The state and prospects of the euro area recovery

Speech by Mario Draghi, President of the ECB, at the European Banking Congress,

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Since the onset of the global financial crisis, 2016 has been the first full year where GDP in the euro area has been above its pre-crisis level. It has taken around 7.5 years to get there.

The economy is now recovering at a moderate, but steady, pace. Employment has grown by more than four million since its trough in 2013. And the recovery has become more broad-based, with less difference in economic performance across countries.

What we have now to ask is what are the factors that have allowed the recovery to gather steam, and whether we have reason to believe that they are sufficient to deliver a sustained adjustment in the path of inflation.

We have witnessed many encouraging developments, not least the healing of the euro area banking sector, which has allowed credit growth to turn positive again and monetary policy transmission to strengthen. This is a necessary condition for a full return to macro-economic and price stability.

But despite the uplift to prices provided by the gradual closing of the output gap, a sustained adjustment in the path of inflation still relies on the continuation of the current, unprecedented financing conditions. It is for this reason that we remain committed to preserving the very substantial degree of monetary accommodation, which is necessary to secure a sustained convergence of inflation towards level below, but close to, 2% over the medium-term.

What I would like to do in my remarks today is explain these perspectives – the factors that have put the euro area economy on a stronger footing, but also the reasons why we cannot yet drop our guard.

New factors making the euro area economy more robust

The first development that gives us comfort is the improving solvency of the banking sector.

We need a strong banking sector to support the economy through the recovery. But if there is one lesson we can draw from the past decade, it is that to be genuinely robust, the banking sector must be well-regulated. Indeed, there is a widespread agreement that one of the main causes of the global financial crisis was the excessive deregulation of the financial sector in the previous two decades.

The financial origins of the crisis explain in turn the slowness of the economic recovery. Banks that overextended credit in the upswing had to clean up their balance sheets and strengthen their capital.

Firms and households that took on excessive debt had to deleverage. And that combination depressed both credit supply and demand.

So the re-regulation of the financial sector is in fact a part of the growth agenda. And major progress has now been made in redressing the mistakes of the pre-crisis era.

The global regulatory agenda, steered by the G-20, has made the sector considerably more robust in terms of capital, leverage, funding and risk-taking. Common Equity Tier 1 ratios in the euro area have improved substantially, rising from less than 7% for significant banking groups in 2008 to more than 14% today. Leverage ratios are now close to 4% for large banks. The Liquidity Coverage Ratio was implemented last year, and most euro area banks are already complying with the Net Stable Funding Ratio ahead of its implementation in 2018.

It is true that this regulatory agenda, which has evolved profoundly in its design over the past eight years, may also have created some uncertainties, for instance over steady state capital levels, which are reflected in bank share prices. Indeed, uncertainty over future capital requirements can give rise to a risk premium, which weighs on banks' cost of finance and acts as a deterrent to expanding activities or supplying credit to the economy.

So now is the time to finalise the regulatory agenda and enter a period of stability. The focus should be on implementation, not on new design. Regulatory measures should be implemented in a balanced way that ensures a level playing-field globally. And while marginal adjustments are possible, there should be no rolling back on what has been decided.

Re-regulation has led to welcome improvements in bank solvency. Meanwhile, asset quality has also improved. The non-performing loan (NPL) ratio has been decreasing in the euro area, even if modestly. Critical in this context was the Comprehensive Assessment of bank balance sheets – including an asset quality review of great depth – which encouraged banks to frontload the strengthening of their balance sheet. While NPLs remain high in some countries, the problem today is more related to profitability than to the robustness of balance sheets, since coverage ratios are close to 50% and much of the remainder is collateralised.

All this progress has gone hand-in-hand with a steadying economic recovery. Increased banking sector resilience has helped shield the recovery from external shocks and sustain its internal momentum. The banking system has been able to weather, among other things, the crisis in emerging market economies, the collapse in oil and commodity prices, and the consequences of the UK referendum. And healthier banks have provided the necessary supply of credit to maintain the pace of the recovery.

The easing in credit supply conditions has been visible in both lending rates and lending volumes. Since mid-2014, bank lending rates have fallen by almost 100 basis points for both euro area households and corporates. Small and medium-sized enterprises have benefitted from even larger declines. Lending volumes, in turn, have posted positive growth rates for households since end-

2014, and for non-financial corporations since the last quarter of 2015, following multi-year declines.

And financing conditions have improved in capital markets too, which has been followed by a pick-up in corporate bond issuance.

This credit reversal has in turn supported a second benign characteristic of the recovery: the fact that it has become increasingly driven by domestic sources of growth.

Domestic demand has now replaced foreign demand as the main driver of growth. Over the past two years, domestic demand has on average added more than a percentage point to GDP growth, supported by very accommodative financing conditions. By contrast, net exports, which were a key growth engine for most of the crisis period, have barely contributed to GDP growth since end-2013 as the global environment has deteriorated.

