Peter Praet: Economic developments in the euro area

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Cercle de Lorraine, Brussels, 1 February 2018.

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The robust pace of economic expansion clearly shows that our monetary policy has been effective in preparing for a return of inflation to a rate below, but close to, 2% over the medium term. Inflation developments remain subdued, however, and we are still some distance away from meeting the Governing Council's criteria for a sustained adjustment in the path of inflation. Overall, an ample degree of monetary stimulus remains necessary for underlying inflation pressures to continue to build up and support headline inflation developments over the medium term[1].

The euro area economic expansion is strong and broad-based. Real GDP in the euro area has expanded for 19 consecutive quarters, growing by 2.7% year on year during the fourth quarter of 2017, according to preliminary data. This compares with the latest potential growth estimates for the euro area of around 1.5%.[2]

The latest economic data and survey results point to continued growth momentum at the end of last year. The composite output Purchasing Managers' Index – which correlates closely with growth in the euro area – remains above its long-term average and is close to a 12-year high. Moreover, Eurostat's Economic Sentiment Indicator is around its highest level for 17 years. Forward-looking components of surveys also point to growth in the quarters ahead.

The ongoing recovery has led to solid employment gains. The number of people employed in the euro area has increased by almost 7.5 million since hitting a low in mid-2013. This means that all of the job losses recorded during the crisis have been recovered. Additionally, the unemployment rate is now at its lowest level for around nine years and continues to decline, despite an increase in labour force participation.

Employment growth, together with the gradual increase in employee compensation, is supporting households' disposable income and underpinning solid consumption dynamics. Robust consumer spending is being driven by buoyant sentiment, favourable bank lending conditions and the notable progress achieved with respect to deleveraging. 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 easy financing conditions as our policy measures have passed through financial markets, benefiting businesses and their customers.

Since the announcement of our policy measures in June 2014, bank lending rates for euro area non-financial corporations have fallen by around 120 basis points and those for households by around 110 basis points. Rates on very small loans, which can be taken as a proxy for loans to small and medium-sized enterprises (SMEs), have declined by around 200 basis points. The significant improvement in funding conditions for SMEs is especially encouraging as these companies 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 which were severely affected by the crisis and that in other countries has narrowed by more than 100 basis points over this period. The pass-through of monetary policy has become more even.

Banks are also passing on the favourable funding conditions to their customers due to the second series of targeted longer-term refinancing operations (TLTRO-II), which further supports these positive developments.[3]

The sharp reduction in bank lending rates has been accompanied by easier access to funding, which continues to improve, according to the latest survey results.[4]

Furthermore, 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 April to September 2017, euro area SMEs have continued to see 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. Meanwhile, real GDP growth is projected to remain above potential growth in the coming years. The acceleration in the cyclical momentum and the ongoing reduction of economic slack strengthen our confidence that inflation will converge towards our inflation aim of below, but close to, 2%.

But inflation continues to be lacklustre. After lingering at levels well below 1% for three years, with occasional dips into negative territory, euro area headline inflation increased towards the end of 2016 and has fluctuated between 1.3% and 1.5% since May of last year. Annual inflation stood at 1.3% in January, according to Eurostat's flash estimate. Looking ahead, on the basis of current futures prices for oil, annual rates of headline inflation are likely to hover around current levels in the coming months. Measures of underlying inflation remain subdued and have yet to show convincing signs of a sustained upward trend.

Muted wage dynamics are one important element keeping a lid on underlying price pressures. These are shaped by many factors. In addition to weak productivity developments, the significant degree of remaining labour market slack is limiting wage growth. When assessing slack, it is important to look also 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, which refers to those members of the workforce who are not seeking employment very actively either because, for example, they are not available to start a new job at short notice or have been discouraged by a fruitless search for work. The U6 measure currently covers around 17% of the labour force and is thus considerably higher than the unemployment rate.[5]

Looking forward, although there still appears to be a disconnect between growth and inflation, the ongoing economic expansion is expected to further contribute to a narrowing of the output and unemployment gaps. As slack in the economy continues to be absorbed, price pressures will gradually build up and the traditional Phillips curve relationship between inflation and the business cycle should eventually reassert itself.

That being said, current estimates still appear to point to a flatter slope of the Phillips curve than in the past, which could be interpreted as an indication that the relationship between economic slack and inflation has weakened. This weakening might be partly the result of a mismeasurement of slack (because of structural changes in the labour market) or an unstable relationship between slack and inflation over time. At the same time, this effect could also result from discrete parallel shifts in the Phillips curve. Such parallel shifts can arise due to temporary changes in wage and inflation mark-ups or an incipient dis-anchoring of inflation expectations, which is of greater concern to a central bank. Empirically disentangling these factors is extremely difficult, so we need to be mindful of such considerations when discussing the relationship between economic slack and inflation developments. Our primary task as a central bank is to ensure that the traditional relationship between the real and the nominal sides of the economy reasserts itself at a steady-state rate of inflation that is below, but close to, 2%.

We have not yet accomplished our mission: with inflation convergence proceeding only

gradually, patience and persistence in our monetary policy remain warranted. In the light of this, the Governing Council in January maintained all elements of its accommodative monetary policy stance. Together, our monetary policy measures will preserve the ample degree of accommodation that remains necessary for inflation pressures to continue to build up and support headline inflation developments over the medium term.

Looking ahead, monetary policy will evolve in a data-dependent and time-consistent manner. Once the Governing Council judges that the three criteria for sustained adjustment – convergence, confidence and resilience – have been met, net asset purchases will expire, in line with our guidance. From that point in time, the evolution of inflation will remain conditional on reinvestments continuing for an extended period of time and on policy rates remaining at their present levels well past the end of our net asset purchases. The stock of long-duration assets held in our portfolio will continue to put downward pressure on longer-term interest rates well beyond the end of our net purchases. Policy rates remaining at their present levels well past the end of our net purchases will contribute to holding the short to intermediate portions of the yield curve in check for as long as necessary, thereby ensuring that financial conditions remain consistent with a sustained adjustment of inflation.

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2 See, for example, the European Commission's "European Economic Forecast – Autumn 2017". Potential growth was estimated at 1.4% for 2017 and 1.5% for 2018 and 2019.

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

4 See the ECB's euro area bank lending survey, January 2018, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, April to September 2017.

5 See the box entitled "Assessing labour market slack", Economic Bulletin, Issue 3, ECB, 2017.