Peter Praet: Economic recovery in the euro area – the role of monetary policy

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Belgian Financial Forum, University of Antwerp, Antwerp, 13 December 2013.

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Ladies and Gentlemen,

It is a great pleasure to speak to you at today's event.

I would like to use this opportunity to share my assessment of where we stand in terms of economic and monetary developments in the euro area.

I will start with the economic situation we currently face and give you my take on the future outlook, also on the basis of latest Eurosystem staff macroeconomic projections, which – as you know – play an important role in informing our economic analysis on a quarterly basis. We are moving on a trajectory of modest growth, gradually recovering from the economic downturn of the past years. Still headwinds persist and I elaborate in a minute on the most important headwinds that we currently seeing.

I will also discuss the signals coming from our monetary analysis, which assesses money and credit developments to identify risks to price stability over a medium- and long-term horizon. Here, particularly the credit side presents itself as still sluggish, thus pointing to subdued price developments in the medium term future.

Finally, I will draw together the complementary bits and pieces of our analysis to explain our current monetary policy orientation, which is characterised by two features: first, that we expect our key interest rates to remain at present or lower levels for an extended period of time; and, second, that we stand ready to adopt additional accommodative monetary policy measures, if and when necessary to safeguard price stability.

Our latest economic analysis

Let me start by briefly summarising how we see the euro area economy evolving, including an assessment of the latest Eurosystem staff projections.

The recovery continues to proceed at a modest and uneven pace across the euro area. In fact, real GDP is projected to pick up from the fourth quarter of this year onwards, and the recovery is expected to accelerate slightly by the end of next year.

In the euro area as a whole, real GDP is projected to still contract this year by 0.4%, but then to increase by 1.1% in 2014 and 1.5% in 2015.

According to our staff's projections, the sustained increase in activity would be mainly driven by a gradual recovery in domestic and external demand, with the pickup in domestic demand being supported by several factors:

First, reduced uncertainty is expected to gradually feed through to the real economy.

Second, our accommodative monetary policy stance will continue to support the recovery, by providing for: low monetary policy interest rates; extensive funding reassurance to euro area banks, inter alia, by offering liquidity via the fixed rate full allotment mode at least until mid-2015; and a lasting positive impact of forward guidance on money market conditions.

Third, the euro area economy will encounter less fiscal drag as countries have made important progress in improving their budgetary positions.

Fourth, real disposable incomes are expected to benefit from a drop in commodity prices.

And, finally, starting from 2014, the recovery is also expected to benefit from fading credit supply constraints.

Still, the key question to ask is why are we not moving faster out of the crisis?

The recovery continues to face headwinds, especially in stressed countries and a number of factors may hinder a faster recovery.

First, notwithstanding some progress in rebalancing, in many euro area countries we will still see further adjustment of private and public sector balance sheets. Don't forget in this context that past recoveries have been driven by a pick-up in housing and construction activity that then continued to feed its way through to overall economy. Now, with a lot of household wealth lost in this crisis and with the balance sheets of the private and public sectors still retrenching, this traditional source for recovery seems to be hampered and less desirable, calling for more structural and balanced growth models.

Second, and closely related, investment has been declining over the past year and will most likely only gradually pick-up, starting from levels far below pre-crisis averages. Of course, anaemic demand conditions, corporate balance sheet restructuring and high lending rates particularly for SMEs are in several countries weighing on investment.

And third, labour market conditions do not provide much comfort. Unemployment is expected to remain high and persistent. Considering also the somewhat less favourable outlook in labour intensive sectors and the growing structural component in the current unemployment figures we may see sluggish labour market conditions for some time in the future, despite decreasing labour cost conditions.

Overall, a significant amount of slack in the economy will persist until the end of the projection horizon. Moreover, the balance of risks around the projected real GDP growth outlook is to the downside in 2014 and 2015. This reflects mainly three risk factors, comprising: potentially higher oil prices, lower euro area foreign demand and additional fiscal consolidation efforts, in particular in 2015.

So what does all this imply for price developments?

In keeping with the weak economic dynamics, we continue to expect subdued inflation extending into the medium-term.

According to our staff projections, euro area HICP inflation is projected to edge slightly upwards from 0.9% in the fourth quarter of 2013 to 1.2–1.3% over the rest of the projection horizon. In yearly averages, HICP inflation is projected to reach 1.4% in 2013, 1.1% in 2014 and 1.3% in 2015.

