Vítor Constâncio: Monetary policy and the euro area problem

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 18th Euro Finance Week, Frankfurt am Main, 16 November 2015.

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Summary

The speech points that the euro area problem is part of a predicament shared by other advanced economies: decades of declining economic and productivity growth rates, prolonged periods of low inflation and an untamed financial sector fuelling asset price booms. Policies adopted by the ECB are thus responding to the present situation of low inflation and tepid recovery. Namely, the low level of policy rates is associated with the declining real rate of equilibrium. The worsening of the international economic situation and the low inflation will lead the ECB to reassess its policy stance in December. To face the challenges confronting the euro area, it is recognised that monetary policy cannot address all the problems and that structural reforms and fiscal policy should help to overcome them.

Ladies and Gentlemen,

I am honoured by Mr Maleki's invitation to speak at the Opening Conference of the 18th Euro Finance Week.

In my remarks today I would like to characterise the current economic situation in the euro area. Furthermore, I will address the roles that monetary policy, supply-side reforms and fiscal policies have played – and can play in the future – in shaping this situation.

The current economic situation in the euro area

The euro area challenges are part of a predicament shared by other advanced economies: decades of declining economic and productivity growth rates, prolonged periods of low inflation and an untamed financial sector fuelling asset price booms. This constitutes a very challenging situation that cannot be solved by one policy area alone, be it monetary policy or any other. Furthermore, issues in the euro area are more acute than in the case of other advanced economies.

Since 2008, the euro area has experienced a deep recession, a quickly interrupted recovery, another long, mild recession, and finally a slow recovery. Euro area GDP per capita at the end of this year is expected to be 1.6 percent below what it was seven years ago, at the end of 2008. Notably, growth outcomes in several member states have been much worse than this disappointing average. At the end of 2015, GDP per capita in Italy is projected to be 10.1 percent lower than seven years before; 4.2 percent lower in Spain; 3.4 percent lower in the Netherlands and 8.5 percent lower in Finland.[1] At the aggregate level, the euro area output is now 20 percent below the level it would have achieved had the trend growth in the previous 15 years continued after 2007. Admitting that the economy would grow from now on at that same trend, the accumulated loss of output until 2030, properly discounted, would represent more than three times the whole output of 2008. The crisis left a permanent economic loss with broad scars in our societies.

This is evident when looking at unemployment data. The unemployment rate in the euro area, as a whole, stood at 7.5 percent on the eve of the financial crisis, in 2007. Unemployment increased steadily in subsequent years, reaching about 12 percent of the labour force in 2013,

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[1] The source of the data on GDP per capita is AMECO, the annual macroeconomic database of the European Commission's Directorate General for Economic and Financial Affairs.

and has since come down only slowly, by one percentage point, to 11 percent. Disaggregated by countries, the range of unemployment rates goes from 4.5 to 25 percent. If we were to add the number of part-time workers preferring to hold a full-time job and of those discouraged to look for a job, (figures also published by Eurostat), the real situation would be undoubtedly grimmer. In spite of recent increases, total employment is still 3.3 million people below the pre-crisis period. High unemployment is destabilizing our continent and challenging our social and political systems.

In the environment of weak economic activity, the euro area has been experiencing downward pressures on inflation. As you know, the Governing Council has defined the price stability objective of the ECB as a year-on-year rate of growth of the Harmonised Index of Consumer Prices (HICP) for the euro area of "below, but close to, 2 percent." The annual rate of inflation measured in terms of the HICP has decreased year after year, since 2011. Inflation ran at 0.4 percent in 2014 and is forecast to be 0.1 percent in 2015. As I will discuss, the Governing Council has undertaken a number of measures to prevent inflation from falling further and to make sure that inflation returns to the level consistent with price stability over the medium-term. In part as a result of these measures, the latest ECB staff projection sees the annual rate of inflation increasing to 1.1 percent next year and to 1.7 percent in 2017, though, again, these forecasts are subject to revision, in particular due to the recent adverse news about the external environment of the euro area. All member states have been experiencing downward pressures on inflation. Inflation ran at 0.8 percent last year in Germany, and is forecast to be only 0.2 percent this year. The analogous numbers for Italy, to take another example, are only somewhat lower, 0.2 percent and 0.1 percent respectively.

The low inflation rates reflect a continued sluggish recovery in the aftermath of the global financial crisis. Numerous reasons can be considered as root causes for this dismal performance. Next to recent declines in oil prices, the combination of low inflation and low growth essentially points to a lack of demand holding back the recovery.

