THE EUROPEAN ECONOMY AND THE MONETARY POLICY RESPONSE AFTER OVER A YEAR OF THE PANDEMIC

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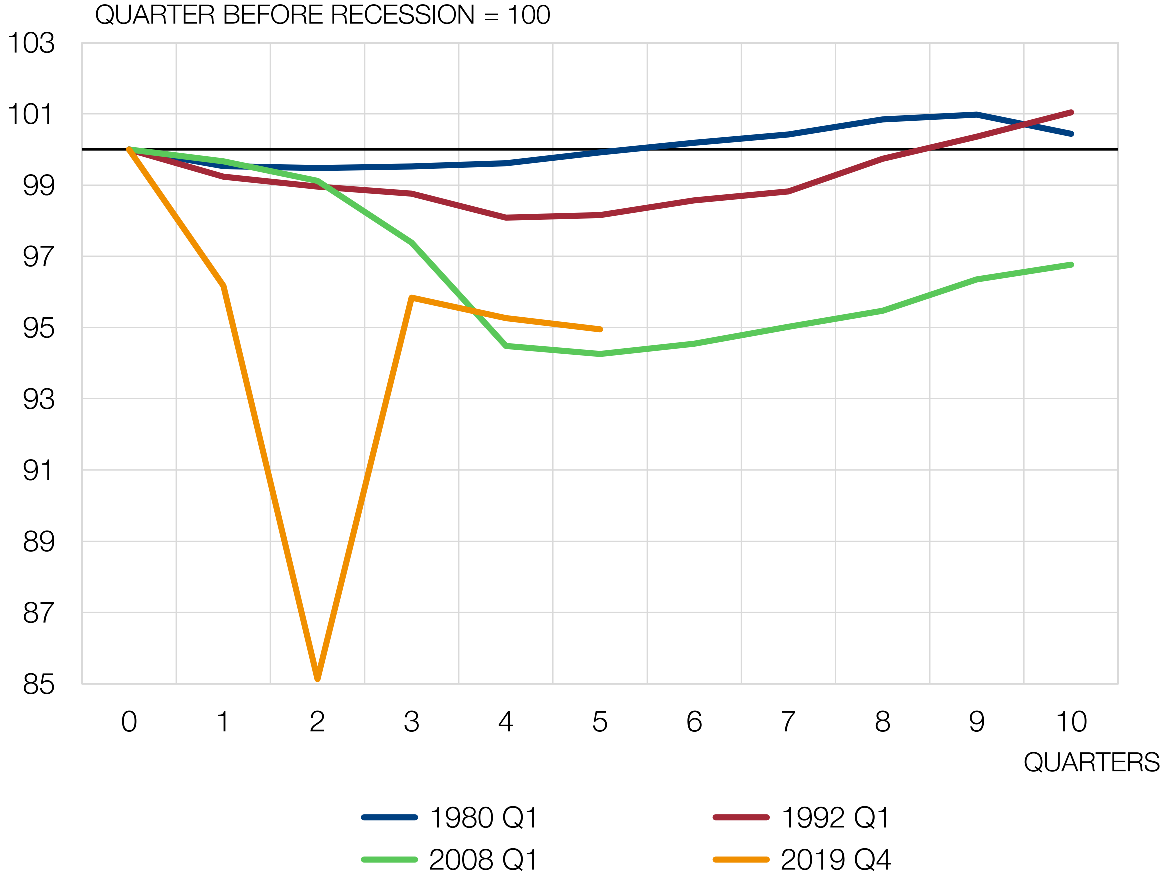
MEETING ORGANISED BY ABANTE ASESORES

