

EURO AREA ECONOMIC PROSPECTS AND MONETARY POLICY

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CV REUNIÓN DE GOBERNADORES DE BANCOS CENTRALES DEL CEMLA

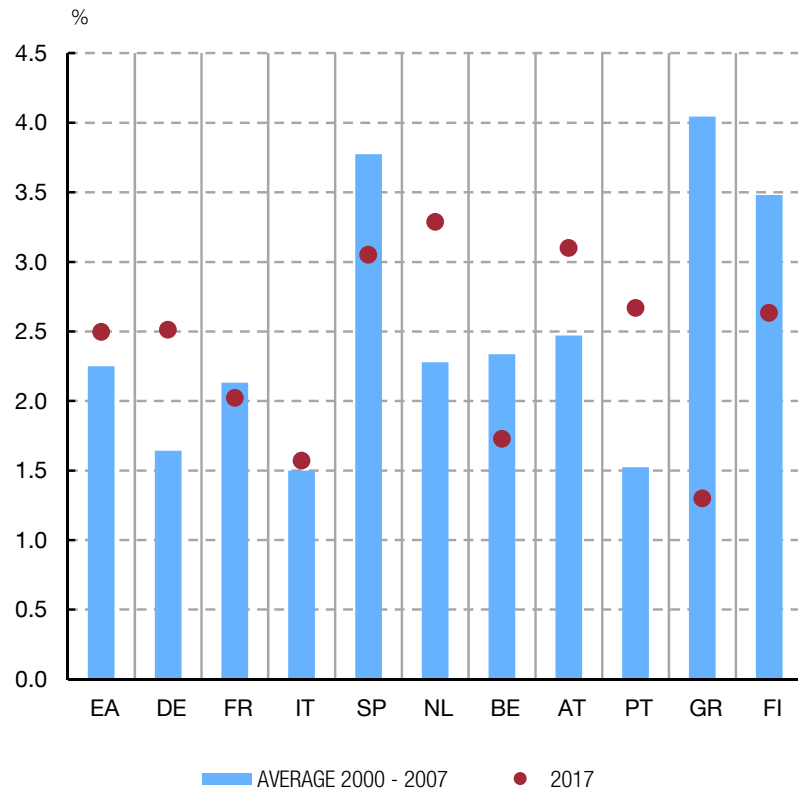
Asunción, 4 y 5 de junio de 2018

ECONOMIC ACTIVITY IN THE EURO AREA A ROBUST AND BROAD-BASED EXPANSION.

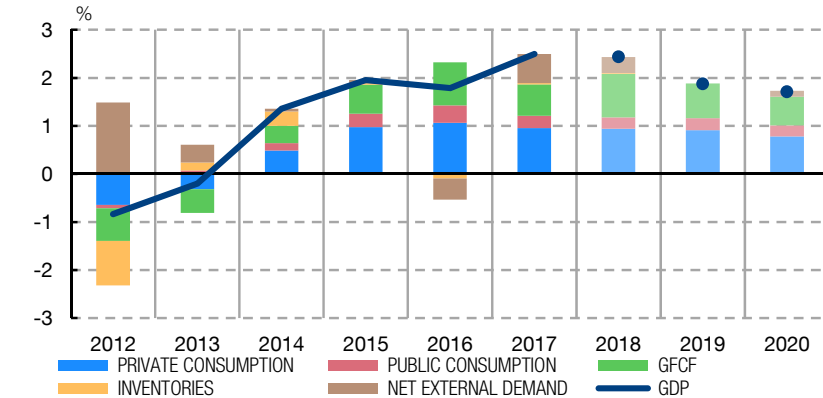


- Economic activity in the Euro Area expanded at brisk rates in 2017, supported by strong domestic demand and exports. Growth is expected to remain robust over the next quarters, although at a more moderate rates.
- The ongoing expansion has led to strong employment gains and to a marked reduction of unemployment.

