

Gertrude Tumpel-Gugerell: The euro area's economic outlook

Intervention by Ms Gertrude Tumpel-Gugerell, Member of the Executive Board of the European Central Bank, during a panel discussion on Europe's financial forecast at the Bloomberg Businessweek European Leadership Forum, London, 23 November 2010.

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Ladies and Gentlemen,

It is a pleasure to attend this year's Bloomberg Businessweek European Leadership Forum. Bloomberg's and Europe's economy have at least one thing in common. Coincidentally, Bloomberg was founded in 1981 and so was the ECU, the European currency unit, one of the forefathers of our common currency, the euro.

So let me take the opportunity, today, to speak about the state of the euro area economy. When assessing the euro area economic outlook, three criteria are of particular relevance in the current juncture. First, how much does the euro area banking sector still rely on central bank liquidity support measures? And second, can we be confident that private sector domestic demand can contribute to a sustained economic recovery? And third, what are the implications for price stability against this background?

In what I will present to you I will argue that there are some good news when assessing these two questions. First, money market activity in the euro area improved which has allowed the ECB to withdraw some of the liquidity support. Second, household incomes and non-financial corporations' balance sheets are improving supporting a positive outlook on euro area growth, also against the background of further consolidation efforts of euro area governments. And third, we expect price stability to be maintained over the medium term, thereby supporting the purchasing power of euro area households, also as inflation expectations remain firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

So let me assess the euro area financial and economic outlook in a bit more detail.

Part I: Assessing the euro area financial and economic outlook

Reduction of central bank intermediation...

The size of refinancing operations has decreased considerably since 30 June 2010, from €881 billion on that date to €510 billion in mid-November. The phasing-out of non-standard measures continued in the third quarter of 2010, and is still continuing in the fourth quarter, as all maturing one-year and six-month longer-term refinancing operations (LTROs) are not being renewed.

... as money markets are improving.

Conditions in the euro area money markets are improving. The volumes in the interbank money market (EONIA) have virtually doubled since summer, and are now back to the levels prevailing before August 2007. The overall reduction in central bank liquidity has brought the interbank (EONIA) rate closer to the policy rate, which is an important step towards going back to our pre-crisis framework.

Euro area activity recovered in the second quarter of 2010...

Economic activity in the euro area is recovering. According to Eurostat's flash estimate, GDP grew by 0.4%, quarter on quarter, in the third quarter of 2010, after increasing by 1.0% in the second quarter.

While no breakdown is available for the third quarter of 2010, all components contributed positively to quarterly GDP growth in the second quarter. In particular, domestic demand contributed quite strongly for the first time since the crisis, namely by 0.5 percentage point.

... and surveys point to ongoing growth into the fourth quarter.

Looking beyond the third quarter, survey indicators, such as the Purchasing Managers' index (PMI) and European Commission business surveys for the manufacturing and the services sectors, point to ongoing growth in October.

Consumer confidence increased in October and stood above its long-term average, pointing to a gradual recovery in euro area consumption.

Good prospects for households' income from the stabilisation in the labour markets...

The sentiment in the survey data finds its support in a number of encouraging developments, both in the household and in the non-financial corporations sector.

On the household side, labour markets are stabilising, with employment levels remaining stable in the first and the second quarters of 2010, while hours worked increased by 0.2%, quarter on quarter, in both these quarters. The effect of the crisis on hours worked was far stronger than that on the number of persons employed. Therefore, the upturn has also been stronger in terms of the hours worked.

Moreover, the unemployment rate has stabilised in the last few months and stood at 10.0% in the third quarter of 2010.

Overall, the stabilisation in the labour markets is creating good prospects for household income and, thereby, also for private consumption. Indeed, the breakdown of households' income shows that the share of compensation of employees has increased recently, while the contribution of net social benefits has declined.

... and upward trend in production and new orders.

As to non-financial corporations, we can observe an increasing improvement in their conditions.

Industrial production (excluding construction) and new orders (excluding ships, railway and aerospace equipment) are on a rising trend after the strong decline observed during the crisis.

Financing conditions are showing signs of improvement...

