Vítor Constâncio: Economic recovery and the new phase of monetary policy

Keynote speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the Opening Conference of the 20th Euro Finance Week, Frankfurt am Main, 13 November 2017.

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Ladies and Gentlemen,

I am grateful for the opportunity to address you today at this event that opens the 20th Euro Finance Week, addressing economic and monetary policy developments in the euro area.

At its last meeting on 26 October, the ECB Governing Council decided to substantially reduce its asset purchases. However, an ample degree of monetary stimulus remains necessary in order for underlying inflation pressures to continue to build-up and support headline inflation over the medium-term. The recalibration of our asset purchases reflects growing hope in the gradual convergence of inflation towards our inflation objective, on account of the increasingly robust and broad-based economic expansion, an uptick in measures of underlying inflation and the continued effective pass-through of our policy measures to the financing conditions and the real economy.

In my remarks today, I will reflect on the broad-based improvement in the general economic and financial situation that has allowed such significant recalibration. I will argue that this improvement illustrates, among other things, the appropriateness of the monetary policy that we have undertaken in the past years. In this perspective, I will focus on the euro area as a whole as well as more disaggregate developments in some countries.

Finally, you certainly cannot expect a central banker to end without a note of caution. In the last part of my speech I will therefore focus on the challenges we are still facing.

Let me start with a description of the current economic developments. The euro area economy is experiencing a broad-based, robust and resilient recovery, and this recovery is underpinned by the monetary policy measures introduced by the ECB since June 2014. However, despite these favourable growth dynamics, inflation developments have been subdued. At the same time, financial stability risks seem contained.

Sustained recovery

The euro area has been expanding for the past four years and the recovery has gained momentum. The GDP in the euro area has finally reached a level above that in 2007, 10 years after the crisis.

Robust economic activity is further being translated into a substantial amount of job creation. Despite the unemployment rate still being too high, almost 7 million more people are now employed in the euro area than in mid-2013, which implies that the employment losses recorded during the crisis have been offset. This stands in contrast to the largely jobless recovery of 2010 and is another indication of the sustained recovery in the euro area.

The improving labour market combined with increasing household wealth, strong consumer confidence and favourable financing conditions are supporting robust private consumption. Investment prospects also look promising, which reflects both the need to make up for forgone investment in previous years as well as the highly accommodative financing conditions which have been passed through to lower borrowing costs for euro area firms. Business investment is now slightly above the 2007 level.

Forward-looking indicators transmit a similarly positive message: business confidence is at a decade high, and survey data point to continued growth in the period ahead.

Broad-based, convergent recovery

Over recent quarters, the economic recovery has also become more broad-based across euro area countries and the different sectors of the economy.

In fact, all euro area countries, for the first time since 2007, are now enjoying positive real GDP growth in annual terms. The convergence of cyclical growth is reflected in the fact that member countries growth rates were never so close to each other since the inception of monetary union.

Moreover, unemployment rates have receded almost everywhere across the euro area. Despite the fact that unemployment is still too high in some countries, notably as regards young people, it is worth mentioning that it came down the most in several of those countries where it had previously been especially high.

Contribution from the accommodative monetary policy of the past years

We recalibrated our policies following the positive economic outcomes, but these outcomes would not have materialised, at least not to the same extent, without the ECB's expansionary monetary policy.

When calibrating its monetary policy instruments, the Governing Council forms a view on the degree of accommodation that is necessary to achieve its price stability objective. Concretely, our monetary policy measures have supported economic growth and the reduction in unemployment in a variety of ways. First and foremost, they have supported domestic demand and have facilitated the deleveraging process in the aftermath of the crisis. The recovery in investment also benefitted from very favourable financing conditions and improvements in corporate profitability.

A precise quantification of the contribution of monetary policy to the current economic recovery is difficult, but current estimates suggest that the measures undertaken have been highly successful. Recent ECB staff estimates indicate that our monetary policy measures are contributing to an increase in the euro area GDP of around 1.7 percentage points, cumulatively over the period 2016–2019. This contribution is well above monetary policy's contribution to the two previous euro area recoveries in 2003Q2-2006Q4 and 2009Q3-2011Q3.

