

THE EURO AREA ECONOMY AFTER A PROLONGED PERIOD OF MONETARY STIMULUS

Pablo Hernández de Cos

Director General Economics, Statistics & Research

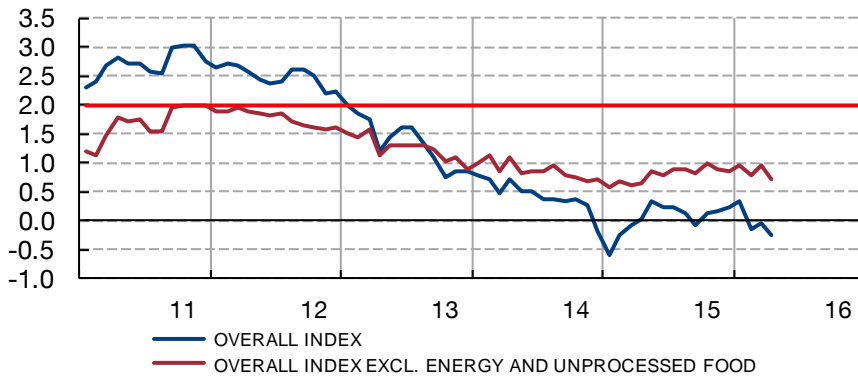
The Society of Business Economists Annual Conference
London, 15 September 2017

THE EURO AREA ECONOMY BACK IN 2014

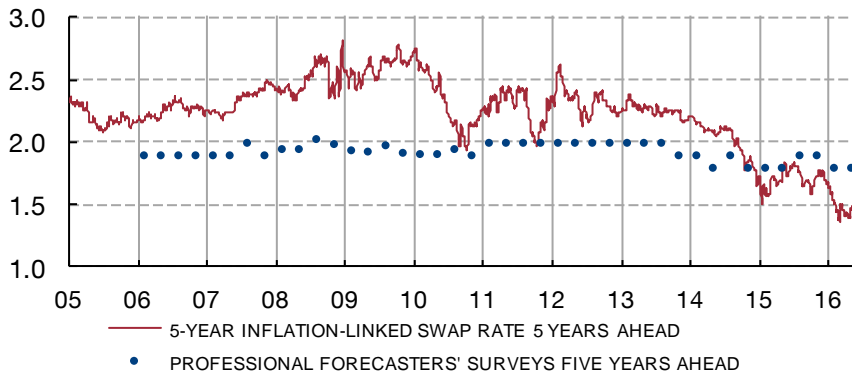


In 2014, the euro area faced a protracted period of excessively low inflation and growing signals of unhinged inflation expectations. The economic recovery, after a double dip recession, was fragile and weak

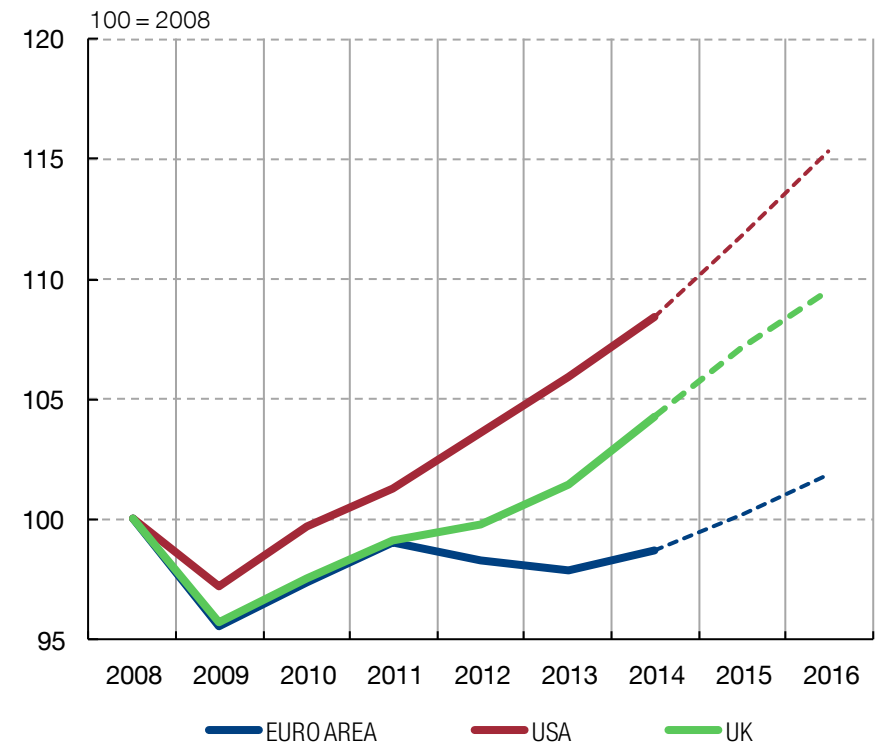
EURO AREA INFLATION



EUROAREA MEDIUM- AND LONG-TERM INFLATION EXPECTATIONS



GDP

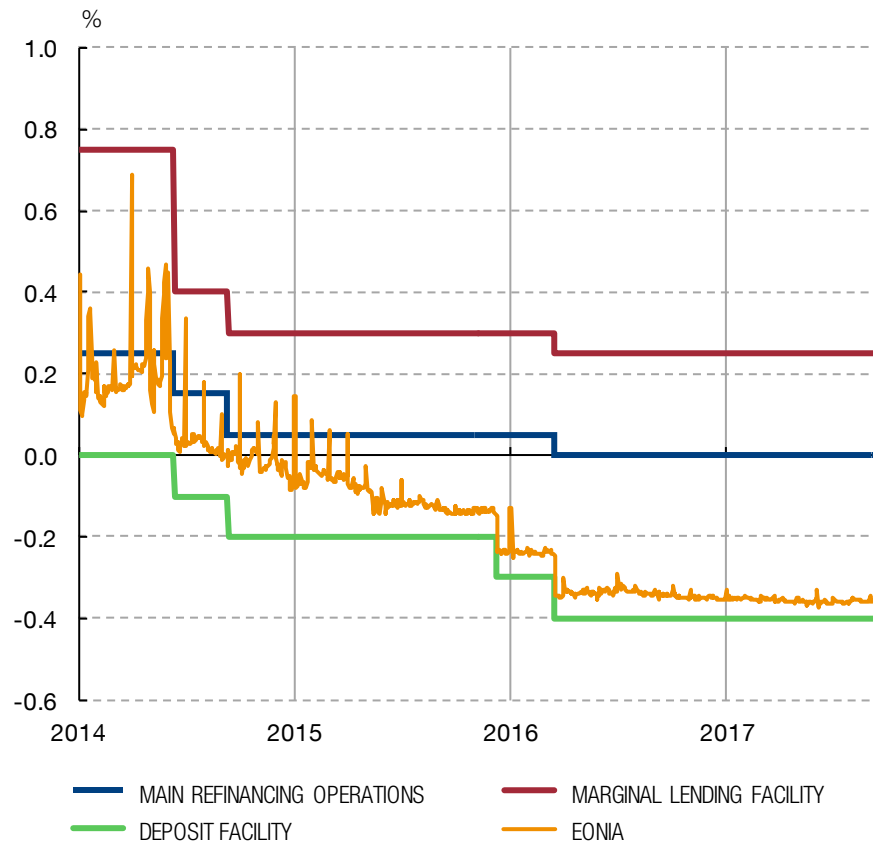


PROJECTIONS TAKEN FROM THE IMF WEO (APRIL 2015).