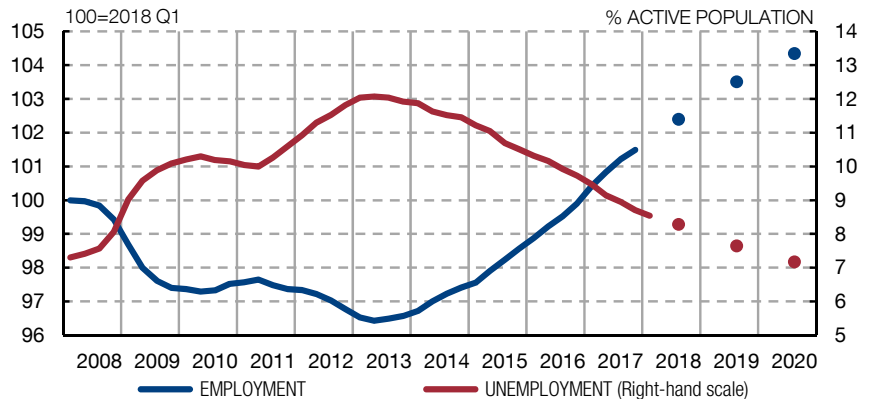
GDP GROWTH



CONTRIBUTIONS TO EURO AREA GDP GROWTH



EURO AREA. EMPLOYMENT AND UNEMPLOYMENT

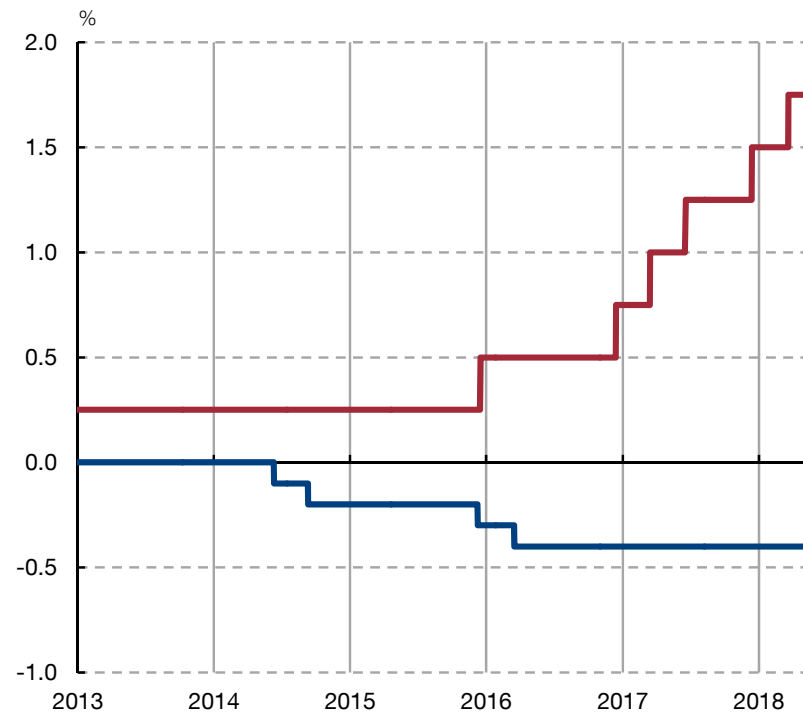


MONETARY POLICY HAS BEEN PIVOTAL TO SUSTAIN THE ECONOMIC EXPANSION.



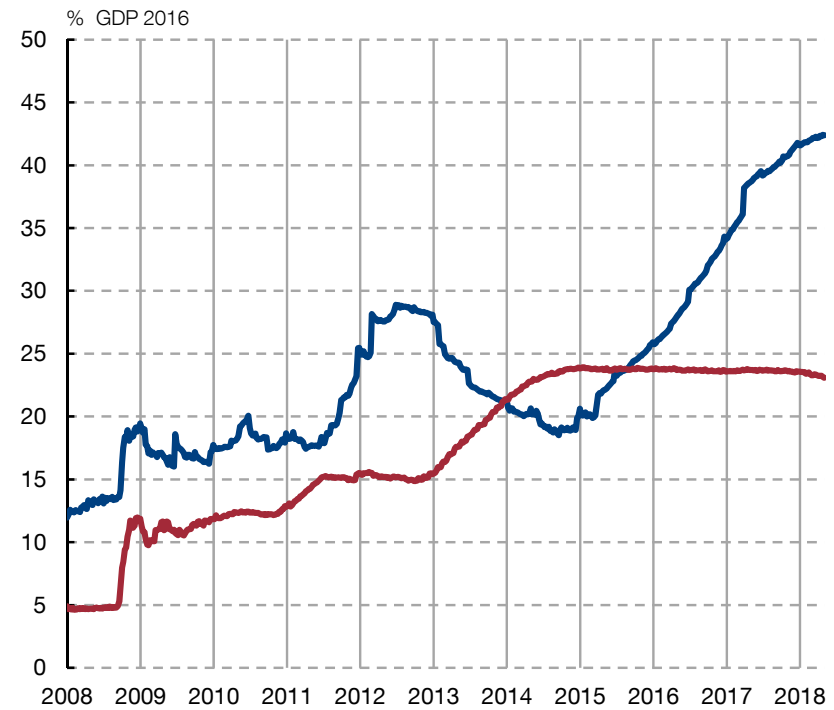
- The ECB monetary policy stance has been based on a comprehensive package of expansionary measures defined by: (1) ultra-low or even negative interest rates; (2) ample liquidity provision (LTRO, TLTRO); (3) the implementation of an ambitious programme of purchases of public and private assets (QE); (4) a new policy of forward guidance

OFICIAL INTEREST RATE



— EUROSISTEMA

CENTRAL BANK'S BALANCE SHEET



— FEDERAL RESERVE

MONETARY POLICY EASED FINANCIAL CONDITIONS AND SUPPORTED GROWTH AND INFLATION.

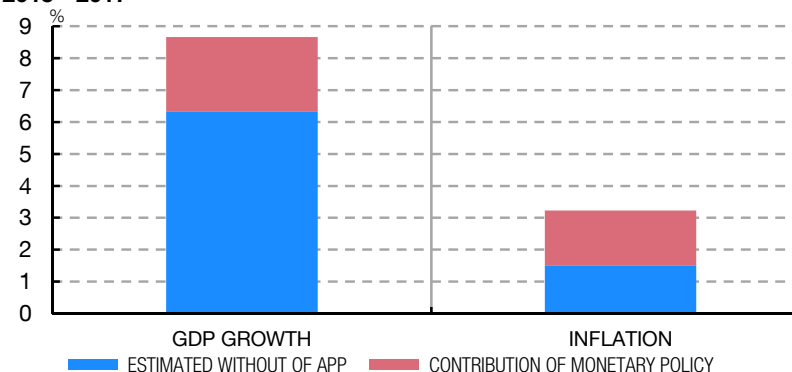


- Expansionary monetary policy has eased financial conditions, supported growth and has avoided deflationary scenarios
- Around 50% of nominal growth in the period 2015-17 can be attributed to the unconventional monetary policy that the ECB has been adopting since 2014