The effectiveness of monetary policy is also reflected in the way our decision to reduce our monthly purchase of securities by half was smoothly received by the financial markets. In spite of the restrictive nature of the decision, bond yields hardly moved and some even came down, while the exchange rate slightly depreciated. This was the result of our cautious preparation and communication, as well as from the ongoing positive growth momentum.

Looking ahead, the growth rate, unemployment, the labour market, the survey data, all provide positive indications that we are moving towards a shrinking output gap as well as an improving labour market. These will eventually produce higher nominal wage growth and thus higher inflation. But we know that this process still relies significantly on our monetary policy support. It is not yet self-sustained and therefore we must be patient and persistent.

Deflation risks diminished, inflation risks remain subdued

Every policy entails risks. Several concerns have thus been expressed about possible collateral consequences of our policy. Such concerns have however not materialised in real facts and we can now underline the appropriateness of our monetary policy stance.

Firstly, our monetary policy measures were not an "experiment" on the economy, but were in line with the policies previously adopted by other major central banks. Interest rate paths and balance sheets of the ECB and the FED are broadly comparable, despite the longer and slower economic recovery of the euro area after the crisis.

Secondly, much-feared inflationary pressures have not materialised, nor can they be foreseen in the immediate future. Measures of underlying inflation have ticked up only moderately in recent months, and have yet to show convincing signs of a sustained upward trend. Underlying inflation in the euro area is expected to rise only gradually over the medium-term, supported by our monetary policy measures, the continuing economic expansion, the corresponding gradual absorption of economic slack and rising wages. Domestic cost pressures, notably from labour markets, are still subdued. The strong worldwide reflationary phase that seemed likely at the beginning of the year has not materialised. Overall, price pressures are still muted and the path of inflation remains conditional on continued support from monetary policy.

Finally, there were concerns that the ECB monetary policy could pose risks to financial stability and provoke excessive asset price increases. Clearly, this did not materialise as there are no generalised asset overvaluations in the euro area. In various countries, some restricted regional pockets of real estate price buoyancy are being dealt with targeted macroprudential measures.

It is against this overall positive background that the ECB Governing Council has decided on a re-calibration of its instruments, with a view to safeguarding the monetary policy impulse that is still necessary to secure a sustained adjustment in the path of inflation, in a way that is consistent with our monetary policy aim.

All countries have benefited from the recovery

An important feature of the recovery is that all member countries have benefited from the recovery and have seen an improvement in their economic fundamentals.

The enormous credit flows from banks in core countries to their peers in the periphery, fuelled economic overheating with housing price bubbles in some cases and generalised high external deficits in the run-up to the crisis. The financial crisis then led to significant fiscal deficits when governments had to assist domestic banks. Notably, since the inception of the financial crisis, those countries have undergone a significant adjustment path, in some cases supported by EU/IMF financial assistance programmes. When we compare today with the situation in 2008, we see an impressive adjustment along several of the main economic variables. Fiscal deficits have been significantly reduced and in those countries the primary fiscal balance is now positive. At the same time, their current account balances have adjusted by more than 12 percentage points from an average of –10 percent of GDP to a surplus of nearly 2 percent at the end of last year. This adjustment has been facilitated by a significant recovery from the losses in competitiveness experienced before the crisis. Unit labour costs of these countries have, on average, been reduced by nearly 10 percent over these years. In turn, this adjustment has been enabled by significant reforms of countries' labour and product markets by allowing more resources to be used in the tradable sectors and increasing the adaptability of their economies at large. Overall, both ECB and IMF estimates show that the current account adjustments are, to a large extent, of a structural nature and not just cyclical. They are therefore likely to be sustained as the economic recovery of the euro area continues.

The general improvement in economic fundamentals also applies to member states that were less severely affected by the crisis. Given the location of my speech today, let me look particularly at Germany. Having been the "sick man of Europe" in the early 2000s, the German economy has become today's engine of the euro area economy. Moreover, growth has recently become increasingly domestically driven. This has clearly also facilitated the recovery in the other euro area economies, via higher German import demand.