A question frequently posed regards the reasons for the ECB's Governing Council not to accept the low increase in prices which, at first glance, appear beneficial to people. There are several reasons why excessively low inflation generates relevant risks for the economy and thus to everyone. First, with monetary policy rates at their lower bound, lower inflation rates imply higher real interest rates; in particular, the real interest rate may end up above the equilibrium value needed to match savings and investment at the full employment level. Second, very low inflation may lead to an un-anchoring of inflation expectations. This would imply second-round effects on price and wage setting protracting the subdued price developments into the future. Third, low inflation increases the debt burden of borrowers, obstructing the needed balance sheet adjustment of highly indebted households, firms and governments. Fourth, should a generalised deflation pressure prevail, nominal rigidities in the economy, and particularly in labour markets, could inhibit the needed relative price adjustments. Finally, empirical studies show that there is a positive measurement bias in the measurement of price developments, which implies that a zero inflation rate would mask actually declining prices.

For all these reasons the ECB has decided a quantitative objective with an inflation rate for the euro area of below but close to 2 percent. This objective guarantees an appropriate buffer to counter the above-mentioned drawbacks of very low inflation or even deflationary tendencies. [1]

The monetary policy measures adopted by the ECB

In order to bring inflation rates closer to the stated objective of price stability over the medium-term, and in order to support the aggregate recovery, our monetary policy continues pursuing its accommodative stance. Our main policy rates will stay low for a prolonged period of time, in line with our forward guidance. The asset purchase programme will keep our balance sheet expanding until we see a sustained adjustment in the path of inflation. When the global financial crisis intensified in September 2008, the interest rate on the ECB's main refinancing operations for banks stood at 4.25 percent. By May 2009, the ECB had reduced this rate to 1 percent, while simultaneously cutting the rate on the deposit facility to 25 basis points. The significant decline of inflation since the later part of 2013 led us to further reduce interest rates during last year and the interest rate on the main refinancing operations currently stands at 5 basis points, whereas the interest rate on the deposit facility is –20 basis points.

Why did the Governing Council reduce the policy rates to such low levels? Policy rates are defined in nominal terms, they have a component related to inflation and another associated to real economic growth. Monetary policy searches for a neutral rate that steers the economy to stable inflation around its target and consequentially, the market for goods and services in equilibrium at full employment. The interest rate in real terms, i.e., adjusted by inflation, is precisely the rate at which the economy's growth rate is equal to the potential growth rate so that no demand pressure makes the inflation rate inconsistent with price stability in the medium-term. Recent estimates for the U.S. indicate that such real rate can now be in negative territory and the same should apply to other advanced economies.[2]

The point that monetary policy cannot affect the equilibrium real rate is important. In addition to the propensity to save, the equilibrium rate depends on the growth rate of potential output. If potential output grows slowly, the equilibrium rate will be low, and therefore the real rate necessary to achieve price stability will also be low, independently of what the central bank does. Unfortunately, the growth rate of potential output in the advanced economies appears to have decreased in the recent years. Labour productivity, defined as output per employee, grew at the same average annual rate of 1.7 percent in the euro area and in the U.S. for two decades, from 1981 to 2000. From 2001 to 2008, the average annual growth rate of labour productivity in the U.S. was lower, at 1.5 percent, and since 2008 it has been only 1.1 percent. The slowdown in growth of labour productivity in the euro area has been far more pronounced: the average annual growth rate of labour productivity dropped to 0.5 percent from 2001 to 2008 and stands at 0.2 percent since then.

Demographic factors also matter for the equilibrium real rate. In an ageing society in which a large fraction of the population is saving for retirement, the propensity to save tends to be high and therefore, the rate of return on savings will be low, independently of monetary policy. In this context, it is important to realize that the working-age population of the European Union and the working-age population of the euro area has been falling since 2012, and this decline is expected to continue.[3] Note that the central bank cannot affect the equilibrium real rate. The equilibrium real rate depends on features such as the households' propensity to save, and the central bank cannot influence this. The ECB did not lead to this environment with underlying negative real equilibrium rates.

The ECB responded to the decline of the real equilibrium rate by reducing the policy rates, and consequently the real rates declined throughout the economy. Had the policy rates been cut less aggressively, real income and inflation would have been even lower today. Now think about the implications for retirement saving by an average household, had the ECB reduced rates less aggressively. The real interest rate would have been higher, but the household's income would have been lower. Therefore, the amount that the household would have saved for retirement would probably have been smaller – not larger – than with the current, low ECB policy rates.

