Peter Praet: Turn cyclical recovery into a structural recovery

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Morgan Stanley Roundtable "What next for Europe", Washington DC, 6 October 2016.

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I would like to thank Danielle Kedan for her contributions to this speech

Today I will give you an assessment of the euro area economy and share some thoughts on where I see us heading and on what is needed to ensure long-run sustainable growth.

Starting with the positive news, we have good indications that the euro area economy is heading for a continued, though moderate, recovery, which seems to have become more resistant to negative outside influences and especially to the heightened uncertainty caused by the outcome of the UK referendum. Real GDP growth has expanded for the 13th consecutive quarter, growing by 0.3%, quarter-on-quarter, during the second quarter. The latest incoming economic indicators point to similar growth rates for the coming quarters.

While it is true that the uncertainty following the UK vote will significantly weaken the outlook for foreign demand and thereby dampen export growth, robust domestic demand should partly counteract the negative impact on growth stemming from the external environment.

Solid domestic demand is anticipated to remain the driving force behind real GDP growth. Consumption expenditure is expected to grow strongly this year and to remain buoyant thereafter. Most notably, consumption is boosted by improving labour market conditions, with unemployment falling steadily despite a rise in participation. Moreover, euro area consumers are still benefitting from higher real disposable incomes, reflecting past declines in oil prices. Business investment is also expected to continue recovering amid support from a number of factors, such as improved expectations of improving business conditions and a need to modernise the capital stock after years of low investment and physical depreciation.

All these developments, of course, are gaining significant support from the effective pass-through of our accommodative monetary policy measures. Taken together, our measures have led to a significant and broad-based easing in financing conditions through both price and quantity channels, which bolters consumption and investment expenditure.

In terms of financing costs, since the beginning of June 2014, bank lending rates for euro area households and NFCs have fallen sharply, with even more pronounced declines for small and medium-sized enterprises (SMEs).[1] The Corporate Sector Purchase Programme (CSPP), which began in June of this year, has led to a significant decline in corporate bond yields, not only for those bonds eligible for purchase under the programme but also for other bonds, including bank bonds. The new series of targeted longer-term refinancing operations (TLTRO-II) are also providing additional stimulus by allowing banks to secure long-term funding under very attractive conditions.

In terms of quantities, bank lending to the private sector has been gradually recovering since early 2014, and survey data show improvements in loan supply conditions for firms and households, as well as in the availability of external sources of financing for SMEs.[2] Corporate bond issuance has also picked up since the announcement of the CSPP in March, while the TLTRO-II should help to support bank lending volumes to the non-financial private sector.

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1 For additional information on the effectiveness of the ECB's non-standard monetary policy measures, see ECB, "The transmission of the ECB's recent non-standard monetary policy measures", Article, Economic Bulletin, Issue 7/2015

2 ECB Bank Lending Survey, July 2016 and ECB Survey on the Access to Finance of Enterprises in the euro area, October 2015 to March 2016.

So our policy measures are clearly effective and are trickling down to the funding rates that matter most for the real economy, such as the ones faced by SMEs, which provide jobs for around two-thirds of those in employment in the euro area.[3]

Favourable financing conditions, along with other factors such as employment gains and improvements in the demand outlook and in corporate profitability, are expected to further support private consumption and investment expenditure going forward. Investment however remains well below its pre-crisis levels and its sensitivity to the borrowing conditions faced by companies is lower than historical norms. According to the September ECB staff macroeconomic projections, annual real GDP growth is expected to increase by 1.7% this year, and by 1.6% in each of the next two years.

Turning to price developments, inflation remains at low levels – far below the level which we consider consistent with our price stability objective – reflecting past declines in oil prices and weak wage growth. Underlying inflation in particular has yet to show clear signs of a more dynamic upward movement. The annual rate of HICP inflation excluding food and energy has continued to hover around 1% as domestic cost pressures remain fundamentally weak. Yet, as the effect of past oil price declines fades, annual HICP inflation is expected to pick up from 0.2% this year to 1.2% in 2017. Moreover, we expect that as the recovery continues and economic slack falls, inflation will gradually accelerate further to 1.6% in 2018.