THE REACTION OF MONETARY POLICY

Against this setting, the ECB initiated a new phase of expansionary monetary policy, introducing a series of non-conventional measures to overcome the constraints from conventional tools

EONIA AND ECB INTEREST RATES



1. OFFICIAL INTEREST RATES

Marginal lending facility	0.25%
Main refinancing operations	0%
Deposit facility	-0.40%

2. BALANCE SHEET EXPANSION

- CREDIT EASING: targeted long-term funding to banks: TLTRO and TLTRO-II
- QUANTITATIVE EASING: large-scale outright purchases of assets through the *Extended Asset Purchase Programme (EAPP)*:
 - Covered bonds (CBPP3)
 - Asset-backed securities (ABSPP)
 - Public sector securities (PSPP)
 - Non bank corporate bonds (CSPP)

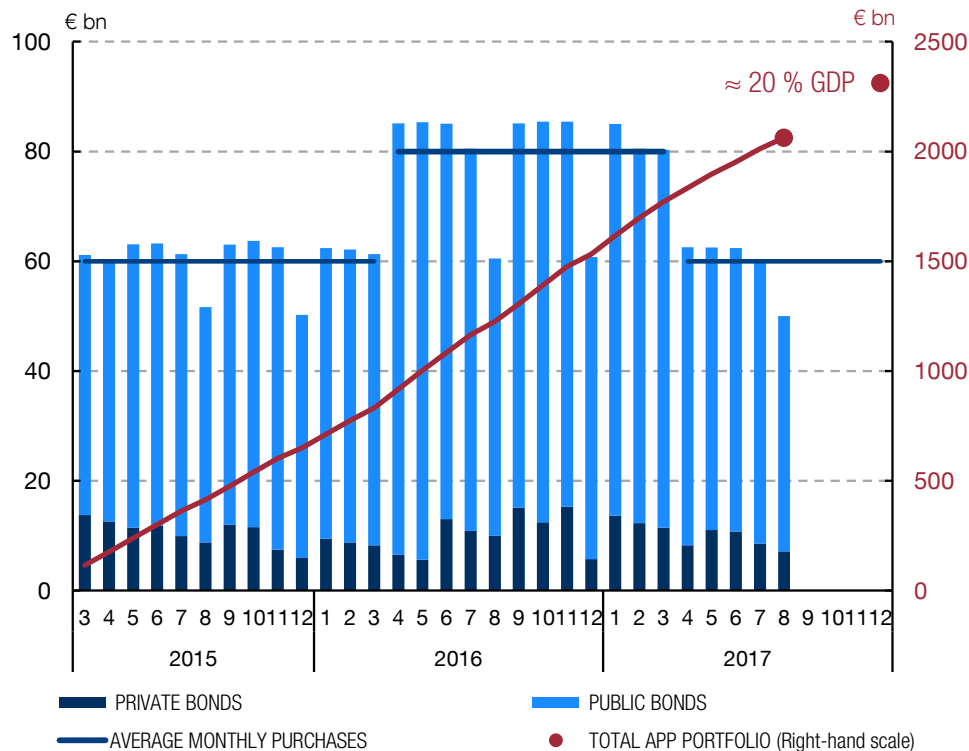
3. FORWARD GUIDANCE, for key interest rates and non-standard measures

ECB BALANCE SHEET MEASURES

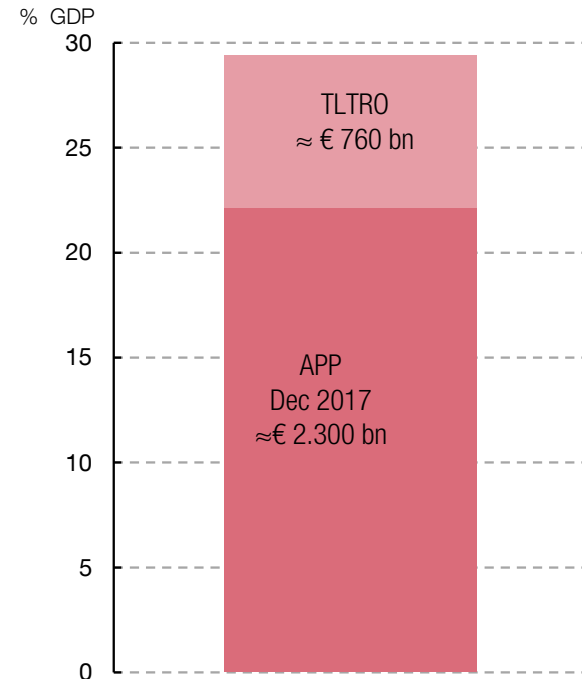


Asset purchases started in March 2015 (€60 bn per month) and, after various extensions, they will run, at least, until end 2017. The monetary stimulus has been very large, with a total liquidity injection close to 30% of GDP, including TLTRO

ASSET PURCHASE PROGRAMME (APP)
Monthly net purchases and cumulative purchases



BALANCE SHEET EXPANSION



THE ECB FORWARD GUIDANCE



The communication – forward guidance (FG) - became an integral part of the ECB toolbox when the room for further reductions in key interest rates was limited and when new instruments were introduced

ECB forward guidance

- Started in July 2013 ...but only at ZLB it became an active instrument of accommodation, also including non-standard measures
- It is not an unconditional commitment, since this is not compatible with the ECB mandate. But it is also not conditional upon any quantitative threshold for an economic variable, it is based on the available information and on economic prospects

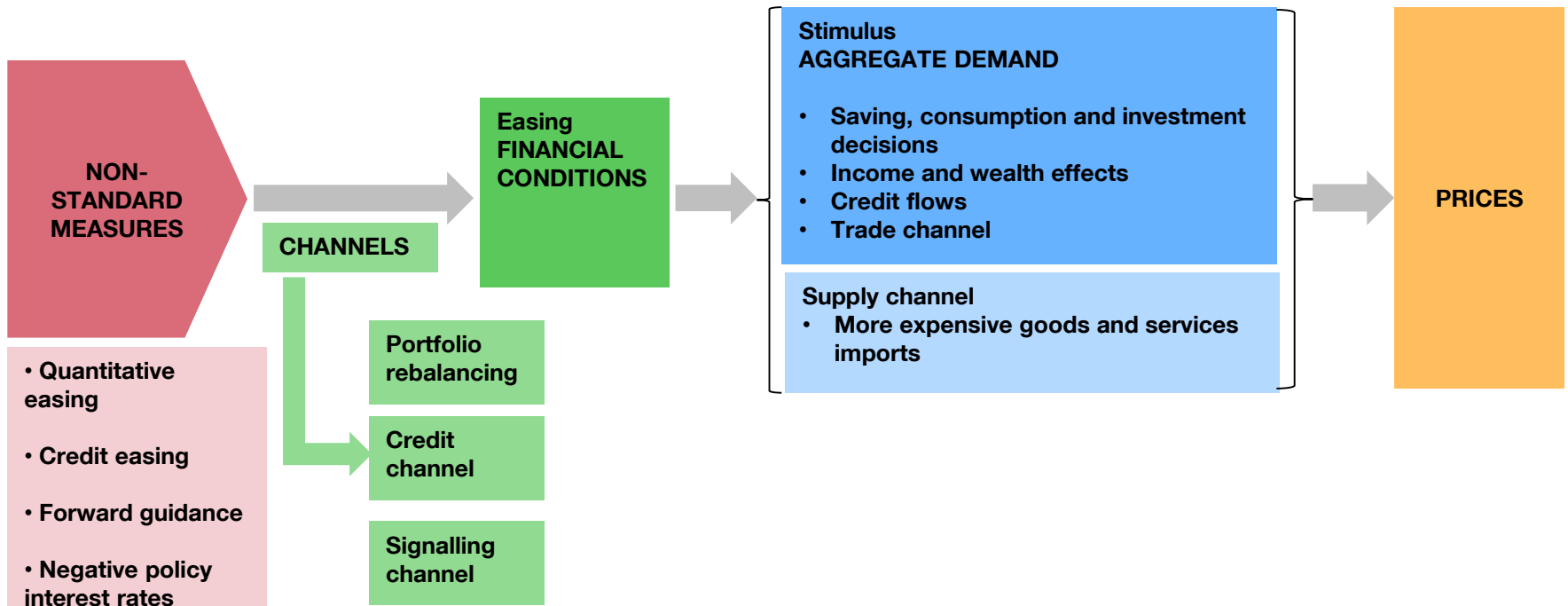
ECB forward guidance in last ECB GC meeting (7 September 2017)

