Luis de Guindos: The euro area - current status and the monetary policy stance

Remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at Deusto Business School, Madrid, 11 February 2019.

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Recent economic developments

- Euro area data have been weaker than expected in recent months. In fact, industrial production growth fell in the second half of 2018 and the decline was widespread across sectors and most major economies. Business investment weakened. On the external side, euro area trade disappointed, with noticeable declines in net exports.
- As a result, economic growth turned out to be weaker than expected: euro area real GDP increased by 0.2% quarter-on-quarter in the last two quarters of 2018, down from 0.4% in the first two quarters (on the basis of preliminary figures).
- Factors of idiosyncratic nature have been pulling growth down as well. These relate to temporary issues in the automotive sector due to new regulation, street protests and weather conditions. While there is uncertainty about the magnitude and persistence of these factors, near-term growth in the euro area is likely to be weaker than previously anticipated.
- Turning to the global environment, global growth is showing signs of a maturing economic cycle. Global activity is still expanding, but growth in important euro area trading partners, such as China, has been moderating. This has been feeding through to lower euro area exports. Indeed, a large part of the growth slowdown in the third quarter of 2018 came from a weaker contribution from net exports.
- Moreover, geopolitical uncertainties, the threat of protectionism, vulnerabilities in emerging markets and financial market volatility have proven to be more persistent than initially foreseen. In Europe in particular, the state of play of the Brexit negotiations is adding to the uncertainty.
- All these elements have increasingly weighed on economic sentiment and are now reflected in moderating business and consumer confidence.
- Headline inflation figures have also been declining: HICP inflation decreased to 1.4% in January, from 1.6% in December, mainly due to falling energy prices. Looking ahead, headline inflation is likely to decline further over the coming months on the basis of the financial market's outlook for oil prices.
- Sound factors of resilience are however in place. The euro area expansion is expected to continue, supported in particular by favourable financing conditions, further gains in employment, rising wages and lower energy prices.
- In fact, bank lending rates to euro area firms and households remain close to historically low levels. The most recent bank lending survey confirms that credit standards remain favourable and loan demand continues to increase. Together with solid earnings expectations and firms' balance sheets, these favourable funding conditions should support business investment. Labour market dynamics remain strong, with euro area unemployment at 7.9% in December, its lowest level in more than ten years. Rising wages should continue to underpin household income and private consumption. Lower energy prices are supporting real incomes and should provide an additional impetus to domestic demand.
- Turning to inflation, high levels of capacity utilisation should continue to strengthen labour cost pressures. Growth in compensation per employee increased to 2.5% in the third quarter of 2018, having increased steadily since 2016. Growth in negotiated wages also picked up in the course of 2018. Moreover, wage growth has become increasingly broad-based in recent years. This, together with our monetary policy measures and the ongoing

economic expansion, is expected to translate into higher underlying inflation over the medium term.

Monetary policy stance

- In this environment of downside risks to the growth outlook, the Governing Council decided at its last monetary policy meeting in January to retain its policy stance, confirming the enhanced forward guidance on policy rates and reinvestment.
- The Governing Council carefully reviews all incoming data with regard to their possible implications for the medium-term inflation outlook. More concretely, we continuously assess whether inflation is converging towards our inflation aim – that is to levels of below, but close to, 2% – in a sustained manner.
- Although near-term growth is likely to be weaker than foreseen, in our view, the conditions for ongoing economic growth remain in place – supportive financing conditions, favourable labour market dynamics and rising wage growth. These will continue to underpin the euro area expansion – and thereby contribute to gradually rising inflation.
- At our meeting in January, we kept our current policy configuration in place. At the same time, we acknowledged that persistent uncertainties and signs of lower than expected near-term growth call for increased caution.
- Significant monetary policy stimulus remains essential to support the further build-up of domestic price pressures and headline inflation developments over the medium term.
- Indeed, the end of our net purchases in December last year does not imply that our monetary policy has become less accommodative. In fact, ample monetary policy accommodation is still provided by our forward guidance on the key ECB interest rates, which is reinforced by our forward guidance on the reinvestments of the sizeable stock of acquired assets.
- The formulation of our forward guidance on our policy rates is crucial. There is the date-based element – that interest rates are expected to remain at their present levels "at least through the summer of 2019". But, in addition, there is a state-contingent element – that rates will remain unchanged "in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term".
- The date-based element ensures that our stimulus is not weakened by premature expectations of a rate hike. The state-contingent element, in turn, ensures that the stance will continue to evolve gradually and in a data-dependent manner, is consistent with a forward-looking and medium-term-oriented monetary policy strategy, and underscores the credibility of the Governing Council's commitment to its price stability objective.
- Likewise, our reinvestment policy will ensure that the stock of assets on our balance sheet remains in place for a long period and continues to support our accommodative stance.
- Indeed, we intend to continue reinvesting, in full, the principal payments from maturing securities purchased under the asset purchase programme for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.
- In addition to maintaining this accommodative stance, the current environment underlines the need for a monetary policy stance that is patient, persistent and prudent to guarantee the return of inflation to our aim in the medium term.

Economic and Monetary Union governance

- The monetary policy measures the ECB has introduced since 2014 have been essential in supporting the robust recovery and paving the way for inflation to return towards our objective.

- This year, we are celebrating the 20th anniversary of the euro. In the two decades of its existence, the euro, underpinned by Economic and Monetary Union (EMU), has been a powerful tool of integration. But it has also faced a crisis so severe that its very existence was at times questioned. This sparked a thorough revision of our institutional framework, in the broader context of the international response to the global financial crisis.
- The architecture of EMU is still incomplete in many ways. Ensuring its longer-term resilience requires joint efforts at both the national and European levels.
- At the national level, we need to pursue reforms that promote sustainable economic convergence, and increase the growth potential and resilience of local economies.
- At the European level, I welcome the agreement reached by the Euro Summit in December last year on a euro area budgetary instrument aimed at fostering competitiveness and convergence. This could help the implementation of structural reforms and strengthen resilience in the euro area. However, the euro area would also benefit from a common stabilisation function – which is not foreseen under the December agreement. 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.
- With a predominantly bank-based financial system, completing the banking union also remains a key priority. Agreeing on a backstop to the Single Resolution Fund through the European Stability Mechanism is an important step in this direction.
- Political momentum is also needed to agree on the missing third pillar of the banking union, the European Deposit Insurance Scheme (EDIS). There were calls to first reduce risks in the banking sector before starting to share them, and considerable risk reduction has indeed taken place in recent years. EDIS would mitigate the risk of financial fragmentation by providing an identical level of depositor protection across the euro area. With the end goal of a fully fledged EDIS, the ECB welcomes the establishment of a high-level working group to agree on the path we need to follow to achieve this goal.
- Furthermore, we need to continue making progress in deepening the Single Market, including by developing a genuine capital markets union (CMU). Deep and well-integrated cross-border funding would improve the private sector's capacity to absorb local shocks, reducing the burden on fiscal policies. Here as well, renewed ambition is needed. Revamping the CMU agenda can play an important role in adapting the EU's financial architecture in view of Brexit. It can also enhance the EU's attractiveness to international investors, and thus help to strengthen the international role of the euro.
- These reforms not only address the weaknesses of the institutional framework, they also ensure that the euro will be able to face tomorrow's challenges. As leaders renewed their political commitment to strengthen EMU at the Euro Summit in December, we need to capitalise on this commitment and translate it into concrete policy actions ahead of the upcoming European elections.