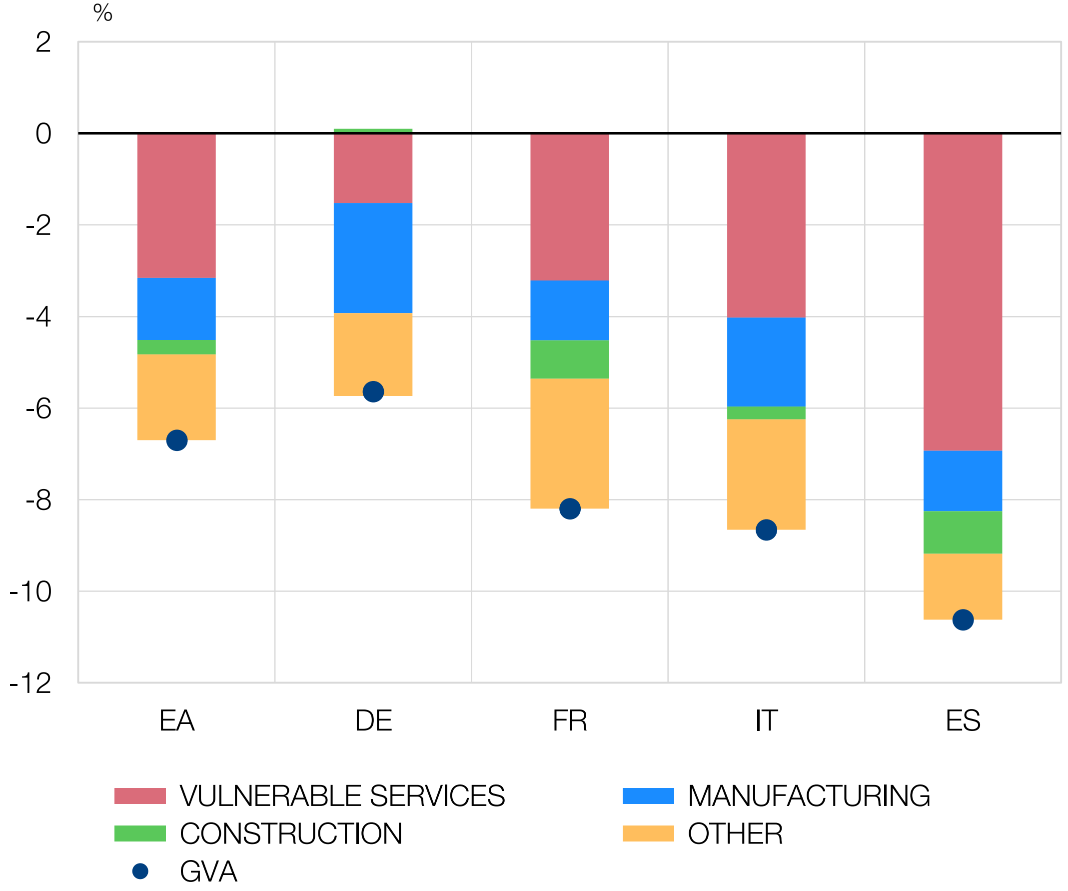
Madrid
9 July 2021

STARTING POINT: A SEVERE CRISIS IN THE EURO AREA, UNEVEN ACROSS SECTORS AND COUNTRIES...

