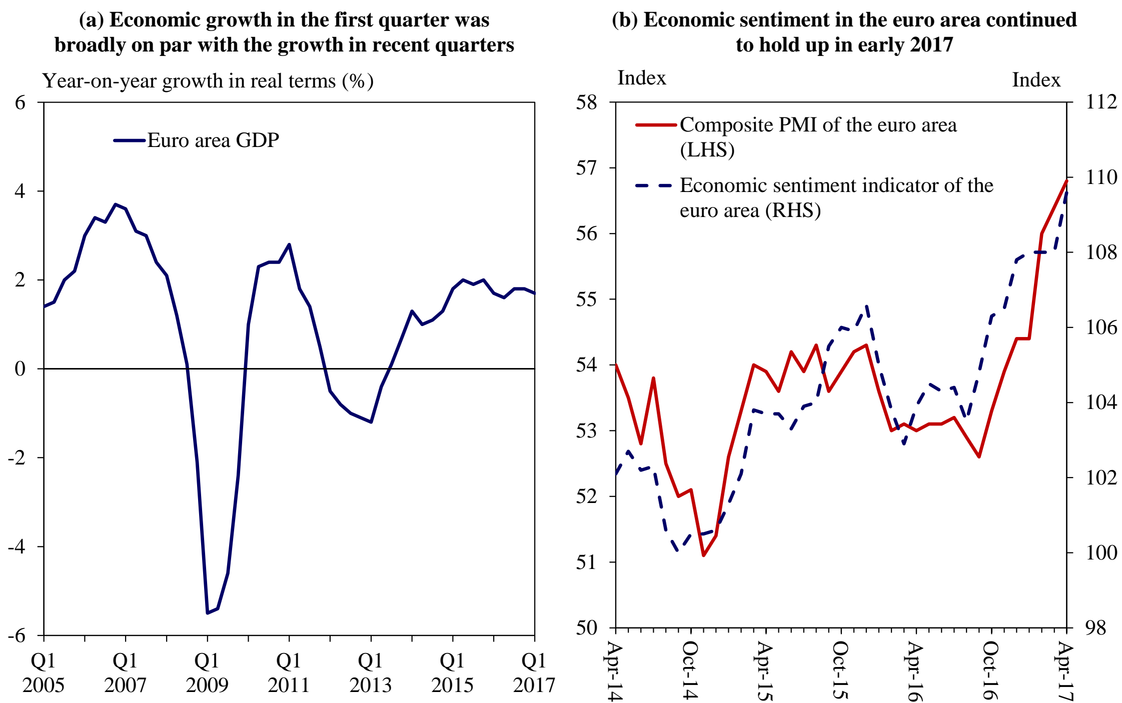
Box 2.1

Recent economic performance of the euro area

In March 2017, the European Central Bank (ECB) raised the projections for economic growth in the euro area slightly by 0.1 percentage point in both 2017 and 2018, to 1.8% and 1.7% respectively. The euro area economy sustained modest growth in recent quarters, with domestic demand acting as the main driver on the back of the highly accommodative monetary policy by the ECB. Although the negative impacts from Brexit developments have so far been limited, the recovery pace of the region has varied visibly between member states and on the whole stayed only modest. This note briefly reviews the latest developments, as well as some obstacles to a more robust recovery, in the euro area economy.

The euro area economy grew by 1.7% in the first quarter of 2017 over a year earlier, broadly on par with the quarterly year-on-year growth which ranged between 1.6-2.0% in the preceding two years ***(Chart 1a)***. Along with the economic expansion, deflation risks have been dissipating. More recently, economic sentiment continued to hold up in April, with the Composite Purchasing Managers' Index (PMI) rising further in the expansionary zone ***(Chart 1b)***.

