Peter Praet: Karl-Otto Pöhl Lecture

Text of the Karl-Otto Pöhl Lecture by Mr Peter Praet, Member of the Executive Board of the European Central Bank, Frankfurt am Main, 13 September 2017.

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The monetary policy measures introduced by the ECB since June 2014 have played a pivotal role in supporting the economy and have proven to be effective in preventing a period of disinflation from degenerating into one of outright deflation. More than three years on, the risks of deflation have largely disappeared and the transmission of our policy measures to the real economy is clearly demonstrated by a broad-based recovery with solid momentum. This is a pre-condition for inflation returning to the medium-term objective that the Governing Council identified almost 15 years ago as its preferred definition of price stability.

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

Real GDP in the euro area has expanded for 17 consecutive quarters, growing by 2.3% year-on-year during the second quarter of 2017, according to Eurostat – and surpassing our projection at the start of the year. This compares with the latest potential growth estimates for the euro area of just over 1%.[1]

See, for example, European Commission (2017), *European Economic Forecast – Spring 2017*.

The latest survey data point to a strong start to the third quarter. The composite output Purchasing Managers' Index – which is highly correlated with growth in the euro area – is above its long-term average and remains close to six-year highs. The forward-looking components of the survey continue to point to growth in the quarters ahead. Moreover, Eurostat's economic sentiment indicator is at a ten-year high.

A distinctive feature of the ongoing recovery is that it has led to tangible employment gains. Since hitting a trough in mid-2013, the number of people employed in the euro area has increased by almost 7 million. As a result, all of the employment losses recorded during the crisis have been offset. The unemployment rate is also continuing to fall, despite an increase in labour force participation, and is now at its lowest level in eight years.

Employment growth, together with the gradual increase in employee compensation, is supporting households' disposable income and underpinning solid consumption dynamics. Buoyant sentiment, favourable bank lending conditions and the notable progress achieved with respect to deleveraging are all conducive to robust consumer spending. The investment outlook is also positive, supported not only by a need to modernise the capital stock after years of subdued investment and an improving outlook for profitability, but also by highly accommodative financing conditions as our policy measures have passed through financial markets to affect the borrowing conditions of businesses and their customers.

Since June 2014, bank lending rates for euro area non-financial corporations have fallen by almost 120 basis points, and for households 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. 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 pass-through of monetary policy has become more even and less distorting.

These positive developments have been further supported by the second series of targeted longer-term refinancing operations, which have led to banks passing on the favourable funding conditions to their customers.[2]

For more details on the impact of the TLTROs, see European Central Bank (2017), “The targeted longer-term refinancing operations: an overview of the take-up and their impact on bank intermediation”, *Economic Bulletin*, Issue 3, Box 5.

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent surveys have shown.[3]

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

Moreover, bank lending volumes have 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 SMEs 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.

Against the backdrop of this substantial easing of financing conditions, domestic demand has become the mainstay of growth in the euro area, making the recovery more resilient to developments overseas. The latest ECB staff macroeconomic projections point to robust private consumption and a continued recovery in investment over the period ahead. Real GDP growth is projected to remain well above potential growth and to average between 1.7% and 2.2% in 2017, 2018 and 2019. The risks to the growth outlook are broadly balanced: on the upside, the current cyclical momentum could result in stronger than expected growth, while the remaining downside risks relate primarily to global factors and developments in the exchange rate.

From today’s point of view, the strength and resilience of the recovery tends to boost our confidence that reflationary forces will gradually support headline inflation returning towards a level that is below, but close to, 2%. But it’s too soon to claim victory: inflation dynamics remain subdued. 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 stood at 1.5% in August according to Eurostat’s flash estimate. Owing to energy-related base effects, headline inflation rates are likely to temporarily decline towards the turn of the year. Looking further ahead, headline inflation, according to our latest staff projections, is expected to remain clearly below a level that is consistent with our inflation aim over the next two years, averaging 1.5% in 2019. Furthermore, the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability. Some measures of underlying inflation – which relates more to domestic price pressures – have ticked up moderately in recent months. For example, HICP inflation excluding food and energy, which in August was 1.3% for the second consecutive month, has surpassed the 1% level where it had been languishing for around three years. Nevertheless, underlying inflation pressures are yet to show convincing signs of a sustained upward trend.

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 is also worth looking at alternative measures of unemployment. The so-called U6 measure captures unemployment, underemployment (meaning workers who would like to work more hours) and marginal attachment, namely those workers who are not competing very actively in the labour market, for example because they are not available to start a new job at short notice. Labour market slack measured in this way currently affects around 18% of the euro area extended labour force and is thus considerably higher than the headline unemployment rate. [4]

See European Central Bank (2017), “Assessing labour market slack”, *Economic Bulletin*, Issue 3, Box 3.

We are undoubtedly experiencing a solid, broad-based and resilient economic recovery that is contributing to a narrowing of the output and unemployment gaps, but a seeming disconnect between growth and inflation remains. As slack in the economy continues to be absorbed, reflationary forces will gradually build up and the traditional Phillips curve connection between inflation and the business cycle should eventually re-assert itself.

Recent empirical evidence suggests the Phillips curve has flattened since the period preceding the global financial crisis. There are two polar interpretations of this development. The weakening of the relationship between inflation and economic slack could be attributed to a mismeasurement of slack, owing to structural changes in the labour market. But there could be a less benign interpretation too. Lower estimates of the slope of the Phillips curve could also stem from parallel shifts in the curve. If such shifts result from sustained disinflationary developments unmooring inflation expectations, they raise significant concerns. It is our duty, as a central bank, to ensure that the Phillips curve reasserts itself at a steady rate of inflation that is in line with our medium-term objective of below, but close to, 2%.

Our mission is not yet accomplished and we must remain patient and persistent.

Patience is required for inflationary pressures 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 programme, have virtually disappeared. But measured inflation rates are exceedingly volatile and metrics of underlying price pressures remain anaemic. The entire distribution of inflation expectations still needs to shift a fair distance to the right.

We must also be persistent with the use of our policy instruments to ensure a durable and self-sustained return of inflation towards a level that is below, but close to, 2% over a meaningful medium-term horizon. 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 towards our monetary policy objective.

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[1] See, for example, European Commission (2017), *European Economic Forecast – Spring 2017*.

[2] For more details on the impact of the TLTROs, see European Central Bank (2017), “The targeted longer-term refinancing operations: an overview of the take-up and their impact on bank intermediation”, *Economic Bulletin*, Issue 3, Box 5.

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

[4] See European Central Bank (2017), “Assessing labour market slack”, *Economic Bulletin*, Issue 3, Box 3.