Mario Draghi: Monetary policy in the euro area

Speech by Mr Mario Draghi, President of the European Central Bank, at the conference "The ECB and its watchers XX", Frankfurt am Main, 27 March 2019.

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The last year has seen a loss of growth momentum in the euro area, which has extended into 2019. This has been predominantly driven by pervasive uncertainty in the global economy that has spilled over into the external sector. So far, the domestic economy has remained relatively resilient and the drivers of the current expansion remain in place. However, the risks to the outlook remain tilted to the downside.

The monetary policy measures we took at the last Governing Council meeting reflect this assessment. In the face of a weaker growth outlook, they help maintain the accommodative policy stance that we managed to preserve last year as we rotated our instruments from net asset purchases to forward guidance. Our policy thereby continues to accompany the economy on its path towards our inflation objective.

The outlook for the euro area economy

We expected the expansion to slow in 2018 as the business cycle matured and growth retreated towards potential. But as the economy weakened in the second part of last year, it was not yet certain whether we were witnessing a temporary departure from this scenario, or a more lasting deterioration in the growth outlook.

The drivers of the deceleration back then appeared, to some extent, to be idiosyncratic and short-lived, relating to the effect of emissions standards on the euro area car industry and a normalisation of world trade from its very strong growth rates in 2017.[1]

Yet it was clear that the loss of growth momentum could become more broad-based and persistent if two risks were to materialise: first, if external demand were to remain weak; and second, if this were to spill over into domestic demand.

In the meantime, the first risk has by and large been realised. The weakness in world trade has continued, which has significantly affected the manufacturing sector. Global goods import growth[2] in January reached its lowest level since the Great Recession, on the back of rising uncertainty about trade disputes and a slowdown in emerging market economies, especially China.

As a result, growth in extra-euro area goods exports was negative at the end of last year for the first time since January 2016, and industrial production fell by 4.2% year on year in December – its largest decline since 2013 – before recovering somewhat in January. Indicators such as new export orders, which have historically been closely associated with industrial production[3], remain in negative territory.

So we are now seeing a more persistent deterioration of external demand. But a “soft patch” does not necessarily foreshadow a serious slump.

During the four euro area business cycle expansions since 1970, there have been 50 soft patches – defined as a two-quarter growth slowdown – and only 4 recessions.[4] In fact, the euro area faced an analogous situation in 2016, when the economy also went through a soft patch triggered by a contraction in world trade. At that time, the strength of the domestic economy was able to shield the recovery from external uncertainties.

The key question is whether, with monetary policy continuing to support the expansion, domestic

demand will remain as resilient today.

The demand component typically affected most by a weaker global environment is investment. ECB internal analysis shows that the more exposed euro area listed firms are to foreign markets, the more sensitive they are to uncertainty when making their investment decisions. And there are some signs that external demand may be affecting investment via manufacturing value chains within the euro area.

In particular, both extra and intra-euro area trade slowed steeply last year, whereas in 2016 intra-euro area trade was robust to the external slowdown. Such a recoupling of intra- and extra-euro area trade growth in a downward direction has not occurred since the start of the global financial crisis. Intra-euro area exports of intermediate and capital goods were hit particularly hard, with capital goods exports registering their strongest contraction since the sovereign debt crisis.

A further rise in global uncertainty could therefore lead to a deceleration in trade and investment. But for now expectations for investment remain relatively robust. Though professional forecasters have slightly downgraded their projections for investment growth this year – from around 3% to around 2.5% – the fundamentals are in place for investment to rebound, if global growth stabilises.

Capacity utilisation stands close to its long-term maximum, financing conditions remain very favourable and corporate leverage[5] (as a percentage of total assets) has fallen to levels last witnessed in the early years of EMU – although gross corporate indebtedness[6] (as a percentage of gross value added) still stands above its pre-crisis level. The latest surveys also suggest some recovery in business sentiment.

While consumption is typically less affected by external developments, its growth rate has slowed over the last year. Higher uncertainty may have played a role, as reflected in the rise in the household saving rate over the course of 2018. But the main drivers were idiosyncratic factors unrelated to the global economy, coupled with country-specific factors in France and Italy.

The most important issue for the consumption outlook is the labour market, since higher employment has been the major driver of consumption during the current expansion. So far the labour market has been resilient to the growth slowdown.

While employment growth moderated in the second half of last year, in 2018 it was significantly higher than would be expected based on the static long-term relationship between employment and GDP growth.[7] As a result, real disposable income has remained resilient and households' assessment of their own financial situation, which is a good leading indicator of consumption, remains positive.

The resilience of the employment-consumption relationship helps explain why, even as the manufacturing outlook has worsened, services have remained relatively robust. Services is the most labour-intensive sector and is associated closely with consumers' expenditure.[8]

There are however lags between changes in GDP and in employment, and surveys on employment, while remaining in expansionary territory, have decelerated since the middle of last year. So should the growth slowdown turn into a more persistent phenomenon, employment and consumption are likely to be affected.

All in all, the current data suggest that external demand has not yet spilled over significantly into domestic demand, but the risks have risen in the last months and uncertainty remains high. This is why our medium-term outlook remains that growth will gradually return to potential, but the risks remain tilted to the downside.

