Mario Draghi: Monetary policy and the outlook for the economy

Speech by Mr Mario Draghi, President of the European Central Bank, at the Frankfurt European Banking Congress "Europe into a New Era – How to Seize the Opportunities", Frankfurt am Main, 17 November 2017.

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Today I would like to describe how the euro area economy is developing and explain our latest monetary policy decisions. The economic recovery is continuing but inflation developments remain subdued. So, while we are confident in the recovery, we still need a patient and persistent approach to our monetary policy to ensure that medium-term price stability is achieved.

The euro area economic recovery

The euro area is in the midst of a solid economic expansion. GDP has risen for 18 straight quarters, with the latest data and surveys pointing to unabated growth momentum in the period ahead. From the ECB's perspective, we have increasing confidence that the recovery is robust and that this momentum will continue going forward. There are three factors in particular that suggest this.

First, the major headwinds that were weighing on the recovery in recent years have now largely dissipated, although downside risks still remain related to external factors.

For some years global growth and world trade have been a drag on the recovery. Now, we are seeing signs of a sustained expansion. Global PMIs remain strong. The share of countries in which growth has been improving relative to the previous three years has risen from 20% in mid-2016 to 60% today. And this has fed through into a rebound in world trade, which is growing at its strongest annual rate in six years, and may well become a tailwind going forward.

Domestically, a key headwind in the past has been the necessary deleveraging by firms and households. But this is also now diminishing as debt returns to more sustainable levels.

For the euro area, gross corporate debt[1] to value added is now roughly back to its pre-crisis level. In vulnerable countries the decline has been steeper. In Spain, corporate debt has fallen from 215% of gross value added in early 2012 to close to 150% today – the same level it had at the end of 2004. Italian firms have seen their debt ratio fall by around 30 percentage points since end 2012, returning to the same level as in mid-2007.[2]

For households, gross indebtedness is also edging down and now stands just below its mid-2008 level. And importantly for the recovery, household deleveraging is now happening largely "passively" – i.e. through nominal growth – rather than "actively", that is, through paying down debt or write offs. We estimate that the monetary policy measures we have implemented in recent years will reduce the household debt ratio by 1.5% of GDP from 2015 to 2019, and by 2% for firms over this period.

The recovery therefore has not come against the backdrop of re-leveraging in any economic sector. In fact, monetary policy is helping to reduce leverage and produce a more sustainable upswing, which should in turn facilitate further balance sheet adjustment.

The second factor that gives us confidence in the recovery is that the drivers of growth are increasingly endogenous rather than exogenous. In the early phase of the recovery, its main motors were falling oil prices and monetary policy.[3]

Now, we see more signs that growth is "feeding on itself", i.e. spending multipliers and endogenous propagation are again supporting activity.

This cycle is most evident for private consumption, which has remained robust even as oil prices have risen by about 30 dollars since the start of 2016. Consumption is being supported by a virtuous circle between rising labour income and rising employment. Employment in the euro area has reached its highest level ever, while unemployment has fallen to its lowest rate since January 2009.

Importantly, this has taken place against the backdrop of a rising participation rate, which is now 2 percentage points above its pre-crisis level.[4]

This has been driven in particular by the increased entry of women into the workforce, whose participation rate has risen by 4 percentage points since 2008 and reached an all-time high.

It has also been strongly driven by older people. Since the start of the crisis[5] , the participation rate has increased by 3.6 percentage points for people aged 50–54, 13.6 percentage points for 55–59 year olds and 17.1 percentage points for 60–64 year olds. The fact that unemployment has fallen so much while labour participation has been rising is a remarkable success story.

As consumption has strengthened and spending multipliers have taken hold, investment has also followed with a lag. Since 2016, investment has contributed almost 45% to annual GDP growth, compared with under 30% in the two years previously.

The third factor that signals a robust recovery is that the economy may be becoming more resilient to new shocks. This is the result of two ongoing trends.

One is the increasing convergence among euro area countries across a range of indicators. The dispersion of both employment and GDP growth between euro area countries is now at record low levels. The previous divergence in credit conditions has also largely disappeared.

