Peter Praet: The economic situation in the euro area and the implications for monetary policy

Keynote speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the IE Business School Leadership Forum, Madrid, 27 March 2017.

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Today I will discuss the macroeconomic situation and monetary policy in the euro area. As a central bank with a clear price stability mandate, we need to ultimately judge economic developments in the light of their implications for price stability. Despite the recent increase in headline inflation, largely on account of rising energy and food prices, underlying inflation pressures remain subdued. Furthermore, convincing signs of a self-sustained convergence in inflation towards levels that are consistent with the Governing Council's objective of below, but close to, 2% have yet to materialise. To ensure price stability over the medium term, we must look through changes in headline inflation to the extent that they are transient. In the near future, we will have to assess how the forces that are driving prices today can influence the outlook for price stability in the medium term and help durably stabilise inflation around our goal.

The economic recovery will support domestic price pressures. Indeed, the upswing is continuing at a steadily firming pace and is broadening across sectors and countries. The recovery has proven to be resilient against past external shocks and influences. In fact, real GDP growth in the euro area has expanded for 15 consecutive quarters, growing by 0.4% during the final quarter of 2016. Economic sentiment is at its highest level in nearly six years and unemployment is at its lowest level in nearly eight years. Looking beyond the euro area, there are signs of a somewhat stronger global recovery and increasing global trade. So overall, as economic conditions are improving, also the risks surrounding the euro area growth outlook have become less pronounced, although they remain tilted to the downside, mainly because of global factors.

Our monetary policy measures have been instrumental in these positive developments in the euro area economy, as well as in supporting the resilience of the recovery in the face of external influences and prevailing uncertainties. The comprehensive set of measures introduced since June 2014 has worked its way through the financial system, leading to a significant easing of financing conditions for consumers and firms. Together with improving financial and non-financial sector balance sheets, this has strengthened credit dynamics and supported domestic demand.

Since June of that year, bank lending rates for both euro area households and non-financial corporations have fallen by around 110 basis points. Lending rates for very small loans, which can be taken as a proxy for loans to small and medium-sized enterprises (SMEs), have declined by around 180 basis points. The significant improvement in funding conditions for SMEs is especially encouraging as they provide two-thirds of total private sector employment in the euro area.

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent surveys have shown[1] These positive developments have been supported by the second series of targeted longer-term refinancing operations, as a result of which banks are passing on the favourable funding conditions to their customers. Moreover, these improvements are not limited to interest rates: bank lending volumes have also been gradually recovering since early 2014. Market-based funding conditions, too, have improved significantly in response to the corporate sector purchase programme launched in June 2016.

Looking forward, we are confident that the ongoing economic expansion will continue to firm and broaden. Incoming data, as well as improving consumer and business sentiment indicators, suggest that the cyclical recovery is gaining momentum. Private consumption growth continues to be a key driver of the ongoing recovery, which is underpinned by improvements in labour market conditions, with unemployment steadily falling despite a rise in participation. These developments increase households' real disposable income, which in turn boosts their spending. Business investment is also expected to continue recovering amid support from better corporate profitability and the very favourable financing conditions.

As for price developments, after hovering at levels well below 1% for three years, with occasional dips into negative territory, euro area headline inflation edged higher towards the end of last year and reached 2% in February. This upward movement of inflation mainly reflects increases in energy and food prices.

Underlying inflation – which relates more to domestic price pressures – continues to remain very subdued and has yet to show clear signs of trend inversion as unutilised resources still weigh on wage and price growth. For example, the annual rate of HICP inflation excluding food and energy has mostly remained below 1% since late 2013.

Concerning the outlook for price developments, our latest staff macroeconomic projections suggest that the strong upward pressures on headline inflation from recent increases in energy and food price inflation are not expected to fundamentally change the medium-term outlook for price stability. In fact, while the staff projections indicate that the recent price pressures will cause a hump in the inflation path in 2017 and 2018 relative to the trajectory expected in December last year, the projection for headline inflation for 2019 has remained largely unaltered.

By ensuring accommodative financing conditions, monetary policy will continue to support domestic demand by mobilising idle resources. This will lead to a build-up of domestic price pressures and ultimately pull underlying inflation up as remaining slack in the economy is gradually reabsorbed and the output gap narrows further. In turn, this will facilitate a durable return of inflation back to a level that is below, but close to, 2% over the medium term.

Today, an important element keeping underlying price pressures subdued is muted wage dynamics, which are shaped by many factors. At this stage, besides weak productivity developments, there is still a significant degree of labour market slack that keeps a lid on wage growth. Furthermore, the process of setting wages is to some extent backward-looking in a number of euro area countries, reflecting formal and informal indexation mechanisms.[2] Additionally, the timing of wage negotiations plays a role in postponing the point in time when growing confidence that inflation is approaching the ECB's intended medium-term level starts to become more visible in aggregate wage figures. Moreover, weak wage growth could also reflect previous downward wage rigidities: difficulties in reducing wages during earlier stages of the crisis may result, symmetrically, in a slower upward adjustment of wages as labour market conditions improve.[3]

Overall, while we are certainly seeing a firming, broadening and more resilient economic recovery, we still need to create a sufficiently broad and solid information basis to build confidence that the projected path of inflation is robust, durable and self-sustained. Underlying inflation pressures still give scant indications of a convincing upward trend as domestic cost pressures, notably wage growth, remain subdued. Importantly, the economic recovery and the outlook for price stability are still predicated on the very favourable financing conditions that to a large extent depend on continued monetary policy support. Absent that quantum of support, the progress towards a sustained adjustment that we see in our projections is likely to be slower or even stall.

Therefore, we need to look through the recent surge in inflation, which is driven by transient factors that will probably fade before long. Our conclusion that a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to build up and support headline inflation in the medium term remains valid.

Of course, monetary policy cannot be the only source of support for growth: action from other policy areas is needed to ensure a sustainable economic recovery. Structural reforms can play a key role in turning the cyclical recovery into a structural recovery and the current low interest rate environment makes it politically and economically easier to implement them. Such reforms, if carried out now, will help to promote favourable economic conditions down the road.

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1 See ECB Bank Lending Survey, January 2017, and ECB Survey on the Access to Finance of Enterprises in the euro area, April to September 2016.

2 For further discussion, see "Recent wage trends in the euro area", Box 2, ECB Economic Bulletin, Issue 3 / 2016.

3 See, for example, "Wage dynamics amid high euro-area unemployment", Deutsche Bundesbank Monthly Report, December 2016.