EURO AREA GDP IN DIFFERENT RECESSIONS



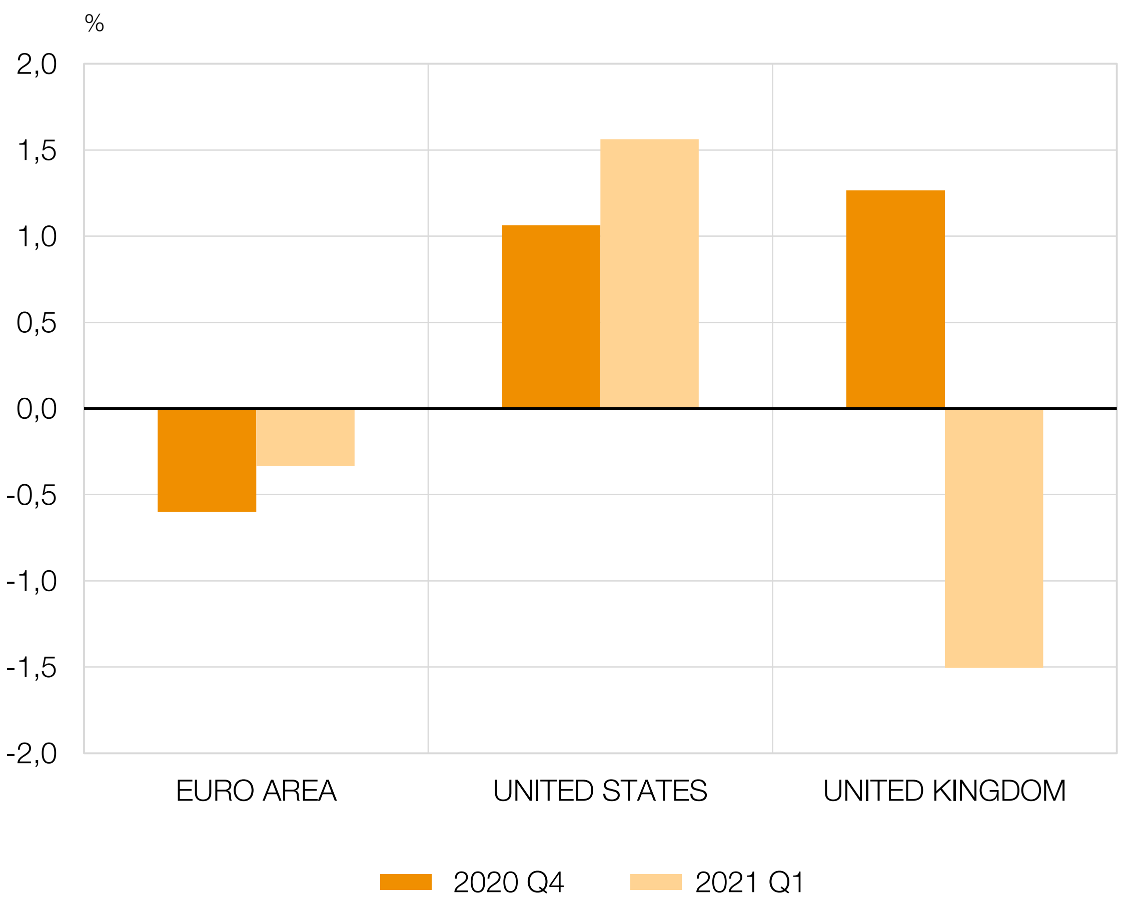
EURO AREA. GVA AND CONTRIBUTIONS
Change on 2020



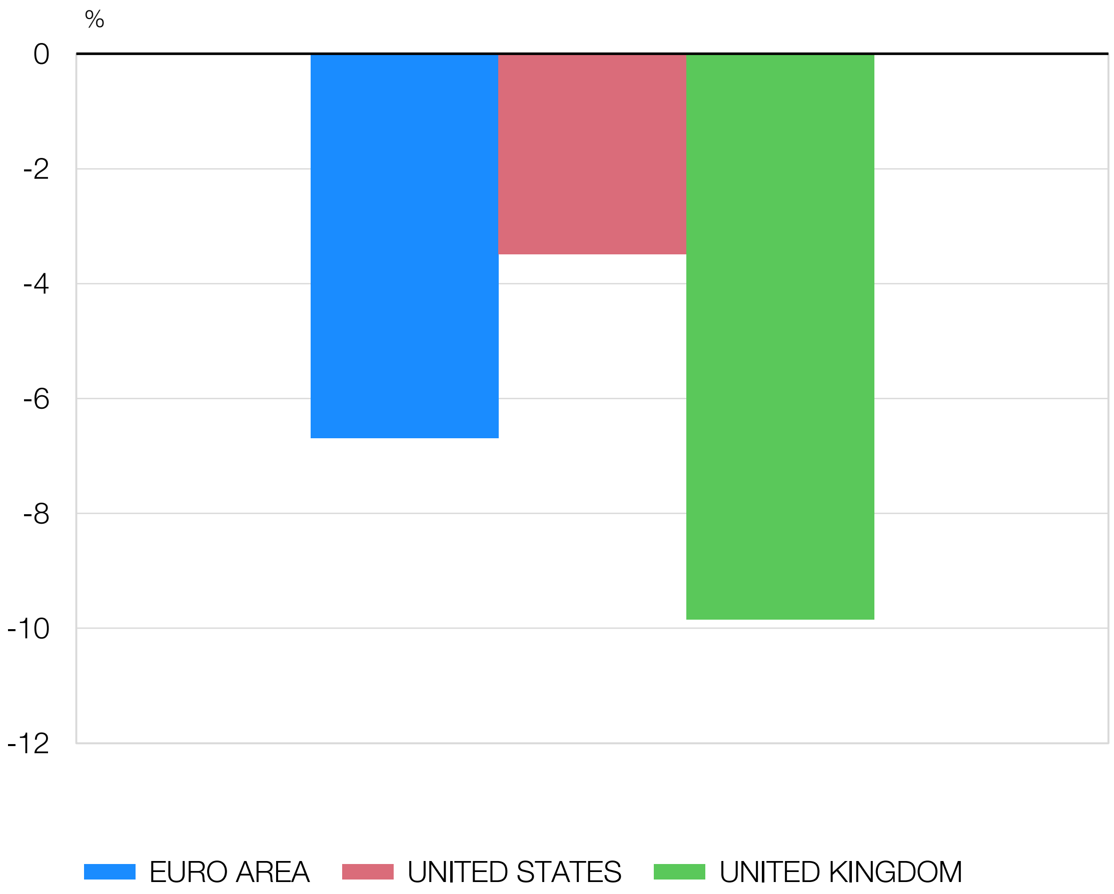
Sources: Eurostat and ECB.