For very small loans – which are a proxy for the financing conditions facing SMEs – the spread between vulnerable and less vulnerable countries has fallen from 170 basis points in mid-2014 to 2 basis points today. For the first time since 2009, loans to firms are moving into positive territory in all major euro area economies. And demand for loans by firms, which at this time last year was still negative in several vulnerable countries, is now positive across the whole euro area.[6]

The other trend is the growing resilience of the financial sector. The total capital ratio of significant banks has increased by more than 170 basis points since early 2015. Their return on equity has risen from 4.4% at the end of 2015 to 7.1% at the start of this year, even as their leverage ratios have declined. All banks have benefited from the upward trend in returns on assets since the start of our monetary policy easing in 2014, although in some cases starting from low levels. Clearly this trend hides some variation among banks, which is largely driven by differences in their business models.

As regards bank profitability, ECB research finds little evidence that our monetary policy is currently doing harm. Net interest income has remained quite stable over the past two years. If there are any negative effects of low rates on net interest income in the future, they should be largely offset by the positive effects of monetary stimulus on the other main components of profitability, such as the quality of loans and therefore on loan-loss provisions.[7]

Low-for-long interest rates might contribute to a build-up of financial risks, and this has to be carefully monitored. At present we do not see systemic risks emerging at the euro area level. If there are some local pockets of risk, the defence lies in micro-prudential and macro-prudential policies, not changing area-wide monetary policy. Furthermore, in such an environment any backtracking on financial regulation would be a mistake, as the pre-crisis experience has shown.

The outlook for inflation and the ECB's recent policy decisions

Despite this progress on the real side of the economy, from a monetary policy perspective our task is not complete, as we have not yet seen a sustained adjustment in the path of inflation.

A sustained adjustment is one where the return of headline inflation towards our objective is durable and not just a temporary blip, and it can be self-sustained without monetary policy support. We do now see inflation moving steadily away from the very low levels of recent years, although progress remains incomplete and partial.

Two indicators are important for gauging the durability of inflation. The first is the outlook for growth, since this helps us assess whether inflation will continue to rise as we expect. The second is underlying inflation. This allows us to assess whether inflation will stabilise around our aim once the effects of volatile factors, such as oil and food price swings, have faded away.

The growth outlook is now clearly improving, for all the reasons I have mentioned. But the underlying inflation trend remains subdued. According to a broad range of measures, underlying inflation has ticked up moderately since the start of this year, but it still lacks clear upward momentum. A key issue here is wage growth.

Since the trough in mid-2016, growth in compensation per employee has risen, recovering around half of the gap towards its historical average. But overall trends remain subdued and are not broad-based. A number of explanations have been put forward for this.

One is that the effects of past low inflation are continuing to weigh on wage growth. A second explanation is that the relationship between wage growth and traditional measures of slack has weakened in the post-crisis period.

There are many reasons why this weakening may have happened.[8]

Slack might be larger than we thought due to rising labour supply or mismeasurement of so-called “underemployment” in traditional measures of slack. Or the relationship between slack and wage growth might itself have changed, due – for example – to a shift in focus by trade unions towards job security rather than wages in view of higher economic uncertainty.

With the continued support of monetary policy that will avoid any unwanted tightening of financial conditions, these factors should slowly fade away. With well-anchored inflation expectations, the effects of past low inflation in wage formation should not be persistent. And as the labour market tightens and uncertainty falls, the relationship between slack and wage growth should begin reasserting itself. But we have to remain patient.

A third explanation is that structural changes due to globalisation and digitalisation have made it more difficult for central banks to stoke domestic inflation. But we do not see much evidence to suggest that e-commerce is depressing inflation in the euro area today – at least to extent that we can measure it.[9]

The same is true for “global slack”.[10]

In fact, as the global economy recovers, the foreign output gap is moving in the same direction as the euro area output gap.[11]

In sum, we are not yet at a point where the recovery of inflation can be self-sustained without our accommodative policy. A key motor of the recovery remains the very favourable financing conditions facing firms and households, which are in turn heavily contingent on our policy measures. An ample degree of monetary stimulus remains necessary for underlying inflation pressures to build up and support headline inflation over the medium term.

This is reflected in the monetary policy decisions that we took last month. These aim to signal our growing confidence in the euro area economy, while also acknowledging that we must be patient and persistent for inflation to return sustainably to our objective.

