

The outlook for the euro area economy

Speech by Mario Draghi, President of the ECB, Frankfurt European Banking Congress, Frankfurt am Main, 16 November 2018

The euro area economy has now been growing for five years, and we expect the expansion to continue in the coming years. Yet we have recently seen a loss in growth momentum. In both of the last two quarterly ECB growth projections, our staff has revised down its estimates. Actual data have also been weak. The flash estimate for euro area growth in the third quarter was just 0.2%.

The slowdown has raised questions about the strength of the growth outlook and, in turn, about whether the ongoing convergence of inflation towards our objective will be sustained. I would like to address these questions in my remarks this morning.

The key issue at stake is as follows: are we witnessing a temporary “soft patch” or a more lasting deterioration in the growth outlook?

There is certainly no reason why the expansion in the euro area should abruptly come to an end. A gradual slowdown is normal as expansions mature and growth converges towards its long-run potential. But the expansion in the euro area is still relatively short in length and small in size.

Since 1975 there have been five periods of rising GDP in the euro area. The average duration from trough to peak is 31 quarters, with GDP increasing by 21% over that period. The current expansion in the euro area, however, has lasted just 22 quarters and GDP is only around 10% above the trough. In contrast, the expansion in the United States has lasted 37 quarters, and GDP has risen by 21%.

In light of this, it is important to understand the sources of the growth slowdown we have witnessed this year. At present there are two main sources.

The first is one-off factors, which have clearly played an important role in the underperformance of growth since the start of the year. In the first half of 2018, weather, sickness and industrial action affected output in a number of countries. And in the third quarter, we saw a significant disruption of car production created by the introduction of new vehicle emissions standards on 1 September.

Production slowed as carmakers tried to avoid building up inventory of untested models, which weighed heavily on economies with large automobile sectors, such as Germany. Indeed, the German economy actually contracted in the third quarter, removing at least 0.1 percentage points from quarterly euro area growth.

But this effect should be temporary. As the testing backlog clears, car production should return to normal by the end of the year and the effect on output should dissipate.^[1]

The latest data already show production normalising.

The second source of the slowdown has been weaker trade growth, which is broader-based. Net exports contributed 1.4 percentage points to euro area growth in 2017, while so far this year they have removed 0.2 percentage points. World trade growth decelerated from 5.2% in 2017 to 4.6% in the first half of this year.

We are witnessing a long-term slowdown in world trade. Some of the factors that previously drove its rapid expansion, such as trade liberalisation and the creation of global value chains, have waned since the financial crisis. We are also witnessing a cyclical correction from the very strong trade growth recorded last year. Trade dynamics are now normalising as global growth retreats towards potential.

Insofar as world trade stabilises at a lower level, its drag on growth could also be temporary. But there are two conditions that could make it longer-lasting.

The first is if trade uncertainty rises and dampens euro area export performance, in particular owing to protectionism.

The preliminary trade agreement reached between the US, Canada and Mexico reduces some uncertainty, but other disputes remain. Some indicators suggest this is feeding into the trade outlook. The manufacturing PMI for the euro area fell to a two-year low in October, with export-oriented economies recording particularly large drops. New export orders contracted for the first time since 2013.

The second condition is if uncertainty about external demand spills over into domestic demand through confidence and investment channels.

For now, there is little tangible evidence that the moderation in growth has affected business investment. But there is some evidence that those euro area firms that are most likely to be affected by proposed tariffs have reduced their rate of capital spending. Moreover, the slowdown in imports has particularly affected capital and intermediate goods, which might signal that firms are scaling back their investment decisions.

So we need to monitor these trade risks very carefully over the coming months. However, we still see the overall risks to the growth outlook as broadly balanced, in large part because the underlying drivers of domestic demand remain in place.

Most important is the virtuous circle between employment, labour income and consumption, which has been the motor of growth throughout the recovery. Various indicators suggest this cycle has not been disrupted by the loss of growth momentum this year.

Employment growth remains relatively strong, even though the latest data suggest some slowdown. The contribution of labour income to household income growth in the first half of this year was the strongest in a decade. And consumer confidence remains above its long-run average in the euro area and across most economies. Perceptions about the general economic climate have declined somewhat this year, but consumers' assessments of their personal situation – which tend to be more correlated with consumption – have remained steady.

There are three considerations that underpin our view that this cycle is resilient.

First, an important force behind employment growth in the euro area is longer-term structural changes, and these are less sensitive to cyclical swings.