When interpreting the subdued inflation profile, it is also important to consider its main drivers. For example, if we are merely observing a one-off decline in more volatile components of HICP inflation, this is less of a policy concern than if low inflation reflects the interplay of more durable economic factors, thus showing up also in less volatile components.

However, decomposing euro area inflation over the last two years into more or less volatile components does not yield a clear-cut picture in this regard.

On the one hand, we see that energy and food prices (both of which tend to be relatively volatile) play a major role – accounting for about 80% of the 2.1 percentage point decline in HICP inflation over that period.

On the other hand, we also observe a decline in the contributions from non-energy industrial goods and most notably services prices – both of which are more closely related to fundamental factors.

Also, low inflation can be an outcome of policy measures. A case in point is Germany, where inflation has remained relatively low, despite a robust recovery from the crisis.

But wage developments have been moderate in Germany, with compensation per employee growing by just 1.8% year on year in reflection of structural reforms that have been undertaken in the past. And, Germany compared with other euro area countries has recorded a relatively low contribution from higher indirect taxes and administrative prices to inflation.

At the euro area level, our staff sees the risks to the projected HICP inflation outlook slightly on the upside towards the end of the projection horizon. This is because upside risks from higher oil prices, a depreciation of the euro and higher indirect taxes are only partly offset by downside risks stemming from lower foreign and domestic demand.

Overall, the staff projections are in line with our assessment of subdued underlying price and cost pressures that suggest a period of prolonged low inflation.

Indeed, pipeline price pressure pressures appear low with producer prices having declined for a while, recently declining even further to –1.4% in October from –0.9% in September. Also labour cost pressures are very much contained, particularly in the presence of moderate wage growth, high unemployment and ample spare capacity.

External price pressures eased during the first three quarters of 2013, i.a. owing to sluggish global demand and declines in oil and non-oil commodity prices. The import deflator is thus estimated to have declined in year-on-year terms over this period. While it will continue to fall in the following quarters as a result of these factors, the import deflator is expected to increase slightly from mid-2014 onwards, as the downward impact of the previous appreciation of the euro fades away, as non-energy commodity prices increase and as import demand gains momentum, allowing for stronger mark-ups.

On that basis, also our recent assessment from the December Governing Council meeting is fully consistent with what we have been saying now for some time: inflation is low and we do not expect this to change for some time.

Signals from the monetary pillar

Let me now turn to the signals we have received from the monetary pillar.

In a nutshell, these signals confirm the subdued medium-term inflation outlook deriving from the economic analysis.

While monetary dynamics have been weak, essentially since the onset of the crisis, growth in broad money moderated further in recent months.

The annual growth rate of the broad monetary aggregate M3 decreased to 1.4% in October 2013 (or 1.7 % adjusting for one-off effects), which is the latest available data point, from 2.0% in September 2013. This marks a continuation in the deceleration from previous months. After M3 still grew at 2.8% in the second quarter of 2013, the third quarter recorded a significant drop in this growth rate to 2.2%.

A key driver of these recent developments in M3 is that, in the current environment, monetary assets only yield little remuneration. As a consequence, money holders are incentivised to engage in two types of substitution:

Either they hold very liquid instruments, such as overnight deposits. This shows up in still robust growth in the narrow monetary aggregate M1, which stood at 6.6% in October 2013, slightly down from 6.7% in September.

Or they diversify away from short-term deposits and marketable instruments towards better remunerated – but riskier and less liquid – instruments. To the extent these instruments are outside M3, this dampens the growth in the broader monetary aggregate.

On a positive note, we are observing some strong net inflows of capital from outside the euro area that support monetary dynamics. Since these inflows are directed at both, stressed and non-stressed euro area countries, they help mitigate financial fragmentation.

At the same time, it remains important to reinvigorate sources of money creation also from inside the euro area as the recovery takes hold.

In this context, we have to acknowledge that the provision of credit to the real economy continued to contract, even if the pace of that contraction has levelled off recently.

The annual growth rate of loans to households stood at 0.3% in October, broadly unchanged since the turn of the year.[1]

At the same time, the annual rate of change of loans to non-financial corporations was –2.9% in October, compared with –2.8% in September. But on the other for larger firms other sources of financing have been more available.

These weak loan dynamics for non-financial corporations continue to reflect primarily their lagged relationship with the business cycle, the overall heightened credit risk and the ongoing deleveraging and overall adjustment of financial and non-financial sector balance sheets, also related to past excesses.