The other point related to savers is that any economic reasoning related to income must be done in real terms. This implies for instance, that in 2007 deposit interest rates in Germany

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2 See J. Williams and T. Laubach (2014), "Measuring the real natural interest rate redux" Federal Reserve Bank of San Francisco Working Paper No. 2015–16, October.

3 The data on working-age population come from the Organisation for Economic Cooperation and Development and refer to the EA-17 and the EU-27.

where little more than 2percent but inflation was higher and so real deposits were negative, i.e., depositors were losing purchasing power. In fact, the Bundesbank wrote in 2014, “As it happens, negative real interest rates have been the norm, rather than the exception, over recent decades”.[4] Recently, deposits have been around zero but the latest inflation rate is at 0.2 percent while real interest rates are even slightly above their levels of 2014. Nominal interest rates can only increase when our policies become successful in the medium-term and inflation is closer to our official target.

In addition to pursuing interest rate policy, the ECB has adopted a number of non-standard monetary policy measures since 2008, including a large scale asset purchase programme, targeting an improvement in financial conditions. The goal of our current monetary policy stance is to incentivise economic risk-taking, in the form of better financing conditions for households and firms. We are, of course, very much aware that side effects are also present, in particular in the form of excessive asset valuations or excessive risk-taking by market participants.

We are following these developments very closely, notably in relation to risks posed by asset valuations and the search for yield phenomenon. Our assessment at present, monitoring a range of asset markets, is that there are no signs of generalised overvaluations in the euro area. At the same time, the banking sector is more resilient, with higher capital ratios, and financial stability conditions are currently fulfilled in spite of the existent risks.

The external environment of the euro area has deteriorated since the asset purchase programme began. In particular, concerns about growth prospects in emerging markets and unfavourable developments in financial and commodity markets have signalled downside risks to the outlook for growth and inflation, relative to the latest ECB staff projection from September. Headline inflation is again at zero and core inflation has not consolidated a more positive development, which points to the need to reassess our policy stance in order to achieve our goals by 2017. Eurosystem staff is currently analysing the impact of the recent external events on the euro area, in particular on the speed of adjustment of the inflation rate to levels consistent with price stability. The next Eurosystem staff forecast, due in December, will help the Governing Council re-examine whether the current degree of monetary accommodation remains appropriate. Further monetary policy options are available should the Council determine that changes to the current policy stance are required.

The role of other economic policies

Allow me now to turn to the role of other economic policies. The transmission mechanism from monetary policy decisions to inflation involves the real economy. With a negative output gap there is a “divine coincidence” between the objective of normalising inflation and that of expanding aggregate demand to reduce the slack in the economy and put pressure on prices. Accordingly, the accommodative monetary policy stance of the ECB has supported and will continue to support real activity. Nevertheless, it has to be acknowledged that monetary policy cannot do it alone. Given how weak the economic performance of the euro area has been in the recent years, coupled with the limitations of monetary policy in what is called a “liquidity trap”, it is critical that supply-side reforms and fiscal policies contribute to improve the euro area’s growth prospects.

Supply-side reforms are vital because the long-term growth rate depends on the productivity of labour and capital. Supply-side reforms can increase productivity, thereby lifting the potential growth rate. Growth friendly reforms include policy actions to improve the business environment, to foster competition, to improve public infrastructure and education. Policies that reduce structural unemployment and raise the labour force participation rate are also important

[4] Deutsche Bundesbank (2014) “ Nothing new about negative real interest rates on deposits” Economic Bulletin 2014–06–30.

so that European firms make full use of the amount of labour available. Demographic policies can play a role too, so that the supply of labour in Europe can grow, rather than shrink, in the future.

In recent years, much of the reform effort within the euro area appears to have taken place in the member states most adversely affected by the global financial crisis and its aftermath. The OECD recently assessed structural reform efforts and achievements since 2011. It classified Estonia, Greece, Ireland, Portugal and Spain as the most successful reformers among all OECD members.[5] The Netherlands and Germany have been laggards in the OECD ranking, even if starting from comfortable positions.

While supply-side reforms are desirable, their objective is typically growth in the long-run. As such, supply-side reforms normally take time to produce positive effects. Furthermore, in the short-run, reforms can dampen aggregate expenditure, when they require costly adjustments up front, as has been recognised in the Stability and Growth Pact. For this reason and amid a tepid recovery, it is important for member states' fiscal policy to be as accommodative as possible.