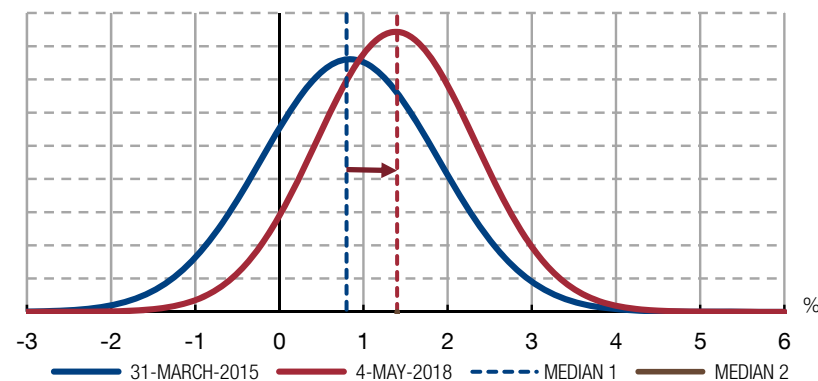
TEN-YEAR INTEREST RATES



EURO AREA. CONTRIBUTION OF MONETARY POLICY DECISIONS 2015 - 2017



INFLATION EXPECTATIONS A 1 YEAR AHEAD 1 YEAR

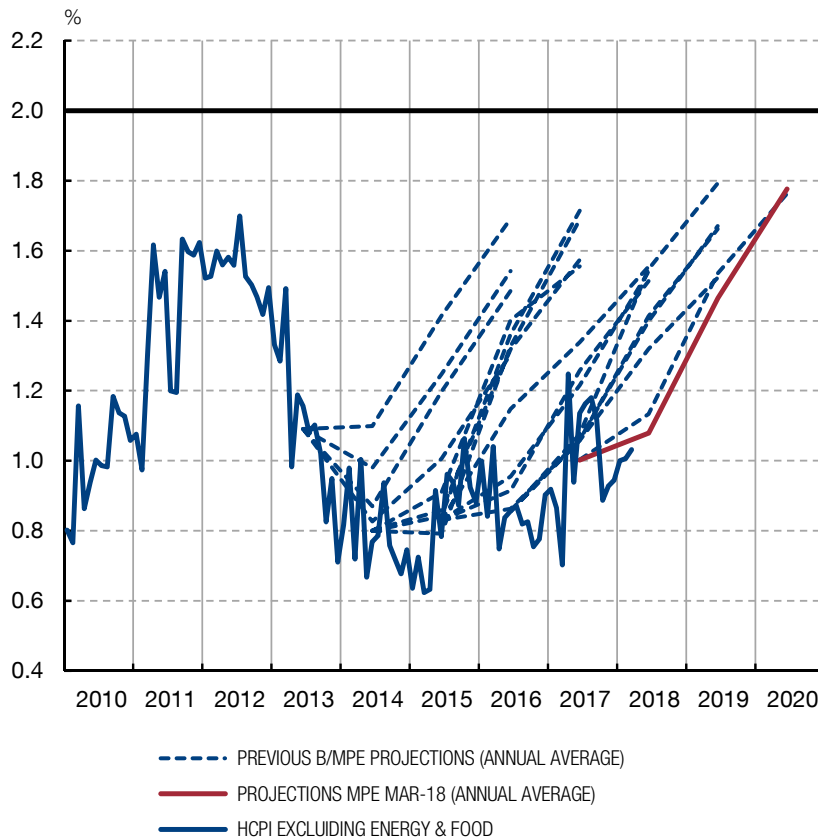


NONETHELESS INFLATION REMAINS SUBDUED...



- Inflation has not yet showed convincing signs of a sustained upward trend.
- Core inflation remains lacklustre (with persistent negative surprises) and market-based indicators of long-term inflation expectations (whilst having increased since mid-2016) remain at moderated levels.

**EURO AREA. HCPI EXCLUDING ENERGY & FOOD
(Year-on-year growth)**



IMPLIED INFLATION FROM INFLATION SWAPS

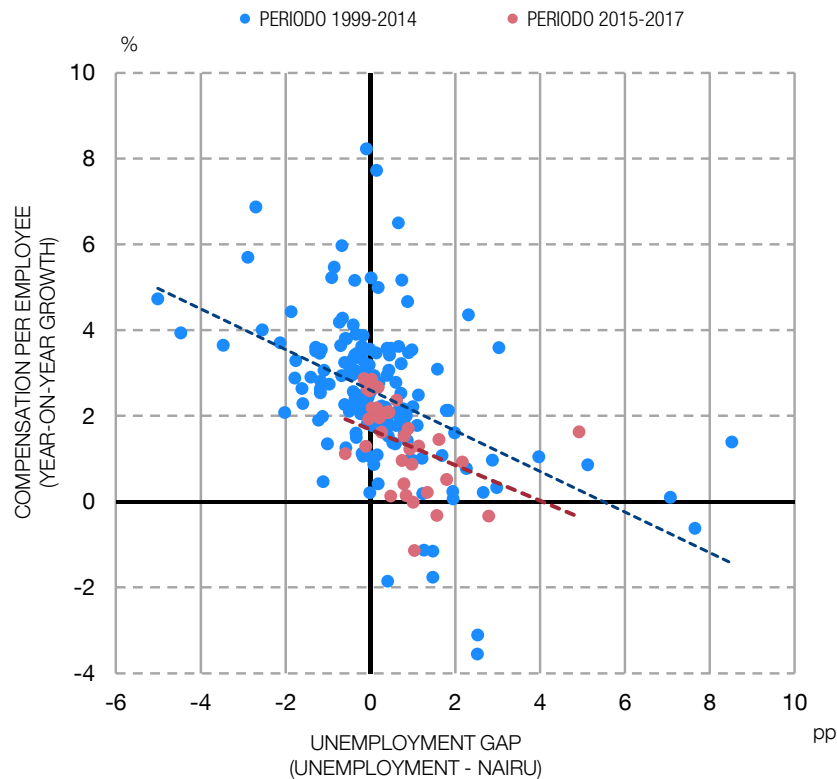


... AND WAGE GROWTH IS STILL VERY MODERATE.