Euro area financing conditions are showing signs of a gradual improvement. Short term and long term bank lending rates are currently at very low levels by historical standards supporting a turnaround in the demand for credit.

... supporting the turnaround in the growth of lending to households and non-financial corporations.

The annual growth of MFI loans to non-financial corporations became less negative in September, confirming that the turnaround in loan dynamics is ongoing. The annual growth

of loans to non-financial corporations is actually expected to turn positive in the last quarter of 2010.

Part II: Challenges ahead

The crisis has brought to the fore a number of challenges for the euro area economy and our common currency, the euro. Some of these challenges are new ones, but some are existing ones that were amplified by the crisis developments.

It is clear that we cannot be complacent against the background of the positive sentiment on the euro area economic outlook. We need to ambitiously and urgently address the challenges that we are facing to ensure a continued and sustainable outlook for euro area growth and price stability. For this reason we need bold reforms in Europe's economic governance, particularly with regard to fiscal and macroeconomic policy surveillance.

Consolidation of public finances...

The crisis has caused public finances to deteriorate significantly, not only in the euro area, but throughout the advanced world. This can be seen, first and foremost, from the rapid rise in government deficits and debt ratios over a short period of time. The budget gaps in the United Kingdom and the United States have actually reached double-digit figures, with Japan coming close as well.

As regards the euro area, according to the Spring 2010 projections by the European Commission, the government deficit could rise to 6.6% of GDP this year, before moderating to 6.1% in 2011.

... and its underlying factors.

These budgetary developments reflect three main factors. The first, is the operation of automatic fiscal stabilisers, i.e. the reaction to the recession built into the budgets, given the existing social security and tax systems. Second, the origins of the fiscal expansion are to be found in the stimulus packages that were a coordinated response to the European Economic Recovery Plan of December 2008 and bank recapitalisation. Their cumulative impact was roughly 2.3% of GDP in 2009–10. Third, a number of other factors show up in an expansionary fiscal stance, namely other discretionary measures, unexpected revenue shortfalls (e.g. losses of income linked to the decline in asset prices) and ongoing spending trends (e.g. in public wages), even as the trend of nominal GDP growth fell markedly.

However, against the background of rapidly deteriorating fiscal positions, many euro area countries have started to implement their consolidation plans, which is reflected in the projected decrease in fiscal deficits for the coming year by the European Commission.

Diverse developments in unit labour costs across countries.

In the years prior to the crisis, the development of competitiveness diverged significantly across euro area countries.

Relative price adjustments have thus far been relatively moderate within the euro area, if there have been any at all. In fact, unit labour costs in the period 2008–09 have generally increased in deficit countries relative to those in the euro area as a whole. Looking forward, such cost adjustment in the period 2010–11 is currently expected to be relatively limited. According to European Commission forecasts, only Ireland is expected to experience a significant improvement in its labour costs relative to those in the euro area. While the growth of labour costs is also expected to decline in all other deficit countries, it will in many cases remain close to, or even above, the corresponding rate for the euro area as a whole.

Therefore including competitiveness as an indicator for surveillance at the European level is key and already foreseen in the new EU economic governance framework.

Reform of the EU's economic governance framework...

European leaders recognize the need of a considerable strengthening of the economic model. At their meeting on 28 and 29 October 2010, the EU Heads of State and Government agreed on the reform of the European Union's economic governance. The proposals put forward by President van Rompuy represent a strengthening of the existing framework for fiscal and macroeconomic surveillance in the European Union. However, the Governing Council feels that they do not go far enough to be the quantum leap forward in the economic governance of Monetary Union that it has been calling for.¹

On the fiscal surveillance, we need an effective surveillance mechanism so that corrective policy action is taken in good time. And we need ambitious targets for the reduction of public debt towards the 60% of GDP ceiling.

On the broader surveillance of macroeconomic policies in the euro area, we need a new system of mutual surveillance in the euro area, concentrating firmly on euro area countries experiencing sustained losses of competitiveness and large current account deficits as these countries face the greatest sustainability challenges. It should be determined by transparent and effective trigger mechanisms and specify clearly the sanctions in case of breach. And we need full transparency. The assessments of macroeconomic imbalances and recommendations for corrective action should be given broad publicity at all stages of the surveillance process.