- *The GC expects the key ECB **interest rates to remain at their present levels for an extended period of time, and well past the horizon of the net asset purchases.***
- ***Net asset purchases**, at the monthly pace of €60 billion, **are intended to run until the end of December 2017, or beyond,** if necessary, and in any case until the GC sees a **sustained adjustment in the path of inflation consistent with its inflation aim.***
- *If the outlook becomes less favourable, or if financial conditions become inconsistent with further progress towards a sustained adjustment in the path of inflation, **the GC stands ready to increase the programme in terms of size and/or duration.***

THE TRANSMISSION CHANNELS



ECB measures operate as a mutually reinforcing package. Depending on the instrument, channels may work differently, but all measures contribute to easing financial conditions faced by agents, strengthening domestic demand and improving inflation dynamics

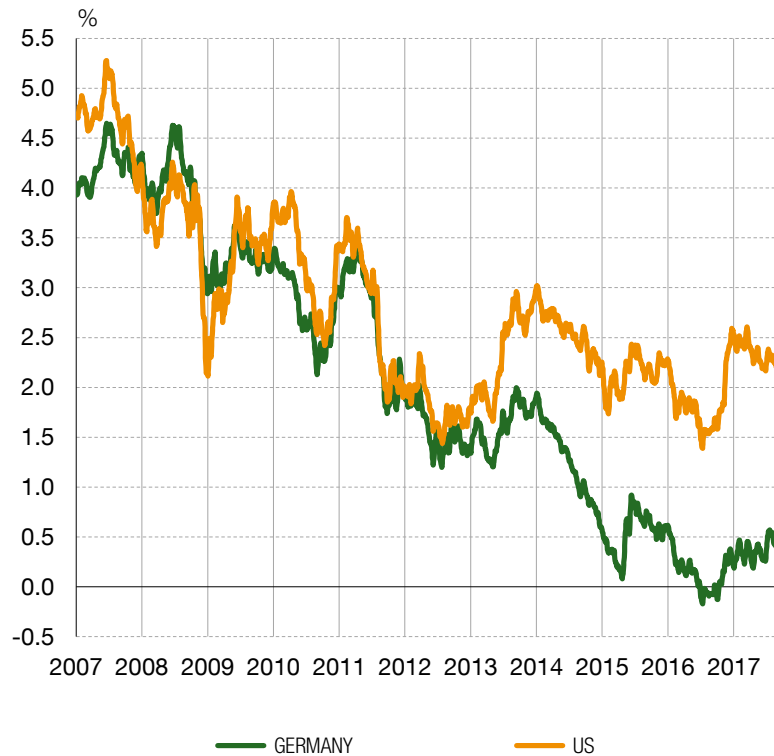


THE IMPACT ON FINANCIAL CONDITIONS

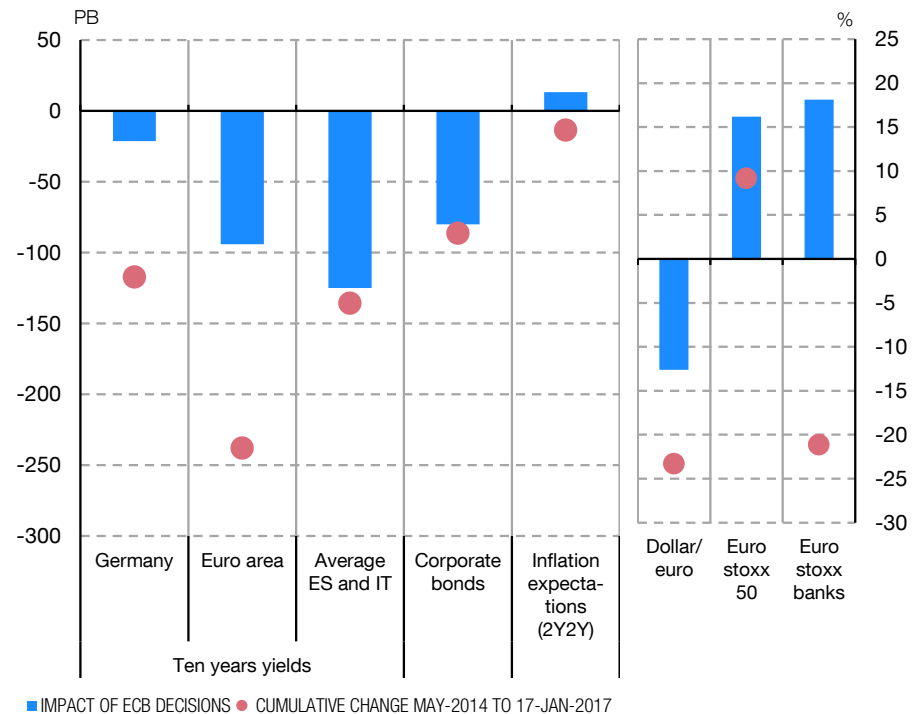


Financial conditions in the euro eased considerably since mid 2014. Analysis of the response of asset prices to the announced ECB measures indicates that monetary policy has contributed appreciably

10-YEAR NOMINAL INTEREST RATE
Five days moving average



CHANGES IN FINANCIAL CONDITIONS AND CONTRIBUTION OF MONETARY POLICY DECISIONS (a)



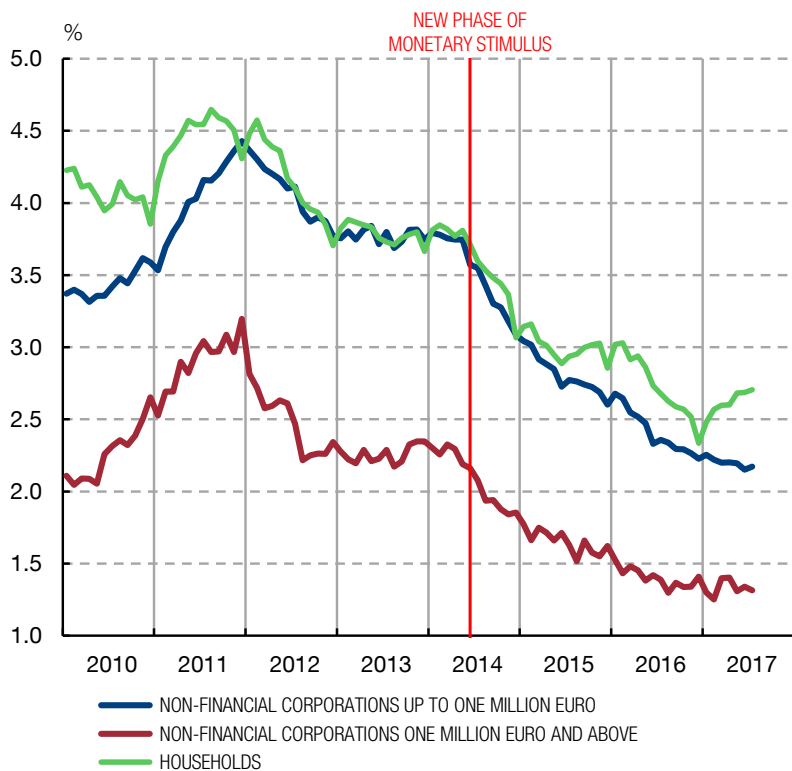
(a) Event study, see chapter 3 of Banco de España 2015 Annual Report.

