Luis de Guindos: The euro area - current status and challenges ahead

Speech by Mr Luis de Guindos, Vice-President of the European Central Bank, at La Granda courses, Asturias, 31 August 2018.

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It is a pleasure to be here at La Granda courses in Asturias. In my remarks today, I would like to review the economic developments in the euro area, explain our recent monetary policy decisions and reflect on the necessary reforms of Economic and Monetary Union, or EMU.

Recent economic developments

Economic growth in the euro area remains solid and broad-based, as confirmed by the latest data. Preliminary figures show that real GDP grew by 0.4% quarter-on-quarter during the second quarter of 2018.

In the first half of 2018, growth weakened from its very high rates of last year, partly reflecting lower exports, compounded by temporary supply-side constraints at national and global level.

Although growth has slowed earlier than anticipated, we expect the expansion to continue. In fact, the current expansion is shorter in length and smaller in size than historical averages. It has lasted just five years and real GDP is now 10% above the trough in the first quarter of 2013.[1] In the past, growth phases lasted, on average, seven and a half years from trough to peak, with GDP increasing 21% over the same period.

While risks surrounding the euro area growth outlook remain broadly balanced, uncertainties emerging from increased global protectionism, the finalisation of the Brexit negotiations and vulnerabilities in emerging markets have become more visible than a few months ago.

The ongoing expansion has led to strong employment gains. Since the beginning of the recovery, around 8.4 million jobs have been created. Euro area unemployment declined to 8.2% in July, the lowest level in almost ten years. This is particularly relevant in Spain, where unemployment declined by almost 11 percentage points from the peak of the crisis, to 15.4% currently. Almost two million jobs (1.9) have been created since the start of the recovery.

Thanks to the recovery in labour markets, consumer spending is still robust. The steady rise in compensation per employee has increased household disposable income. Moreover, consumption benefits from an easier transition from unemployment to employment and increased job security. Lower unemployment not only pushes up the disposable income of those who find a job, but also reduces the perceived risk of job loss, giving workers less incentive to hold precautionary savings.

The investment outlook remains solid on the back of improving profitability and favourable financing conditions. According to the July bank lending survey, credit standards for loans to enterprises and households have loosened further. Moreover, net demand for all types of loans has increased and is expected to grow in the next quarter too, supporting loan growth. In Spain, credit standards for new loans eased across all segments. While net demand for loans to enterprises remained unchanged, it increased for loans to households.

We are therefore confident that the underlying strength of the euro area economy will continue to support the sustained convergence of inflation to our aim in the medium term.

According to the flash estimates, HICP inflation edged down to 2.0% in August from 2.1% in July, mainly reflecting higher energy prices. On the basis of the latest oil futures prices, headline inflation is expected to hover around the current level for the rest of the year.

Although measures of underlying inflation remain generally muted, they have risen from previous lows. Looking ahead, underlying inflation is expected to pick up towards the end of the summer, supported by our monetary policy measures and strengthening domestic price pressures, which are sufficiently robust to counter the downward pressure from the euro's appreciation in 2017.

Domestic price pressures have gradually risen on the back of the ongoing economic expansion, the resulting absorption of economic slack and rising wage growth. In particular, the tightening in labour markets supports the pick-up in nominal wage growth both across countries and sectors.

Non-wage domestic cost pressures and the stronger pricing power of domestic firms are further contributing to higher prices. Moreover, domestic producer price inflation for non-food consumer goods increased further in June, with the year-on-year growth rate at its highest level since late 2012. Services producer price inflation has been on an upward trajectory since the second quarter of 2016.

Against this backdrop, the ECB's Governing Council carried out a thorough assessment of price and wage pressures and the inflation outlook at its meeting in June of this year.

Monetary policy stance

The Governing Council carefully reviewed the progress achieved towards a sustained adjustment in the path of inflation, guided by three criteria: convergence, confidence and resilience.

For convergence, headline inflation should be on track to reach levels consistent with the Governing Council's inflation aim of below, but close to, 2% over the medium term. In line with this criterion, the June Eurosystem staff projections see headline inflation reaching 1.7% in each of the next three years. These are the latest in a series of projections that have pointed to a convergence of headline inflation towards the Governing Council's inflation aim.

Regarding confidence, uncertainty around the projected path of inflation has diminished. Moreover, underlying inflation has increased from the very low levels observed in 2016 and is expected to rise amid an expanding economy, high levels of capacity utilisation and labour market tightening. Stronger underlying inflation pressures, in turn, should pass through to headline inflation.

In terms of resilience, the projected path of inflation is expected to be maintained even after a gradual ending of net asset purchases.

On the basis of this assessment, the Governing Council concluded that substantial progress has been made towards a sustained adjustment. Given the underlying strength of the euro area economy, together with well-anchored longer-term inflation expectations, we are confident that the sustained convergence of inflation towards our aim will continue in the period ahead, even after a gradual winding-down of our net asset purchases.

As a result, we took a number of decisions in June.

First – subject to incoming data confirming our medium-term inflation outlook – we anticipate reducing the monthly net asset purchases from €30 billion to €15 billion at the end of September 2018 and ending net asset purchases at the end of December 2018.

Second, we intend to continue reinvesting the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time after the end of net purchases, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary policy accommodation.

Third, we expect the key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure that the evolution of inflation remains aligned with our current expectations of a sustained adjustment path.

Together, these measures will continue to provide the necessary degree of monetary policy accommodation to bring inflation back towards a level that is below, but close to, 2%. Looking ahead, monetary policy will continue to be firmly guided by the outlook for price stability and our stance will evolve in a data-dependent and time-consistent manner.

