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The European economy and monetary policy

Inauguration of La Granda courses

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Mr Chairman of the La Granda courses, Mr Rector of the University of Oviedo, Mr Mayor of Gozón, Mr Secretary of the La Granda Courses, Authorities, dear colleagues:

Let me begin by thanking Professor Velarde for his invitation to me to participate in the inauguration of the thirty-ninth edition of the now-classic La Granda courses.

But first I should like to congratulate Professor Velarde on the Menéndez Pelayo International Prize he has recently received and which is just one in a long list of accolades. Juan Velarde is much more than an eminent academic. He is a true humanist whose work, anchored in different areas of the economy, has always included historical and social concerns where his deep-seated and – I would say – benign liberalism prevails. Professor, my warmest congratulations on your Menéndez Pelayo prize.

The European economic recovery

Moving on to the subject of my address today, I should like to share with you some thoughts on the euro area economy and monetary policy. I shall begin by reviewing the key features of the current expansionary phase in the European economies and the fundamental role that monetary policy has played in providing for its take-off. I shall then refer to the main challenges over the course of these difficult years for the European economy and to the need to complete the institutional architecture of the monetary union.

After several years' moderate growth, the euro area has arrived at a favourable cyclical juncture. On the latest available figures, annual output growth is currently running at almost 2%. This rate exceeds the European Commission's estimates of potential growth, which stand at around 1%.

The soundness of the economic recovery is beginning to be reflected in the more dynamic behaviour of private investment. That breaks with a long period over which companies' plans to increase capital were checked by uncertainty over future growth and the need to reduce their high levels of debt.

Moreover, the recovery is extensive to the entire euro area, since all countries, including Greece, have attained positive growth rates.

The improvement in economic activity has also enabled unemployment levels to be reduced to rates close to 9%, down from the levels of 13% observed at the worst points of the crisis.

Significantly, this improvement in activity has come about against a difficult political background, marked by the start of the Brexit process and the rise in certain trends that are against free trade and the free circulation of people, freedoms that are the bedrock of the European project, and this without forgetting the permanent threat of terrorism.

Returning to the positive economic developments, we should not forget two central matters.

Firstly, these developments are largely the consequence of the extraordinary stimulus received from monetary policy. Secondly, monetary union still has a long way to go to achieve sounder governance that will reduce the union's vulnerability to shocks, provide for better coordination of its economic policies and promote the reforms needed to encourage and to be able to sustain long-term growth.

The role of monetary policy

I shall first address the role that monetary policy has played and is continuing to play in the recovery.

The confluence of the financial and sovereign crises in a European monetary union whose institutional architecture was incomplete meant that the ECB had to assume a pivotal role in the economic policy response.

Initial measures took the form of a gradual reduction in interest rates and the granting of practically unlimited amounts of liquidity to banking systems, at increasingly longer maturities, with greater flexibility in the attendant collateral policies.

In 2012, amid a second recession in the euro area and financial turmoil, the possibility of purchasing the public debt of countries subject to financial pressures was introduced. While this possibility was not actually activated, it contributed to staving off the threat of the single currency breaking up.

Yet by mid-2014, and despite the fact that the most acute episodes of the crisis had been overcome, the euro area was immersed in a scenario of low growth and deflation risks in which various external and internal factors were at play.

On the external front, the weakness of global growth and the collapse of commodities prices accentuated the downside pressures of producer prices.

In the euro area economies, the high unemployment levels and the need to reduce significant debt ratios curbed the expansion of demand, while the fragility of banking systems hampered the transmission of monetary policy measures to the real economy.

These factors obliged the ECB to take a different tack and turn to so-called non-conventional measures.

Firstly, the interest rates on ordinary monetary policy operations were successively cut, placing the deposit facility rate at a negative level of -0.4%, which currently remains in place.

Secondly, the ECB introduced a new long-term financing facility for the banking system, which was linked to the granting of loans to households and firms.

Thirdly, in 2015, the ECB took the historic step of launching a quantitative easing programme by means of the large-scale purchase of public and private assets. Currently, purchases are being made at a monthly pace of €60 billion, and this is expected to continue at least until next December, whereby at the end of the current year the scale of asset purchases will be drawing close to 22% of euro area GDP.

Lastly, communication has become a most important instrument for influencing agents' expectations and heightening the effectiveness of measures. Specifically, the ECB has incorporated forward guidance on interest rates and the purchase programme into its communication.

To offer an overall view of the scale of the measures adopted by the ECB, the size of the Eurosystem's balance sheet has more than tripled since the crisis broke in 2008, up to figures close to 40% of GDP. The scale of its balance sheet currently exceeds that of the Federal Reserve and the Bank of England, although it is far below the size of the Bank of Japan's balance sheet, namely 90% of GDP.

This extensive range of measures has been effective in easing financial conditions, in reducing financial fragmentation, i.e. the existence of greatly differing financing conditions in different jurisdictions for borrowers presenting similar risks, and in preventing the period of negative inflation rates that the European economies experienced from turning into a deflationary spiral.

Our estimates indicate that the package of monetary policy measures adopted since mid-2014 will have had a cumulative effect in the 2015-2017 period, for the euro area as a whole, of 1.7 pp on the level of GDP and of 1.5 pp on the level of prices. According to these calculations, the monetary policy measures may be viewed as responsible for around 50% of the nominal GDP growth recorded in this period.

In sum, for the first time in the 10 years that have elapsed since the international financial crisis broke, we may declare the current cyclical juncture of the euro area to be sound and that we have left the risks of deflation behind.