… AND PERSISTENT: UNLIKE IN OTHER DEVELOPED ECONOMIES, GDP IN THE EURO AREA CONTRACTED IN THE LAST TWO QUARTERS

QUARTER-ON-QUARTER GDP GROWTH

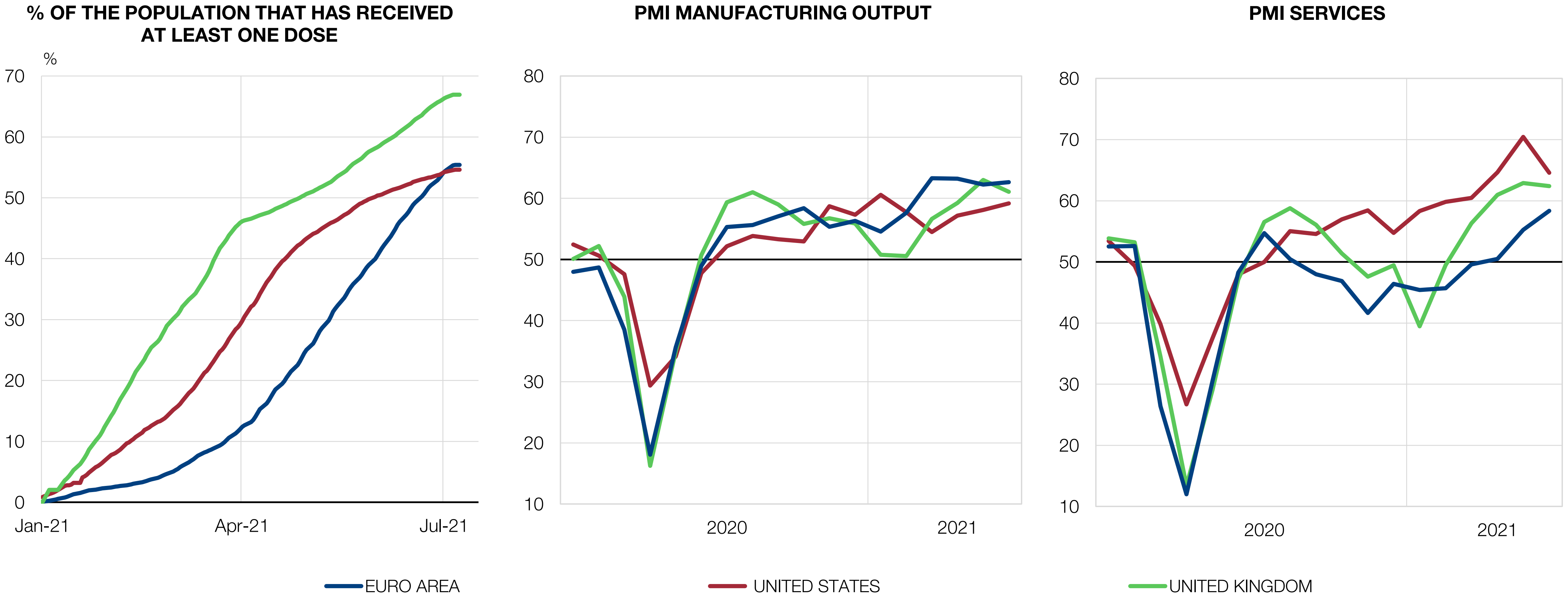


FALL IN GDP IN 2020



Sources: Eurostat and Thomson Reuters.