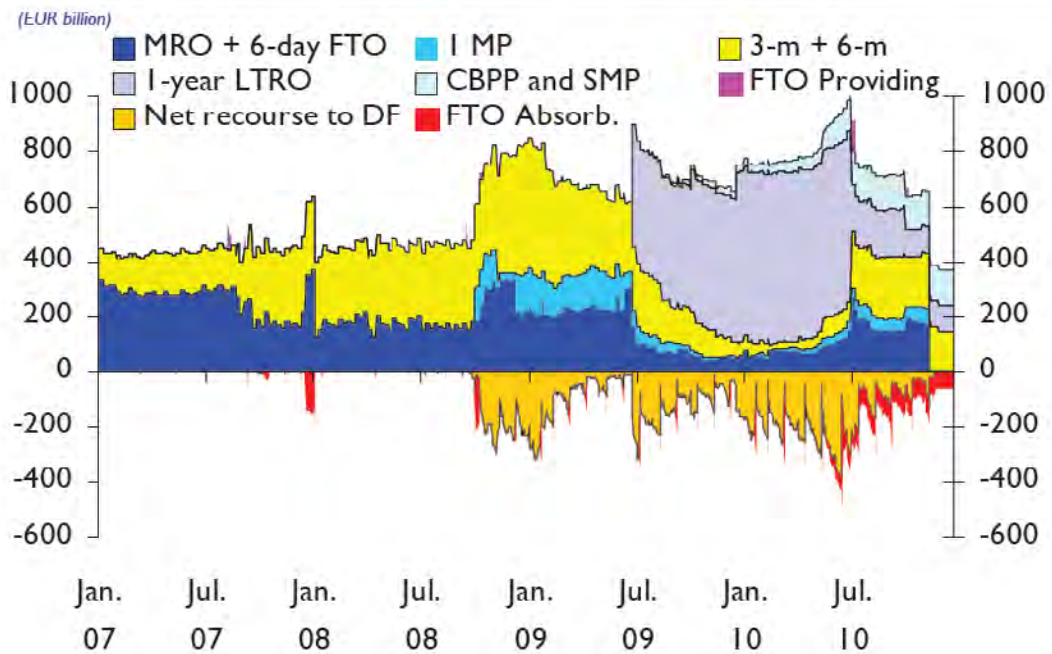
... with a special focus on financial surveillance.

And finally, the financial crisis has taught us that economic growth can be severely impacted by financial market disruptions. For this reason, European leaders agreed on a new financial supervisory architecture for the EU aiming to prevent financial disruptions of the kind that we have been experiencing in the future. This new financial supervisory architecture, which will become operational as of 1 January 2011, includes the three new European Supervisory Authorities (ESAs) for banking, insurance and securities markets to enhance micro-prudential supervision and the European Systemic Risk Board (ESRB) as the new macro-prudential supervisory body in the EU.

The ECB will provide the secretariat to the ESRB. The assignment to the ECB of specific tasks concerning the functioning of the ESRB is welcome, but does not constitute a change in the mandate or an additional objective for monetary policy. Rather, these tasks should contribute to financial stability, while being fully in line with the ECB's primary objective of maintaining price stability. There are clear lines of institutional separation between the ECB and the ESRB. In particular, both institutions are independent and have separate, clearly defined mandates, namely the maintenance of price stability in the case of the ECB and the mitigation of systemic risk in that of the ESRB.

¹ See the ECB proposals on "Reforming economic governance in the euro area", which President Trichet submitted to the van Rompuy Task Force on behalf of the Governing Council on 15 June 2010.

Reduction of central bank intermediation...



Source: ESCB.

... as money markets are improving.

