# Peter Praet: Recent economic developments in the euro area

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Febelfin working group of bank economists, Brussels, 16 November 2017.

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The ECB has introduced several monetary policy measures since June 2014, which have played a crucial role in supporting the economy and have been demonstratively effective in preventing a period of disinflation from slipping into one of outright deflation. More than three years later, the risks of deflation have mostly disappeared due to the effective transmission of our policy measures to the real economy, which 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. Overall, inflation developments, despite the solid growth, remain subdued. Convergence of inflation towards our aim therefore remains conditional on a substantial degree of monetary policy accommodation.

Before focusing more on price dynamics and monetary policy, let me make some observations about the latest economic developments. Real GDP in the euro area has expanded for 18 consecutive quarters, growing by 2.5% year on year during the third quarter of 2017, according to Eurostat – a rate that exceeded our projection at the start of the year. This compares with the latest potential growth estimates for the euro area of just over 1.4%.[1] The latest survey data point to a strong fourth quarter. The composite output Purchasing Managers' Index – which has a high correlation with growth in the euro area – remains above its long-term average and is close to six-year highs. Overall, survey data continue to point to growth in the quarters ahead. Moreover, Eurostat's Economic Sentiment Indicator is near a ten-year high.

The ongoing recovery has led to solid employment gains. The number of people employed in the euro area has increased by almost 7 million since hitting a trough in mid-2013. This means that all of the employment losses recorded during the crisis have been offset. Additionally, the unemployment rate is now at its lowest level in eight years and continues to decline, notwithstanding an increase in labour force participation.

Employment growth, together with the gradual increase in employee compensation, supports households' disposable income and is underpinning solid consumption dynamics. Robust consumer spending is driven by buoyant sentiment, favourable bank lending conditions and the notable progress achieved with respect to deleveraging. 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 easy 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 around 120 basis points and those for households by around 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.

Banks are passing on the favourable funding conditions to their customers due to the second series of targeted longer-term refinancing operations, which further supports these positive developments.[2] The sharp reduction in bank lending rates has been accompanied by easier access to funding, which continues to improve in the third quarter according to newest survey results.[3] Furthermore, 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. Real GDP growth is projected to remain above potential growth in the coming years. 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 continue to be 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 1.4% in October 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. At the same time, measures of underlying inflation have ticked up moderately since early 2017, but have yet to show more convincing signs of a sustained upward trend.

Muted wage dynamics are one important element keeping underlying price pressures subdued. These 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 worthwhile 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 experiencing a solid and broad-based economic expansion 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 relationship between inflation and the business cycle should eventually reassert itself.

That being said, current estimates of the slope of the Phillips curve still 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. A mismeasurement of slack (because of structural changes in the labour market) or an unstable relationship between slack and inflation over time could be among the reasons. At the same time, this effect could also result from discrete parallel shifts in the Phillips curve. Such parallel shifts can arise due to temporary changes in wage and inflation mark-ups, or – more concerning from a central bank’s perspective – the incipient dislodging of inflation expectations. While unlikely, an extreme scenario would see the entrenchment of disinflationary developments initiate a downward drift in the Phillips curve and unmoor inflation expectations. Empirically disentangling these factors is extremely difficult, so we need to be mindful of such considerations when discussing the relationship between economic slack and inflation developments, especially in an environment of uncertainty over the anchoring of inflation expectations. Our primary task as a central bank is 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.

We have not yet accomplished our mission, and so we must remain patient and persistent. In light of this, the October monetary policy decisions were taken to preserve the favourable financing conditions that are still needed for a sustained return of inflation rates towards levels that are below, but close to, 2%. In particular, the recalibration of our asset purchases reflects growing confidence in the gradual convergence of inflation rates towards our inflation aim.

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1 See, for example, the European Commission's "European Economic Forecast – Autumn 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, October 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.