BUT THE PACE OF VACCINATION HAS STEPPED UP, GIVING RISE TO A SIGNIFICANT IMPROVEMENT IN ACTIVITY INDICATORS IN Q2

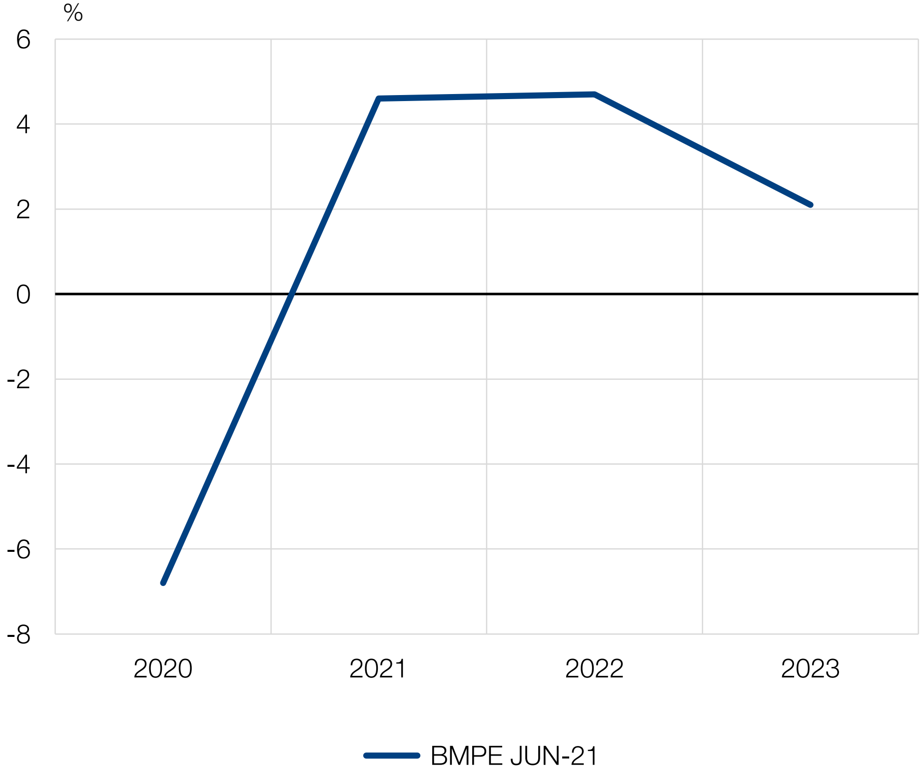


Sources: Johns Hopkins Coronavirus Resource Center and Markit. Latest observation: vaccination (8 July) and PMI (June).

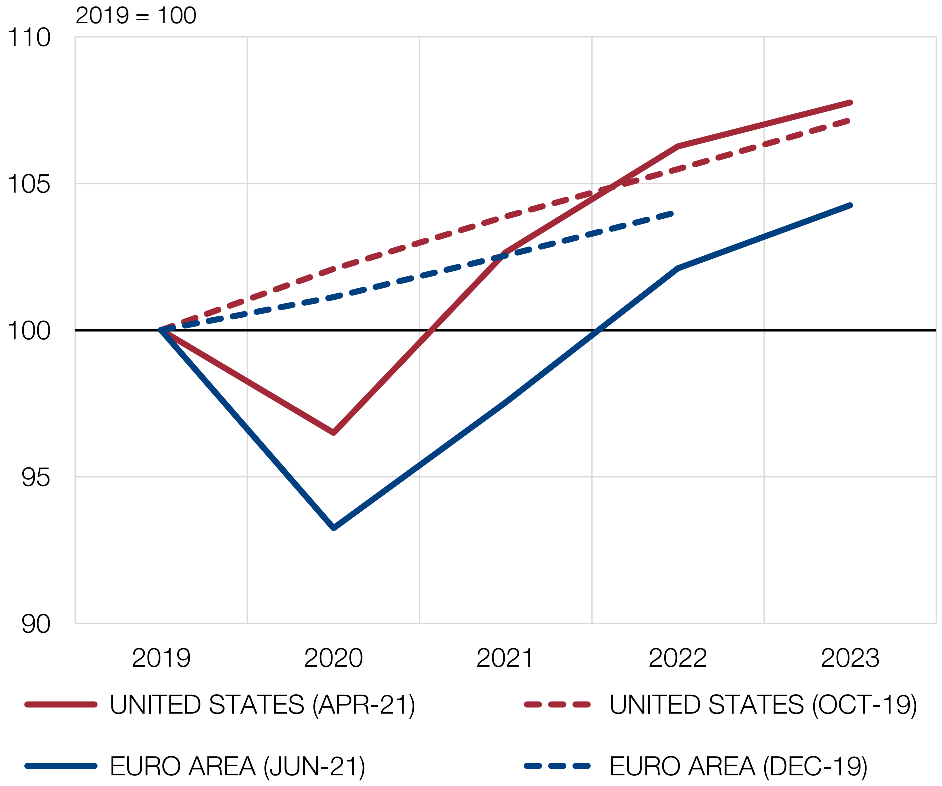
A PICK-UP IN ACTIVITY IN THE EURO AREA IS EXPECTED IN 2021 H2, CONTINUING INTO 2022…

