Peter Praet: Europe's economic recovery and implications for monetary policy

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the International Conference of Commercial Bank Economists (ICCBE) in France, Paris, 6 July 2017.

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Since June 2014, the ECB has introduced a range of unconventional measures, alongside our conventional ones, in pursuit of its price stability objective. Together, these measures have proved to be extremely effective in preventing a period of disinflation from spiralling into one of deflation. Nearly three years on, the risks of deflation have vanished and the transmission of our policy measures to the real economy is clearly evidenced by the recovery, which has gathered some further momentum recently.

Before turning to price developments and monetary policy, let me say a bit more about the latest economic developments in the euro area.

The solid upswing continues to broaden across sectors and countries. Real GDP in the euro area has expanded for 16 consecutive quarters, growing by 1.9% year-on-year during the first quarter of 2017, according to Eurostat. This compares with the latest potential growth estimates for the euro area of just over 1%.[1]

Moreover, recent survey data point to a strong start to the second quarter. For example, the composite output Purchasing Managers' Index – which is strongly correlated with growth in the euro area – remains close to six-year highs in June. The forward-looking components of the survey continue to point to growth in the quarters ahead. Moreover, economic sentiment is at its highest level in nearly a decade and has increased notably from May to June 2017.[2] Unemployment is at its lowest level in eight years. Looking ahead, the latest Eurosystem staff macroeconomic projections point to a continued economic expansion at a somewhat faster pace than previously expected.

The breadth of the economic recovery is also notable. The dispersion of growth rates across both countries and sectors is at its lowest level in two decades, reflecting a convergence of growth rates around higher levels. This is reassuring for the growth outlook because recoveries tend to be firmer and more robust when they are broad-based. It's a similar picture for employment, with dispersion of employment growth rates across euro area countries at its lowest level on record.

The increasingly solid cyclical recovery reflects the success of our monetary policy measures, which have worked their way through the financial system and led 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 2014, bank lending rates for euro area non-financial corporations have fallen by almost 120 basis points and for households (for house purchase) by over 100 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 almost 190 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. Heterogeneity of lending rates across countries has also fallen sharply, indicating that our non-standard measures have been particularly effective in counteracting bank funding and financial fragmentation in some jurisdictions. For example, the difference between the average lending rate for firms in countries that were severely affected by the crisis versus other countries has narrowed by about 100 basis points over this three-year period.

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent surveys have shown.[3] 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.[4] Moreover, these improvements are not limited to interest rates: bank lending volumes have also been gradually recovering since early 2014. According to the latest Survey on the Access to Finance of Enterprises, covering the period from October 2016 to March 2017, euro area small and medium-enterprises have continued to signal improvements in the availability of bank loans. Market-based funding conditions, too, have improved significantly in response to the corporate sector purchase programme launched in June 2016.

The easing of financing conditions has underpinned the recovery in domestic demand, which is now the mainstay of growth in the euro area. As the unemployment rate continues to decline despite a rise in labour force participation, households' real disposable income is improving. Given the broadly stable savings rate, increased labour income is translating into higher private consumption expenditure. Business investment is also picking up as a result of the favourable financing conditions, the need to modernise the capital stock after years of subdued investment and strengthening corporate profitability.

From today's point of view, there are signs of a stronger global recovery and a pick-up in international trade. The continued global economic upswing across regions should further support the euro area recovery.

As for price developments, after hovering at levels well below 1% for three years, with occasional dips into negative territory, euro area headline inflation has again edged higher towards the end of last year. Headline inflation – slightly down from May – stands at 1.3% in June, according to Eurostat's flash estimate. The decrease mainly reflects a decline in energy inflation and to a smaller extent, food inflation, which more than offset an increase in HICP inflation excluding food and energy. Underlying inflation – which relates more to domestic price pressures – continues to remain subdued, as unutilised resources still weigh on wage and price growth. In fact, the annual rate of HICP inflation excluding food and energy has mostly remained below, or around, 1% since late 2013.

Today, an important element keeping underlying price pressures subdued is muted wage dynamics, which are shaped by many factors. Besides weak productivity developments, the significant degree of remaining labour market slack acts to contain wage growth. When assessing slack, it can prove useful to also look at broader measures than the unemployment rate. The so-called "U6 measure" captures unemployment, underemployment (meaning workers who would like to work more hours) and marginal attachment, namely those workers that are not competing very actively in the labour market, e.g. because they are not available to start a new job on short notice. This measure currently covers 18% of the labour force in the euro area, and is thus considerably higher than the unemployment rate.[5] 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.[6]

Overall, we are certainly seeing a firming, broadening and more resilient economic recovery. The economic upturn seems to have gathered some further momentum. Real activity is expanding more strongly than previously expected and risks to the growth outlook are now broadly balanced. This clearly puts our confidence in the recovery on a stronger footing and has made very adverse scenarios for the inflation outlook less likely, in particular as deflation risks have largely vanished. As a consequence of this change in the risk assessment, the Governing Council decided to remove its reference to lower interest rates from its forward guidance on policy rates at the meeting in June.

As the economic prospects brighten, higher expected returns on business investment will make borrowing conditions increasingly attractive. This, as in our plans, will reinforce accommodation and make sure that inflation convergence develops strong foundations.

But our mission is not yet accomplished. We need patience and persistence. We need to be patient, because inflation convergence needs more time to show through convincingly in the data. The euro area's economic environment is improving, and the negative tail risks to inflation expectations, which were so visible at the start of our asset purchase program, have virtually disappeared. This strengthens our confidence that headline inflation will gradually move towards the Governing Council's objective of below, but close to, 2% over the medium term. But measured inflation remains exceedingly volatile and metrics of underlying price pressures continue to be subdued. The entire distribution of inflation expectations still needs to shift a fair distance to the right.

We need to be persistent, because the baseline scenario for inflation going forward remains crucially contingent on very easy financing conditions which, to a large extent, depend on the current accommodative monetary policy stance.

Therefore, maintaining a steady hand continues to be critical to fostering a durable convergence of inflation toward our monetary policy aim.

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1 See, for example, European Commission, European Economic Forecast, Spring 2017.

2 See, European Commission, business and consumer survey results, June 2017.

3 See the ECB's euro area bank lending survey, April 2017, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, October 2016 to March 2017.

4 For more details on the impact of the TLTROs, see "The targeted longer-term refinancing operations: an overview of the take-up and their impact on bank intermediation", Economic Bulleting, Issue 3, Box 5, ECB, 2017.

5 See ECB (2017), "Assessing labour market slack", Box 3, Economic Bulletin, Issue 3.

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