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How to address the low growth and inflation environment in the euro area

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World economic growth is projected to stand in 2019 at its lowest level since the international financial crisis and economic activity forecasts have been revised downwards across the board over the past year. The deterioration stems from the proliferation of protectionist measures. These have significantly impacted global trade flows through value chains and have also generated negative effects as a result of their effect on global confidence and investment. In addition, the uncertainty surrounding the Brexit negotiations and the emergence of other sources of uncertainty in Latin America and Asia have contributed to the deterioration in the world economy. This has been compounded by the impact of the economic slowdown in China, resulting essentially from the switch to a model increasingly oriented towards the replacement of imports by domestic demand.

The deterioration in the euro area growth outlook has been particularly sharp. This reflects, first, the fact that the euro area economy is especially vulnerable to shocks from abroad, owing to its high degree of openness, its significant participation in value chains and its productive and trade specialisation (exports of capital goods and cars having a significant presence); and, second, that the industrial sector has also been affected by the difficulties in the car industry, especially in Germany, as a result of regulatory uncertainty and technological change. This environment has ultimately had a negative bearing on firms' investment decisions and households' consumption of durables.

The services sector, in contrast, has been more resilient (albeit with a mildly slowing profile), and employment generation (which has remained robust), buoyant wage growth and favourable financial conditions have underpinned private consumption growth. The outcome, in any event, is that the real GDP of the euro area as a whole grew in the first three quarters of 2019 by 1.1%, as compared with 2.5% in 2017 and 1.9% in 2018. Meanwhile, the latest Eurosystem macroeconomic projections foresee real GDP growth of 1.2% in 2019, 1.1% in 2020 and 1.4% in 2021 and 2022.

Along with the moderation in activity, the latest period has been characterised by low inflation. Specifically, core inflation (excluding energy and food) has fluctuated in recent years at around 1%, at a considerable distance from the reference value of the European Central Bank (ECB) (close but below 2%), while indicators of inflation expectations stand at historic lows. Although there are perceptible upward pressures on labour costs, against a background of tensions in euro area labour markets, the lower momentum of growth is leading to a decline in margins, which is delaying their pass-through to inflation. Other, more structural factors, such as globalisation and the greater exposure of economies to international competition, along with the impact of new technologies, digitalisation and the extension of new ways of trading, also appear to be curbing the rise in inflation.

All these factors, along with other more persistent ones, such as population ageing and productivity stagnation, tend to support the view that the low growth and moderate inflation environment could be long-lasting. The forecasts of most international agencies coincide with this view.

This worrying environment means that a reconsideration of the macroeconomic policy framework in Europe is urgent and necessary, in order for the response to the challenges to be appropriate.

With regard to **monetary policy,** the Governing Council of the ECB has reiterated the need for monetary policy to remain highly accommodative for a prolonged period of time. It has also asserted its willingness to deploy all of its instruments, as necessary, in order to ensure that financing conditions are favourable, support the economic recovery and are conducive to sustained convergence of inflation to levels compatible with the ECB's medium-term objective. This objective is interpreted in symmetric terms, which means that we are committed to acting with the same resolve whether inflation is persistently above or persistently below our target.

Thus, following the decisions adopted in September, we expect interest rates to remain at their present or lower levels until we have seen the inflation outlook robustly converge to the objective within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics. Likewise, within the framework of our asset purchase programme, net purchases (resumed on 1 November) will run for as long as necessary to reinforce the accommodative impact of our policy rates and will end shortly before we start raising the key ECB interest rates. Also, we expect to continue reinvesting, in full, the principal payments from maturing securities for an extended period of time past the date when we start raising interest rates.

Testifying to the importance of the monetary policy measures for sustaining euro area activity, it is estimated that the measures adopted since mid-2014 will impact real GDP growth overall by around 2.5 pp from 2016 to 2021. Significantly, these effects arise from the combination of the various instruments used which, beyond their individual impact, complement and mutually reinforce one another.

The current setting also calls for reflection on the monetary policy strategy in the medium term. The above-mentioned secular trends suggest that the economy's potential growth and equilibrium interest rates (those balancing saving and investment requirements) have persistently fallen. As a result, central banks will have less space to cut rates in response to future crises and will have to resort more frequently to less conventional measures. This situation has led some central banks (such as the US Federal Reserve and the Bank of Canada) to discuss possible alternatives to their current monetary policy strategy. At the ECB we shall also review our strategy in 2020.

All told, we cannot have the responsibility for the recovery and the maintenance of higher growth rates in the medium term in the euro area rest exclusively on monetary policy. In this connection, other economic policies must contribute.

Specifically, **structural policies** should be expedited to boost productivity and growth potential, to reduce structural unemployment and to raise the area's resilience. These structural reforms, in the form of expansionary supply-side policies, are particularly appropriate in the macroeconomic setting I have described. In this respect, the slow progress by the euro area members in implementing the structural reform recommendations, noted by the European Commission in its assessment in the last European Semester, is a cause for concern.

Fiscal policies should also contribute to overcoming these challenges. Their composition should be reoriented so as to make them more conducive to long-term economic growth and to enable the challenges posed by environmental, technological and demographic developments to be addressed. Further, the countries with more fiscal room for manoeuvre could afford a greater budgetary stimulus in their economies in the short term. That, in the current setting of very low interest rates, would generate a high positive impact that would also spread to the other countries in the area. Countries with a high public debt, for their part, should prioritise healthier public finances if fiscal policy is to be fully deployed as a national instrument of macroeconomic stabilisation in the face of future, potentially more adverse scenarios.

In any event, we should recall that, in the current euro area framework, budgetary policy decisions are the responsibility of national Governments, which makes a coordinated response more difficult. It is worrying, in this connection, that the euro area still does not have fiscal policy tools – like those in the United States – capable of contributing to offering a common response to the foregoing challenges and promoting a greater degree of cyclical stability for the Union as a whole.

Nor can we forget the role that **macroprudential policy** can and should play in the current setting. Firstly, low interest rates holding firm for a prolonged period may have adverse effects on financial stability. Macroprudential policy should be first in line to react, combating potential excessive growth in debt and protecting financial institutions ahead of any hypothetical materialisation of these risks. Such action should affect the banking and non-bank financial sectors alike, depending on where the signs of exuberance are perceived. Secondly, some macroprudential instruments, such as the countercyclical capital buffer, may be used to build up capital cushions at financial institutions in boom periods that can be used when conditions worsen. The use of this additional macroeconomic stabilisation mechanism may prove particularly suitable in a context, such as the present, in which monetary policy headroom is more limited.

Lastly, a further pressing concern is **to improve the functioning of the euro area** before any future crisis should arise. To achieve this, greater financial integration should be pursued with the development of the Capital Markets Union, and the Banking Union should be completed with the creation of a common deposit guarantee scheme and a common safe asset.