Peter Praet: Economic developments in the euro area

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the European Finance Forum, Frankfurt, 9 April 2018.

* * *

I would like to thank Claus Brand, Maarten Dossche and John Hutchinson for their support in preparing this speech.

The economic expansion clearly shows that our monetary policy has been effective in laying the groundwork for a return of inflation to a rate below, but close to, 2% over the medium term. Inflation developments remain subdued, however, and we have not yet met the Governing Council's criteria for a sustained adjustment in the path of inflation, which is our stated condition for ceasing our net asset purchases. Overall, an ample degree of monetary stimulus remains necessary for underlying inflation pressures to continue to build up and support headline inflation developments over the medium term.

Real GDP has expanded for 19 consecutive quarters. It grew by 2.7% year on year in the fourth quarter of 2017, according to preliminary data. This is well above the latest potential growth estimates of around 1.5%.[1]

See, for example, the European Commission's "European Economic Forecast – Autumn 2017". Potential growth was estimated at 1.4% for 2017 and 1.5% for 2018 and 2019.

The latest economic data and survey results point towards some moderation of late, but remain consistent with strong growth for the first quarter of this year. The composite output Purchasing Managers' Index – which is closely correlated with growth in the euro area – remains above its long-term average and is close to a 12-year high. Moreover, Eurostat's Economic Sentiment Indicator is around its highest level for 17 years. While risks to growth can be assessed as being broadly balanced, the international trade environment may have added to the downside. This is also reflected in financial conditions, which have recently tightened while remaining very supportive.

The ongoing expansion has led to strong employment gains. The number of people employed in the euro area has increased by almost 7.8 million since the trough in mid-2013. This implies that all of the job losses recorded during the crisis have been recovered. The unemployment rate is at its lowest level since December 2008, despite an increase in the labour force of more than 2%.

Consumer spending is being driven by steady growth in households' real disposable income, favourable bank lending conditions and the notable progress achieved in deleveraging. Since 2016 employment growth, together with the gradual increase in compensation per employee, has become the main driver of households' real disposable income, while the contribution of taxes and transfers has become more negative, as in good times automatic fiscal stabilisers somewhat dampen the growth of real disposable income. This also contrasts with the early years of the recovery (2014–15), when real disposable income was still strongly supported by improvement in the terms of trade as a result of the fall in oil prices.

The investment outlook is supported by a need to modernise the capital stock after years of subdued investment and an improving outlook for profitability. Moreover, it is also supported by easy financing conditions as our policy measures have passed through the financial system to the benefit of businesses and their customers.

Since we announced our policy measures in June 2014, financial conditions have eased considerably. In particular, bank lending rates for euro area non-financial corporations have fallen by around 120 basis points, and for households by around 110 basis points. Rates on very small

loans, which can be taken as a proxy for loans to small and medium-sized enterprises (SMEs), have declined by around 200 basis points. The significant improvement in funding conditions for SMEs is especially encouraging as these companies provide two-thirds of the 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 which were severely affected by the crisis, and the average lending rate for firms in other countries, has narrowed by more than 100 basis points since we announced our policy measures. The pass-through of our monetary policy has become more even.

Banks are also passing on the favourable funding conditions to their customers due to our second series of targeted longer-term refinancing operations (TLTRO-II), which further supports these positive developments.[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.

The sharp reduction in bank lending rates has been accompanied by easier access to funding. According to the latest Survey on the Access to Finance of Enterprises[3]

See the ECB's euro area bank lending survey, January 2018, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, April to September 2017.

, covering the period from April to September 2017, euro area SMEs have continued to see improvements in the availability of bank loans. Market-based funding conditions have also improved significantly in response to the corporate sector purchase programme we launched in June 2016.

Against the backdrop of this substantial easing of financing conditions, domestic demand has become the mainstay of euro area economic growth, making it more resilient to developments overseas. Meanwhile, real GDP growth is projected to remain above potential growth in the coming years. The cyclical momentum and the ongoing reduction of economic slack further strengthens our confidence that inflation will converge towards our aim of below, but close to, 2%.

That being said, inflation continues to be lacklustre. After lingering at levels well below 1% for three years, with occasional dips into negative territory, euro area headline inflation increased towards the end of 2016 and has fluctuated, for the most part, between 1.3% and 1.5% since May last year. Annual inflation stood at 1.4% in March, according to Eurostat's flash estimate. On the basis of current futures prices for oil, annual rates of headline inflation are likely to hover around current levels in the coming months. Measures of underlying inflation remain subdued and have yet to show convincing signs of a sustained upward trend.