That outlook is also being buttressed by the pre-emptive reaction of stabilisation policies. Fiscal

policy in the euro area has become mildly expansionary, with the aggregate fiscal stance expected to be –0.4% of GDP in 2019 after five years of being broadly neutral.[9] And our forward guidance on monetary policy has been effective, as shown by the continuing easing of financial conditions since last December.

The outlook for wages and inflation

The weakening growth picture has naturally affected the inflation outlook as well. Our projections for headline inflation this year have been revised downwards and we now see inflation at 1.6% in 2021. Slower growth will also lead to a more muted recovery in underlying inflation than we had previously expected.

Reflecting the weaker outlook, market-based measures of inflation expectations have edged down recently. The fall in market-based measures has mainly been driven by a decline in inflation risk premia, a volatile component of overall inflation-linked swap rates, not by a drop in "genuine" inflation expectations. While a decrease in inflation risk premia may suggest that market participants assign increased prominence to lower-than-expected outcomes of future inflation, survey-based measures have remained relatively stable.

We therefore remain confident that the sustained convergence of inflation to our aim has been delayed rather than derailed – meaning that we expect inflation to reach our objective at a later date than we previously foresaw. This view is based on our assessment of the resilience of the labour market and therefore of wage growth. Wage dynamics have so far broadly withstood the growth slowdown.

Growth in compensation per employee fell slightly in the last quarter of 2018 from 2.5% to 2.2%, but remains just above its long-term average. Unit labour cost growth rose to 2.4% in the same period, partly driven by a fall in productivity growth reflecting the resilience of employment growth to the economic slowdown.

The key question – and one currently being asked in many advanced economies – is why these labour cost pressures are not already being reflected in rising prices. Underlying inflation has moved broadly sideways over the last year, repeatedly falling short of expectations and staying below the levels recorded before 2008.

Academic literature based on US data has responded by casting doubt on the link between labour costs and inflation, in particular at shorter horizons. Studies find no conclusive results on whether, empirically, labour costs tend to precede or follow prices.[10] This has led to a debate as to whether "cost-push" models from wages to prices can still accurately describe the inflation process.

There are certainly a number of forces at work today that make forecasting inflation more complex, not least the effects of globalisation and digitalisation. Yet research by ECB staff finds that, unlike in the United States, the structural conditions for pass-through from wages to prices remain in place in the euro area.

Over the period from 1985 to 2018, there is a continuing link between labour cost and price inflation in the four major euro area economies and across the three main sectors.[11] Pass-through is on the whole strongest in the services sector, where wages account for around 40% of costs. That is important for the current inflation outlook given the resilience of services to the growth slowdown.

What appears to be delaying the pass-through today is the fact that firms are absorbing labour cost increases by squeezing profit margins. This reflects two cyclical factors.

First, the euro area is coming out of a prolonged period of low inflation, which historically leads to

a slower pass-through.[12] One reason is that price dispersion is narrower when inflation is low, implying that if an individual firm were to raise its prices, it would attract the attention of consumers and lose market share. Firms are therefore more reluctant to pass on cost increases to consumers.[13]

The second factor is the softening of activity in 2018. Labour costs are typically passed on more strongly to prices when demand is stronger,[14] so the fact that the euro area has recently experienced a negative demand shock is likely to have held firms back from raising prices.

The delay in pass-through may also be explained by an additional factor, which is lower imported inflation over the last two years. This has been reflected, since late summer 2017, in a growing discrepancy between the growth of the GDP deflator and core inflation. The GDP deflator has followed a more pronounced upward trend, rising from 0.6% at the end of 2016 to 1.5% at the end of 2018.

One development that may have contributed to lower imported inflation was the appreciation of the euro exchange rate by around 8% in nominal effective terms over the last two years. ECB internal analysis suggests that this had an impact on non-energy industrial goods inflation in 2018, especially for durable goods.[15]

The upshot is that the pass-through of wages to prices is likely to be moderate until these various factors have played out. But there are several reasons to believe that they will unwind over the medium term.

Our monetary policy will remain accommodative and will respond to any changes in the inflation outlook. The effects of exchange rate appreciation have now reversed. Demand should recover, so long as the downside risks to our outlook do not materialise. And with stronger demand, firms should be able to rebuild margins.

Moreover, even if the economy were to slow more than expected, the risks to wage growth may be contained. Since the end of 2017, wage growth has been driven less by wage drift[16] and more by negotiated wages, which are more persistent and react more slowly to cyclical labour market conditions. Negotiated wages for 2019 have to a substantial degree already been set by previous negotiating rounds.

The outlook for monetary policy

Substantial accommodation is still needed to secure the path of inflation convergence and this is reflected in our past monetary policy decisions. In parallel to winding down net purchases, we have strengthened our forward guidance on interest rates and bond reinvestments. This has allowed us to rotate the instruments used to set the policy stance, while leaving the stance itself broadly unchanged.

Our forward guidance framework has been specifically designed to accompany the economy by facilitating needed adjustments in the policy stance as the outlook evolves. It works along three main dimensions.

