Peter Praet: Economic developments in the euro area

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Swiss Financial Analysts Association (SFAA), Geneva, 7 May 2018.

* * *

Accompanying slides of this speech.

I would like to thank John Hutchinson for his support in preparing this speech.

After several quarters of higher than expected growth, the latest euro area data point towards some moderation, but remain consistent with a solid and broad-based economic expansion.

I would like to thank John Hutchinson for his support in preparing this speech.

Monetary policy measures introduced since 2014 have been central in supporting euro area growth and paving the way for a return of euro area inflation to a rate below, but close to, 2% over the medium term. Inflation developments, however, remain subdued. 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 in the euro area has expanded for 20 consecutive quarters, growing by 0.4% quarter on quarter during the first quarter of 2018, according to preliminary data. While the pace of economic expansion has moderated compared with the previous quarters, the underlying strength of the euro area economy is expected to persist.

The moderation in the pace of economic growth indicated by the flow of recent economic data and survey results in part reflects some pull-back from the strong growth of last year and may also be due to some temporary factors. We will need to monitor whether, and if so to what extent, these developments also reflect a more durable softening in demand. The composite output Purchasing Managers' Index – which is closely correlated with growth in the euro area – still remains above its long-term average and is close to a 12-year high. While risks to growth remain broadly balanced, those related to global factors, including the threat of increased protectionism, have become more prominent.

A deceleration from the exceptionally high growth rates observed in the second half of 2017 had been expected. However, the slowdown has come sooner than anticipated. The downward surprise in incoming information has been broad-based, as it can be observed in both hard data and survey indicators across most sectors and countries.

Transitory factors are likely to have played a role in the overall slowdown in recent economic indicators. These exceptional factors include the cold weather conditions, influenza, the timing of Easter and school holidays, and industrial strikes in some countries. These developments may have been particularly relevant for the retail and construction sector. In addition, concerns about trade protectionism may also have dampened business sentiment and expectations.

Nevertheless, the recent slowdown could also be a sign that supply-side constraints are becoming increasingly binding, albeit only in some sectors and in some countries. For instance, in the capital goods sector, capacity utilisation and backlogs/supply delivery times stand at all-time highs. Whereas in the construction sector, an increasing number of firms are indicating that a shortage of labour is limiting their production.

There is so far no evidence that the moderation in the pace of economic expansion reflects a durable softening in demand. Recent information remains consistent with a solid and broad-based expansion in domestic demand. Sentiment indicators remain in expansionary territory and are still well above long-term averages for most sectors and countries. Moreover, the underlying momentum is still supported by favourable financing conditions, a robust labour market and steady income and profit growth.

The ongoing expansion has led to strong employment gains. The number of people employed in the euro area has increased by more than 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. The contribution of taxes and transfers, by contrast, has become more negative, as automatic fiscal stabilisers act to somewhat dampen the growth of real disposable income in times of economic expansion. These developments contrast with the early years of the recovery (2014–15), when real disposable income was still strongly supported by improvements in the terms of trade as a result of the fall in oil prices.

The investment outlook continues to strengthen and is supported by an ongoing need to modernise the capital stock after years of subdued investment, as well as by very favourable financing conditions, an improvement in profitability and solid demand. The European Commission's biannual investment survey, which was released on 27 April, shows expectations of a strong increase in real industrial investment of 7% in 2018.

Finally, signs that the past euro appreciation is dampening export growth remain limited. Extra-euro area export growth slowed down in the first two months of the year, albeit from very high levels. Moreover, over the same period, extra-euro area industrial new orders continued to expand. At the same time, the sharp decline in some sentiment indicators relating to the export sector is a source of concern.

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 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 110 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 as a result of our second series of targeted longer-term refinancing operations, which further supports these positive developments.[1]

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 euro area bank lending survey for the first quarter of 2018, credit standards have eased considerably for loans to firms and loans for house purchases, with loan demand increasing across all categories. Banks also reported that the ECB's asset purchase programme has led to an easing of lending conditions and has had a positive effect on lending volumes across all loan categories. 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 is expected to remain the key driver of growth. Meanwhile, real GDP growth is projected to remain above potential in the coming years. Nonetheless, 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. According to the flash estimate, annual euro area headline inflation stood at 1.2% in April, while HICP inflation excluding food and energy declined to 0.7%, slightly lower than expected. This negative surprise in core inflation is mainly attributable to a decrease in services inflation, which is likely to be related to developments in volatile items, also reflecting the timing of Easter this year. On the basis of current futures prices for oil, inflation is likely to hover around 1.5% in the coming months.

Looking beyond some short-term volatility, measures of underlying inflation have moved sideways in recent months and have yet to show convincing signs of a sustained upward trend. Wages continue to edge higher, which is an encouraging sign as overall muted wage dynamics have been an 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 this regard, 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.[2]

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. Indeed, 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. As cost-push shocks tend to be temporary, they are less meaningful for the medium-term orientation of monetary policy.

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 in the longer run. While there were signs of de-anchoring 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, 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.

Another type of disconnect that policymakers have to contend with relates to the substantial easing of financing conditions prompted by our policy measures, which could have been expected to boost inflation more forcefully. Across advanced economies we have indeed witnessed a ubiquitous downward trend in real interest rates. In the euro area they have lately 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. 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 – such as 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 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.

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