Chart 1 : Euro area economy has sustained modest growth



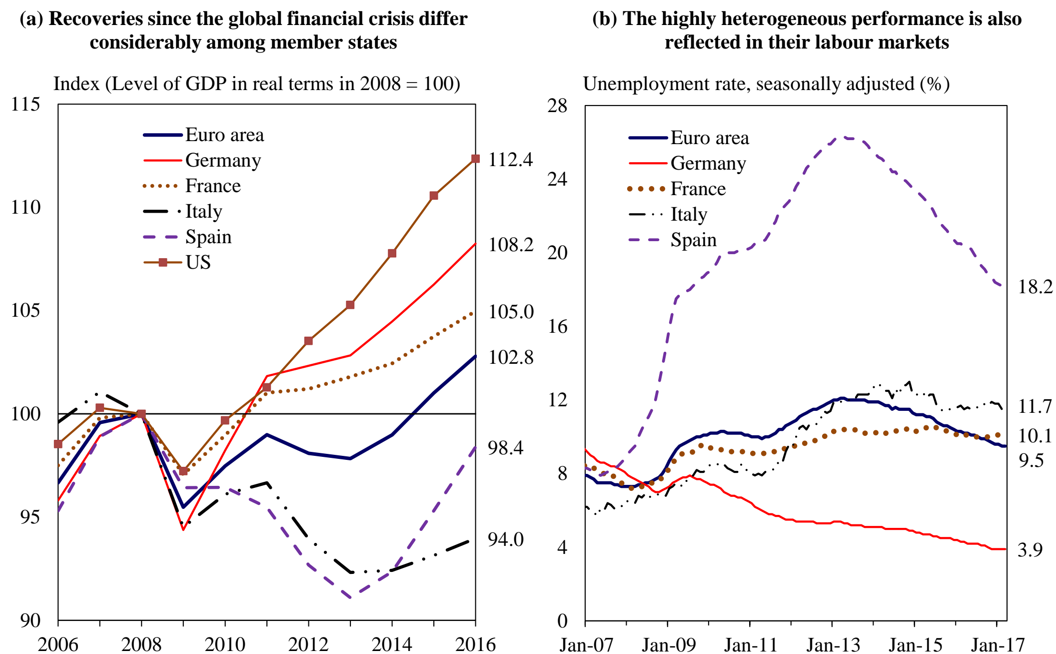
Sources: Eurostat and Markit.

Nevertheless, the situations of major member states varied considerably. The real GDP of Spain and Italy have yet to return to their levels before the global financial crisis of 2008 ***(Chart 2a)***. Mostly dragged by their weak economic fundamentals, their recovery paths have been particularly bumpy, being derailed by the European sovereign debt crisis during 2011-2013, notwithstanding some recent improvements.

Box 2.1 (Cont'd)

By comparison, Germany and France fared much better, with their real GDP in 2016 being 8% and 5% respectively higher than in 2008, as these two economies were not at the epicentre of the European sovereign debt crisis. Nonetheless, all the four major member states of the euro area underperformed the US economy, which had expanded by 12% since 2008.

Chart 2: The economic situations of major member states varied considerably



Sources: Eurostat and the US Bureau of Economic Analysis.

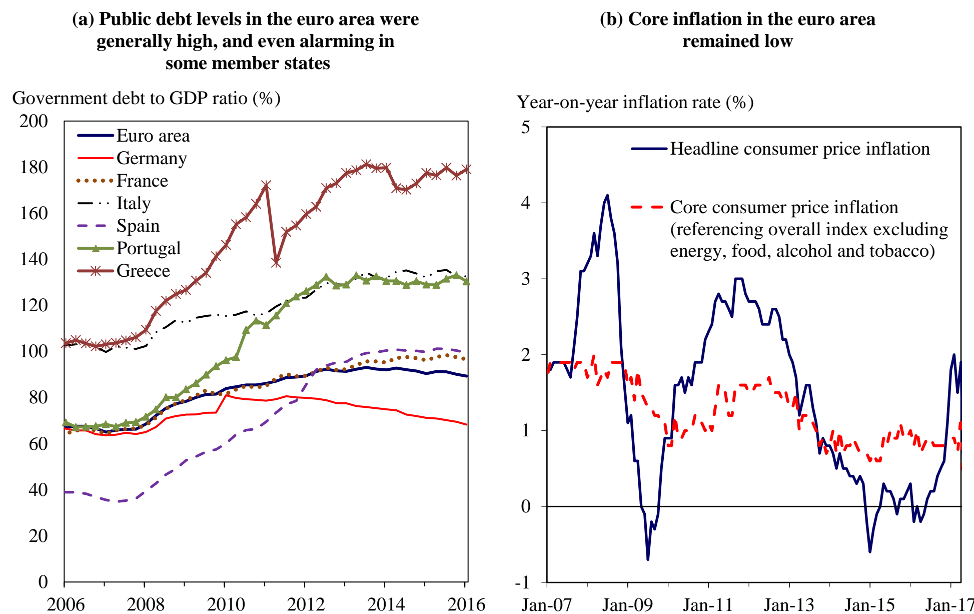
The highly heterogeneous performance is also reflected in their labour markets. The overall seasonally adjusted unemployment rate for the euro area climbed down steadily from a peak of 12.1% in April 2013 to 9.5% in March 2017, and some five million jobs had been regained since 2013. However, while the unemployment rate in Germany fell notably to a low level of 3.9% in March, the improvements in France and Italy were less discernible. The unemployment rate in Spain, while falling, was still at an alarmingly high level of 18.2% ***(Chart 2b)***. Persistently high unemployment rates could dampen consumer sentiment and drag domestic demand in the short run, and would pose impediment to economic growth potential in the long run.