First, the state-based leg of our guidance ensures that interest rate expectations are anchored to our ultimate inflation objective, and thereby acts as an “automatic stabiliser” in the event of downside risks emerging. Second, the date-based leg provides extra information to focus rate expectations over the near term.

Third, since our forward guidance on reinvestments is tied to our guidance on rates, adjustments to rate guidance automatically entail a change of the reinvestment horizon in the same direction. This reinforces the easing impact of a flatter expected rate path by compressing the term

premium component of longer-term interest rates.

We will continue monitoring how banks can maintain healthy earning conditions while net interest margins are compressed. And, if necessary, we need to reflect on possible measures that can preserve the favourable implications of negative rates for the economy, while mitigating the side effects, if any. That said, low bank profitability is not an inevitable consequence of negative rates.

ECB analysis finds that the best-performing banks in the euro area in terms of return on equity between 2009 and 2017 share three key features: they have been able to significantly reduce their cost-to-income ratios; they have embarked on large-scale investments in information technology; and they have been able to diversify their revenue sources in a low interest rate environment.[17]

At its last meeting, the Governing Council decided, based on the weaker outlook for inflation, to extend the date-based leg of our rate guidance "at least through the end of 2019". That in turn implies that we will continue to keep the very sizeable stock of assets bought under the asset purchase programme unchanged for even longer.

The Governing Council also decided to launch a new series of targeted longer-term refinancing operations (TLTRO-III) in order to preserve favourable bank lending conditions and maintain the efficient bank-based transmission of our policy.

These decisions ensure that our policy stance remains accommodative in the face of a weaker growth outlook. And the calibration of the remaining parameters of the TLTRO-III will reflect the evolving macroeconomic conditions.

Our current reaction function is well designed to respond to further delays in inflation convergence. In such a situation, just as we did at our March meeting, we would ensure that monetary policy continues to accompany the economy by adjusting our rate forward guidance to reflect the new inflation outlook.

But the commitment to our objective also implies alertness to future risks and a readiness to respond to them should the medium-term outlook continue to deteriorate significantly. In this case as well, the ECB will adopt all the monetary policy actions that are necessary and proportionate to achieve its objective. We are not short of instruments to deliver on our mandate.

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[1] See Draghi, M. (2018), "The outlook for the euro area economy", speech at the Frankfurt European Banking Congress, Frankfurt am Main, 16 November.

[2] Three-month-on-three-month percentage changes; CPB Netherlands Bureau for Economic Policy Analysis.

[3] See De Bondt, G. and Hahn, E. (2014), "Introducing the Euro Area-wide Leading Indicator (ALI): Real-Time Signals of Turning Points in the Growth Cycle from 2007 to 2011", *Journal of Forecasting*, 33:47–68.

[4] See Anderson G. and Y. Liu (2012), "On the Road to Recovery, Soft Patches Turn Up Often", *The Regional Economist*, Federal Reserve Bank of St. Louis, pp. 12–13.

[5] Leverage is calculated by dividing total liabilities net of shares and other equity by total assets.

[6] Consolidated gross debt is defined as the sum of total loans granted to NFCs net of intra-sectoral lending, debt securities issued and pension liabilities.

[7] See Botelho, V. and Dias da Silva, A. (2019), "Employment growth and GDP in the euro area", Box 3 in *Economic Bulletin,* Issue 2, ECB.

[8] See Anderton, R., Aranki, T., Bonthuis, B. and Jarvis, V. (2014), "Disaggregating Okun's law − Decomposing the impact of the expenditure components of GDP on euro area unemployment", *Working Paper Series*, No 1747, ECB, December.

[9] The fiscal stance is measured as the change in the cyclically adjusted primary balance net of government assistance to the financial sector.

[10] See Knotek, E. S. and Zaman, S. (2014), "On the Relationships between Wages, Prices, and Economic Activity", *Economic Commentary*, August; Bidder, R. (2015), "Are Wages Useful in Forecasting Price Inflation?", *FRBSF Economic Letter*.

[11] Bobeica, E., Ciccarelli, M. and Vansteenkiste, I. (2019), "The link between labor cost and price inflation in the euro area", *Working Paper Series*, No 2235, ECB, February.

[12] Bobeica et al., op. cit.

[13] See Head, A., Kumar, A., and Lapham, B. (2010), "Market Power, Price Adjustment, and Inflation", *International Economic Review*, 51(1):73–98; and Taylor, J. (2000), "Low Inflation, Pass-Through and the Pricing Power of Firms", *European Economic Review*, 44:1389–1408.

[14] Bobeica et al., op. cit.

[15] See Hahn, E. and O'Brien, D. (2018), "Monitoring the exchange rate pass-through to inflation", Box 3 in *Economic Bulletin*, Issue 4, ECB.

[16] See Koester, G. and Guillochon, J. (2018), "Recent developments in the wage drift in the euro area", *Economic Bulletin*, Issue 8, ECB.

[17] Andersson, M., Kok, C., Mirza, H., More, C. and Mosthaf, J. (2018), "How can euro area banks reach sustainable profitability in the future?", Special Feature, *Financial Stability Review*, ECB, November.