Prices and wages in the international economy

But there are still areas of risk in the international context, associated mainly with the uncertainty over the course of US economic policy, with the imbalances building up in the Chinese economy and with the unfavourable data emanating from the United Kingdom, which is apparently beginning to feel the effects of its exit from the EU. In the euro area the solvency and profitability of the banking sector must be improved and the level of NPLs lowered, as they weaken the impact of the monetary impulses on productive activity.

Furthermore, there are still no firm signs that inflation has moved onto a rising trajectory drawing it permanently closer to our objective of 2%. This can be seen in the measures of core inflation, which strip out the more volatile components of prices and which are sound indicators of the latent inflationary pressures in the economy. These measures of inflation have remained anchored around 1% over the last three years.

Behind this inflationary behaviour are, among other factors, highly contained wage growth in the euro area as a whole – and I insist, the euro area in its entirety – that contrasts with the improvement in employment. Compensation per employee has sustained increases of close to 1.2% since mid-2014, far below its historical average which is at slightly over 2%.

This fact has attracted the attention of analysts, who point to the confluence of various factors to explain why the response by wages to the fall in unemployment is not following the usual patterns.

First, it is pointed out that the number of workers who are employed part-time, involuntarily, increased notably after the crisis and has scarcely fallen with the improvement in economic activity.

In parallel, there has also been an increase in the weight of some groups that are not included in the habitual definition of unemployment, such as economically inactive individuals whose reason for not seeking a job is because they believe they will not find one; or who do not seek a job for whatsoever reason, but are available and wish to find a job; or who, although they are seeking employment, are not available to immediately take up a new job.

The measure of the unemployment rate that were to include these groups would, for the euro area as a whole, stand at around 18% of the labour force, practically double the habitually estimated rate. In terms of their influence on wage bargaining, these workers could exert downward pressure on wages.

Additionally, the excess supply of unskilled labour, which in some cases is amplified by immigrant inflows, may also reduce upward pressure on wages; and, moreover, there is some evidence of changes in wage-setting mechanisms which, against a background of low growth in prices, would be setting greater store by past or actual inflation, as opposed to expected inflation.

True, this situation also arises in other developed economies that are ahead in the cycle, as is the case of the United States, where the latest inflation figures have been surprisingly on the downside and wage pressures are also low. But in the euro area an added difficulty is the absence of mechanisms that provide for the support of other economic policies to monetary policy. And on this point we must look at fiscal policy.

Fiscal policy in the EU

In the case of fiscal policy, it is true that despite the improvement recorded in the euro area in recent years, the high levels of public debt leave little leeway in various countries to pursue an expansionary policy. These economies, Spain among them, should see through the process of fiscal consolidation, harnessing the room for manoeuvre that may result from changes in the composition of taxes towards figures more conducive to growth and a greater gearing of public spending towards investment, education and innovation.

But nor are there mechanisms in the European framework to encourage economies that have a favourable budgetary situation and fiscal space to use them if the circumstances of the area as a whole so require.

Euro area-wide fiscal policy is, at present, the result of the sum of national policies. When designing policy conduct, there are no mechanisms conducive to countries internalising the benefits of achieving a suitable economic policy mix for the area as a whole; and this especially at a time, such as the present, when the existence of a very accommodative monetary policy means that both the national effects and the impact on other countries associated with a specific fiscal impulse are greater.

Against this backdrop, and as highlighted in the recent discussion paper on the deepening of EMU published by the European Commission, it would be necessary in the medium term to develop a fiscal capacity for the euro area as a whole that contributed to supporting monetary policy.

The estimates detailed in this year's Annual Report of the Banco de España suggest that a study could be conducted of a common fiscal instrument, managed at the supranational level, but which does not entail permanent transfers between countries and which, without committing a high volume of funds (around 1% of GDP), provides the euro area with a fiscal stabilisation capacity similar to that other federal states have.

It also appears necessary to seize the opportunity afforded by the favourable economic juncture and the overcoming of some of the political risks to complete the reform of European governance, along the lines considered by the Five Presidents' Report published in 2015 and the recent discussion paper by the European Commission.

Likewise, further headway would be needed in reducing sovereign-banking links, which contributed notably, as is known, to heightening the severity of the crisis in the euro area.

In this connection, the banking union requires supranational support that would increase the financial capacity of the Single Resolution Fund in the event of a systemic crisis and which would afford it greater power during the transition process established for its full constitution. The European Commission's proposal that the European Stability Mechanism should provide this support might be an appropriate solution.

It is also necessary to create a common deposit guarantee scheme whereby depositors' confidence in banks is irrespective of the health of their Public Treasuries.

Progress on the set of initiatives encompassing the Capital Markets Union would also contribute to achieving greater financial integration, diversifying sources of financing and empowering to a greater extent private mechanisms geared to sharing the risks that originate through these markets.

Conclusions

In any event, it should be stressed that, although the recovery is providing for the correction of some imbalances, some fallout from the crisis remains at large.

The high levels of unemployment and of public and private debt, low productivity growth and the weakness of the capitalisation process pose challenges that require greater reform-minded ambition. Along with the initiatives being developed to modernise and harmonise insolvency procedures and to tackle the vulnerability arising from the scale of the non-performing loans still on bank balance sheets, the euro area economies must reinstate a reform agenda geared to enhancing productivity and to improving both the flexibility of product and factor markets and the business environment.

Over recent years the monetary union and the European integration project have overcome the difficulties that called into question its existence. At present, there is some consensus on how to proceed in order to strengthen the project and to enable the ensuing benefits to be clearly perceived by all European citizens. European governments and institutions have a clear responsibility to heed the lessons learnt and to provide the appropriate economic policy responses.

Thank you for your attention.