Having reflected on the current economic situation in the euro area and the corresponding monetary policy stance, let me now turn to the future, notably to governance of EMU.

EMU governance

The ECB's monetary policy measures introduced since 2014 have been essential in supporting the robust recovery and paving the way for inflation to return towards our objective. Similarly, the removal of some of the institutional and structural factors that contributed to the crisis helped maintain that recovery. Nonetheless, the architecture of EMU is still incomplete in many ways.

Further reforms are needed to make the financial sector more stable. As the euro area's financial system is predominantly bank-based, completing the banking union remains a key priority. We gladly welcome the agreement on the European Stability Mechanism, or ESM, as the backstop for the Single Resolution Fund. If implemented swiftly, it will create confidence in the effectiveness of resolution and make the sector as a whole more stable.

Most importantly, we need to make headway in establishing the third pillar of the banking union, the European Deposit Insurance Scheme, or EDIS. Ongoing discussions have been held up on the premise that risk reduction must come before risk-sharing.

However, substantial risk reduction has already taken place. The significant banks' Common Equity Tier 1 ratios – a key indicator of bank health – are now 67% higher than they were ten years ago. And further reduction of non-performing loans and toxic assets in the portfolios of some large banks is under way.

Moreover, risk-sharing can help reduce risks. In its envisaged steady state as a fully mutualised fund, EDIS would reduce the risk of bank runs and allow full fungibility of deposits across the euro area, thereby mitigating the risk of financial fragmentation. EDIS would hence help contain market panic when crises hit and reduce the fallout for taxpayers, as costs can be borne by the banks themselves[2]. Risk-sharing and risk reduction are thus mutually reinforcing.

At the same time, we need to make progress in developing a genuine capital markets union. Deep and well-integrated cross-border funding would improve the private sector's capacity to absorb local shocks, reducing the burden on fiscal policies. A capital markets union would provide various additional benefits. For example, harmonised insolvency frameworks would make it easier for banks to deal with non-performing assets, thereby facilitating orderly risk reduction.

Beyond these necessary reforms in the financial sector, more economic convergence is needed to make EMU resilient.

At the national level, structural reforms remain a priority in order to increase the growth potential and resilience of local economies. While a full, transparent and consistent implementation of the Stability and Growth Pact is essential, country-specific recommendations, or CSRs – issued under the European Semester – should be given similar importance.

CSRs provide guidance to Member States on how to address reforms and macroeconomic imbalances. They have a broad focus on fiscal-structural policies, framework conditions, and labour and product markets. In light of persistent imbalances, the track record in CSR implementation remains poor. Over the past five years, most CSRs were, at best, only partly addressed by Member States. This is unsatisfactory, especially as the economic recovery provides a favourable environment for reform.

At the same time, Member States should agree on broad-based and balanced institutional reforms to facilitate better collective outcomes. These dimensions – action at the national and supranational level – should be seen as complementary.

Improving the crisis management framework at the supranational level would make EMU more resilient. In this regard, the ECB welcomes the commitment to strengthen the ESM made at the recent Euro Summit.

Moreover, the euro area would benefit from a common stabilisation function. Such an instrument could provide macroeconomic support in the event of euro area-wide recessions, thereby maintaining convergence and reducing the burden on monetary policy. However, such a fiscal instrument should not undermine incentives for Member States to pursue sound policies at the national level.

Conclusion

Growth in the euro area economy is solid and broad-based. The underlying strength of the economy continues to support the sustained adjustment of inflation towards our objective.

Following strong growth rates in 2017, the recovery in the euro area has slowed down in 2018, however. The duration of the current expansion, which began in 2013, is still below the historical average. Its amplitude, the percentage gain in GDP relative to the trough, is also low by historical standards.

At the same time, downside risks to growth, notably related to the threat of protectionism and the rise in trade tensions, remain prominent. The outlook for US monetary policy moves and vulnerabilities in emerging markets add to the overall uncertainty, as does the limited progress on the Brexit discussion.

Solidifying the institutional architecture of EMU is essential in order to foster cohesive economic performance without fragmentation or excessive imbalances. Monetary policy has played the key role since the financial crisis but cannot remain the only game in town. We now need action in other policy areas – notably fiscal policy and structural reforms. There is a need for responsible fiscal policy, given the levels of public debt. Some countries should take advantage of the ongoing recovery and favourable financial conditions to reduce debt burdens, whereas countries with fiscal space should increase their public investment. Likewise, significant steps should be taken on the structural policy side, with a view to increasing potential growth in the medium term. Measures to improve the functioning of labour and product markets and to strengthen procedures for the correction of macroeconomic imbalances take prominence here.

A robust economy relies on sound economic governance. Reforms at the national and EU level are needed to uphold a stable financial system and a resilient monetary union. A common stabilisation function, which − in the spirit of a true counter-cyclical fiscal policy instrument – would maintain convergence in the event of large shocks, is an overriding priority. Completing the banking union with the establishment of EDIS, its third pillar, and firm moves towards capital markets union, promoting deep and liquid bond and equity markets, are necessary reforms of the financial sector. Attaining these goals is highly relevant for financial stability, further integration, private risk-sharing and economic growth.

Thank you for your attention.

[1] See also Camba-Mendez, G. and Forsells, M., "The recent slowdown in euro area output growth reflects both cyclical and temporary factors", *Economic Bulletin*, Issue 4, ECB, 2018.

[2] Carmassi, J., Dobkowitz, S., Evrard, J., Parisi, L., Silva, A. and Wedow, M. (2008), "Completing the Banking Union with a European Deposit Insurance Scheme: who is afraid of cross-subsidisation?", *Occasional Paper Series*, No 208, ECB, Frankfurt am Main, April.