Peter Praet: Monetary policy and the euro area economic expansion

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the JP Morgan Seminar entitled "Euro Zone: Will the European Recovery Continue?", Washington DC, 12 October 2017.

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Accompanying slides

The monetary policy measures introduced by the ECB since June 2014 have played a pivotal role in supporting the economy and have proven to be effective in preventing a period of disinflation from degenerating into one of outright deflation. More than three years on, the risks of deflation have largely disappeared and the transmission of our policy measures to the real economy is clearly evidenced by a broad-based cyclical recovery with solid momentum. This lays the groundwork for a return of inflation to below, but close to, 2% over the medium term. The strong economic expansion should not lead to complacency, however. Strengthening euro area longer-term growth potential and reducing vulnerabilities requires decisive contributions from other policy areas. Implementing growth-enhancing structural reforms and strengthening the institutional architecture of Economic and Monetary Union are essential to support the resilience of the euro area on a lasting basis.

Before turning to price dynamics and monetary policy, let me say a bit more about the latest economic developments.

Real GDP in the euro area has expanded for 17 consecutive quarters, growing by 2.3% year on year during the second quarter of 2017, according to Eurostat – a rate that surpassed our projection at the start of the year. This compares with the latest potential growth estimates for the euro area of just over 1%.[1] The latest survey data point to a strong third quarter. The composite output Purchasing Managers' Index – which is highly correlated with growth in the euro area – is above its long-term average and remains close to six-year highs. The forward-looking components of the survey continue to point to growth in the quarters ahead. Moreover, Eurostat's Economic Sentiment Indicator is near a ten-year high.

A notable feature of the ongoing recovery is that it has led to tangible employment gains. Since hitting a trough in mid-2013, the number of people employed in the euro area has increased by almost 7 million. As a result, all of the employment losses recorded during the crisis have been offset. The unemployment rate also continues to decline, despite an increase in labour force participation, and is now at its lowest level in eight years.

Employment growth, together with the gradual increase in employee compensation, supports households' disposable income and is underpinning solid consumption dynamics. Buoyant sentiment, favourable bank lending conditions and the notable progress achieved with respect to deleveraging are all conducive to robust consumer spending. The investment outlook is also positive, supported not only by a need to modernise the capital stock after years of subdued investment and an improving outlook for profitability, but also by highly accommodative financing conditions as our policy measures have passed through financial markets to affect the borrowing conditions of businesses and their customers.

Since the announcement of our policy measures in June 2014, bank lending rates for euro area non-financial corporations have fallen by almost 120 basis points and those for households by 100 basis points. Lending rates for very small loans, which can be taken as a proxy for loans to small and medium-sized enterprises (SMEs), have declined by almost 190 basis points. The significant improvement in funding conditions for SMEs is especially encouraging as they provide two-thirds of total private sector employment in the euro area. Heterogeneity of lending rates across countries has also fallen sharply. For example, the difference between the average lending rate for firms in countries that were severely affected by the crisis versus other countries has narrowed by around 100 basis points over this period. The pass-through of monetary policy has become more even.

These positive developments have been further 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.[2]

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent surveys have shown.[3] Moreover, bank lending volumes have been gradually recovering since early 2014. According to the latest Survey on the Access to Finance of Enterprises, covering the period from October 2016 to March 2017, euro area SMEs have continued to signal improvements in the availability of bank loans. Market-based funding conditions, too, have improved significantly in response to the corporate sector purchase programme launched in June 2016.

Against the backdrop of this substantial easing of financing conditions, domestic demand has become the mainstay of growth in the euro area, making the recovery more resilient to developments overseas. The latest ECB staff macroeconomic projections point to robust private consumption and a continued recovery in investment over the period ahead. Real GDP growth is projected to remain well above potential growth and to average between 1.7% and 2.2% in 2017, 2018 and 2019. The risks to the growth outlook are broadly balanced: on the upside, the current cyclical momentum could result in stronger than expected growth, while the remaining downside risks relate primarily to global factors and developments in the exchange rate.