Another issue of concern is the fiscal health within the currency bloc. The overall government debt to GDP ratio in the euro area was at 89% as at end-2016 ***(Chart 3a)***, visibly higher than the 60% required in the Stability and Growth Pact (SGP) of the EU. The government debt to GDP ratios in some member states of weaker economic fundamentals such as Greece, Italy and Portugal were alarmingly elevated, at 179%, 133% and 130% respectively, whereas those in Spain and France were also high, with both of them close to 100%.

Admittedly, there has been some relative stabilisation in the overall euro area government debt to GDP ratio of late, but it has been partly thanks to the improvement in Germany. Other debt-ridden states such as Greece, Portugal and Italy in fact saw little improvements. Market concerns about their debt sustainability could still cause jitters in the international financial markets going forward.

Box 2.1 (Cont'd)

Chart 3: Fiscal health remains a concern in the currency bloc



Source: Eurostat.

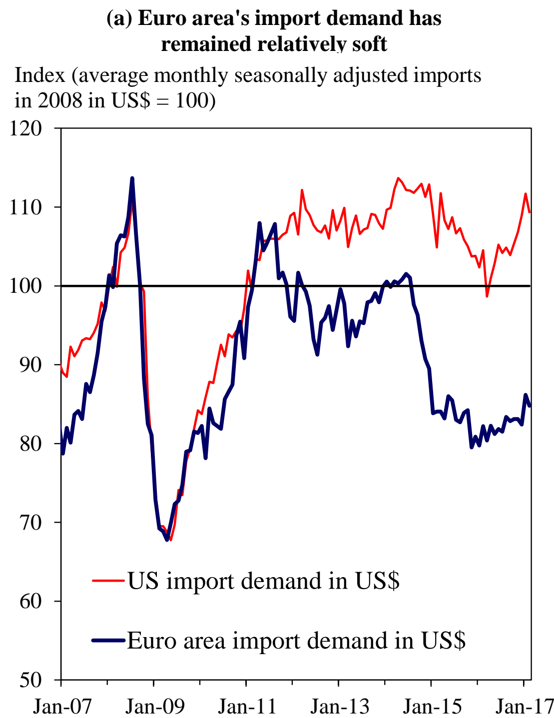
Moreover, there are notable policy challenges facing those member states with weak fundamentals. For the debt-ridden, slow-growing states, they need strong fiscal stimuli but their own elevated levels of government debt, which are already well above the requirements of SGP, give them no policy space to do so. As the monetary union members, the use of a single currency also deprives them of enjoying greater currency depreciation to revive their economies. From the longer-term perspective, further fiscal and economic reforms in debt-ridden member states are necessary in order to improve their fiscal sustainability and regain competitiveness. However, the challenges in implementing reforms should not be underestimated, considering the social resistance involved and the implications for the possible rise of anti-establishment sentiment in these member states. Broadly speaking, the prolonged weakness of these member states could limit the euro area's overall economic performance going forward.

