

Luis de Guindos: The euro area economic outlook and the current monetary policy stance

Remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at the European Banking Federation Committee meeting, Frankfurt am Main, 20 February 2020.

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It is a pleasure to be here today at the European Banking Federation. I will use this opportunity to provide an overview of the economic situation in the euro area and on the current monetary policy stance.

Recent economic developments

Although the expansion has moderated in the recent quarters, euro area growth continues to be supported by the underlying strength of domestic activity, bolstered by strong labour market dynamics and favourable financing conditions.

After the gradual worsening over the past two years, the outlook for global economic activity outside the euro area has been showing some signs of improvements recently. The global sentiment indicators, like the manufacturing output Purchasing Managers' Index, stabilised in the past few months following its persistent deceleration since early 2018. Nevertheless, international trade remains weak and uncertainty around the future trading relationships among major global partners remains elevated, despite receding somewhat after the US-China "phase-one" agreement.

This global weakness continues to weigh on manufacturing that remains a drag on the euro area growth momentum. Some forward-looking survey indicators show tentative signs of mild improvements. For example, the Purchasing Managers' Index manufacturing business expectations in twelve months' time has increased in the five consecutive months through January. Likewise, the European Commission's Economic Sentiment Indicator improved for the third consecutive month in January. However, the latest figures on industrial output in the euro area are a reminder that overcoming the manufacturing recession that has weighed on the euro area growth performance in the last couple of years is still challenging.

We draw some comfort from the fact that, as yet, we do not see spillovers from the manufacturing weakness to the service sector. In the third quarter of 2019, euro area consumption increased by 0.5% quarter-on-quarter, while resilient retail sales and broadly stable consumer confidence indicate robust consumer spending also in the following months. The services sector continues to be strong and survey indicators remain in expansionary territory.

Consumption is supported by solid labour markets dynamics. According to Eurostat's flash estimates, in the fourth quarter of 2019, employment expanded by 0.3% quarter-on-quarter, while unemployment declined further to 7.4% in December, the lowest level since May 2008. The number of people employed has increased by more than 11 million since its trough in mid-2013. At the same time, while investment is supported by favourable financing conditions, it was curbed by the slowdown in the euro area growth momentum and by the elevated uncertainties over the past quarters.

Looking ahead, the underlying fundamentals for a continued though moderate expansion of the euro area economy remain in place, as foreseen in the December 2019 Eurosystem staff projections, which entail annual real GDP increasing by 1.1% in 2020, 1.4% in 2021 and in 2022. But the risks surrounding the euro area remain tilted to the downside. In particular, the outbreak of the coronavirus and its potential effect on global growth add a new layer of uncertainty.

The modest growth performance of the euro area economy is also reflected in subdued inflation

dynamics. According to Eurostat's flash estimates, headline inflation increased to 1.4% in January, up from 1.3% in December 2019, reflecting mainly higher energy and food inflation. Measures of underlying inflation are subdued, although they have mildly increased from earlier lows.

Wage growth remains resilient and broad-based, and is expected to shore up inflation in the upcoming months. With the decline in unemployment and the tightening of labour markets, labour cost pressures have strengthened. Recent data on negotiated wages continue to signal robust wage growth, which is expected to gradually push up underlying inflation. However, the weaker growth momentum is delaying the pass-through to inflation, as firms appear to be absorbing wage rises in their profit margins rather than passing them on to customers.

While survey-based long-term inflation expectations in the euro area have remained anchored at levels of at least 1.7%, market-based measures of long-term inflation expectations have stagnated at levels that are not consistent with our medium-term inflation aim.

Overall, inflation is expected to increase, supported by the ongoing expansion, the solid wage growth and our monetary policy measures. This is broadly reflected in the latest December 2019 Eurosystem staff projections, which foresee inflation at 1.1% in 2020, 1.4% in 2021 and 1.6% in 2022. At the same time, annual HICP inflation excluding energy and food is expected to be 1.3% in 2020, 1.4% in 2021 and 1.6% in 2022.

The monetary policy stance

Against a backdrop that remains clouded, the euro area economy still needs strong support from monetary policy. The policy stimulus that is in place is working its way through the economy and is expected to support growth and job creation, a key precondition for inflation to move towards our medium term inflation aim.

Hence, at the last meeting, the Governing Council confirmed its forward guidance on the ECB's policy interest rates, asset purchases and reinvestments. According to our guidance, we expect to maintain the key ECB interest rates "at their present or lower level until the inflation outlook robustly converges to a level sufficiently close to, but below, 2% within the projection horizon."

While rate guidance has been effective in steering rate expectations along the short- to medium-term portion of the term structure, our ongoing net purchases, at a monthly pace of €20 billion, act primarily on the longer end of it. We also 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". In current conditions of uncertainty, investors – reading our rate guidance – tend to anticipate a more extended period of time to the date of a rate hike. By the chained structure of our forward indications of all instruments, this automatic adjustment mechanism extends the horizons for full reinvestments too, and thus reinforces the impact of rate guidance on longer-term interest rates.

Moreover, our new series of long-term refinancing operations (TLTRO-III), which started in September 2019 and will end in March 2021, help to ensure favourable bank funding conditions in support of an efficient bank-based transmission of monetary policy in the euro area.

The combination of our monetary policy measures continues to prove effective in stabilising the economy and in ensuring very favourable financing conditions. This is evident in the successful pass-through of our policy measures to financing conditions that matter for the real economy. In fact, bank lending rates for both firms and households have continued to decline in the recent months and remain close to historical lows. Loan growth to non-financial corporations, while moderating in tandem with the slowdown in the economy, is still supporting capital creation and the mortgage market. Our recent Bank Lending Survey confirms that credit supply conditions are favourable.

Overall, the present monetary policy stimulus lends substantial support to growth and inflation developments, buffering to a large degree the negative impulse from global factors. Indeed, the unfolding of our monetary policy measures will ensure that financial conditions will remain very favourable, shielding the economy against the external headwinds and laying out the conditions for the build-up of domestic price pressures.

At the same time, we are attentive to the possible side effects of the present monetary policy measures. These need to be carefully and continuously monitored.

The ECB strategy review

In January, the Governing Council decided to launch a review of the ECB's monetary policy strategy. After more than 16 years, it was time to conduct a thorough review taking stocks of the profound structural changes that have intervened since the 2003 strategy exercise, and reflecting on what these changes and new trends mean for our framework.

This process is expected to last one year and it will be conducted by the Eurosystem and the ECB staff. We will also reach out to academics, Members of Parliament – including the European Parliament – representatives from the civil society and business, and seek the opinion of financial market participants on selected issues.

The scope of the strategic review will be comprehensive. That means that we will look at the quantitative formulation of price stability, together with the approaches and instruments by which price stability is achieved. We will also reflect on how other considerations, such as financial stability, employment and environmental sustainability, can be relevant in pursuing the ECB's mandate. We will conduct a review of the effectiveness and the potential side effects of the monetary policy toolkit developed over the past decade. Finally, the review will include an examination of directions in which the economic and monetary analyses through which the ECB assesses the risks to price stability could be enhanced, as well as an evaluation of our communication practices.

Our strategy review will have a long-term perspective, with the aim to build an efficient and lasting framework. It will not interfere with our meeting-by-meeting policy agenda, in which we will continue to set policy as appropriate given the evolving outlook. Our reaction function is clear and entirely data-driven. As we said after our last monetary policy deliberations, “the Governing Council continues to stand ready to adjust all of its instruments, as appropriate, to ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry”.