Peter Praet: The macroeconomic situation and monetary policy in the euro area

Introductory remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the MNI Connect Roundtable and OMFIF lunch discussion, London, 23 February 2017.

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Today I will discuss the current economic situation in the euro area, the outlook and the implications for monetary policy.

As a central bank with a clear price stability mandate, we need to ultimately judge economic developments with regard to their implications for price stability. Inflation has fallen short of the ECB's medium-term inflation goal of below, but close to, 2% since the beginning of 2013. But recently, with the fading of the declines in energy prices that restrained inflation, headline inflation has moved up quite sharply. In the near future, we will have to assess how the forces that are driving prices today can influence the outlook for price stability in the medium term and help durably stabilise inflation around our goal.

The economic recovery will help support domestic price pressures. Indeed, the upswing is continuing at a moderate, but firming pace, and is broadening gradually across sectors and countries. Real GDP growth has expanded for 15 consecutive quarters, growing by 0.4% during the final quarter of 2016 in the euro area according to the Eurostat flash estimate. Economic sentiment is at its highest level in nearly six years and unemployment is back to single-digit figures. Looking beyond the euro area, the global economy, too, is showing increasing signs of a cyclical upturn.

The euro area economy has been resilient in the face of a number of risks and uncertainties at global level. One example of its improving resilience is the fact that domestic demand is now the mainstay of real GDP growth. Previously, growth in the euro area was closely correlated with the strength of international trade, but that relationship has weakened recently; last year's growth would not have been possible in view of the lacklustre international conditions.

Our monetary policy measures have been a key contributor to these positive developments in the euro area economy. The comprehensive set of measures introduced since June 2014 has worked its way through the financial system, leading to a significant easing of financing conditions for consumers and firms. Together with improving financial and non-financial sector balance sheets, this has strengthened credit dynamics and supported domestic demand.

Since June of that year, bank lending rates for both euro area households and non-financial corporations have fallen by over 110 basis points. Lending rates for small and medium-sized enterprises, which provide two-thirds of total private sector employment in the euro area, have declined by over 180 basis points.

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent surveys have shown.[1] These positive developments have been supported by the second series of targeted longer-term refinancing operations, as a result of which banks are passing on the favourable funding conditions to their customers. Moreover, these improvements are not limited to interest rates: bank lending volumes have also been gradually recovering since early 2014. Market-based funding conditions, too, have improved significantly in response to the corporate sector purchase programme launched in June 2016.

We expect the euro area economy to recover further. Private consumption growth and the continued cyclical recovery of business investment are expected to support domestic demand. Underpinning consumption are the improvements in labour market conditions, with unemployment steadily falling despite a rise in participation. These developments increase households' real disposable income, which boosts the spending of established employees, who are confident about their earnings prospects, as well as new employees. Business investment is also expected to continue recovering amid support from better corporate profitability.

As for price developments, after hovering at levels well below 1% for three years, with occasional dips into negative territory, euro area headline inflation edged higher towards the end of last year and reached 1.8% in January. This upward movement of inflation mainly reflects increases in energy and food prices. By contrast, underlying inflation – which relates more to domestic price pressures – continues to remain very subdued and has yet to show clear signs of a more dynamic upward movement. For example, the annual rate of HICP inflation excluding food and energy has mostly remained below 1% since late 2013.

So why is underlying inflation still slow to pick up? And will further monetary accommodation really facilitate a durable return of inflation back to a level that is below, but close to, 2% over the medium term? To answer these questions we need to acknowledge that monetary policy controls medium-term inflation through two main channels: by influencing cyclical conditions and by pinning down expectations.

As you see, I have omitted from my list the sort of "structural factors" that have figured prominently in the recent debate on secular stagnation and have been invoked – in that context – as an explanation for low inflation. This is not to say, however, that forces that are structural in nature and unrelated to monetary policy cannot influence the inflation trajectory for what might be a protracted period of time. For example, a supply shock that reduces firms' pricing power by either weakening barriers to entry or by increasing price transparency can result in a mark-up squeeze for firms, triggering a drawn-out process of disinflation that can last for years. But once firms have adjusted to the new competitive landscape and their selling prices stabilise around a lower equilibrium level, the mark-up squeeze will cease to drive aggregate inflation down. Inflation – once more – will start fluctuating around the level that the central bank chooses for the medium term. The traditional Phillips curve connection between current inflation, expectations of future inflation and the cycle will re-assert itself.

