# Peter Praet: The euro area economy, monetary policy and structural reforms

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Observatory Group roundtable, New York City, 18 November 2016.

* * *

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.[1]

On a positive note, we have good indications that the euro area economy is heading for a continued moderate, but steady recovery, which seems to have become resilient to global economic and political uncertainty. Real GDP growth has expanded for the 14th consecutive quarter, growing by 0.3%, quarter-on-quarter, during the third quarter according to the flash estimate. The latest incoming economic indicators continue to point to similar growth rates for the coming quarters.

Although global uncertainties continue to weigh on the outlook for foreign demand and could 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. These improvements support the consumption expenditure of both existing employees, who are reassured of their earnings prospects, as well as new employees. 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 improvements in corporate profitability 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 for euro area firms and households, which bolsters 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). Corporate bond yields have fallen significantly, too, amid support from the Corporate Sector Purchase Programme (CSPP), which began in June of this year. 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, which they can pass on to their customers.

In terms of quantities, bank lending to the private sector has been gradually recovering since early 2014. In the latest bank lending survey, banks continued to report that the ECB's Asset Purchase Programme (APP) and the negative deposit facility rate had contributed to more favourable terms and conditions on loans, and are supporting lending volumes.[2] Meanwhile, other survey data indicate improvements in the availability of external sources of financing for SMEs.[3]

Corporate bond issuance has also picked up since the announcement of the CSPP in March, while the TLTRO-II should help to further support bank lending volumes to the non-financial private sector.

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.[4]

Favourable financing conditions, along with other factors such as employment gains and improvements in the demand outlook, 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, headline inflation increased in October to 0.5% in year-on-year terms, owing to a continued increase in annual energy inflation. So although price dynamics are improving, 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 hovered around 0.8% for the last three months 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.

Therefore, we will ensure that monetary policy continues 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 and ultimately secures inflation to return to levels below, but close to, 2%.

We remain fully committed to preserving the very substantial amount of monetary accommodation which is necessary to secure a sustained convergence of inflation towards our inflation aim and stand ready to act, if warranted, to achieve our price stability objective by using all the instruments available within our mandate. To this end, at our policy meeting in early December, we will be in a good position to take a comprehensive perspective on the inflation outlook, our progress made in achieving a sustained adjustment and the monetary policy stance, benefitting from incoming data and survey information, the new staff macroeconomic projections as well as the work of the Eurosystem committees on options to ensure a smooth implementation of our purchase programme until March 2017, or beyond, if needed.

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%, half that of the United States.[5]

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.[6]

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.[7]

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.

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 economic 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.

---

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

2 ECB Bank Lending Survey, October 2016.

3 ECB Survey on the Access to Finance of Enterprises in the euro area, October 2015 to March 2016.

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

5 European Commission, European Economic Forecast, Autumn 2016.

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

7 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.