

Luis de Guindos: The euro area economy and our monetary policy stance

Remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, during the Instituto de Empresa (IE) Business Leadership Forum at the IE Business School, Madrid, 10 June 2019.

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Recent economic developments

Despite the somewhat better than expected data for the first quarter, in part due to temporary factors, the most recent information indicates that global headwinds continue to weigh on the euro area outlook. In particular, world trade remains subdued due to rising trade tensions and the global growth momentum has slowed somewhat, mainly on account of the weakness in manufacturing. Moreover, downside risks have increased on account of the re-escalated trade dispute between the US and China. Also, uncertainty surrounding Brexit is prolonged and fragilities in emerging market economies remain. While inflation is expected to rise gradually due to tightening labour markets and rising wages, current dynamics of underlying inflation remain muted. It is against this background, that the Governing Council decided a number of policy measures at its last meeting, including an extension of its forward guidance on policy interest rates, a confirmation of the reinvestment policy and favourable pricing conditions for our new series of targeted longer term refinancing operations (TLTRO III).

Euro area real GDP growth came in at 0.4% quarter-on-quarter in the first quarter of 2019, surprising somewhat on the upside. The better than expected outcome was in part driven by temporary factors, such as the mild weather supporting a pick-up in construction and some sector specific developments. Economic indicators suggest that domestic demand remains resilient, as signalled by the growth of consumption, which grew 0.5% quarter-on-quarter in the first quarter of the year, and investment, which grew by 1.1% during the same period.

While first quarter growth was somewhat stronger than previously anticipated, incoming data and survey information point to somewhat more moderate growth over the next few quarters. This reflects the ongoing weakness in international trade in an environment of prolonged global uncertainties, which are weighing, in particular, on the euro area manufacturing sector. In fact, some leading indicators such as manufacturing PMI and the ECB indicator on euro area new orders have declined recently, confirming weakening dynamics in the euro area manufacturing sector. At the same time, the euro area services and construction sectors are showing resilience and the labour market is continuing to improve.

Looking forward, the underlying fundamentals for a continued expansion of the euro area economy remain in place. In fact, favourable financing conditions, strong labour market conditions and rising wages continue to underpin domestic demand supporting ongoing solid consumption and investment dynamics.

Consumer confidence remains overall robust and has recently increased, as indicated by the EC Consumer Survey. Moreover, households' financial situation continues to strengthen, in line with further declines in unemployment, which supports private consumption.

Financial conditions have slightly tightened since the April meeting, amid ongoing trade tensions, where equity prices have declined and the euro appreciated in effective terms. Despite this slight tightening, financial conditions remain significantly looser compared to the beginning of the year, due to lower risk free interest rates, higher equity prices and a somewhat weaker euro exchange rate.

In addition, financing conditions for euro area non-financial corporations (NFCs) remain very favourable. Lower costs of equity and market-based debt have meant a decline in the nominal cost of external financing for NFCs. Bank lending rates for firms and households remain close to historical lows as bank funding conditions remain favourable, also supported by our new series of TLTRO III. Moreover, the recent SAFE Survey reported that access to finance was considered the least important obstacle for small and medium enterprises.

Labour markets remain robust, as figures of employment growth were higher than expected and unemployment continued to decrease. Employment growth was 0.3%, which is higher than anticipated, albeit lower than the average quarterly growth of 0.4% that has characterized the second quarter of previous years. Furthermore, euro area unemployment came in at 7.6% in April, the lowest since August 2008.

Overall, our assessment on the euro area economic outlook is broadly reflected in the June 2019 Eurosystem staff macroeconomic projections for the euro area. These projections foresee annual real GDP increasing by 1.2% in 2019, 1.4% in 2020 and 1.4% in 2021. Compared with the March 2019 ECB staff macroeconomic projections, the outlook for real GDP growth has been revised up by 0.1 percentage points for 2019 and has been revised down by 0.2 percentage points for 2020 and by 0.1 percentage points for 2021.

At the same time, there are clear downside risks to this central scenario, largely on account of the prolonged presence of uncertainties relating to the international environment. These uncertainties could weaken or delay the recovery in external demand and also weigh on euro area investment and consumption dynamics.