COST OF BANK LOANS

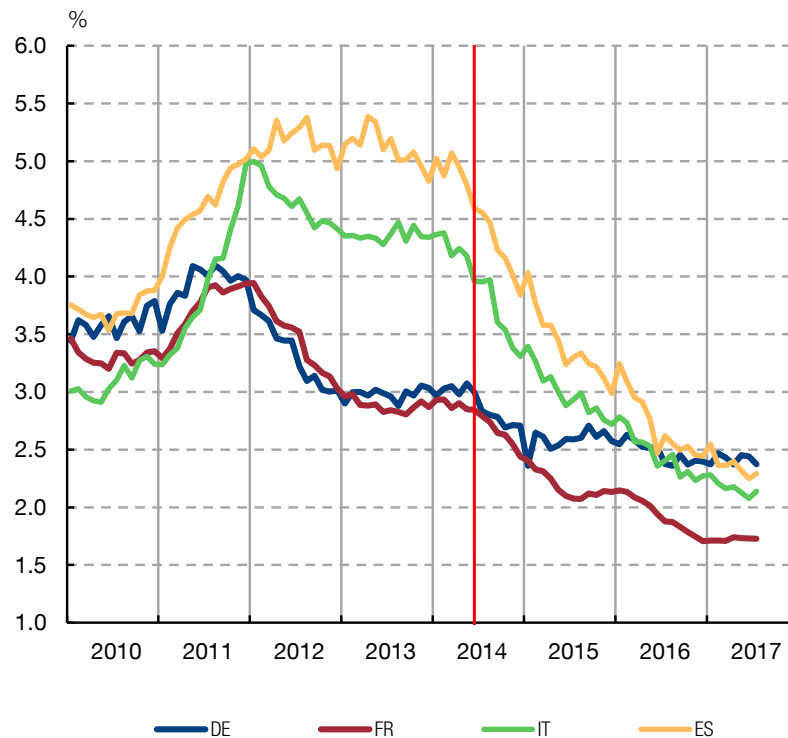


The decline in bank's financing costs has been passed on to borrowing conditions for firms and households. Country bank rate differentials also compressed markedly

EURO AREA BANK INTEREST RATES. LOANS



**INTEREST RATES ON BANK LOANS BY COUNTRY
LOANS TO NFC UP TO 1 MILLION EUROS**

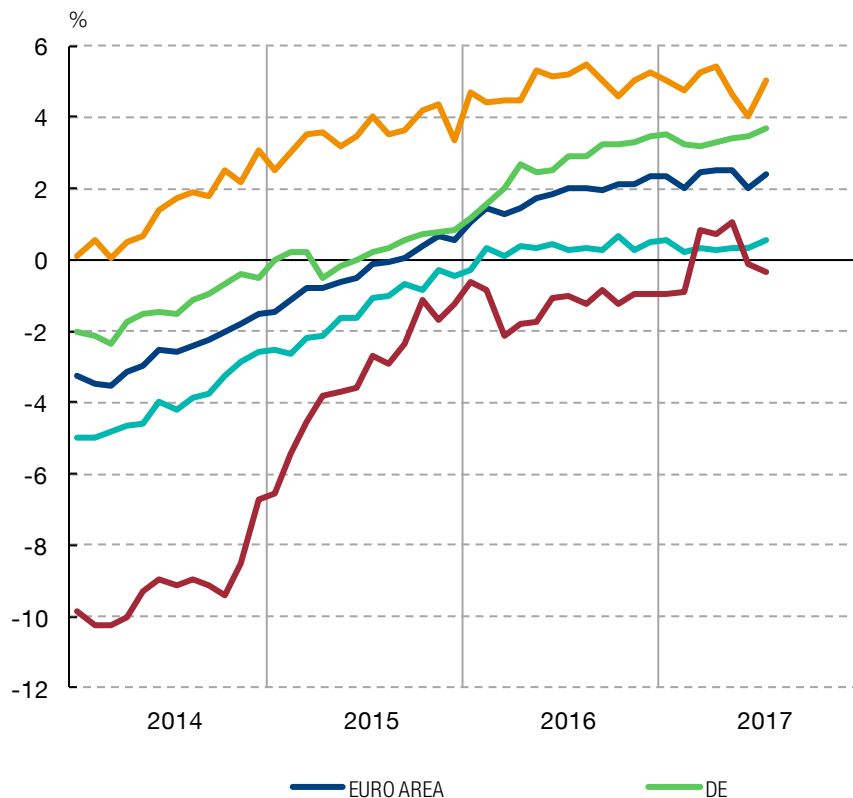


BANK LENDING

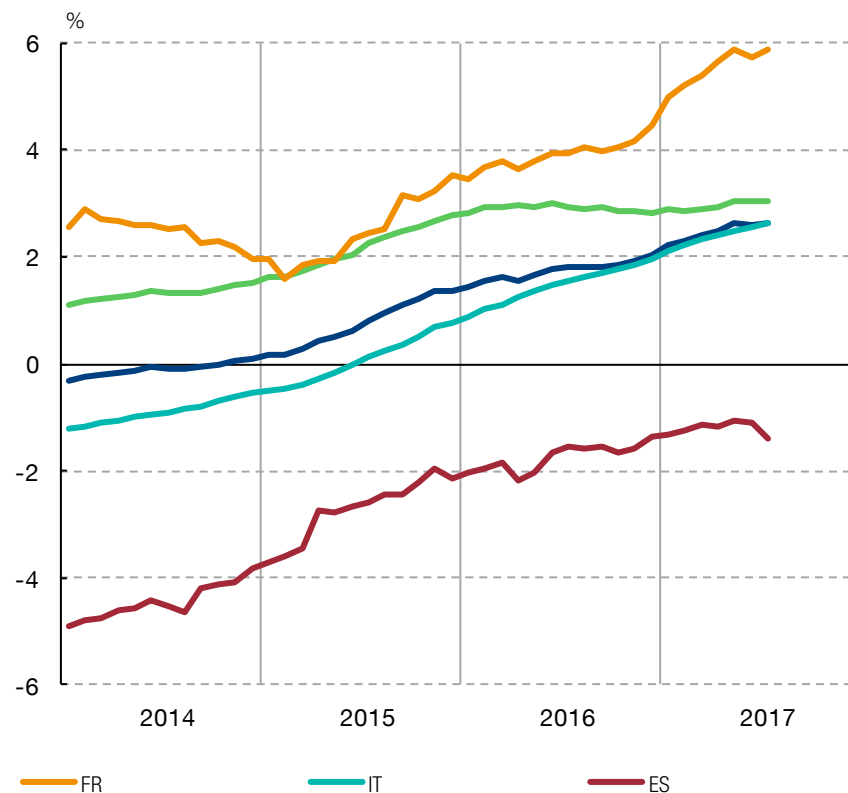


Effects are also visible in a gradual recovery of bank lending flows, both for households and firms. Country growth rates are still uneven, since correction of indebtedness is an ongoing process