(left-hand scale: EUR billion; right-hand scale: percentages)

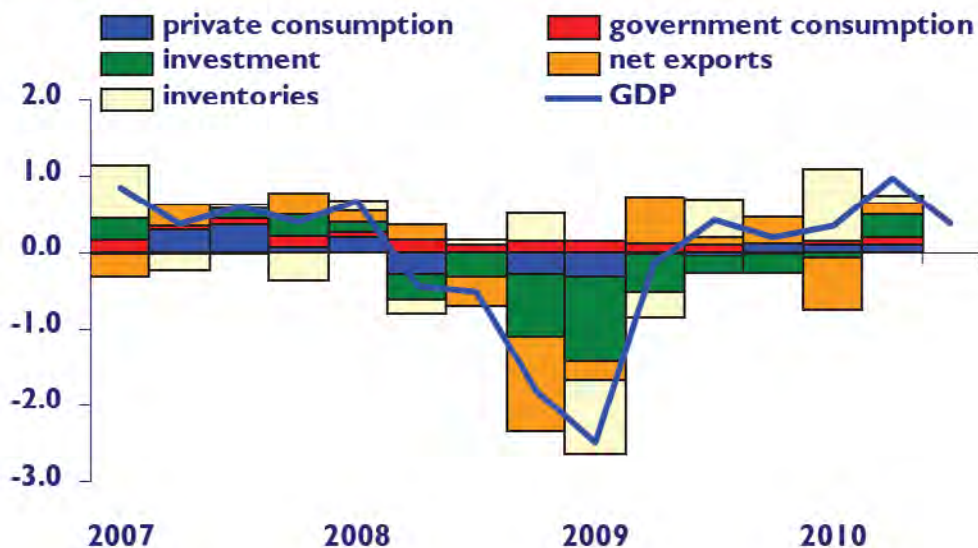


Source: Reuters

Latest observation: 16 November 2010.

Euro area activity recovered in Q2 2010...

(quarter-on-quarter growth rate and quarterly percentage point contributions; seasonally adjusted)

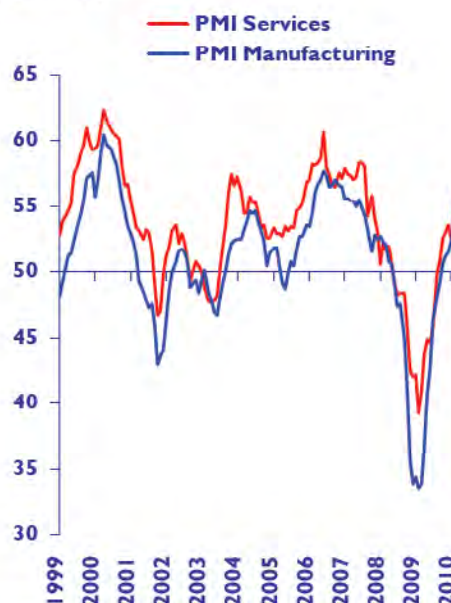


Sources: Eurostat and ECB calculations.
Latest observations: Q2 2010.

... and surveys point to ongoing growth in Q4.

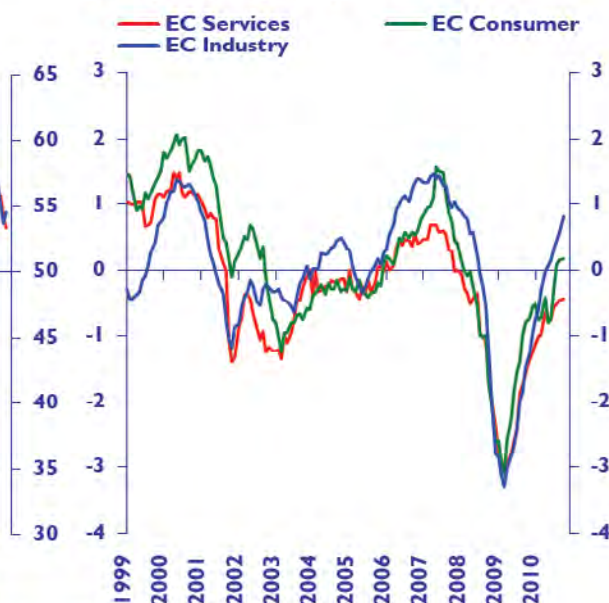
PMI surveys

(diffusion index)



EC surveys

(mean-adjusted percentage balance)