With regards to inflation, euro area annual HICP inflation was 1.2% in May 2019, after 1.7% in April, reflecting mainly lower energy and services price inflation. On the basis of current futures prices for oil, headline inflation is likely to decline over the coming months, before rising again towards the end of year. Measures of underlying inflation remain rather muted, having moved largely sideways over recent months.

At the same time, inflation dynamics are supported by strengthening labour cost pressures amid high levels of capacity utilisation and tightening labour markets. In fact, recent data on negotiated wages point towards a continuation in the upward trend in wage growth, which is expected to gradually push up underlying inflation.

Market based measures of long term inflation expectations have further declined, while survey-based measures have remained stable. The probability of deflation implied by options markets remains low and continues to suggest that deflation risks remain contained. Yet, market-based measures of inflation expectations point to a prolonged period of low inflation, indicating only a very gradual return to levels close to, but below 2%. Nevertheless, survey-based measures of inflation expectations have remained anchored.

This assessment is also broadly reflected in the latest June 2019 Eurosystem staff projections, which foresee inflation at 1.3% for 2019, 1.4% for 2020, and 1.6% for 2021. Compared with the March 2019 ECB staff macroeconomic projections, the outlook for HICP inflation has been revised slightly up for 2019 and revised slightly down for 2020. Annual HICP inflation excluding energy and food is expected to be 1.1% in 2019, 1.4% in 2020 and 1.6% in 2021.

The monetary policy stance

Against this overall background, the Governing Council took a number of monetary policy decisions at its recent meeting in Vilnius in early June.

First, the Governing Council decided to adjust its forward guidance on the key ECB interest rates. We now expect these to remain at their present levels at least through the first half of

2020, and 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.

This formulation consists of two parts. There is a date-based element – that interest rates are expected to remain at their present levels “at least through the first half of 2020”. And 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”.

Shifting the date-based part of our rate guidance outwards ensures that our monetary accommodation is not weakened by premature expectations of a rate hike.

In addition, the state-dependent element ensures that our monetary policy stance will remain accommodative for as long as necessary and will evolve gradually following incoming economic data.

Second, we reiterated our forward guidance on reinvestment. 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.

Our reinvestment policy continues to provide a significant degree of policy stimulus. In fact, by linking the reinvestment horizon to the date when we start raising the key ECB interest rates, we are reinforcing the stimulative effects of our forward guidance as market expectations for the reinvestment horizon should evolve in line with expectations for the date of rate lift-off.

Third, we decided on the pricing modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III), which we had already announced in March. The aim of these operations is to offer long-term funding at attractive conditions to banks, which will help to preserve favourable bank lending conditions and support the smooth and efficient bank-based transmission of monetary policy.

This series of operations will start in September 2019 and end in March 2021, and have a maturity of two years each.

At our last meeting, we decided that the interest rate in each operation will be set at a level that is 10 basis points above the average rate applied in the Eurosystem’s main refinancing operations over the life of the respective TLTRO. For banks whose eligible net lending exceeds a benchmark, the rate applied in TLTRO III will be lower and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation plus 10 basis points.

We also assessed the impact of negative rates on the euro area economy and concluded that, at this point in time, the positive contribution of negative rates to the accommodative monetary policy stance and to the sustained convergence of inflation is not undermined by possible side effects on bank-based intermediation. However, we will continue to monitor carefully the bank-based transmission of monetary policy and the case for mitigating measures.

Overall, we are confident that the monetary policy measures will provide the monetary accommodation necessary for inflation to remain on a sustained path towards levels that are below, but close to, 2% over the medium term. Indeed, they ensure that financial conditions will remain very favourable, supporting the euro area expansion, the ongoing build-up of domestic price pressures and, thus, headline inflation developments over the medium term.

At the same time, we remain alert in the wake of mounting global uncertainties. The Governing Council is, therefore, determined to act in case of adverse contingencies and also stands ready

to adjust all of its instruments, as appropriate, to ensure that inflation continues to move towards the Governing Council's inflation aim in a sustained manner.