BANK LOANS. NON FINANCIAL CORPORATIONS
Annual growth



BANK LOANS. HOUSEHOLDS
Annual growth

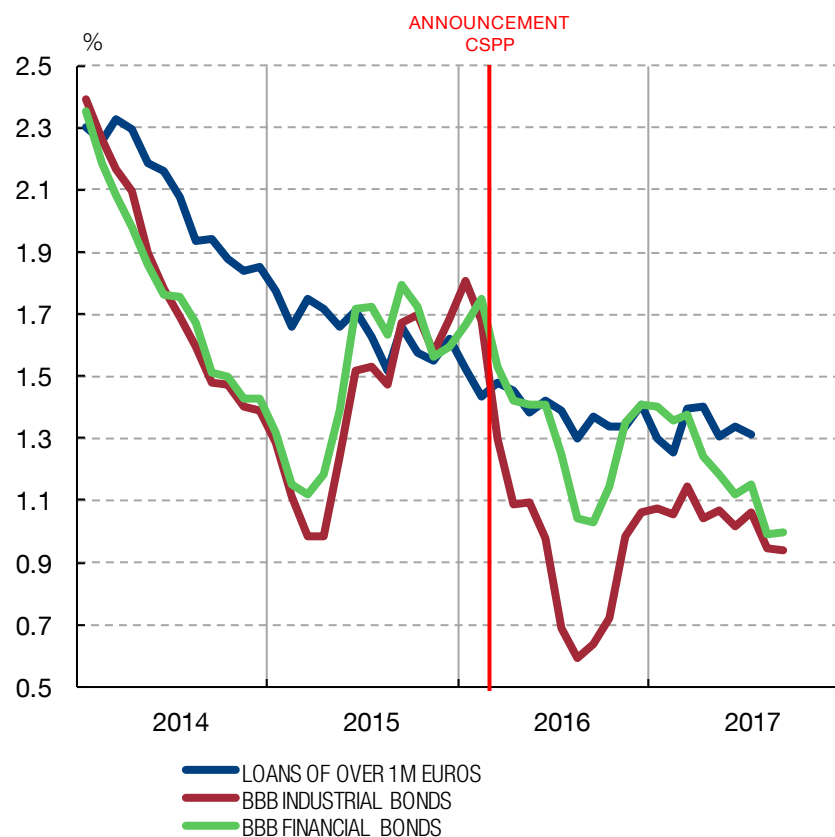


CORPORATE BOND FINANCING

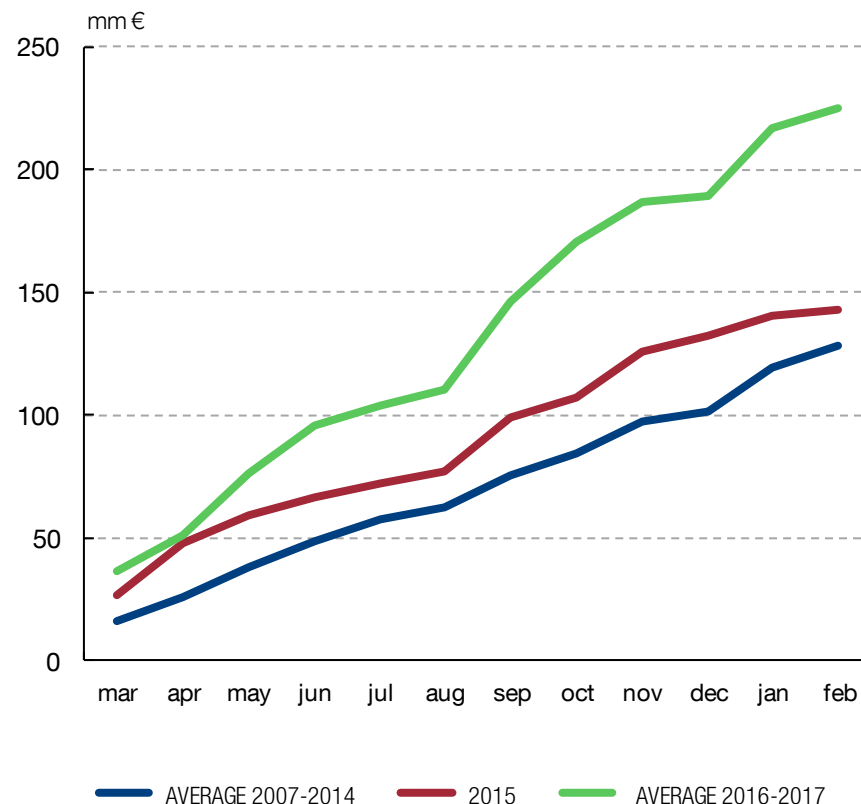


Private debt capital markets also benefited from the Corporate Sector Purchase Programme (Mar-2016) with strong impact both on prices and primary markets. Shifting financing decisions to markets is also expected to have positive side effects on the supply of bank loans for smaller companies

COST OF FINANCING



NON-FINANCIAL CORPORATIONS BOND ISSUES

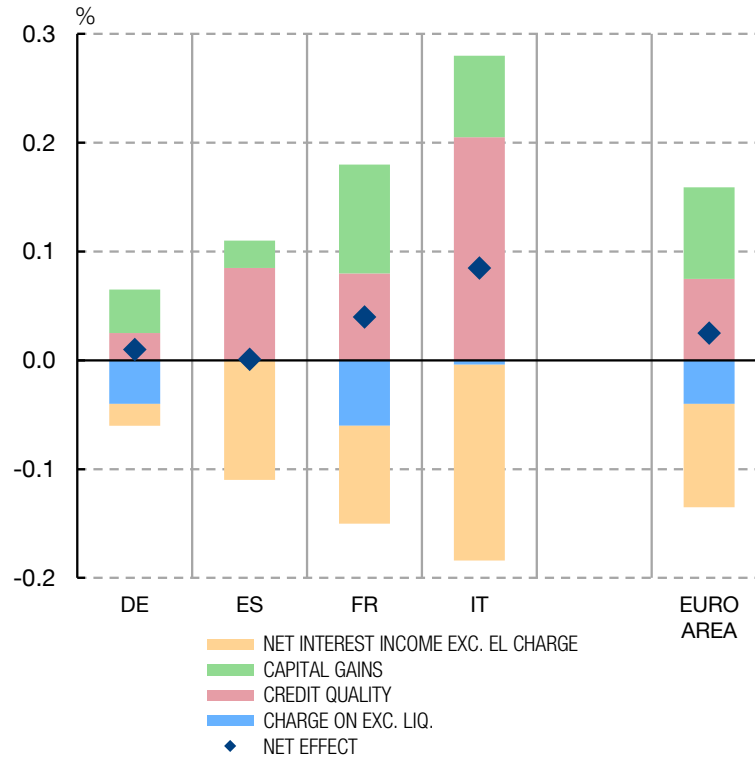


BANK PROFITABILITY



Both the impact on the economic recovery and increasing volumes of credit should offset the negative effects of low interest rates on bank profitability

BANK PROFITABILITY AND MONETARY POLICY: 2014-2017
(Contribution to ROA)



Source: Speech by Benoît Cœuré (2016), Assessing the implications of negative interest rates.

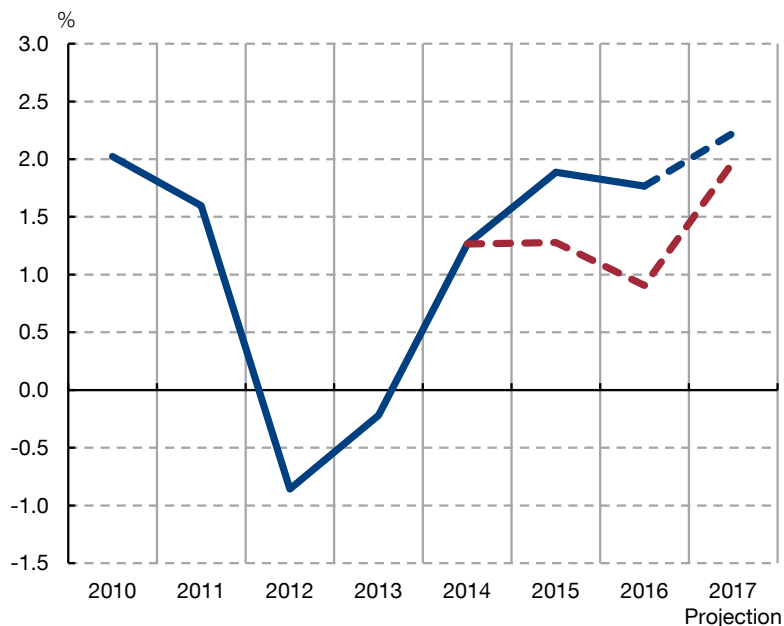
ECB MEASURES HAVE BEEN TRANSMITTED TO THE BROADER ECONOMY



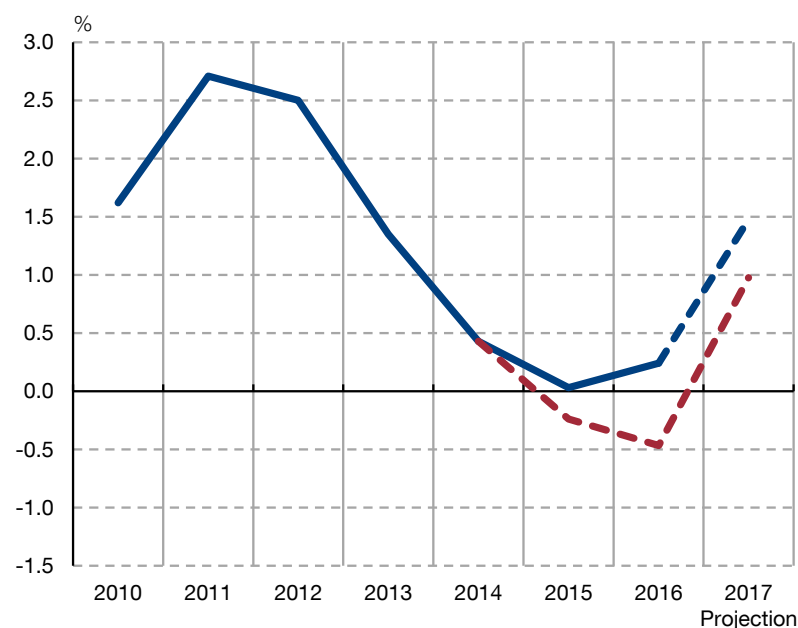
Analysis by Banco de España estimates that, in cumulative terms, about 50% of nominal growth over the period 2015-2017 can be attributed to the action of monetary policy since mid-2014 (1.7 pp GDP growth, 1.5 pp inflation).