Muted wage dynamics are one important element keeping a lid on underlying price pressures. There is much discussion about the Phillips curve having become flatter in recent years, suggesting that the relationship between economic slack and inflation has weakened. But it is difficult to determine empirically whether changes in the Phillips curve stem from a mismeasurement of slack or from parallel shifts in the curve. In other words, a flattening of the Phillips curve could be confused with a mismeasurement of slack or a parallel shift of the complete curve.

Indeed, there is considerable uncertainty regarding the degree of slack in the economy. One reason for this is that productive capacities may have been positively affected by labour market reforms. In addition, the prolonged period of robust economic expansion entailed a reversal of crisis-related hysteresis. Indeed, non-accelerating inflation rate of unemployment (NAIRU) estimates have been continuously revised downwards. When looking at slack over the past few

years, it is also worth considering alternative measures of unemployment. The U6 measure, for example, captures unemployment, underemployment (meaning workers who would like to work more hours) and marginal attachment, namely those workers who are not competing very actively in the labour market, for example because they are not available to start a new job at short notice.[4]

See the box entitled “Assessing labour market slack”, Economic Bulletin, Issue 3, ECB, 2017.

Parallel shifts of the Phillips curve could arise from the impacts of cost-push shocks or from a de-anchoring of inflation expectations, with different implications for monetary policy. External and domestic cost-push shocks could have led to a downward shift in the Phillips curve of the euro area. Over recent years the global economy has experienced negative price shocks in energy markets, which have tended to push up output while containing inflation in the euro area.

If, however, shifts in the Phillips curve are the result of a de-anchoring of inflation expectations, they raise significant concerns over the ability of the central bank to achieve its inflation objective. While there were signs of de-anchoring appearing in 2014, our monetary policy measures have been successful in stabilising inflation expectations and making deflation risks vanish. Our primary task as a central bank is to ensure that the traditional relationship between the real and the nominal sides of the economy reasserts itself at a steady-state rate of inflation that is below, but close to, 2%.

In summary, there appears to have been a disconnect between growth and inflation. However, the ongoing economic expansion is expected to further contribute to a narrowing of the output and unemployment gaps, whatever their current levels. As slack in the economy continues to be absorbed, price pressures will gradually build up and the traditional Phillips curve relationship between inflation and the business cycle should eventually reassert itself.

The disconnect between output growth and inflation is not the only type of disconnect that we have to contend with. If past regularities were a guide, the substantial easing of financing conditions prompted by our policy measures could have been expected to boost spending and inflation more forcefully Across advanced economies we have indeed witnessed a ubiquitous downward trend in real interest rates. In the euro area, lately they have been around –1.5% at short maturities and around –0.5% in the ten-year maturity segment. Both figures are around 1.5 percentage points lower than their corresponding averages over the first ten years of Economic and Monetary Union (EMU). The fact that inflation dynamics have been tepid indicates that historical averages may not be an appropriate benchmark for today’s policy stance and that corresponding benchmark levels must have fallen.

Policymakers need to be wary of these trends. They are probably rooted in receding growth rates in potential output and the legacy of financial factors that have emerged in the wake of the financial crisis (like risk aversion and deleveraging pressures). The degree of monetary policy accommodation, based on various real return measures, needs to be assessed relative to these benchmark trends in real yields.

Certainly, if these slow-moving trends in real yields are also taken into account, the current level of real interest rates provides an ample degree of policy accommodation. But interpreting their present levels against the background of their protracted downtrend and persistently subdued inflation underpins our stance that we have to be prudent, patient and persistent in calibrating our policy, as inflation will probably converge only gradually towards our objective.

Looking ahead, monetary policy will evolve in a data-dependent and time-consistent manner. Once the Governing Council judges that the three criteria for sustained adjustment – convergence, confidence and resilience – have been met, net asset purchases will expire, in line with our guidance. From that point in time, inflation developments will remain conditional on reinvestments continuing for an extended period of time and on policy rates remaining at their

present levels well past the end of our net asset purchases. The stock of long-duration assets held in our portfolio will continue to put downward pressure on longer-term interest rates well beyond the end of our net purchases. Policy rates remaining at their present levels well past the end of our net purchases will contribute to holding the short to intermediate portions of the yield curve in check for as long as necessary, thereby ensuring that financial conditions remain consistent with a sustained adjustment of inflation.

---

1 See, for example, the European Commission's "European Economic Forecast – Autumn 2017". Potential growth was estimated at 1.4% for 2017 and 1.5% for 2018 and 2019.

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, January 2018, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, April to September 2017.

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