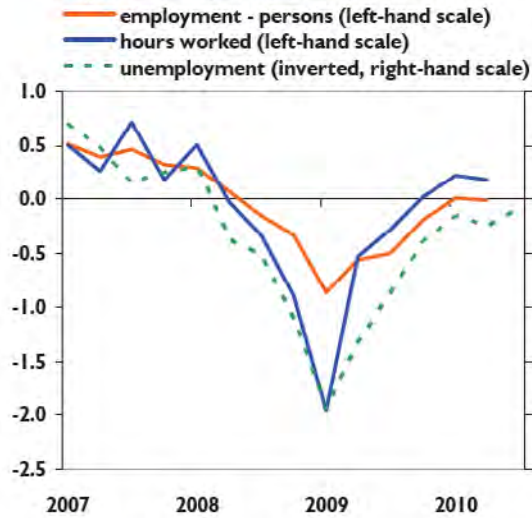


Sources: European Commission (balances adjusted from long-term averages) and Markit.
Latest observation: **October 2010.**

Good prospects for households' income from the stabilisation in the labour market...

Employment and unemployment

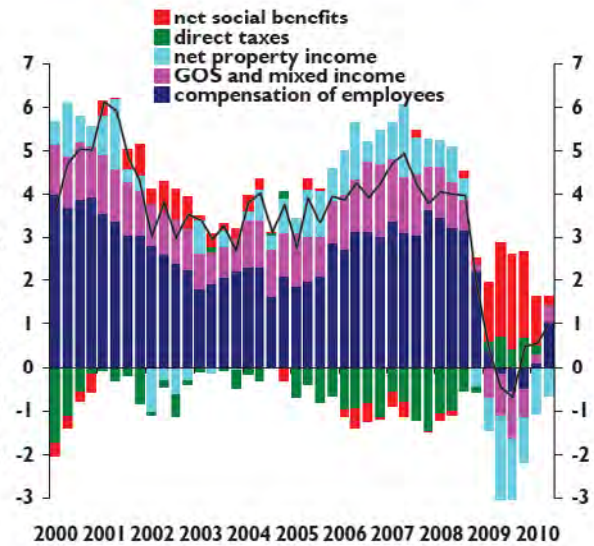
(left-hand scale: quarterly percentage changes; right-hand side: change of rate in % of active population)



Source: Eurostat.
 Latest observations: 2010Q2 for employment, 2010Q3 for unemployment.

Households' nominal gross income by source

(contribution to year-on-year growth rate; percentage point contributions)



Source: Eurostat, Euro area integrated accounts. Latest observation: 2010Q2.

... and upward trend in production and new orders.

Industrial production and new orders

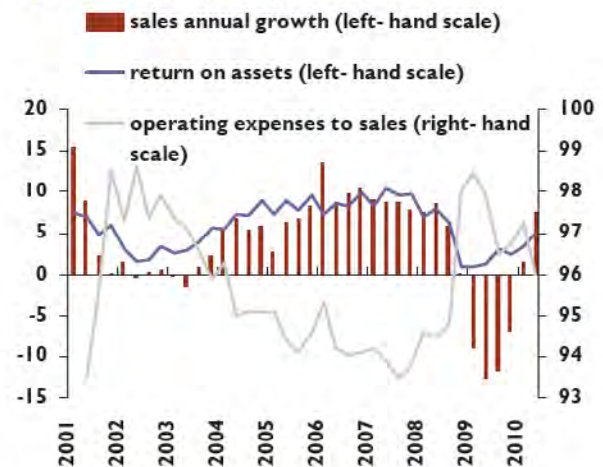
(index Q1 2006 = 100)



Sources: Eurostat and ECB staff calculations
 Latest observations: September for industrial production (excluding construction) and August for new orders (excl. ships, railway and aerospace equipment).