Over the past five years, employment has increased by 9.5 million people, rising by 2.6 million in Germany, 2.1 million in Spain, 1 million in France and 1 million in Italy.^[2]

This growth is similar to the five years before the crisis, when employment grew by 10 million people. In that period, however, close to 70% of employment growth was “prime age”, meaning it came from the 25-54 age group. But since 2013 more than 70% of employment growth has come from those aged 55-74. This partly reflects the impact of past structural reforms, such as to pension systems.

Indeed, the participation rate of people aged 55-74 has almost doubled, from around 20% in 1999 to 38% in 2017. The share of women in work has also risen by more than 10 percentage points since the start of EMU to almost 60% – its highest level ever. In addition, countries that have implemented structural reforms have in general seen a rise in labour demand in recent years compared with the pre-crisis period. Germany, Portugal and Spain are all good examples.

The second consideration that points to the resilience of domestic demand is the strong link between consumption and job growth in the euro area. Consumption is much more conducive to jobs than exports, reflecting the higher labour-intensity of services, which are the bulk of consumers' expenditure. In contrast, exports have a higher manufacturing content and are less labour intensive.^[3]

This is one reason why the labour market recovery was not affected by the contraction in world trade in 2015-16.

In fact, the continued strength of consumption may explain why firms are still hiring even as growth slows, with permanent contracts accounting for the vast majority of the increase in employment this year. But clearly this could change if firms start to see the slowdown as more persistent.

The third consideration is the still very favourable financing conditions in the euro area, underpinned by our accommodative monetary policy.

The cost of bank borrowing for firms fell to record lows in the first half of this year across all large euro area economies, while the growth of loans to firms stood at its highest rate since 2012. The growth rate of loans to households is also the strongest since 2012, with consumer credit now acting as the most dynamic component, reflecting the ongoing strength of consumption. Household net worth remains at solid levels on the back of rising house prices and is adding to continued consumption growth.

But there are some risks to financing conditions as well.

Lack of fiscal consolidation in high-debt countries increases their vulnerability to shocks, whether those shocks are autonomously produced by questioning the rules of EMU's architecture, or are imported through financial contagion. So far, the rise in sovereign spreads has been mostly restricted to the first case and contagion across countries has been limited.

Such developments feed into tighter bank lending conditions for the real economy. To date, though some repricing in bank lending is happening where the rise in spreads has been more significant, overall bank funding costs remain near historical lows in all large countries, thanks to a steady deposit base.

To protect their households and firms from rising interest rates, high-debt countries should not increase their debt even further and all countries should respect the rules of the Union.

Other risks stem from the possibility of a disorderly increase in global risk premia. The reaction of asset prices to surprise inflation in other jurisdictions at a more advanced stage in the business cycle, a return to the financial deregulation that was the primary cause of the financial crisis, and fragilities in several emerging market economies exposed to currency mismatches, are all risks that warrant close monitoring.

Outlook for inflation and monetary policy

So, how is the growth picture affecting the outlook for inflation? Here we need to assess to what extent wage growth will be robust to slowing growth momentum, and to what extent wage increases will pass through to prices.

The link between output growth and wage growth in the euro area has strengthened compared with recent years. As the domestic expansion continues, wage pressures have started to build and have surprised on the upside this year. Annual growth in compensation per employee reached 2.3% in the second quarter. This increase is broad-based and present across most sectors and euro area economies.

Two factors suggest wage growth should be resilient to a period of slower growth.

The first is that the labour market is already showing signs of tightness, and this should remain the case so long as growth continues at or above potential. Labour shortages have become more prominent and widespread across the euro area. Broader measures of slack – that include underemployed workers – have also fallen substantially, although there is still some heterogeneity across countries.

The second factor is the changing composition of wage growth. The initial pick-up in wages from the trough in 2016 was driven by wage drift, which includes components such as bonuses and overtime and tends to react more quickly to the cycle. But more recently negotiated wages have strengthened, rising from the trough of 1.4% in mid-2016 to 2.2% in the second quarter of 2018. Negotiated wage agreements frequently last two or three years, suggesting that higher rates of wage growth are likely to persist.

However, the next leg of the inflation process – the pass-through of wage growth to prices – remains relatively muted. Measures of underlying inflation, such as core inflation, continue to hover around 1% and have yet to show a convincing upward trend.

To some extent, this lagged response is in line with the standard pattern of demand-driven expansions in the euro area.^[4]

As demand picks up, employment initially reacts slowly, which boosts overall productivity and lifts margins. Firms therefore have little need to increase prices. But as the expansion matures, businesses increase wages more strongly to attract labour, and unit labour costs rise, squeezing margins and putting upward pressure on prices.

