Background Note on the Regional Outlook for Western Europe

The economic situation in Western Europe is precarious, particularly in the euro area. Growth at the beginning of 2014 was already very subdued, with GDP expanding by only 0.2 per cent in the first quarter in the euro area, but activity stagnated in the second quarter of 2014, with zero growth of GDP. The slowdown was led by the large economies, where Germany sharply reversed its strong gain of the first quarter, France registered a second consecutive quarter of zero growth, while Italy fell into technical recession.

To some extent the recent poor results reflect the deepening tensions in the Ukraine and resulting economic sanctions, which are affecting both trade and industrial confidence, particularly in those countries with a strong manufacturing base. But it is against a backdrop of very weak growth, easily disturbed by exogenous events. One aspect of this weakness is that the euro area is very close to deflation. Inflation has been below 1 per cent since Sept of 2013. In August it fell further to 0.3 percent. Another is that unemployment is extremely high. In July it was 11.5 per cent in the euro area, but was 24.5 per cent in Spain.

The weak environment is caused by: continuing fallout from the great recession and subsequent euro area crisis; fiscal austerity programs in many countries required by euro area fiscal rules in light of high country deficits and debts; high unemployment coupled with strong pressures against wage expansion which leads to weak consumption expenditure; a fragmented financial system whereby the periphery country firms are unable to find funding for investment; and a generally weak banking system. In this latter regard, the European Central Bank (ECB) and the European Banking Authority are performing a major Asset Quality Review and bank stress tests during 2014 for a large sample of the region's banks and are expected to find a need for significant recapitalization of some banks, with a question of who will pay for this. The proposed banking union is still being negotiated and to date is not expected to have sufficient funds for this purpose. So it may again fall to governments to finance this recapitalization.

With fiscal policy severely constrained, monetary policy has been the only source of policy stimulus. The tensions in the region surrounding the debt crisis subsided dramatically after the ECB announced its Outright Monetary Transactions facility, despite the fact that the policy was never actually deployed. Since then the ECB has lowered its policy interest rates twice, even introducing a negative rate of interest on its Deposit rate. Currently it is contemplating the introduction of additional non-standard policies, but the possibility of a full blown Quantitative Easing program of buying sovereign bonds is constrained by member government reluctance to mix monetary policy in fiscal affairs.