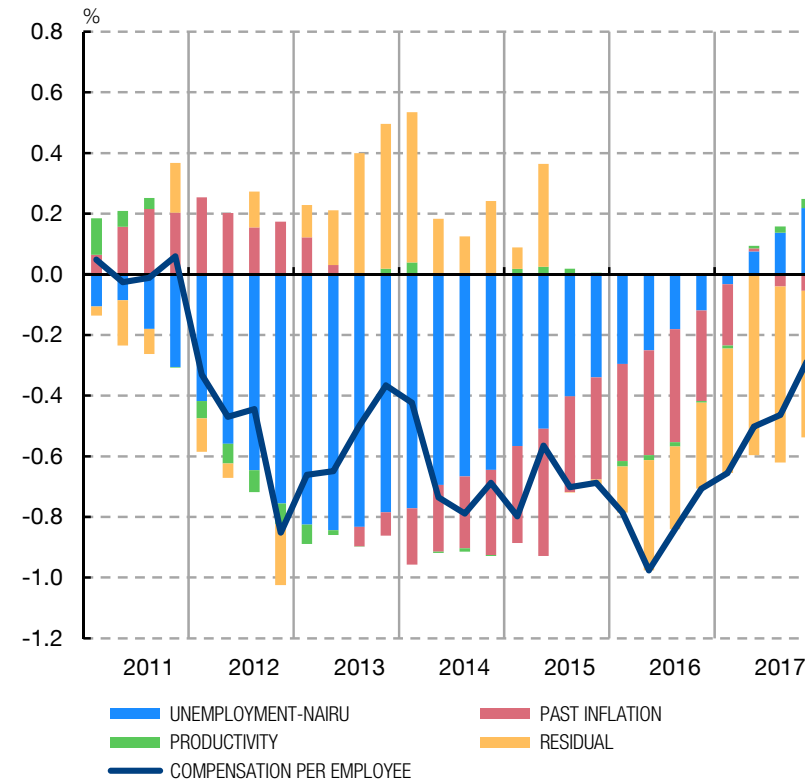
- Moderate inflation developments mirror muted wage dynamics.
- The relationship between wages and traditional indicators of labor slack seems to have weakened in most countries due to several factors: (1) labor market slack may be larger than measured by standard indicators; (2) persistent low inflation and the prevalence of some backward-looking elements in wages negotiations; (3) weak productivity growth; (4) short-term effects of labor market reforms.

**COMPENSATION PER EMPLOYEE AND EMPLOYMENT GAP
EURO AREA COUNTRIES (1999 - 2017)**



**EURO AREA. COMPENSATION PER EMPLOYEE GROWTH
DESCOMPOSITION**

Breakdown based in Phillips Curve
(Deviations from the mean)

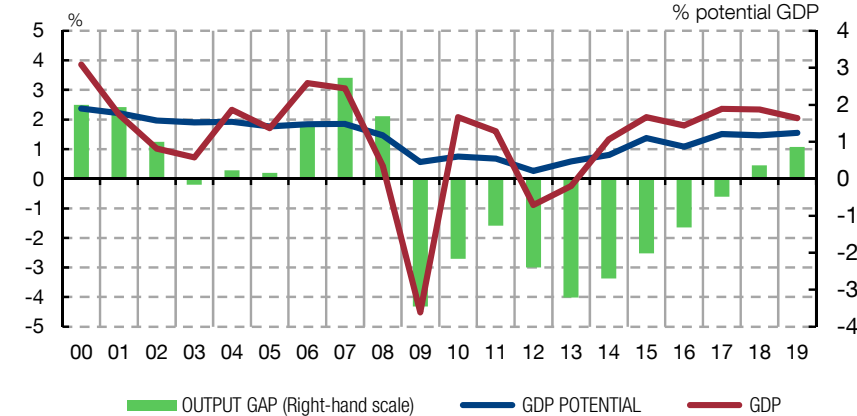


THE DEGREE OF SLACK IN THE ECONOMY: AN OPEN QUESTION

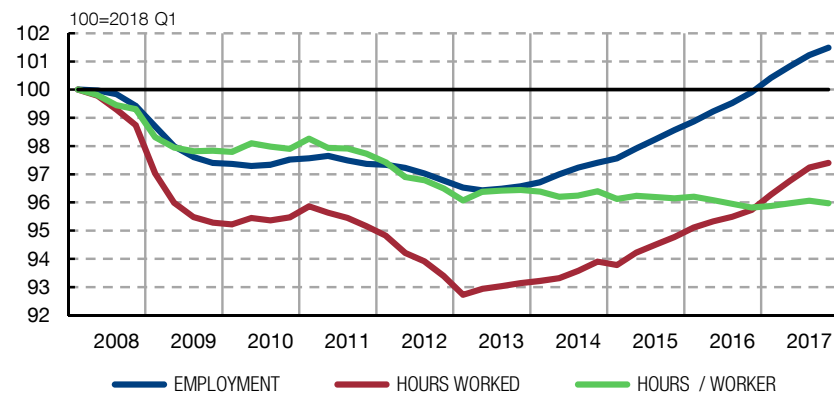


- There are mixed signals about the position of the business cycle in the euro area. While the output gap is projected to be positive this year and capacity utilization stands at maximum levels in most countries...
- ... there are some signals of remaining slack in the labour market: hours per worker are still below pre-crisis levels and broader definitions of unemployment points to larger labor underutilization.