IMPACT OF THE ASSET PURCHASE PROGRAMME (APP) ON EURO AREA GDP AND INFLATION (a)

GDP Y-O-Y GROWTH



INFLATION



— ACTUAL AND SEPTEMBER 2017 ECB PROJECTION

- - - ESTIMATED PATH IN ABSENCE OF APP

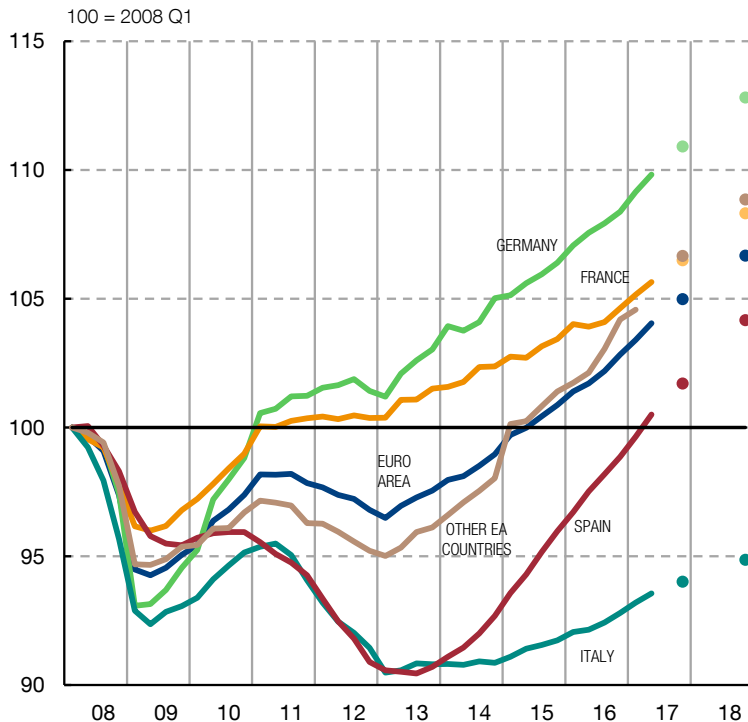
a Estimation based on Burriel and Galesi (2016), "Uncovering the heterogeneous effects of the ECB unconventional monetary policy across euro area countries" Working paper 1631. Banco de España.

EURO AREA ECONOMIC RECOVERY

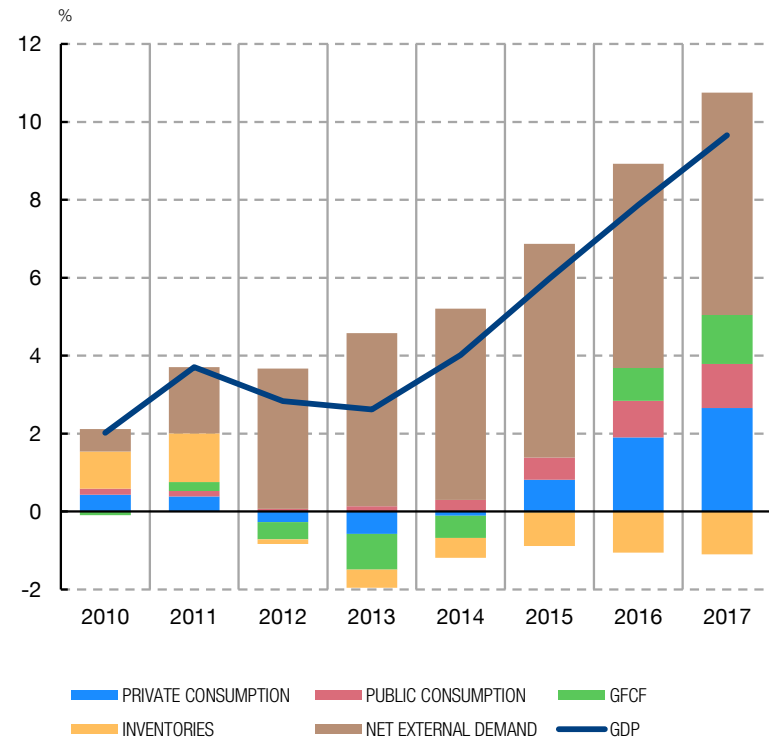


The euro area recovery is well on track, with economic expansion broadening across sectors and countries, driven by domestic demand

**REAL GDP
2008=100**



CONTRIBUTIONS TO EURO AREA GDP ACCUMULATED GROWTH

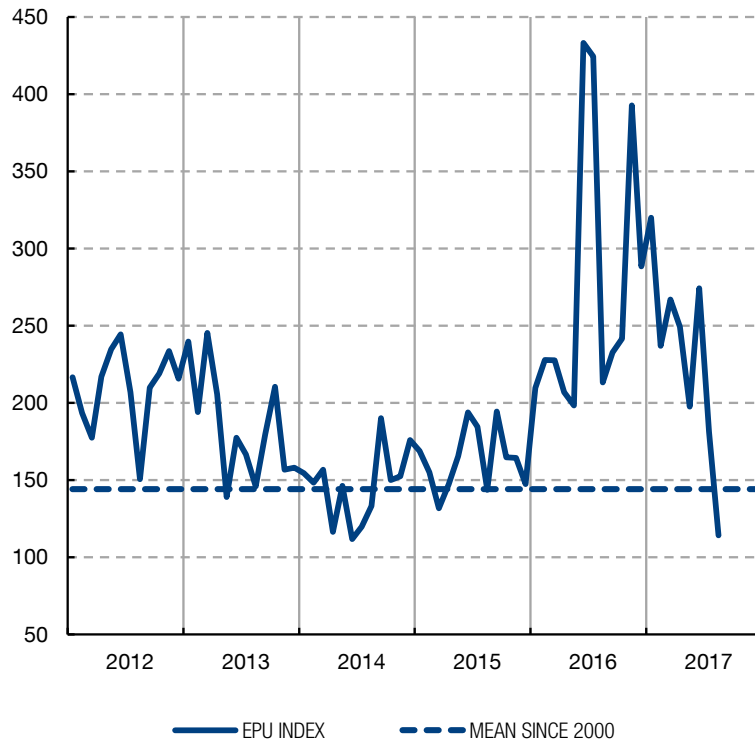


A RESILIENT RECOVERY

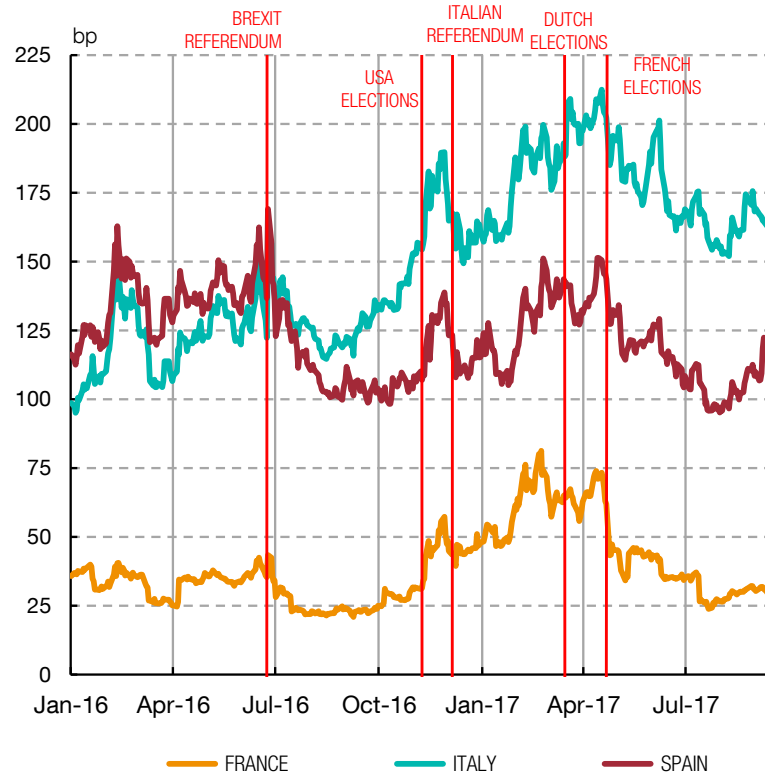


The recovery has been resilient to different sources of uncertainty -US elections, BREXIT and domestic political events-

