Luis de Guindos: The euro area economy and our monetary policy stance

Remarks by Mr Luis de Guindos, Vice-President of the European Central Bank, at Asociación para el Progreso de la Dirección (APD), Madrid, 18 March 2019.

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Recent economic developments

- In recent months, incoming euro area data have continued to be weak and the economy has grown below expectations.
- That is, euro area real GDP increased by 0.2% quarter-on-quarter in the fourth quarter of 2018 (according to preliminary estimates), which was slightly up from 0.1% in the quarter before, but well below the 0.4% growth observed in the first half of 2018.
- The continued weakness, particularly in the manufacturing sector, reflects the slowdown in external demand, compounded by some country and sector-specific factors.
- The global economy is expanding at a more modest pace. According to IMF estimates, global growth has moderated to 3.7% in 2018 (from 3.8% in the previous year), and is expected to slow to 3.5% in 2019. Important euro area trading partners, such as China, show signs of a maturing economic cycle, and this has affected euro area exports. Net exports recovered in the fourth quarter of 2018 (according to preliminary estimates), but weaker exports were the main factor behind the steep growth slowdown observed in the third quarter.
- In the euro area, the slowdown in growth has been particularly visible in the manufacturing sector. Euro area industrial production, excluding construction, declined by 1.4% quarter-on-quarter in the fourth quarter of 2018, with the slowdown being widespread across sectors and most major economies. Purchasing managers' survey data on manufacturing production also moved into contractionary territory last month. Growth in services, in contrast, proved to be more resilient.
- Country and sector-specific factors have been playing a role as well. Temporary issues in the automotive sector due to new regulation, for example, caused industrial production to fall particularly strongly in some euro area countries. These idiosyncratic factors are only fading slowly, and have been weighing on growth for longer than anticipated.
- Meanwhile, persistent uncertainties have left their mark on business and consumer confidence. These uncertainties relate to geopolitical factors, such as the state of play of the Brexit negotiations, the continued threat of trade protectionism and vulnerabilities in emerging markets. By denting confidence, uncertainty might affect real economic variables, such as capital goods production, which declined strongly last quarter, possibly as a result of this reduced confidence.
- All these elements indicate that the moderation in the pace of the euro area economic expansion will likely extend into the current year. This is also reflected in our staff macroeconomic projections. In fact, growth for this year has been revised downwards to 1.1%, which is 0.6% lower than anticipated in the December forecast.
- The fundamental factors supporting the euro area expansion remain broadly in place, however.
- Looking ahead, the effects of the idiosyncratic factors currently weighing on economic growth are expected to unwind, albeit at a slower pace than initially foreseen. For instance, recent data on motor vehicle production show signs of normalisation, and consumer confidence recently edged up again.
- Beyond more temporary fluctuations, the euro area expansion will continue to be supported

by favourable financing conditions, further gains in employment and rising wages. Also, the ongoing yet somewhat more modest expansion in global activity should continue to support euro area growth.

- In fact, bank lending rates to euro area firms and households remain close to their historical lows. The euro area unemployment rate currently stands at its lowest level in more than a decade, and the wage increases that result from tightening labour markets should continue to underpin household income and private consumption. On the external side, preliminary estimates for the fourth quarter of 2018 point to a pickup in net exports after a very weak third quarter.
- For these reasons, GDP growth in the euro area is expected to remain sound in the medium term. Accordingly, our staff projections expect euro area GDP growth to reach 1.6% in 2020 and 1.5% in 2021, which is largely unchanged from the December forecast round.
- The risks surrounding euro area growth are still considered to be tilted to the downside, on account of the persistence of the uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets.
- Turning to inflation, HICP inflation increased to 1.5% in February, from 1.4% in January (according to preliminary estimates). This slight increase was mostly driven by higher energy and food price inflation, while measures of underlying inflation remain generally muted. Headline inflation is likely to remain around current levels in the coming months, before declining towards the end of year on the basis of the financial market's outlook for oil prices.
- In line with this, our latest projections foresee annual HICP inflation declining to 1.2% in 2019, before recovering to 1.5% in 2020 and 1.6% in 2021.
- Compared with the December forecast round, the outlook for HICP inflation has been revised downwards across the projection horizon. This downward revision reflects, in particular, the more subdued near-term growth outlook, which is delaying the adjustment of inflation to our aim.
- Also for inflation, supportive factors continue to be in place that will lift inflation above this year's muted levels in the more medium term. Labour cost pressures have strengthened and broadened amid high levels of capacity utilisation and tightening labour markets. Together with the economic expansion, these forces are expected to trickle through to wage growth and support underlying inflation.
- Finally, in addition to the factors mentioned, the monetary policy measures we announced at the last Governing Council meeting will add to our already accommodative stance, which will continue to underpin the economic expansion and the convergence of inflation to our medium-term aim.

The monetary policy stance

- The sizeable moderation in the euro area's expansion and the downward revisions to the near-term growth outlook and inflation projections have led the Governing Council to take a number of decisions in pursuit of its price stability objective.
- One decision was to adjust our forward guidance on the key ECB interest rates. We now expect these to remain at their present levels at least through the end of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.
- This formulation consists of two parts. There is a date-based element – that interest rates are expected to remain at their present levels "at least through the end of 2019". And there is a state-contingent element – that rates will remain unchanged "in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term".

- By shifting the date-based part of our rate guidance further into the future, from “at least through the summer” to “at least through the end” of 2019, we ensure that our accommodation is not weakened by premature expectations of a rate hike. Market participants who were factoring in the probability that our rates could increase before this date should no longer do so.
- On top of that, the state-contingent element ensures that the stance will continue to evolve gradually and in a data-dependent manner.
- Second, the ongoing full reinvestment of the stock of assets purchased under the asset purchase programme will continue to provide a significant degree of stimulus. And this will hold true for an extended period of time past the date when we start raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.
- By linking the reinvestment horizon to the date when we start raising the key ECB interest rates, we are reinforcing the stimulative effects of our forward guidance, as market expectations for the reinvestment horizon should evolve in line with expectations for the date on which we start raising rates.
- Third, we decided to launch a new series of quarterly targeted longer-term refinancing operations, namely TLTRO-III, starting in September 2019 and ending in March 2021, each with a maturity of two years.
- Although bank funding conditions remain favourable, the moderation in the growth momentum and the persistence of several uncertainties could affect these conditions in the future. We need to remain vigilant.
- By offering long-term funding at attractive conditions to banks, the new series of TLTROs will help to preserve favourable bank lending conditions and support the smooth and efficient bank-based transmission of monetary policy.
- More specifically, under TLTRO-III, counterparties will be entitled to borrow up to 30% of the stock of eligible loans as at 28 February 2019 at a rate indexed to the interest rate on the main refinancing operations over the life of each operation.
- Similar to the outstanding TLTRO programme, the “targeting” feature of the operations will offer built-in incentives for credit conditions to remain favourable. We will communicate the precise terms of these operations in due course.
- A fourth decision was to continue conducting all our lending operations as fixed rate tender procedures with full allotment for as long as necessary, and at least until the end of the reserve maintenance period starting in March 2021. This measure ensures that we continue providing banks with a liquidity backstop against sufficient and adequate collateral.
- Finally, as always we stand ready to adjust all of our instruments, as appropriate, to ensure that inflation continues to move towards the Governing Council’s inflation aim in a sustained manner.
- Taken together, this set of decisions should ensure that inflation remains on a sustained convergence path towards our medium-term aim, while also preserving favourable bank lending conditions and supporting the smooth transmission of our monetary policy.