Vítor Constâncio: The outlook for the global economy

Remarks by Mr Vítor Constâncio, Vice-President of the European Central Bank, at City Week, London, 9 May 2016.

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This is the full text of a speech delivered in abridged form at City Week on 9 May.

Ladies and Gentlemen,

I would like to thank the organisers for inviting me to participate in this event.

In my remarks today, I intend to outline my assessment for the euro area outlook against the backdrop of developments in the rest of the global economy. In doing so, I will discuss the prospects of the euro area's recovery as well as some of the policy initiatives which are required to make it more lasting and vigorous.

The main point that I want to make is that the shock absorption capacity of the euro area has increased. This notwithstanding, the continuation of our accommodative monetary policy needs to be supported by a determined implementation of structural reforms as well as growth friendly fiscal policies in order to strengthen and secure the recovery and with this, accelerate the return of inflation to levels below, but close to, 2%.

Prospects for the global economy: cyclical developments

In the euro area, the overall data points towards a continued moderate recovery, which is nonetheless still subject to fragilities. According to the latest EU Commission projections, euro area real GDP is expected to expand by 1.6% this year and 1.8% next year (figures stood at 1.4% for 2016 and 1.7% for 2017, according to the March 2016 ECB staff macroeconomic projections). That said, the euro area's emergence from the financial crisis has been protracted, particularly when seen from an historical perspective. It was only in the first quarter of this year that it surpassed its pre-crisis peak level of output. In this quarter, the euro area had a higher growth rate than the U.S. or the U.K., which creates a positive dynamics for this year's overall growth, exceeding recent forecasts.

This recovery needs to be seen in a context where legacies from the crisis continue to dampen growth, and the contribution of external demand to the recovery is less assured. The latter reflects a 5-year string of weakening growth in Emerging Market Economies (EMEs) as well as less favourable than expected out-turns at the turn of this year, at a global level.

While domestic demand in the euro area is rising, it still shows a weakness that relates in part to the fact that the euro area is coming out of a balance sheet recession, where economic activity is constrained by the need for governments, firms and households to deleverage. For instance, the ratio of euro area investment to GDP is still more than 3 percentage points below its pre-crisis peak level. This phenomenon of economic growth remaining weak in the aftermath of banking crises has been well documented.

Moreover, the repercussions of the crisis have also weakened the recovery in all major economies – albeit in different ways and in varying degrees – and with this, the demand for euro area exports. Indeed, the only positive contribution to euro area real GDP growth in 2015 came from domestic demand, which in itself highlights how important our monetary policy measures have been in supporting the recovery of key euro area spending components.[1] Monetary policy has been practically the only expansionary macro policy in the euro area, the recovery would have been much weaker without it.

Concerns over the weakness in the global economy generated apprehension in financial markets earlier in the year, but have receded somewhat since then. This is evidenced by the subsidence of financial markets turbulence, as stock markets recouped their losses and commodity prices rebounded. This has also helped to ease financial conditions in many emerging market economies, where capital flows have returned amid an improved global risk appetite. Also, oil prices have recovered to a degree, which reflects a moderation in the global oil supply overhang as well as better than expected global oil demand largely stemming from India and other non-OECD Asian countries. Uncertainties, however, remain and further bouts of volatility cannot be precluded.

In terms of economic activity in major economies, following rather weak readings at the start of the year, both the services and manufacturing sectors are showing signs of a modest pick-up, which is expected to continue. This improvement is broad based with the main exception being Japan. Global trade has also showed resilience early this year, although remaining still relatively weak when seen from an historical perspective.

More specifically, in the U.S., following a moderate expansion of real GDP by an annualised rate of 1.4% in the fourth quarter of 2015, economic activity showed signs of further deceleration in the first quarter of this year, in particular business equipment spending and real consumption growth have remained moderate. However, the strengthening of the labour market in combination with household balance sheets being largely repaired, are expected to support real income and consumption looking ahead. In my view, the degree to which the U.S. economy continues on this path of solid employment creation as well as the normalisation of its monetary policy, will be key in determining how global economic developments unfold in the period ahead.

Equally important for the shaping of the global economic outlook are developments in China. The Chinese economy has been experiencing a gradual transition to a new growth model. In this context, growth is undergoing a gradual slowdown which is in line with the new growth target range, yet it continues to be underpinned by policy support as well as by a rapid credit expansion. The greater stability in financial markets and the Renminbi exchange rate have helped in alleviating some of the uncertainty, which was particularly high at the start of the year. Across other emerging markets, growth momentum remains relatively weak and heterogeneous. Activity has by and large remained resilient in commodity-importing countries and very weak in commodity exporting countries, particularly Russia and Brazil.

In sum, while I expect the recovery in the global economy to gather momentum as the headwinds eventually dissipate, there are many factors which could potentially derail it. And from the euro area's perspective, I expect support from external demand to be considerably lower in the future when compared to the pre-crisis years, even if none of the downside risks materialise.