This shift in the composition of growth is important, from an inflation perspective, since it makes the recovery in the euro area less vulnerable to external shocks. Indeed, domestic strength has helped insulate the euro area against recent global weakness, which otherwise would have dragged the recovery off track – and with it, the expected pick-up in the path of inflation.

The domestic picture is also contributing to a third encouraging development: the strong rebound in employment. This has been driven by a striking reconnection between GDP and employment growth in recent years.[1]

The temporary post-Lehman rebound in 2010-11 was essentially a jobless recovery. The current recovery, however, has reduced the unemployment rate from more than 12% in 2013 to 10% today. And, besides lower unemployment, the overall labour force has expanded as well in recent years, reflecting increasing labour participation rates.[2]

A faster return to full employment – or what economists call the "non-accelerating inflation rate of unemployment" – is clearly supportive of price stability, since it heralds a tighter labour market and stronger wage pressures. And while those pressures might be somewhat offset by the increasing number of people entering the labour force as the recovery strengthens, a larger workforce will ultimately support both supply – by raising potential growth – and demand.

With strengthening labour market prospects, existing employees can be reassured of their earnings prospects and revive their spending plans with greater confidence; and new recruits can satisfy some of the pent-up demand they accumulated while unemployed. The elasticity of aggregate consumption to new hires is particularly large. As such, these labour market trends represent a key factor in preserving growth and inflation momentum in conditions where global demand may become a less dependable engine of growth.

Factors warranting prudence

We have therefore every reason to be more confident in the strength of the recovery than we were one year ago. But we cannot be sanguine over the economic outlook.

Besides the geopolitical risks that remain prevalent, there are indeed three factors that warrant caution: the profitability of euro area banks, the relative weakness of inflation dynamics, and the dependence of the recovery on accommodative monetary policy.

Even though the euro area banking system is today more resilient, its profitability remains a challenge – one that is weighing on bank share prices and raising the cost banks face when raising equity. There has in fact been a negative gap between euro area banks' return on equity and their cost of equity since the 2008 financial crisis. While the level of bank equity prices is not *per se* a matter for policymakers, insofar as it raises financing costs for banks, it could ultimately curtail lending to the real economy and hold back the recovery.

One of the factors weighing on profitability is the low growth and low inflation environment, which translates into lower levels of policy interest rates. But legacy and structural challenges are also at play, which banks and policymakers can and should address.

Where the legacy stock of NPLs is depressing profitability, key is to create an environment where the resolution of bad loans can be accelerated. And where profitability is being affected by structural issues, such as overcapacity and inefficient cost structures, rationalisation and consolidation must form part of the answer. Indeed, such inefficiencies may have been exposed by the low interest rate environment, but they have certainly not been created by it.

A second reason to remain alert is that despite the recovery in growth and employment, the persisting output gap is still keeping inflation dynamics weak. The October inflation rate stood at 0.5%. While this marks the highest level recorded in almost two years, it remains far below the ECB's objective. And while we expect headline inflation to continue rising over the coming months, much of this increase will be driven by statistical factors related to the mechanical unwinding of the extreme oil price declines a year ago. We do not yet see a consistent strengthening of underlying price dynamics.

Our objective is – and will remain – a rate of inflation below, but close to, 2% over the medium term. Going forward, our assessment will depend on whether we see a sustained adjustment in the path of inflation towards that objective. And that means that inflation convergence towards 2% is durable, even with a reduction in monetary accommodation. Inflation dynamics, in other words, need to be *self-sustained*.

And this brings me to the third factor which calls for prudence over the outlook: the fact that the euro area recovery still relies to a considerable degree on accommodative monetary policy. The recovery in credit is being facilitated by a more resilient banking sector, but the impetus comes from our monetary policy.

Our measures and their effective transmission underpin our outlook for growth and inflation. According to staff estimates, our measures will raise the inflation rate by more than half a percentage point, on average, over 2016 and 2017. And they will contribute to increasing real euro area GDP growth by more than one and a half percentage points cumulatively between 2015 and 2018. In other words, monetary policy remains a key ingredient in the reflation scenario we foresee for the euro area in the coming years.

Conclusion

So even if there are many encouraging trends in the euro area economy, the recovery remains highly reliant on a constellation of financing conditions that, in turn, depend on continued monetary support. The ECB will continue to act, as warranted, by using all the instruments available within our mandate to secure a sustained convergence of inflation towards a level below, but close to 2%.

We also have to recognise that we operate under a still significant degree of uncertainty. Whether the economic recovery becomes more solid, and how quickly inflation dynamics become more self-sustained, depends not just on the current monetary policy stance, but also on other policies, as I have discussed on several other occasions. Restoring a sense of direction – and therefore confidence – would be the simplest and yet most powerful way to deliver economic stimulus.

[1]For further detail, see ECB Economic Bulletin, Issue 6/2016 – Article on “The employment-GDP relationship since the crisis”.

[2]For further detail, see ECB Economic Bulletin, Issue 1/2015 – Box on “Recent developments in the labour force participation rate in the euro area”.