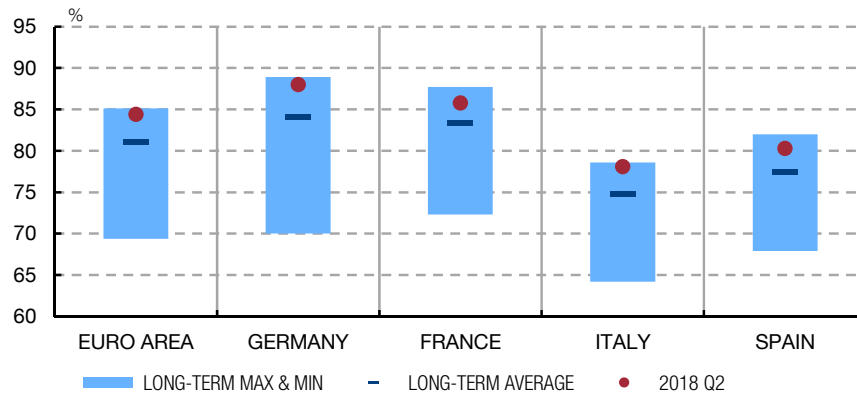
EURO AREA. GDP GROWTH AND OUTPUT GAP



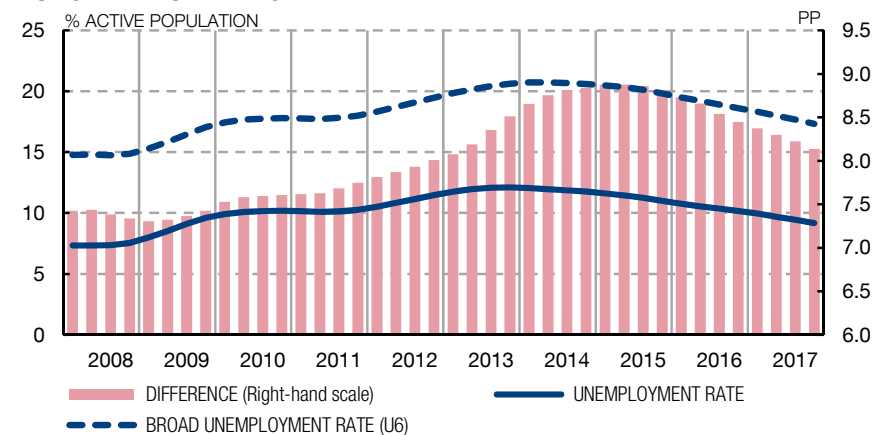
EURO AREA. EMPLOYMENT



LEVEL OF CAPACITY UTILIZATION TOTAL INDUSTRY. SINCE 1999



EURO AREA. UNEMPLOYMENT RATE

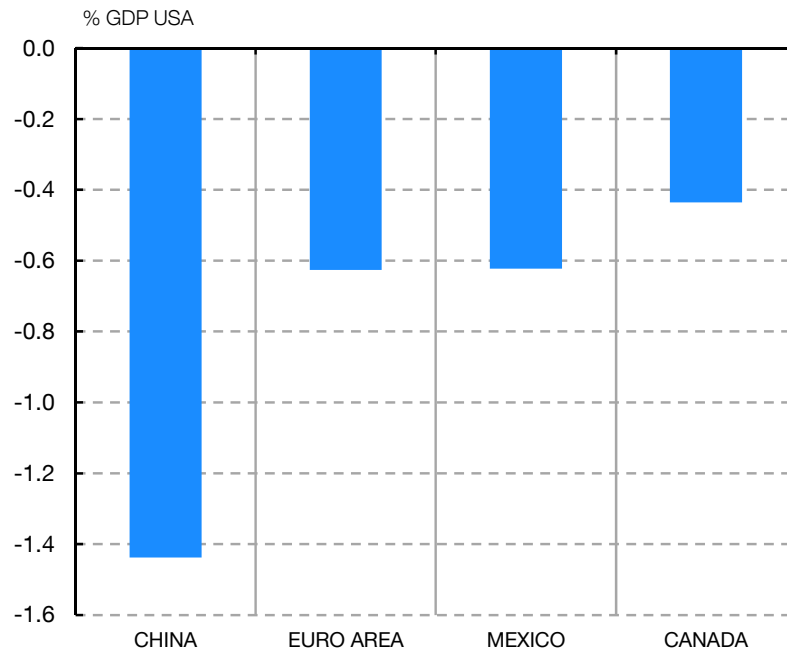


MEANWHILE GLOBAL RISKS HAVE INCREASED: PROTECTIONISM AND GEOPOLITICAL TENSIONS

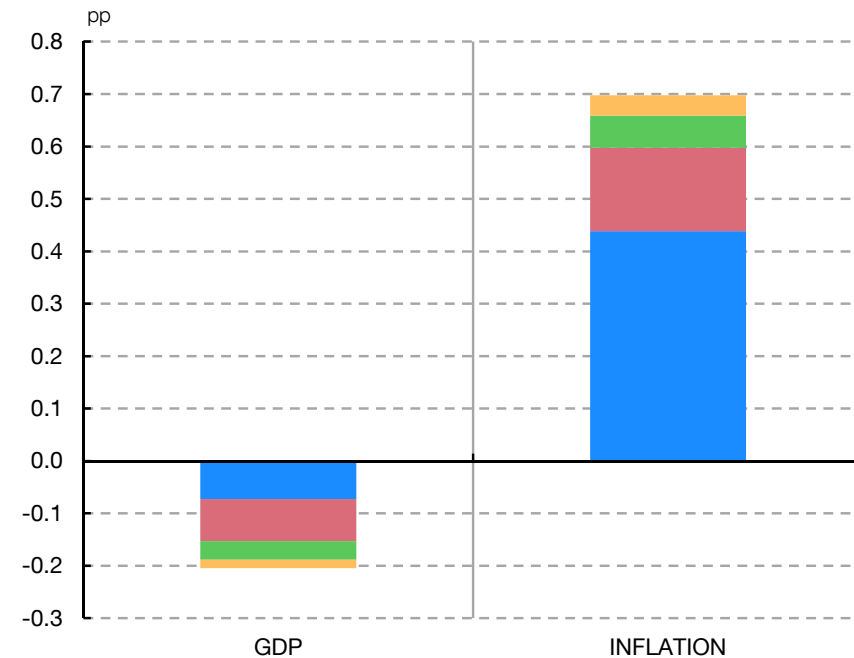


- US trade policies may negatively weigh on global growth.
- At the same time, recent geopolitical tensions are provoking a sharp increase in oil prices which could have a significant impact on EA growth and inflation.