EUROPEAN ECONOMIC POLICY UNCERTAINTY (EPU INDEX) (a)



SOVEREIGN SPREADS TEN YEAR BONDS TO GERMAN BUND



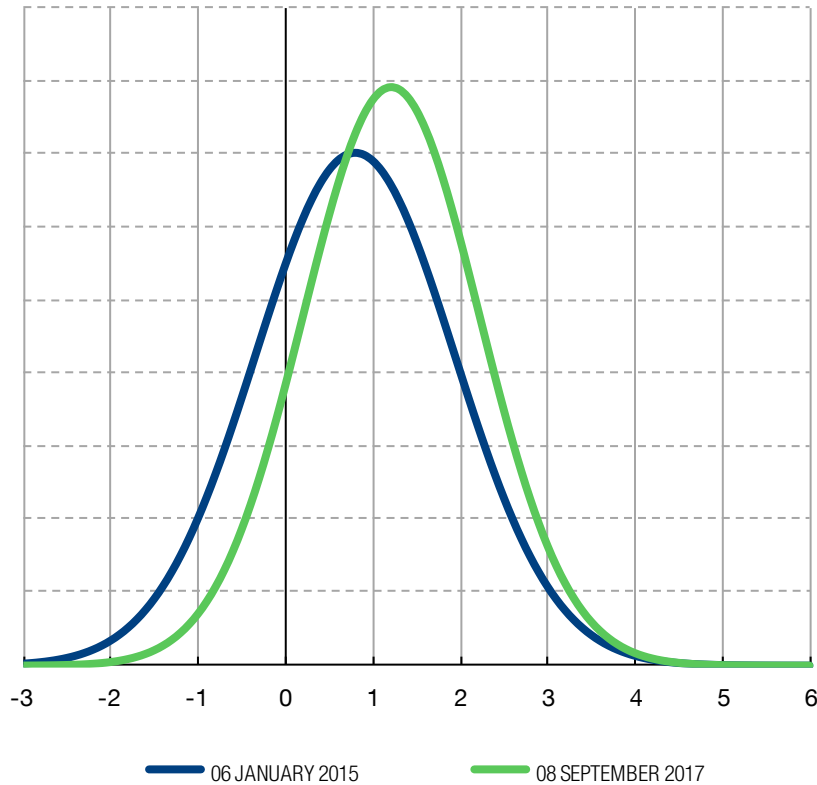
(a) Includes United Kingdom, Germany, France, Spain and Italy. Source Baker, Bloom and Davis (2016)

DEFLATION RISK

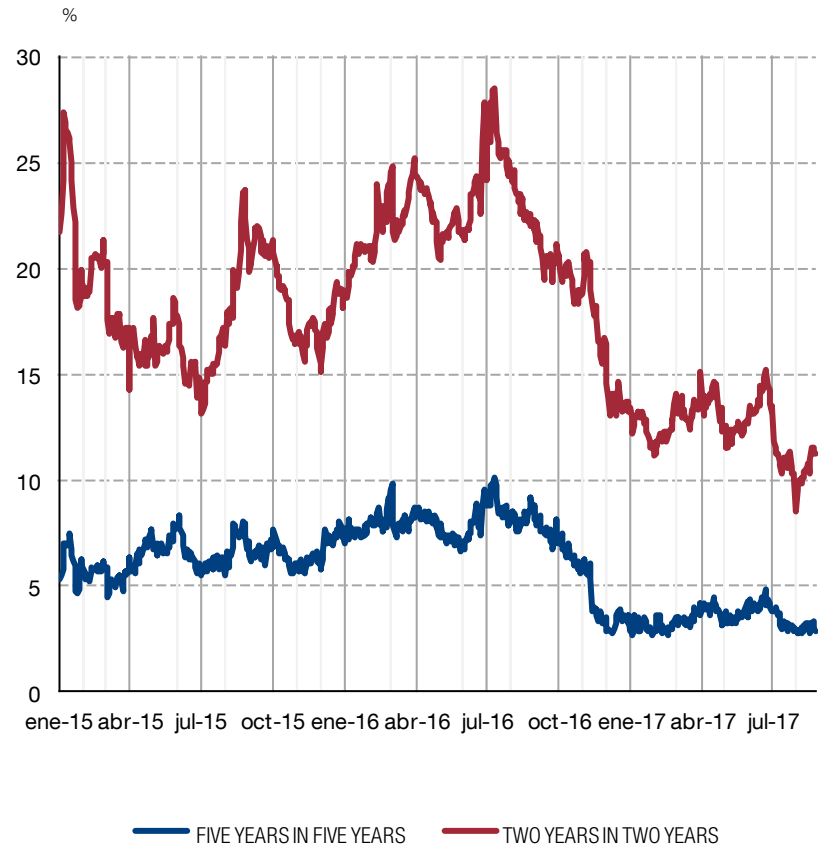


Tail risks to inflation have disappeared. ...

INFLATION EXPECTATIONS. 2 YEARS IN 2 YEARS
OPTIONS MARKETS



EURO AREA. PROBABILITY OF INFLATON BELOW 0%

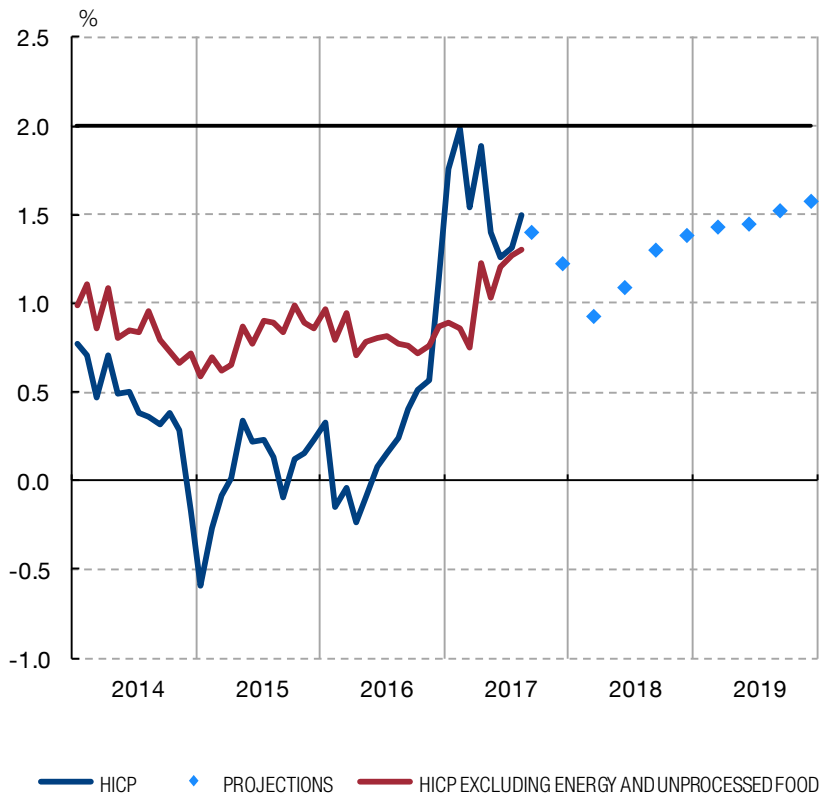


INFLATION DEVELOPMENTS



- Headline inflation has been volatile, reflecting the ups and downs of oil prices;
- Core inflation, which has increased somewhat in recent months, but remains subdued, at levels well below the medium-term objective of monetary policy;
- Market-based indicators of long-term inflation expectations remain at low levels