The ECB's comprehensive balance sheet assessment, including Asset Quality Review and Stress Test, should lead to greater clarity on the state of the banking sector. Combined with appropriate resolution strategies and backstops, this will strengthen banks' balance sheets and ultimately improve the prospects for bank lending in the future.

Implications for monetary policy

How should monetary policy act in these conditions?

Assessed against our price stability objective, the subdued inflation outlook, on the back of weak economic and monetary dynamics, clearly warrants an accommodative stance.

It is against this background that we lowered rates in November. And it is against this background that we expect our key interest rates to remain at present or lower levels for an extended period of time.

Taking stock of the effects that our recent policy measures have had on economic and financial conditions, we see positive signs emerging.

The November rate cut has been followed by a pronounced and persistent easing in monetary conditions in the euro area – as manifest for instance in a downward shift in term money market interest rates and other important market interest rates.

Moreover, our forward guidance continued to effectively support our policy intentions: first, it has mitigated the sensitivity of the money market term structure to surprises from economic data releases; and second it has reduced market uncertainty about the path of future short term rates.

But notwithstanding this favourable track record of our recent policy measures, we should remain alert to any contingencies that may give rise to downside risks to price stability.

In particular, we are closely monitoring money market conditions and their potential impact on our monetary policy stance. By extending the horizon of the fixed rate full allotment mode at least until mid-2015 we have provided additional funding reassurance that will support the transmission of monetary policy signals through the banking system.

[1] The number for loans to households and non-financial corporations are adjusted for loan sales and securitisation.

At the same time, we stand ready to adopt additional measures if we were to observe developments in money market conditions that threaten to interfere with our policy intentions.

Moreover, the subdued inflation outlook provides little safety margin against further adverse shocks that may give rise to downside risks to price stability.

That safety margin is reflected in our focal point of inflation rates just below 2% in the context of our price stability. It ensures that steady state inflation provides for a sufficient buffer away from zero.

With an inflation outlook below this focal point, our reaction time for additional accommodative policy action shortens accordingly.

In this regard, the debate among observers has focused on the question, which measures the ECB were to take under these circumstances.

As explained – and demonstrated – in the past, the ECB is in a position to adopt a wide range of instruments to ensure price stability, in line with the extensive instrument independence it has been granted under the Treaties.

This allows us to tailor our policy response to the specific contingencies that the euro area may face at a given point in time.

We will continuously evaluate our policy options and we will act if the circumstances so warrant and adopt measures that are most effective in confronting the challenges at hand.

But we need to be also wary of the limitations of further measures. Let’s not forget that our monetary policy stance is already accommodative and financing conditions are favourable overall.

Indeed, we see sluggish demand for credit despite low lending rates. We see muted investment, despite firms building up cash reserves. This cannot be solved by further accommodation, but is a clear cut case for the right structural policies.

In fact, with structural economic policies directed towards more competitiveness, sustainable fiscal budgets and financial sector policies and governance that set the stage for sound banks’ balance sheet and more stable financial market conditions, economic confidence and confidence in the euro area as an economic and financial centre will return and unleash the willingness for more credit provision, more investment and domestic demand.

Conclusion

With this, let me conclude.

The euro area economy continues to recover, albeit at a slow and uneven pace. Reflecting the weak economic and monetary dynamics, underlying price pressures in the euro area are expected to remain subdued over the medium term.

The ECB’s monetary policy has successfully contributed to this outlook. Our stance is accommodative in full consistency with our prime task to maintain price stability in the euro area. This is vindicated by the consistent anchoring of inflation expectations for the euro area over the medium to long term in line with our aim of maintaining inflation rates below, but close to, 2%. Yet, there is no doubt that the outlook on inflation remains subdued and we expect only a very gradual upward movement towards inflation rates below, but close to, 2% later on.

That’s why our monetary policy will continue to provide an appropriate degree of accommodation. And just be reminded that our forward guidance to keep interest rates at present or lower levels for an extended period of time remains in place. Let me also assure you that the ECB has and always will respond to downside risks to price stability if they were to emerge going forward. Here our policy rate margin still leaves some room for manoeuvre and our operational framework provides the necessary tools to react swiftly if warranted.

But let's be clear: by ensuring price stability, the ECB is making its contribution to the economic recovery. Yet, a durable return to robust and sustainable growth requires that governments persevere in their fiscal and structural reform agenda.