Sales growth, return on assets and cost/sales ratio of listed non-financial firms in the euro area

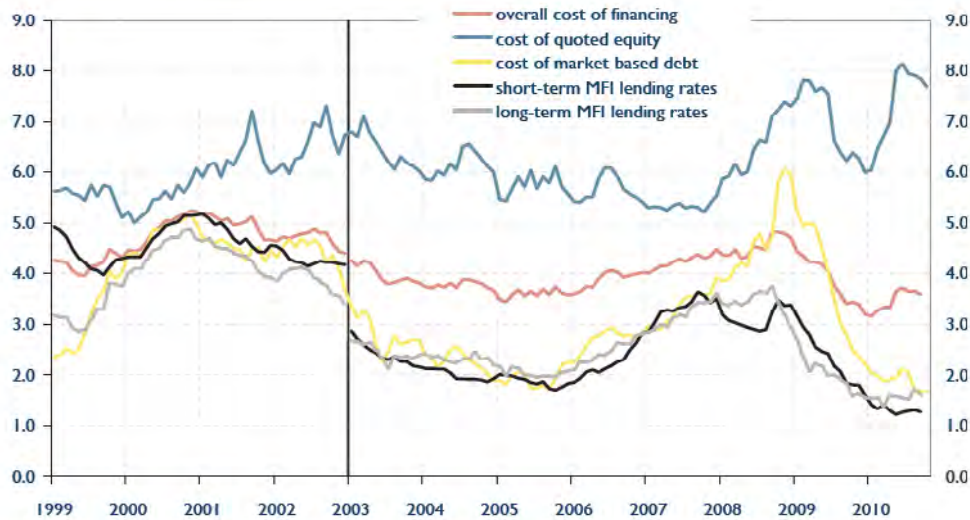
(Q1 2001 – Q2 2010; percentages; medians)



Sources: Thomson Reuters Datastream and ECB calculations

Financing conditions show signs of improvement...

Real cost of external financing (in annual percentage change)

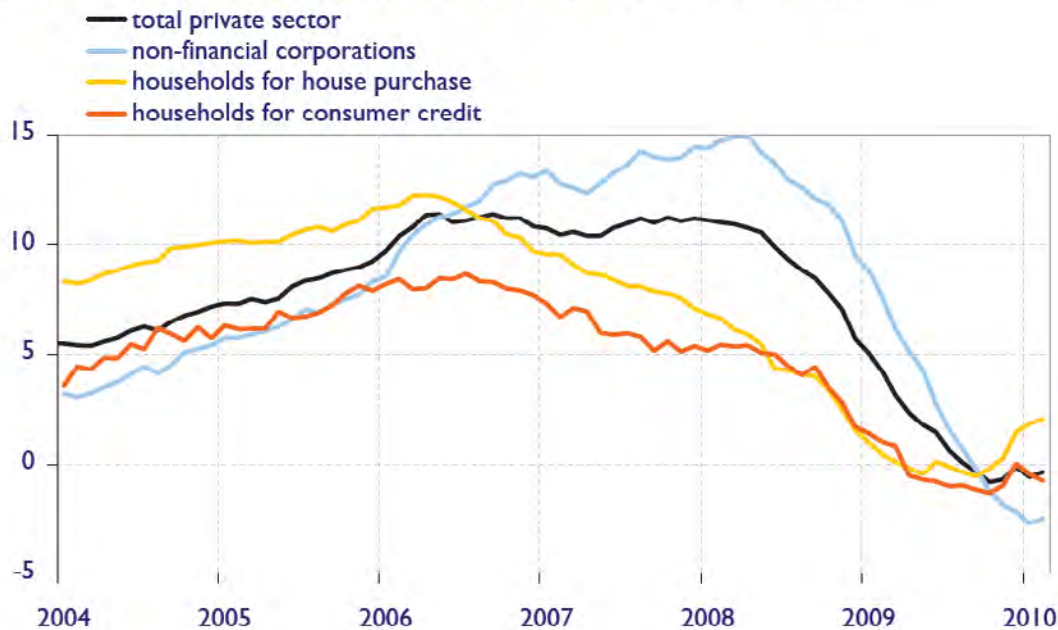


Latest observation. Sept. 2010 for bank lending rates and Oct. 2010 for cost of equity and market securities.

Sources: ECB, Thomson Financial Datastream, Merrill Lynch, Consensus Economics Forecast and ECB calculations.

...supporting the turnaround in the growth of lending to households and non-financial corporations.