Although the euro area recovery is showing signs of resilience, material downside risks remain, mainly stemming from the external environment and significant uncertainties following the outcome of the UK referendum. Moreover, our baseline scenario for growth and inflation in the euro area remains crucially dependent on the current supportive financing conditions staying in place.

Monetary policy will continue to play its role in facilitating the cyclical recovery. By ensuring accommodative financing conditions that buoy demand, monetary policy is helping to raise output back to its potential level. We therefore remain committed to preserving the very substantial amount of monetary support that is embedded in our staff projections and that – barring a fundamental change in sentiment and in the underlying momentum driving the recovery – remains necessary to secure a return of inflation to levels below, but close to, 2% over the medium term.

Nevertheless, potential growth in the euro area is low after years of decline, while structural unemployment remains high. The European Commission estimates that the potential growth rate of the euro area economy this year is just 1%, less than half that of the United States.[4]

Low potential growth casts a shadow over the long-run economic prospects for the euro area, creating a negative feedback loop. Because low potential growth dampens expectations of future income, it curbs consumption and investment today, which further lowers rates of potential growth tomorrow. This can lead to a permanent destruction of productive capacity, including jobs.[5]

Low potential growth also has important implications for monetary policy in that it lowers what is known as the "natural" rate of interest. This is the interest rate around which the policy rate should oscillate in the long-run to support a full utilisation of resources and a rate of inflation steady around target. A lower natural rate of interest implies less scope for conventional monetary easing in the future.

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3 See ECB, "Small and Medium-sized enterprises in the euro area: economic importance and financing conditions", Box 6, ECB Monthly Bulletin, July 2013.

4 European Commission, European Economic Forecast, Spring 2016.

5 For further discussion, see Praet, P., "Lifting potential growth in the euro area", Speech at the Welt-Währungskonferenz, 23 April 2015.

It is therefore imperative that decisive action is taken now in order to propel the on-going cyclical recovery into a structural recovery. Long-run growth depends on the efficiency with which resources are allocated, the ease of doing business, the incentives for investment and confidence in public institutions. Making strides in these areas requires structural reforms aimed at supporting investment, enhancing productivity and increasing flexibility in the markets for labour, goods and services. Structural reforms will go a long way, not only in bolstering the trend of long-run growth but also in reducing the fluctuations around that trend.[6]

Such reforms are the means of addressing the ongoing adjustment difficulties faced by the economy and of preventing secular stagnation – which is not inevitable. However, such reforms are outside of the scope of monetary policy and fall under the remit of other national and European policymakers.

Just as persistently low potential growth can create a negative circle, structural reforms and the ensuing increase in the economy's growth potential and in its adjustment capacity – or flexibility to respond to shocks – can create a virtuous circle. Higher potential growth feeds into expectations of higher incomes and also of higher tax revenues, increasing the resilience of public finances. At the same time, higher potential growth raises the natural rate of interest. Together, this means that fiscal and monetary policies have more space to stabilise the economy when needed. Furthermore, increased flexibility of labour and product markets means that the private sector can adjust more quickly to shocks through relative price changes and a more efficient reallocation of resources.

As the benefits of structural reforms can take time to materialise, they must be implemented without undue delay and are needed in order to reap the full benefits from our monetary policy measures. The highly accommodative stance of monetary policy creates ideal conditions for the implementation of structural policies, as it can help to cushion the potential short-term adjustment costs of such policies by supporting current demand conditions.

To conclude, the euro area economic recovery remains resilient despite the continued headwinds stemming from global and political uncertainties. Nevertheless, in order to transform the cyclical recovery into a structural one, and thereby ensure resilience of growth in the long-run, other policymakers must play their part. The support to demand from monetary policy must be complemented with supply policies that bolster the potential growth, productivity and flexibility of the euro area economy.

6 For further details, see Praet, P. "Structural reforms and long-run growth in the euro area", Intervention on panel at 43rd Economics Conference of Oesterreichische Nationalbank, 15 June 2015.