Longer-term growth trends

These cyclical developments have been accompanied by unfavourable long-term global trends affecting economies' growth potential. Indeed, there is a growing chorus among

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[1] ECB staff estimates suggest that, had there been no asset purchase programme (including the recalibration of December 2015 but not including the March 2016 package as it is currently assessed by staff in the context of the projection exercise that will become available in June), inflation would have been negative in 2015. ECB assessments also suggest that the asset purchase programme (including the recalibration of December 2015, but not including the March 2016 package as it is currently assessed by staff in the context of the projection exercise that will become available in June) will contribute to raising the GDP of the euro area by around 1.6% in the period 2015–18.

commentators and academics postulating that even when all the impediments from the crisis are surmounted, there may be unrelated secular forces at play which have shifted down long-term growth rates.[2] Two of these contributing factors relate to declining productivity and weak demographics. In relation to the former, Robert Gordon (2016) argues that the slowdown in the pace of innovation of the so-called general-purpose technologies, which are those with a broad-based impact on living standards and business practices, is the cause of the reduction of total productivity growth in the U.S. and most advanced economies. While for the latter, Charles Goodhart and co-authors (2015) emphasise the fact that the positive global labour supply shocks recorded in past decades are fading out, implying that another crucial source of growth is drying-up.

In the event that a permanently lower potential growth rate materialises, this would have considerable ramifications.[3] First, if firms and households believe that future growth will be lower, they may refrain from undertaking consumption and investment in the present and thereby, reduce economic potential further. Additionally, it makes surmounting the large debt overhang which prevails in the global economy more arduous. There would also very likely be societal implications, as lower economic growth would not be able to create enough jobs for citizens and may exacerbate income inequality.

But it would also have significant implications for the conduct of monetary policy. For example, a lower potential growth rate reduces the equilibrium interest rate, that is, the interest rate where resources are fully employed in the economy and inflation is stable. Monetary policy strives to engineer its policy rate as close as possible to the equilibrium rate in order to steer output back towards its potential and thereby, close the output gap and keep inflation at the central bank's desired level. However, as the equilibrium rate falls, the central bank faces challenges coming from the lower bound on nominal interest rates as it attempts to reduce its policy rates to a low enough level. In addition, it may be forced to keep rates at low levels for long in order to provide the required stimulus to the economy.

Addressing this situation requires a combination of both supply and demand side policies. Supply side measures are required to increase potential growth, and consequently the equilibrium real interest rate. Monetary and fiscal policies can stimulate demand, which helps speed up the closing of the output gap while at the same time, boosting potential growth by facilitating investment. In addition, by mitigating a prolongation of the recession, monetary policy can help prevent hysteresis from gaining a foothold in the labour market, which in itself weighs on an economy's economic potential.

Policy measures adopted by the ECB

The ECB's monetary measures since the summer of 2014 have been geared at easing overall financial conditions while at the same time restoring specific market segments and the bank lending channel. The latter is a particularly important channel for transmitting monetary impulses to euro area firms and households. In doing so, this has greatly reduced the cost of capital for firms, which is a key determinant underpinning the investment decisions of firms. By reducing the real cost of capital, the hurdle for generating a positive net return on investments declines and consequently, this spurs economic growth and subsequent investment with a virtuous circle emerging. Indeed, increasing investment in the euro area will be crucial in terms of absorbing the considerable amount of economic slack and reducing unemployment.

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2 See speech by V. Constâncio (2016) "*International headwinds and the effectiveness of Monetary Policy*", at the 5th Annual Hyman P. Minsky Conference on the State of the U.S. and World Economies at the Levy Economics Institute of Bard College, Blithewood, Annandale-on-Hudson, New York, 13 April 2016.

3 See speech by P. Praet (2015) "*Lifting potential growth in the euro area*", at the Welt-Währungskonferenz, Berlin, 23 April 2015.

Eliminating the negative output gap is an important way to normalize inflation towards our medium-term objective. This year, we will continue to have the effect of low commodity prices and so our staff projections point to an average inflation of 0.1%, with several months still in negative territory. However, since the last quarter of this year, statistical base effects related with the new level of oil prices are expected to start to increase inflation, as reflected in the forecast of 1.4% growth, just published by the EU Commission. On the other hand, the ECB will continue to do what is necessary to achieve its goal of reaching a level of inflation close to 2% and enough policy tools can still be used. Our monetary policy has been effective. We have to allow some time for the package of measures adopted in March to produce its effects, while closely monitoring external developments.

Conclusions

Let me conclude. Besides the ECB's determination to pursue its expansionary policies, other actors need to do their part in order to deliver a sustainable recovery and boost the productive capacity of countries. And, as I see it, there are, in particular, three policies which are ripe for action. First, the introduction of measures to increase productivity, such as improving the business environment and providing adequate public infrastructure. Second, the implementation of growth friendly fiscal policies, while adhering to the fiscal rules of the European Union. And finally, the completion of the banking and capital markets union, which would greatly strengthen the euro area's capacity to withstand future shocks. Combined, this would make the euro area fit to deliver a more prosperous future for its citizens.

Thank you for your attention.

References

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