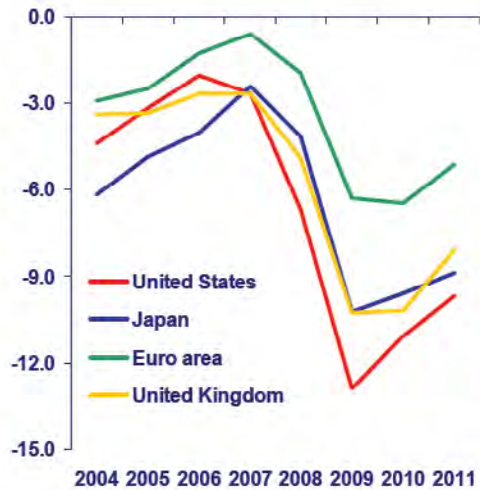
Private sector loans developments in the euro area (in annual percentage change)



Sources: ECB.

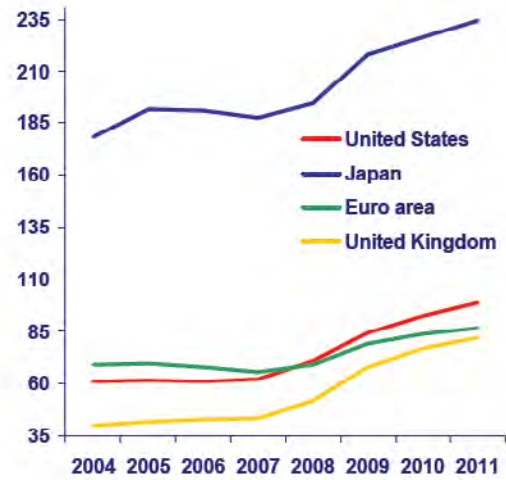
Consolidation of public finances...

Budget balance, general government
(2004-2011, percentage of GDP)



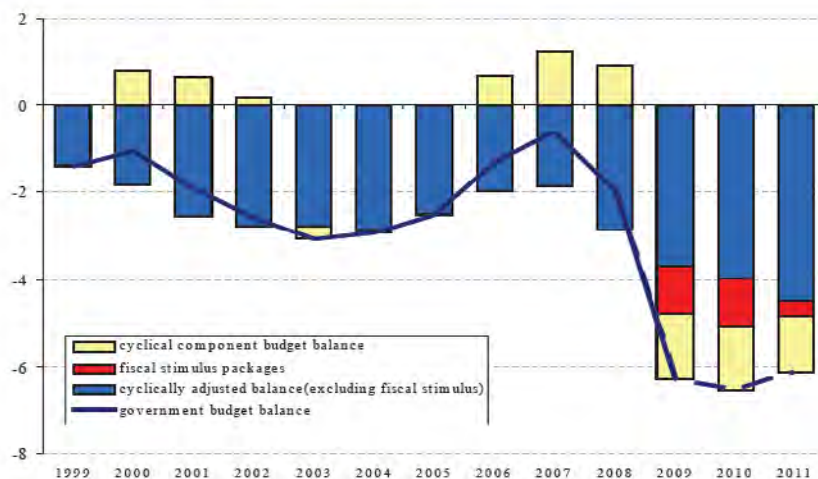
Source: IMF World Economic Outlook, October 2010

Gross debt, general government
(2004-2011, percentage of GDP)



... and its underlying factors

Government deficit (as a percentage of GDP)