We decided to reduce the pace of our monthly asset purchases from €60 billion to €30 billion, while extending the horizon of those purchases until end of September 2018, or beyond, if necessary, and in any case until we see a sustained adjustment in the path of inflation.

This recalibration of our asset purchases, supported by the sizeable stock of acquired assets and the forthcoming reinvestments, and by our forward guidance on interest rates, helps to maintain the necessary degree of accommodation and thereby to accompany the economic recovery in an appropriate way. In this sense, the recent decisions follow the same logic as those in December last year when we reduced the pace of purchases from €80 billion to €60 billion.

Our monetary policy influences long-term yields through both its main components: by compressing the term premium, and by anchoring the expected path of policy rates in the future.

By accumulating a portfolio of long-duration assets, the central bank can compress term premia by extracting duration risk from private investors. Via this "duration extraction" effect, the central bank frees up risk bearing capacity in markets, spurs a rebalancing of private portfolios toward the remaining securities, and thus lowers term premia and yields across a range of financial assets.

In the past, since the crisis had heightened risk perceptions, the Eurosystem had to purchase very sizeable amounts per month to foster a certain impact on the term premium and on long-term yields. But, as market conditions have normalised and the economic outlook has improved, risk perceptions have declined and the capacity to absorb risk in private portfolios has risen. This explains why we reduced the pace of monthly purchases.

But asset purchases matter also for the signals they entail about the path of future policy rates: the so-called "signalling effect". In the euro area this effect is reinforced by the sequence in which our instruments are ordered.

Specifically, the length of the horizon of our net asset purchases, and the statement that our policy interest rates are expected to remain at their present levels "well past" the end of those net purchases, mechanically affect the time of the first expected rate hike, anchoring the path of expected policy rates over the lifespan of the net asset purchase programme and beyond.

The signalling effect of asset purchases has therefore naturally increased in prominence relative to the duration effect. This explains why our decisions three weeks ago to reduce the pace of purchases while extending the horizon left, on impact, financial conditions largely unchanged.

Conclusion

Let me conclude. The ECB's mandate is framed in terms of price stability, as this is the best contribution that we can make to the welfare of citizens. Ensuring price stability is a precondition for the economy to be able to grow along a balanced path that can be sustained in the long run. This is the guiding principle of all our monetary policy decisions.

With the recovery ongoing, now is the right moment for the euro area to address further challenges to stability. This means actively putting our fiscal houses in order and building up buffers for the future – not just waiting for growth to gradually reduce debt. It means implementing structural reforms that will allow our economies to converge and grow at higher speeds over the long term. And it means addressing the remaining gaps in the institutional architecture of our monetary union.

[1] On a consolidated basis. Consolidated gross debt includes total loans granted to NFCs net of intra-sectoral loans, debt securities issued and pension liabilities.

[2] European Central Bank (2016), "Business investment developments in the euro area since the crisis", Economic Bulletin, Issue 7; Bank for International Settlements (2017), "87th Annual Report"; Barkbu B., Berkmen P., Lukyantsau P., Saksonovs S., and H. Schoelermann (2015), "Investment in the euro area: why has it been weak?", IMF Working Paper, No. 32; Arce O. (2017), "Financing corporate investment along the recovery: the case of Spain", presentation at the Global Interdependence Center, March.

[3] For more detail on this point see Draghi, M. (2017), "Monetary policy and the economic recovery in the euro area", speech at The ECB and Its Watchers XVIII Conference, Frankfurt am Main, 6 April 2017.

[4] For people aged 15–64.

[5] 2008Q1 to 2017Q2.

[6] According to Bank Lending Survey data.

[7] Altavilla C., M. Boucinha and J.-L. Peydró (2017), "Monetary Policy and Bank Profitability in aLow Interest Rate Environment", forthcoming.

[8] See Draghi, M. (2017), "Accompanying the economic recovery", speech at the ECB Forum on Central Banking, Sintra, 27 June 2017.

[9] ECB (2015), "Effects of E-Commerce on Inflation", Box 6, Economic Bulletin Issue 2.

[10] ECB (2017), "Domestic and global drivers of inflation in the euro area", Economic Bulletin, Issue 4.

[11] Nickel, C. (2017), "The role of foreign slack in domestic inflation in the Eurozone", VoxEu, 28 July.