EURO AREA INFLATION



INFLATION SWAPS IMPLIED INFLATION 5 YEARS AHEAD 5 YEARS

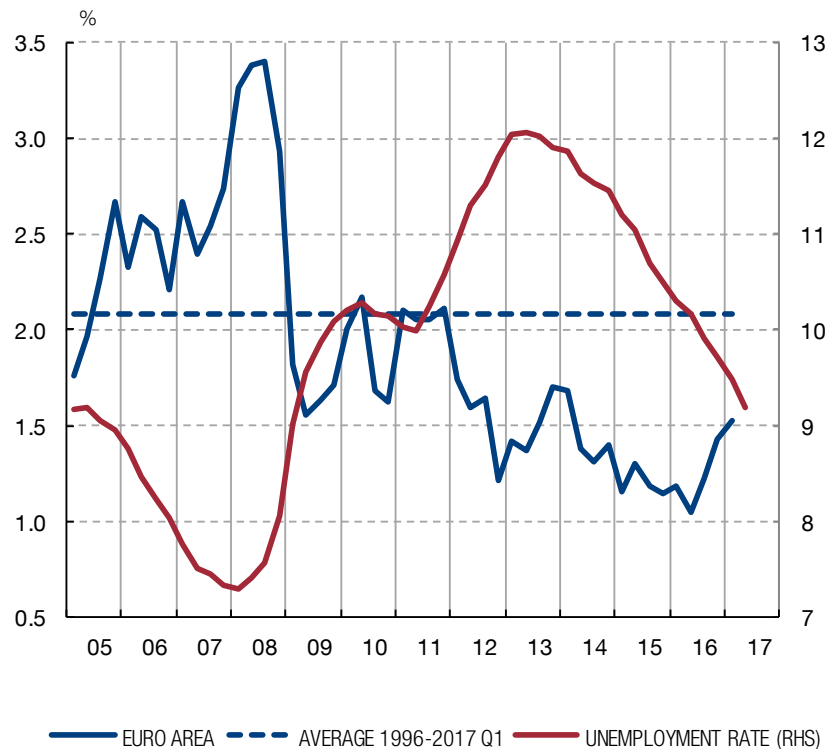


FACTORS BEHIND MODERATE INFLATION



Moderate inflation developments reflect not only the effect of temporary external shocks on oil and commodity prices, but also weak underlying domestic cost pressures

EURO AREA. COMPENSATION PER EMPLOYEE AND UNEMPLOYMENT RATE

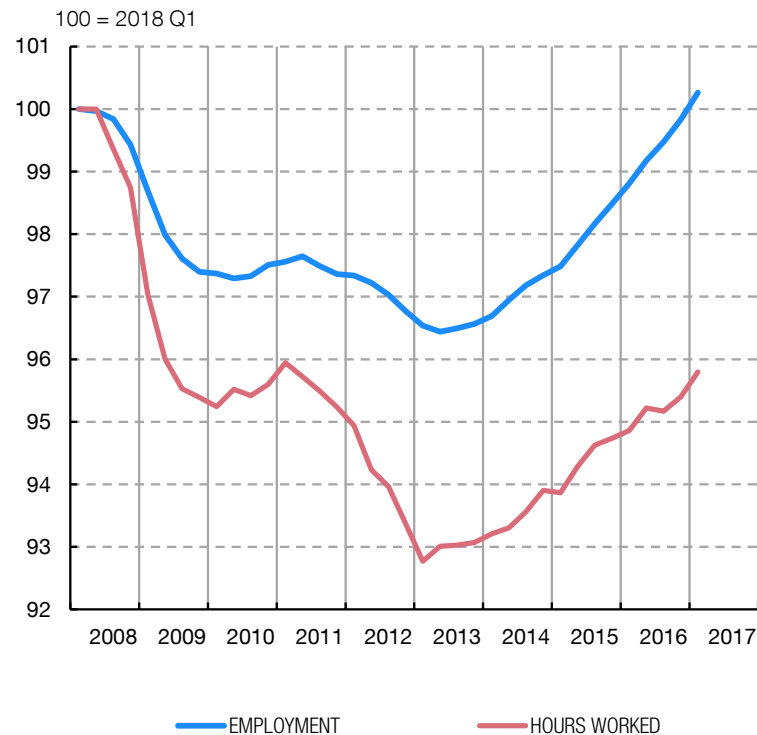


WAGE DEVELOPMENTS

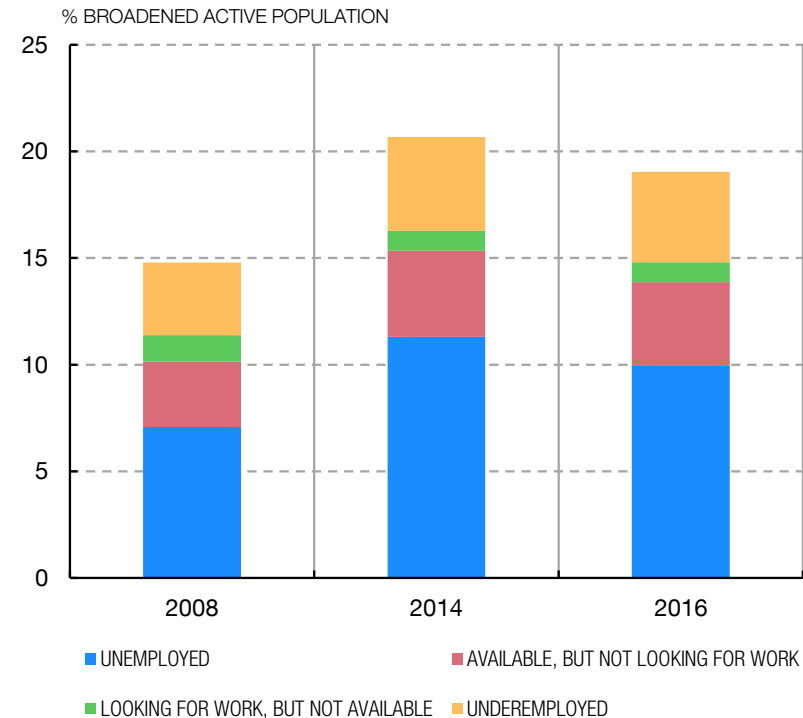


Subdued wage developments are related to still significant labor market slack and the prevalence of some backward-looking elements in wage negotiations. Other factors, such as the effects of past structural reforms and weak productivity growth, may also be playing a role

EURO AREA. EMPLOYMENT AND HOURS WORKED



BROADER ESTIMATIONS OF UNDERUTILIZATION OF LABOR IN THE EURO AREA



FINAL REMARKS

- After a prolonged period of exceptional monetary policy accommodation, the euro area is finally undergoing a **robust recovery**, with growth firming and broadening across countries;
- Supported by monetary policy and some other tail winds, the economic recovery has been **resilient** to domestic and global uncertainties, many of which are of political nature;
- Yet, the fact that “*underlying inflation is nowhere near where it should be*” suggests that a very significant degree of monetary accommodation will be needed for an extended period of time, in line with ECB forward guidance. The arguments are compelling:
 - *The growth outlook is still largely **dependent** on the current monetary stimulus ...*
 - *Underlying inflation remains subdued, and convergence of headline inflation towards the 2% reference is projected to be very slow;*
- There is a need for **other economic policies** to address the root causes of economic weakness and financial fragility in the euro area