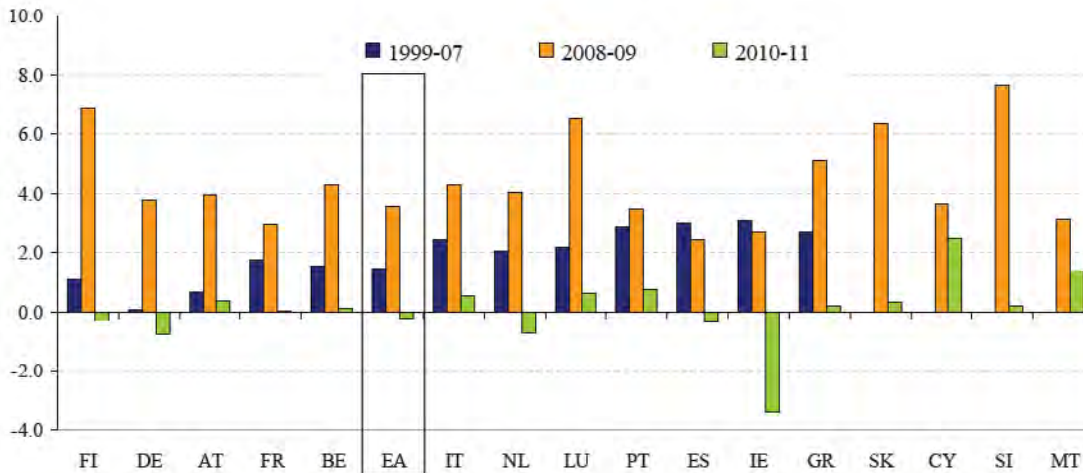


Source: European Commission Forecast (Spring 2010).

Note: for 2011 it has been assumed that a third of the fiscal stimulus packages is still in place.

Diverse developments in unit labour costs across countries.

ULC growth (annual averages)



Sources: Eurostat and European Commission. Notes: Countries are ranked in ascending order according to the average HICP increase in 1999-2007 (2001-2007 for Greece). The new euro area countries have been added at the end of the chart.

Reform of economic governance in the EU...

The European Council endorsed the report of the van Rompuy Task Force at its meeting on 28-29 October 2010.

The proposals put forward by President van Rompuy represent a strengthening of the existing framework in the European Union.

What is needed:

- Effective fiscal surveillance
- Effective macroeconomic surveillance
 - For euro area countries experiencing sustained losses of competitiveness and large current account deficits
 - Procedure should be determined by transparent and effective trigger mechanisms

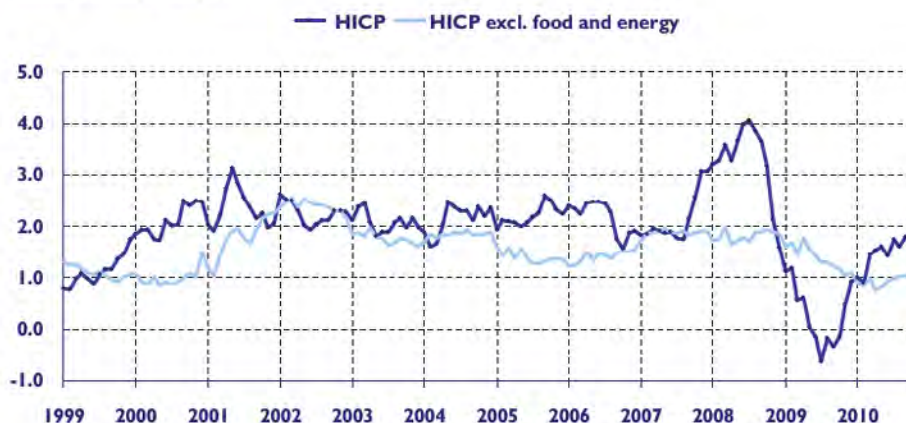
... with a special focus on financial surveillance

- **Three ESAs (banking, insurance and securities markets) will enhance micro-prudential supervision**
 - **The ESRB will be the new macro-prudential supervisory body in the EU**
 - The ECB will provide the secretariat to the ESRB
 - There are clear institutional separation lines between the ECB and the ESRB
- ➔ **both institutions are independent and have clearly defined separate mandates: price stability for the ECB and mitigating systemic risk for the ESRB**

Inflation expected to remain moderate

Headline and underlying inflation

(annual percentage changes)



Source: Eurostat. Latest observations: October 2010.

Overall HICP inflation has steadily increased since the summer of 2009, reaching 1.9% yoy in October.

HICP inflation excl. food and energy is creeping up since April 2010 and stood at 1.1% in October.

HICP inflation rates are expected to hover around current levels, before moderating again in the course of next year.

Inflation expectations over the medium to longer term continue to be firmly anchored.