From today's point of view, the strength and resilience of the recovery tends to foster our confidence that reflationary forces will gradually support a return of headline inflation towards a level that is below, but close to, 2% over the medium term. But inflation dynamics remain subdued. 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 stood at 1.5% in September according to Eurostat's flash estimate. Owing to energy-related base effects, headline inflation rates are likely to temporarily decline towards the turn of the year. Looking further ahead, as reflected in the latest ECB staff projections, headline inflation is expected to remain notably below a level that is consistent with our inflation aim over the next two years, averaging 1.5% in 2019. Furthermore, the recent volatility in the exchange rate represents a source of uncertainty which requires monitoring with regard to its possible implications for the medium-term outlook for price stability. Some measures of underlying inflation – which is more closely related to domestic price pressures – have ticked up moderately in recent months. For example, HICP inflation excluding food and energy had been stuck below 1% for around three years, but was 1.1% in September. Nevertheless, underlying inflation pressures are still too weak and have so far failed to show convincing signs of a sustained upward trend.

An important element keeping underlying price pressures subdued is muted wage dynamics, which are shaped by many factors. In addition to weak productivity developments, the significant degree of remaining labour market slack is limiting wage growth. When assessing slack, it can prove useful to also look at broader measures than the unemployment rate. The so-called "U6 measure" captures unemployment, underemployment (meaning workers who would like to work more hours) and marginal attachment, namely those workers that are not competing very actively in the labour market, for example because they are not available to start a new job at short notice. This measure currently covers just below 18% of the labour force and is thus considerably higher than the unemployment rate.[4]

We are undoubtedly experiencing a solid, broad-based and resilient economic recovery that is contributing to a narrowing of the output and unemployment gaps. But there still appears to be a disconnect between growth and inflation. As slack in the economy continues to be absorbed, reflationary forces will gradually build up and the traditional Phillips curve connection between inflation and the business cycle should eventually reassert itself.

That being said, current estimates of the slope of the Phillips curve appear to be flatter than in previous times, which could be interpreted as an indication that the relationship between economic slack and inflation has weakened. This could be due to either a mismeasurement of slack (because of structural changes in the labour market) or the relationship between slack and inflation not being stable over time. At the same time, this effect could also result from discrete parallel shifts in the Phillips curve. Such parallel shifts may occur because of temporary changes in wage and inflation mark-ups, or – more concerning from a central bank's perspective – the incipient dislodging of inflation expectations. In an extreme scenario, the entrenchment of disinflationary developments could sustain a downward drift in the Phillips curve and unmoor inflation expectations. Empirically disentangling these factors is extremely difficult, so such considerations need to be borne in mind when discussing the relationship between economic slack and inflation developments, particularly in an environment of uncertainty over the anchoring of inflation expectations. It is our primary task, as a central bank, to ensure that the reconnection of the real and the nominal sides of the economy – what I referred to before as the Phillips curve regularity eventually reasserting itself – occurs at a steady state rate of inflation that is consistent with our medium-term aim: a level below, but close to, 2%.

We have not yet accomplished our mission, and so we must remain patient and persistent.

Patience is required for inflationary pressures to show through convincingly in the data. The euro area's economic environment is improving, and the negative tail risks to inflation expectations, which were clearly visible at the start of our asset purchase programme, have virtually disappeared. But measured inflation rates are exceedingly volatile and metrics of underlying price pressures remain weak. The entire distribution of inflation expectations still needs to shift a fair distance to the right.

We must also be persistent in using our policy instruments to ensure a durable and self-sustained return of inflation towards a level that is below, but close to, 2% over a meaningful medium-term horizon. Crucially, the baseline scenario for future inflation remains contingent on easy financing conditions, which, to a large extent, depend on the support of monetary policy.

In the next few weeks, the Governing Council will assess how the evolving macroeconomic conditions, most notably the outlook for price stability, and the state of monetary policy transmission can be expected to influence the monetary policy stance. It will recalibrate its instruments accordingly, with a view to delivering the monetary policy impulse that remains necessary to secure a sustained adjustment in the path of inflation in a manner that is consistent with our monetary policy aim.

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[1] See, for example, the European Commission's "European Economic Forecast – Spring 2017".

[2] For more details, see the box entitled "The targeted longer-term refinancing operations: an overview of the take-up and their impact on bank intermediation", *Economic Bulletin*, Issue 3, ECB, 2017.

[3] See the ECB's euro area bank lending survey, July 2017, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, October 2016 to March 2017.

[4] See the box entitled, "Assessing labour market slack", *Economic Bulletin*, Issue 3, ECB, 2017.