This pattern has been visible in the euro area since the start of 2017. Unit labour cost growth fell initially last year, but rose measurably this year to reach 1.6% in the second quarter, its strongest rate since the start of 2013. There is evidence that margins are now being squeezed, with unit profit growth decreasing substantially from 2.7% in the third quarter of 2017 to 0.7% in the second quarter of 2018. We should therefore expect price pressures in the euro area to mount.

However, the speed of this process is state-dependent. Preliminary ECB research finds that the recent history of inflation is a key factor in the speed and strength of the pass-through from wages to prices. The pass-through is systematically faster and stronger in periods of higher inflation than in periods of lower inflation.^[5]

Thus, following several years of low inflation in the euro area, a more tentative pass-through of wages to prices is understandable. But as labour costs rise, the buffer room for absorbing cost increases through margins will eventually vanish. As price increases become more widespread and firms become more confident about their pricing power, we should see a higher degree of pass-through.

That said, if firms start to become more uncertain about the growth and inflation outlook, the squeeze on margins could prove more persistent. This would affect the speed with which underlying inflation picks up and therefore the inflation path that we expect to see in the quarters ahead.

When the Governing Council met in October, we confirmed our confidence in the economic outlook. The underlying strength of domestic demand and wages continues to support our view that the sustained convergence of inflation to our aim will proceed. But in the light of the lags between wages and prices after a period of low inflation, patience and persistence in our monetary policy is still needed.

With monetary policy providing a significant degree of stimulus through our interest rate policy, stock of acquired assets and reinvestments of maturing bonds, the Governing Council assessed that inflation convergence could be maintained even after a gradual winding-down of our net asset purchases. Subject to incoming data confirming this assessment, we anticipate that net asset purchases will come to an end in December.

However, the Governing Council also noted that uncertainties surrounding the medium-term outlook have increased. When the latest round of projections is available at our next meeting in December, we will be better placed to make a full assessment of the risks to growth and inflation.

We have conveyed that we expect interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure that inflation continues to move towards our aim in a sustained manner. And we have stated that reinvestments will continue for an extended period of time after the end of net purchases, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

The nature of this forward guidance is contingent on economic developments and therefore acts as an automatic stabiliser. If financial or liquidity conditions should tighten unduly or if the inflation outlook should deteriorate, our reaction function is well defined. This should in turn be reflected in an adjustment in the expected path of future interest rates.

Our forward guidance has been effective in anchoring expectations about the future path of interest rates and preventing an undue tightening of monetary policy caused by premature expectations of policy normalisation. It has also helped shield financial conditions in the euro area from policy changes in other jurisdictions.

Conclusion

In conclusion, I want to emphasise how completing Economic and Monetary Union has become more urgent over time not less urgent – and not only for the economic reasoning that has always underpinned my remarks, but also to preserve our European construction.

This is my last speech at this conference as President of the ECB, and in preparing for it, I looked back at the speech I gave here in November 2011. There I lamented that the economic crisis would require a faster pace in strengthening the Monetary Union, especially for decisions that had already been taken.^[6]

This perhaps has a familiar ring today. Since then, the work has been remarkable, but it is still far from finished.

The completion of the banking union in all its dimensions, including risk reduction, and the start of the capital markets union through implementing all ongoing initiatives by 2019, have now become as urgent as the first steps were in euro area crisis management seven years ago.

These are urgent today not because of an economic crisis that we have successfully addressed, but because they are the best response to the threats that are being levied at our monetary union: to these threats, more Europe is the answer.

^[1]See Deutsche Bundesbank, *Monthly Report*, October 2018.

^[2]Data for France and Italy are only available up to the second quarter of 2018.

^[3]See Anderton, R., Aranki, T., Bonthuis, B. and Jarvis, V., “Disaggregating Okun’s law – Decomposing the impact of the expenditure components of GDP on euro area unemployment”, *Working Paper Series*, No 1747, ECB, Frankfurt am Main, December 2014.

^[4]See Gumiel, J. and Hahn, E., “The role of wages in the pick-up of inflation”, *Economic Bulletin*, Issue 5, ECB, 2018.

^[5]Bobeica, E., Ciccarelli, M. and Vansteenkiste, I., “The link between labor costs and price inflation in the euro area”, paper prepared for the XXII Annual Conference at the Central Bank of Chile, Santiago, 26 October 2018.

^[6]See Draghi, M. (2011), “Continuity, consistency and credibility”, speech at the 21st Frankfurt European Banking Congress “The Big Shift”, Frankfurt am Main, 18 November 2011.