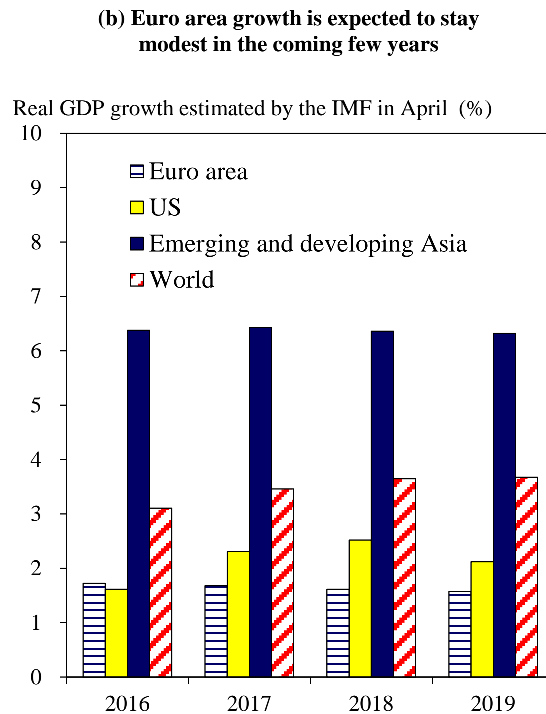
With the overall economic growth in the euro area staying modest and the underlying consumer price inflation pressures remaining subdued (core inflation was at only 0.8% on average in the first quarter of 2017) ***(Chart 3b)***, accommodative monetary policy is expected to remain the mainstay of the euro area economic policy tools. Although the ECB has reduced the size of its monthly asset purchase to €60 billion starting from April 2017, it continued to indicate that a very substantial degree of monetary accommodation is still needed and that key ECB interest rates would remain at the present or lower levels in the period ahead. Against this background, monetary divergence between major central banks will likely continue, especially in light of the continued monetary policy normalisation in the US (see ***Box 1.1*** for details).

There are also other developments that are worth attention. The future relationship between the UK and the EU remains highly uncertain at this stage, as the Brexit negotiation would be a highly complicated process, with possible repercussions for the EU economy. The early general election in the UK in June adds further uncertainty to the issue. Separately, general elections to be held in France in June as well as Germany in September are also a cause for concern. Heightened geopolitical tensions in Eastern Europe and the Middle East, the influx of migrants and the threats of terrorist attacks, could also possibly dampen the region's economic sentiment.

Box 2.1 (Cont'd)

Chart 4: Euro area's growth outlook is still modest





Sources: Eurostat, CEIC and International Monetary Fund (IMF).

In the context of global trade, the euro area is a major export market for Asian economies. However, with the rather slow recovery in Europe and the weak euro (the euro depreciated by 16%[(1)] between April 2008 and April 2017), the currency bloc's import demand remained relatively soft. Despite some recent improvement, euro area's monthly import demand in US dollar terms in the first two months of 2017 was still some 15% lower than the average monthly imports in 2008 after seasonal adjustments ***(Chart 4a)***. In contrast, being another major market for Asian exports, US' average import demand in the first two months of this year was some 11% above the average monthly level in 2008.

In sum, while there was progress in the economic recovery in the euro area in recent years, the structural issues as well as the highly heterogeneous situations among member states could still constrain the growth of the euro area beyond the near term. In April, the IMF forecast the euro area's annual economic growth to stay modest in 2017 to 2019, at 1.6-1.7%, assuming the Brexit negotiations proceed without raising excessive uncertainty and the arrangements could eventually avoid a very large increase in economic barriers. Such a forecast growth pace, if realised, would be still slower than that for the US and way below that for the emerging and developing Asia ***(Chart 4b)***. With the euro area being a major economic bloc that has close economic ties with Hong Kong, the Government will stay alert to the developments and monitor the situation closely.

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(1) This is based on the nominal effective exchange rate index calculated by the ECB, using weighted averages of bilateral euro exchange rates against 19 trading partners of the euro area.