US TRADE BALANCE BY TRADE PARTNER



EURO AREA. IMPACT ON GDP AND INFLATION OF THE INCREASE IN OIL PRICE BY 15%

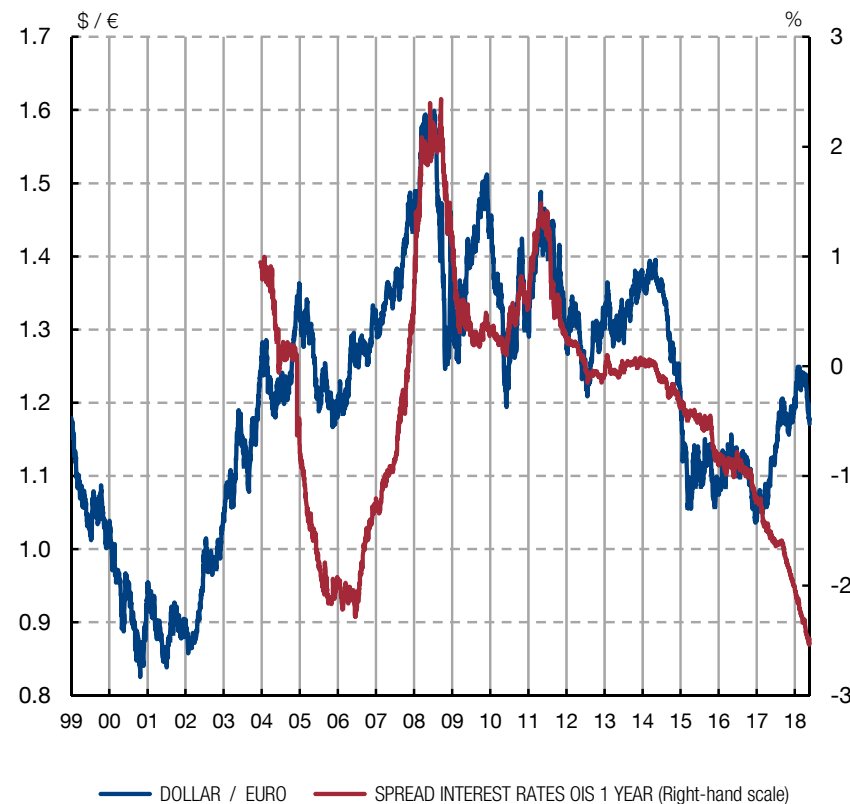


EURO EXCHANGE RATE AND INCREASING RISKS IN THE FINANCIAL MARKETS



- The appreciation of the euro since mid-2017, partially corrected in recent-months, did not appear to be backed on divergences on the expected tone of monetary policy. US fiscal policy might may have increased doubts on the sustainability of the twin deficits.
- The euro area is not immune to possible new corrections in the stock markets.

EXCHANGE RATE AND INTEREST RATE SPREAD EA-US



STOCK MARKET

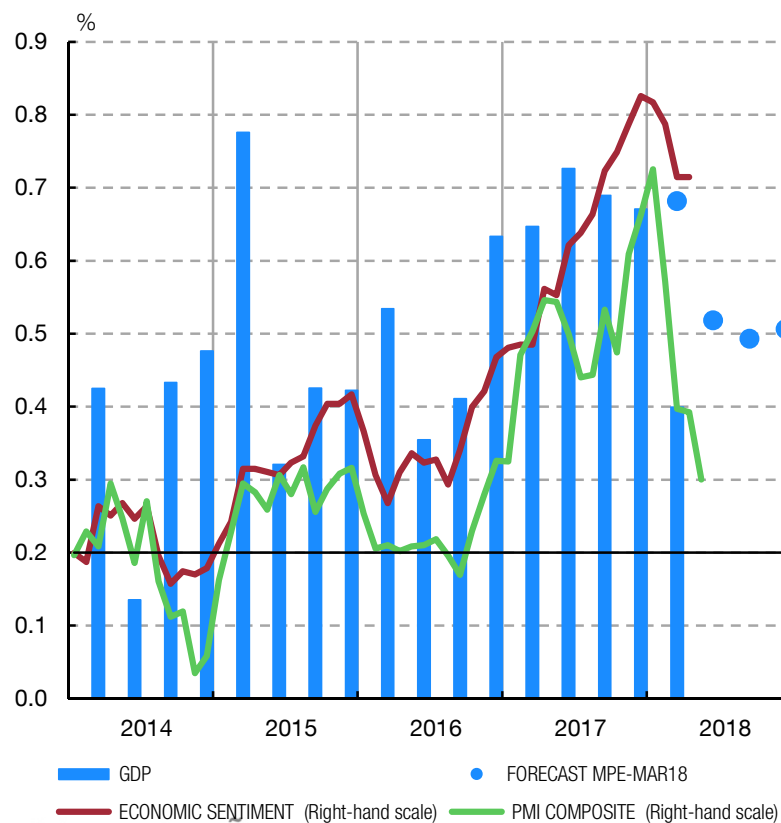


REMAINING DOMESTIC RISKS.



- Latest data surprised on the downside, pointing to some moderation in economic activity, while remaining consistent with a solid economic expansion.
- Increasing political uncertainty posts significant risks
- Legacy issues underlying some vulnerabilities: high level of non performing loans and indebtedness (private and public) in some countries and sectors.