Concerning inflation, fears that our accommodative monetary policy could boost excessive inflation in Germany have clearly not materialised. Headline inflation has picked up this year from the very low level of 0.4 percent last year. Most of this increase resulted from the significant pick-up in oil prices. Underlying price pressures in Germany by contrast, have remained subdued, as indicated by the rather stable core inflation rate.

The increase in house prices may be more of concern, particularly in some of the biggest cities, but there is so far no evidence of broad-based excessive house price valuations in Germany as a whole.

Strong economic growth demonstrates that Germany is the member state that, after Ireland, shows the highest increase in income per person since the beginning of the euro. At the same time, the present unemployment rate is the lowest in the last 37 years and is well below the European average.

Challenges ahead

Let me summarise. We are witnessing a sustained economic recovery in the euro area as a whole and in all its member states. In particular, countries under financial assistance programmes have been implementing significant policy measures to improve their resilience and competitiveness. Many of these reforms will support potential growth but they tend to exert their full impact with a considerable lag. In any case, such measures have increased the resilience of member states' economies and of the euro area as a whole.

At the same time, these positive developments should not lead to complacency. Inflation, which is the core of our mandate, is still below our target after four years of growth supposedly above potential. We are not yet fulfilling our mandate and that is why monetary policy will have to continue to be very accommodative, assuring favourable financial conditions to foster growth and spur wages and prices.

On the other hand, vulnerabilities and challenges remain in many euro area economies. Unemployment rates have indeed come down, but in particular the number of young and long-term unemployed is still unacceptably high. Moreover, despite an adjustment of flow variables, such as the absence of excessive credit growth, lower budgetary deficits and improved current account balances, the legacy of the crisis is still visibly expressed in high stock imbalances, namely the high indebtedness of the private and public sector across many euro area countries. These high debt levels make the countries vulnerable to adverse shocks. Furthermore, the crisis has also interrupted the progress of real convergence in the more vulnerable economies towards higher living standards. Negative divergences in personal income levels in relation to the euro area average have again increased. Higher and more sustainable growth potential requires decisive policy actions.

At the national level, many structural and institutional reforms are still needed to safeguard and improve the future functioning of countries' economies and thereby the euro area as a whole. We should also review the way in which national policies are currently co-ordinated in the EU. Both the Five Presidents Report on "Completing Europe's Economic and Monetary Union" (2015) and the recent EU Commission paper on the "Deepening of the Economic and Monetary Union" (2017) provide guidance on the way to proceed. It is nevertheless a sign of the times that the EU Commission felt compelled to reduce the ambition of its proposal regarding the European deposit guarantee scheme[1], a significant component of the banking union. This just indicates that there are understandable but relevant uncertainties about the future. Any agreement about the evolvement of European integration is a difficult endeavour as it implies the involvement of all member states as well as their respective public opinion. Some of the possible issues at stake are indeed sensitive and could generate instability if not carefully assessed. This provides another reason to take into account the concerns of all member states.

It is however also true that the present favourable economic environment, should be used to make progress in reinforcing the economic and monetary union resilience. This corresponds to the common interest of countries made closely interdependent by the single currency. Reforms at national and EU level will be crucial to improve resilience to shocks, increase growth potential and ultimately restore a path of real economic convergence among member countries.

Thank you for your attention.

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1 See EU Commission (11 October 2017) "COMMUNICATION TO THE EUROPEAN PARLIAMENT, THE COUNCIL, THE EUROPEAN CENTRAL BANK, THE EUROPEAN ECONOMIC AND SOCIAL COMMITTEE AND THE COMMITTEE OF THE REGIONS ON COMPLETING THE BANKING UNION". As the press release issued by the Commission explains: " …In particular, today's Communication is suggesting for discussion the introduction of EDIS more gradually compared with the original proposal of November 2015. There would be only two phases: a more limited reinsurance phase and then coinsurance. However moving to this second phase would be conditional on progress achieved in reducing risks."