Fiscal policy and to some extent, income policy, have room for manoeuvre whenever an economy is running a current account surplus. This is the case for the euro area that currently has a surplus of 3percent of GDP and is projected to remain as such the next few years. The surplus was only 0.1 percent in 2007 at the peak of the cycle, and will reach USD 365 billion this year. This is quite high by historical standards, it is now higher than China´s surplus at USD 329 billion. In my view, a pure economic reflection is warranted. This big increase in the surplus took place while the unemployment rate increased from 7.5 percent to 12 percent standing now at 11 percent and while employed population is down by 3.3 million people compared with 2007 figures. In the U.S., employment deserves a higher priority for well-known historical reasons. Levels of employment have already surpassed those of 2007 while the external current account shows a deficit of USD 460 billion.

Economically, a surplus means that domestic savings are higher than investment or, seen from another angle, that domestic expenditure is lower than what the domestic economy produces. From an international perspective, a surplus means that the economy is importing demand from other countries that are necessarily running a deficit. As a consequence, it means that the economy is absorbing and reducing world demand. What is also important to grasp is that this is a macroeconomic phenomenon and that total savings of an economy are not just the result of individual preferences and behaviour but the end result of a whole set of macroeconomic policies – from tax and fiscal to monetary or income policy. The macroeconomic policies of one economy affect the savings or expenditure of other countries. Trade and finance link all economies in a specific way. Not all economies can have a surplus. The relation between savings and investment or expenditure and domestic production is not unilaterally determined.

What all these economic points imply is that an economy that has a surplus can adopt macroeconomic policies to increase domestic demand, either by income policy or by using its fiscal space to cut taxes or increase expenditure, while still keeping the basic macroeconomic equilibrium of not spending more than what it produces. The points I made provide the rationale for the statement made last year in Der Spiegel by the Bundesbank´s Chief Economist, welcoming the then "recently agreed pay rises above 3 percent".[6]

The surplus situation also means that, for the euro area as a whole, there is fiscal space to be used to help closing the existent output gap resulting from lack of demand. This would put upward pressure on prices, speeding up the path towards normalisation.

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5 OECD: "Structural reforms in Europe: achievements and homework." April 2015.

6 See Der Spiegel, 21 July 2014.

It is crucial to note again that this is about macroeconomic policy and not about microeconomic efficiency. It is definitely not about asking our economies to compromise productivity and competitiveness. It is about fostering a broader use in the present of what a productive economy can sustain.

The problem is that there is no common European fiscal policy, which is also not foreseen in the Treaty. The overall fiscal stance is not discussed and there is no substantive effort to co-ordinate independent national fiscal policies. Many economists have pointed out that this constitutes a significant shortcoming of our monetary union design. Economic governance of the monetary union depends only on monetary policy without any concept of a macroeconomic policy mix.

This shortcoming provides the rationale for the proposal in the recent Five Presidents' Report, that points for the creation of "an euro area-wide fiscal stabilisation function" in the longer term.

On the way to the "longer term", one could envisage some steps to strengthen the European dimension of fiscal policy in the Eurogroup. Another initiative could be to expand the financial capacity of the Juncker Plan in order to really help to jump start investment at the level of the European Union. This would be consistent with the existent overall fiscal space.

A last important remark is that a more flexible overall fiscal policy does not require changing the existing framework of the Stability and Growth Pact that binds euro area Member States. As recently emphasised in a document by the European Commission,[7] the Pact already envisages a certain degree of flexibility in the way its rules should be applied. One example is the notion of "structural budget balance" which Member States are obliged to meet. The structural budget balance is, in effect, the budget balance corrected for the effects of the business cycle. The objective of the correction is to allow fiscal policy to play its role in mitigating possible economic shocks. The scope of flexibility within the Stability and Growth Pact should thus be exploited in full.

Let me conclude.

The euro area has been experiencing a protracted period of low inflation and weak economic activity, with two recessions and a very slow recovery since the latter recession. Monetary policy has been and will continue to be accommodative, but monetary policy alone cannot respond to all the existing challenges. Recent developments only add to the urgency of addressing economic, social and demographic problems of the euro area. No complacency with mass unemployment should be tolerated.

Outcome legitimacy is, at present, the main source of legitimacy for the European project. The euro area must deliver on its promises of stable prosperity, knowing that societies do not live in the long-term but in the here and now. The task requires new institutional reforms and a sense of unity. As Helmut Schmidt wrote in 2011, we should "strive to ensure that the historically unique European Union emerges unshaken and with self-confidence from its current period of weakness".[8]

Thank you for your attention.

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7 European Commission: "Making the best use of the flexibility within the existing rules of the Stability and Growth Pact." January 2015.

8 Helmut Schmidt (2011) Speech " Deutschland in und mit und für Europa".