QUARTER-ON-QUARTER GDP GROWTH AND ECONOMIC SENTIMENT AND PMI COMPOSITE



SOVEREIGN SPREADS TEN YEAR BOND TO GERMAN BUND

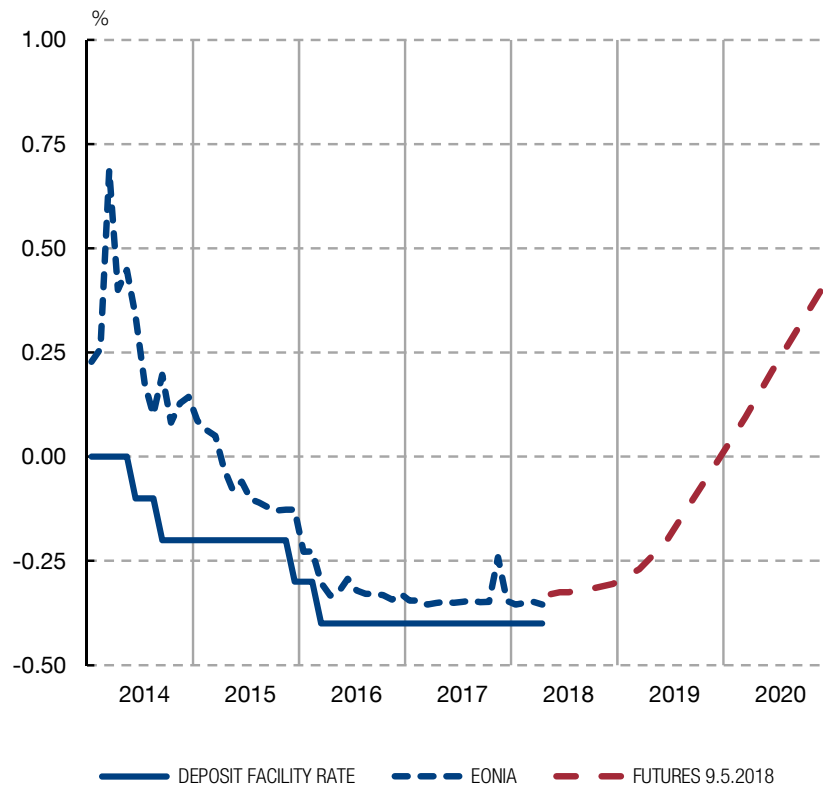


A SUBSTANTIAL SUPPORT FROM MONETARY POLICY IS STILL NEEDED.

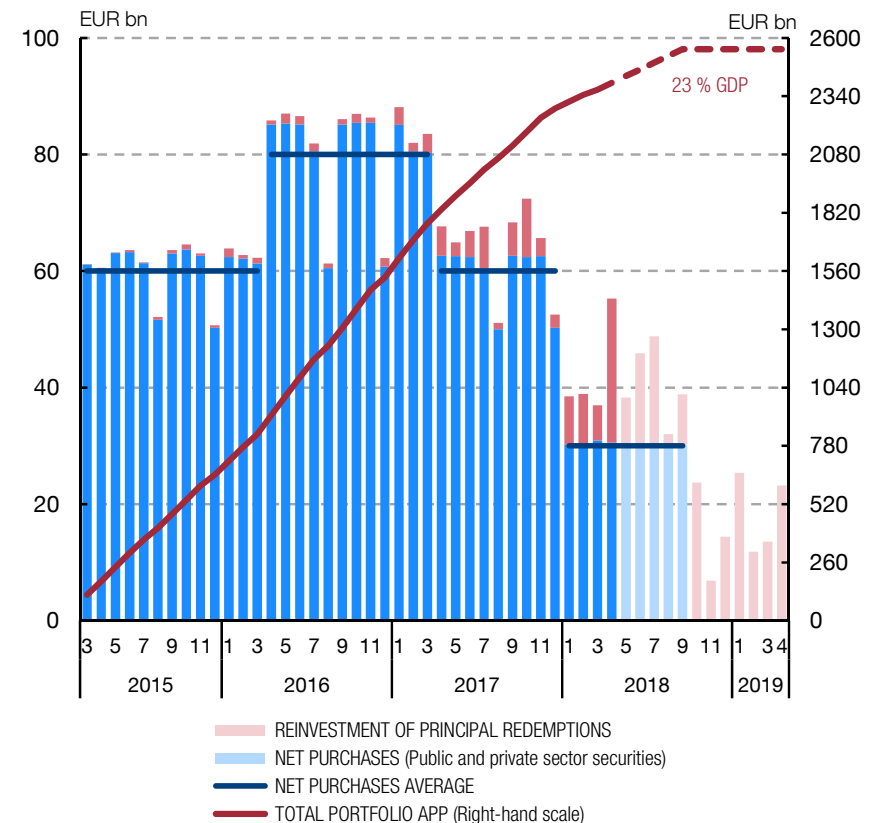


- For the time being, an ample degree of monetary accommodation remains necessary to make sure inflation moves towards rates that are below, but close to, 2% over the medium term.
- Going forward, normalization of monetary policy is expected to be very gradual to avoid unwarranted changes in financial conditions.

INTEREST RATES EXPECTATIONS



ASSET PURCHASE PROGRAMMES (APP) Monthly net purchases and reinvestment

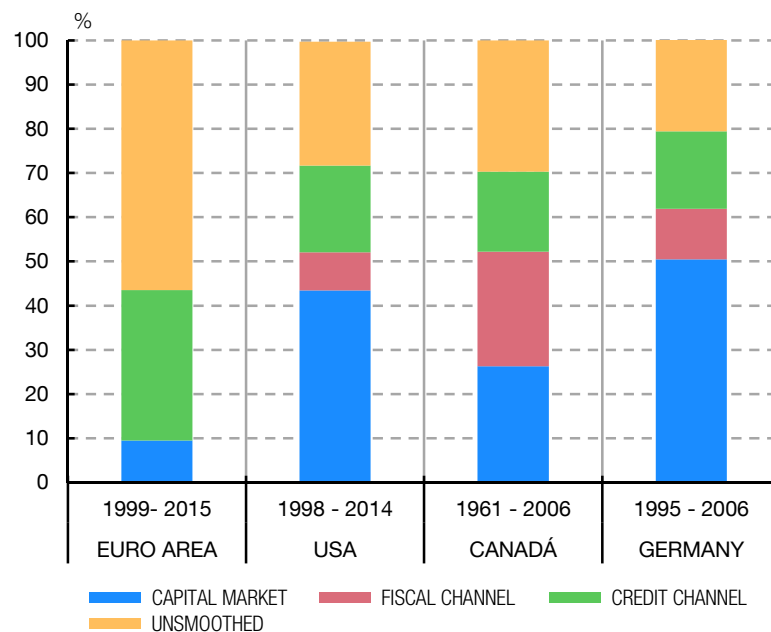


THE GOVERNANCE REFORM AGENDA MUST ADVANCE..