Eurosystem staff analysis confirms that the Phillips curve remains alive and well in the euro area. Today, that empirical regularity says that, while being on a gradual reabsorption path, some remaining slack continues to restrain underlying inflation in the euro area.[2] By ensuring accommodative financing conditions, monetary policy supports domestic demand, which creates the environment necessary for the mobilisation of idle resources to bring output back to its potential level. This will lead to a build-up of price pressures and ultimately pull inflation up.

Monetary policy also plays a pivotal role in anchoring inflation expectations, which are an important explanatory factor of actual inflation. After all, inflation expectations determine the intercept of the Phillips curve.

Under normal conditions, longer-term inflation expectations should remain unaffected by transitory shocks that typically dissipate over the medium term, such as those related to oil prices. However, recurrent shocks that lead to either a prolonged period of above- or below-target inflation can be misinterpreted as a lasting change in underlying inflation. In my earlier example, if the central bank tolerates a prolonged period of declining mark-ups, and headline inflation is weaker than the central bank's target, then the Phillips curve in all likelihood will re-anchor around a lower medium-term inflation level. In the worst scenario, self-reinforcing spirals may result, as firms and households start to extrapolate from past inflation outcomes. Their expectations become self-fulfilling through adaptive wage- and price-setting behaviour.

Today, an important element keeping underlying price pressures subdued is muted wage dynamics, which are shaped by many factors. At this stage, there is still a significant degree of labour market slack and weak productivity developments that keep a lid on wage growth.

Furthermore, the process of setting wages is to some extent backward-looking in a number of euro area countries, reflecting formal and informal indexation mechanisms.[3] Additionally, the timing of wage negotiations plays a role. Wage negotiations often have a multi-year horizon; given that headline inflation remained below 1% for 38 consecutive months until December of last year, it is going to take some time for an increase in headline inflation to translate into second-round effects on broader inflation. Moreover, weak wage growth could also reflect previous downward wage rigidities: difficulties in reducing wages during the crisis may result in a slower upward adjustment of wages as labour market conditions improve.[4]

Just as our monetary policy measures have effectively underpinned the economic recovery, they have also prevented the prolonged period of disinflationary pressures from turning into a sustained period of deflation. In fact, the accommodative monetary policy stance appears to be increasingly visible in developments in inflation expectations, which are showing signs of reversal from previous flat or negative trends, while also reflecting changes in the global environment. For example, market-based measures of euro area inflation expectations have been trending upwards since early September, while survey-based measures of inflation expectations continue to signal an increase of inflation.

So while we are certainly seeing a firming, broadening and more resilient economic recovery that will in time translate into a durable increase in inflation, we cannot ignore the fact that one of the main forces behind the upward inflation trajectory that we expect to see over the medium term is monetary policy itself. The economic recovery and the outlook for price stability are still predicated on the very favourable financing conditions that to a large extent depend on continued monetary policy support.

Therefore, we need to look through the volatility in short-term data resulting from transitory factors in order to assess whether progress towards a durable and self-sustaining convergence in the path of inflation has been sufficient.

With this aim in mind, the Governing Council reaffirmed at its last meeting that the asset purchase programme will continue until the end of December 2017, or beyond, if necessary, and in any case until we are sufficiently confident that inflation converges towards levels below, but close to, 2% over the medium term and that this process will not reverse under less supportive monetary policy conditions.

Of course, monetary policy cannot be the only game in town: other policymakers must display the same commitment to ensuring a sustainable economic recovery. Structural reforms can play a key role in turning the cyclical recovery into a structural recovery and the current low interest rate environment makes it politically and economically easier to implement them. Such reforms, if carried out now, will help to promote favourable economic conditions down the road.

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[1] See ECB Bank Lending Survey, January 2017, and ECB Survey on the Access to Finance of Enterprises in the euro area, April 2016 to September 2016.

[2] For more detailed discussion of the Phillips curve and low inflation in the euro area economy, see Praet, P. "Maintaining price stability in the euro area", remarks at the 15th Handelsblatt Jahrestagung "Zukunftstrategien für Sparkassen und Landesbanken", Berlin, 2 February 2017.

[3] For further discussion, see "Recent wage trends in the euro area", Box 2, ECB Economic Bulletin 2016/03.

[4] See, for example, "Wage dynamics amid high euro-area unemployment", Deutsche Bundesbank Monthly Report, December 2016.