- Risk sharing channels are weaker in the euro area than in other monetary union. It needed
 - *Upgrading the potency of private and public risk sharing channels*
 - *Better exploiting the synergies among them*
- Although some steps towards a genuine Economic Monetary Union have already taken in recent years, the architecture is still incomplete and vulnerabilities remain

**POWER OF THE RISK-SHARING CHANNELS
INTERNATIONAL COMPARATION**



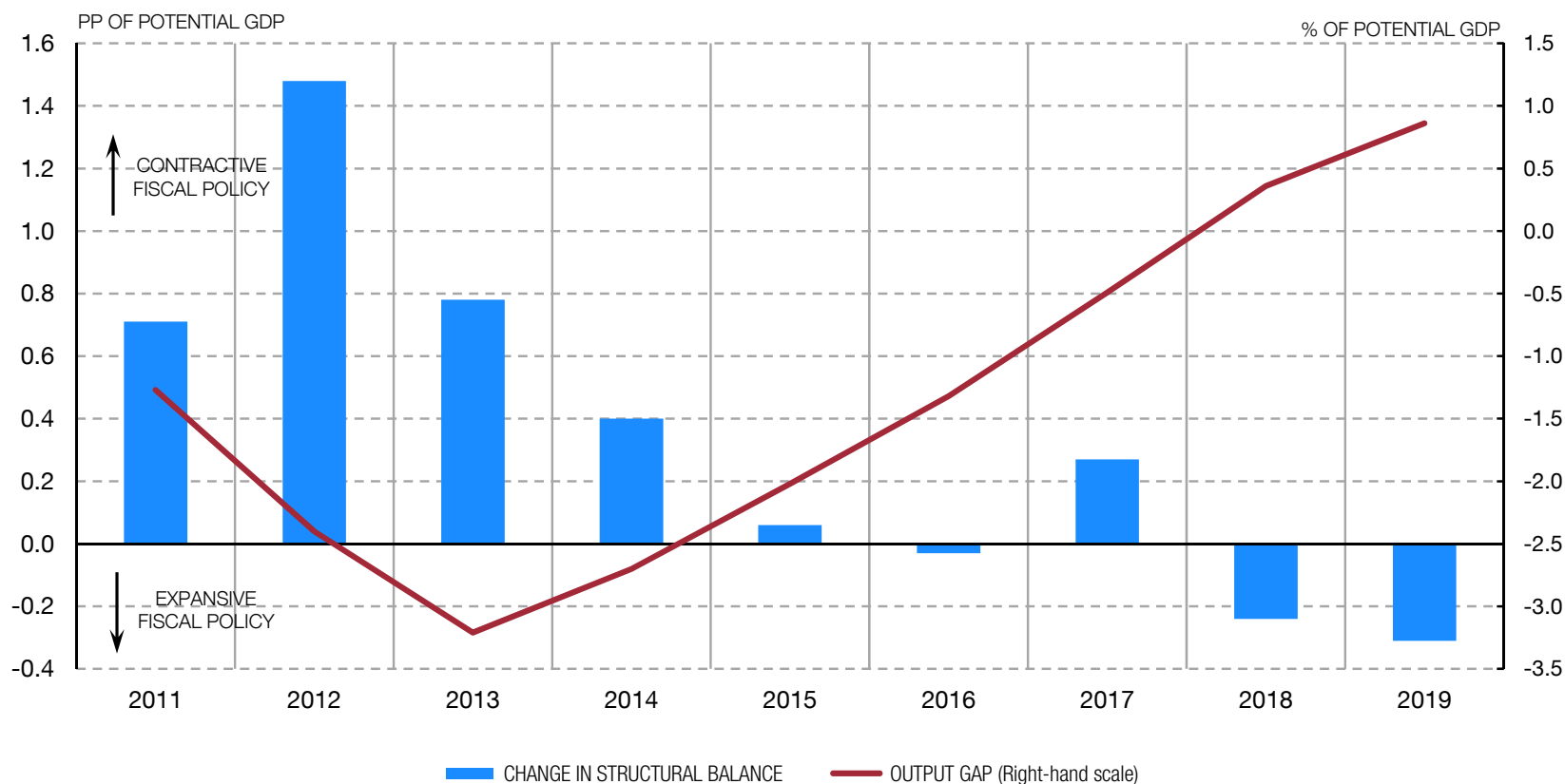
- Further progress to complete the Banking Union is a priority:
 - *Stablishment of a common fiscal backstop for the Single Resolution Fund*
 - *Creation of a common European Deposit and Insurance Scheme (EDIS)*
- And also
 - *Deliver on the Capital Markets Union initiatives.*

...AND THE FISCAL FRAMEWORK IMPROVES.



- The EU rule-based fiscal framework needs to gain in simplicity and transparency, and contribute decisively to generate enough room for the design of domestic countercyclical fiscal policies.
- Supranational instruments are needed to absorb asymmetric shocks and to define an euro area fiscal stance.

CHANGE IN STRUCTURAL BALANCE AND OUTPUT GAP OF THE EURO AREA



FINAL REMARKS



- Growth fundamentals are strong ...
 - A solid domestic demand with still high levels of business and consumers confidence
 - Very favourable financing conditions
 - Significant improvement in the labour markets

- But risks are increasing..
 - Geopolitical and trade policy uncertainty could dent global growth
 - Global financial markets have shown signs of stress recently
 - Domestic risks remain (political uncertainty, banking vulnerabilities, high levels of debt).

- For the time being, an ample degree of monetary stimulus remains necessary in the euro area for inflation to converge on a sustainable basis towards the 2% medium term reference.

- Domestic policies must contribute to raising the longer-term growth potential and reducing vulnerabilities. Improving the functioning of Economic and Monetary Union remains a priority.