- **The euro area will return to pre-pandemic levels later than the United States (specifically, in early 2022), although with cross-country differences; pre-crisis trends will also resume later than in the United States, and not before 2023**
- **The projected dynamism is based on the expected improvement in the epidemiological situation, growth in world demand, expansionary policies in the euro area and the United States, and strong consumption growth**

EURO AREA GDP



INTERNATIONAL GDP COMPARISON (a)

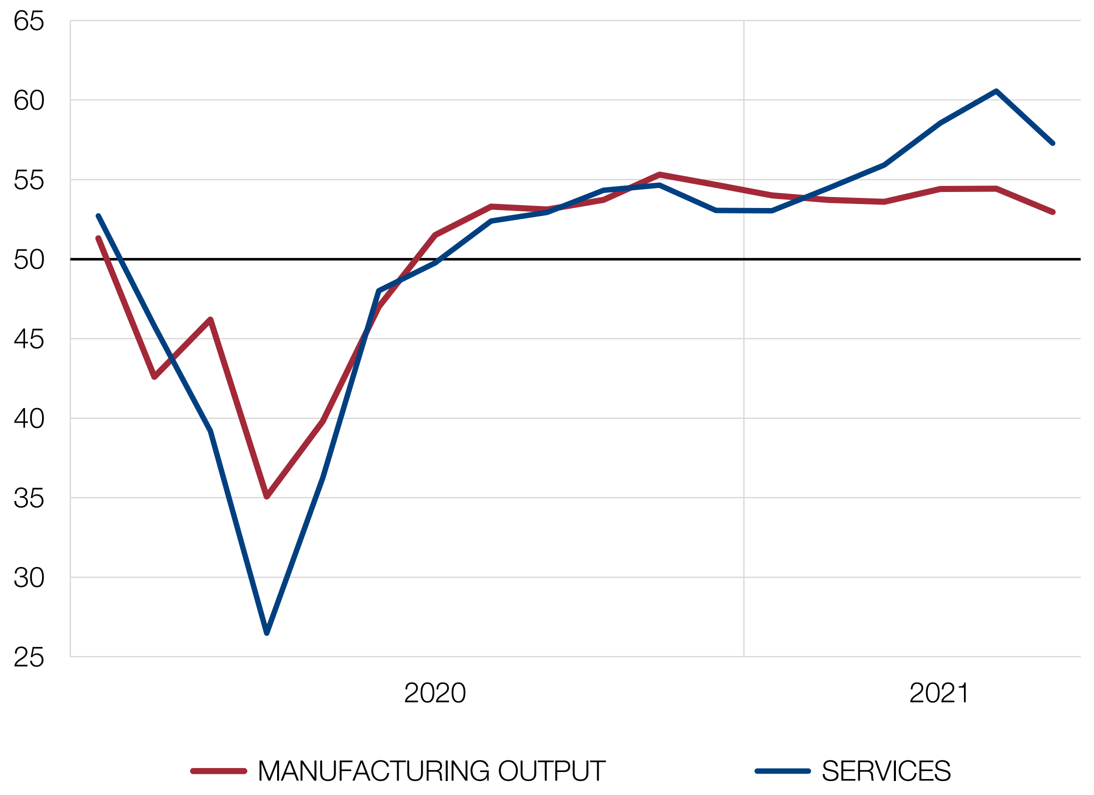


Sources: IMF and Eurosystem.
(a) IMF data for the United States and Eurosystem data for the euro area.

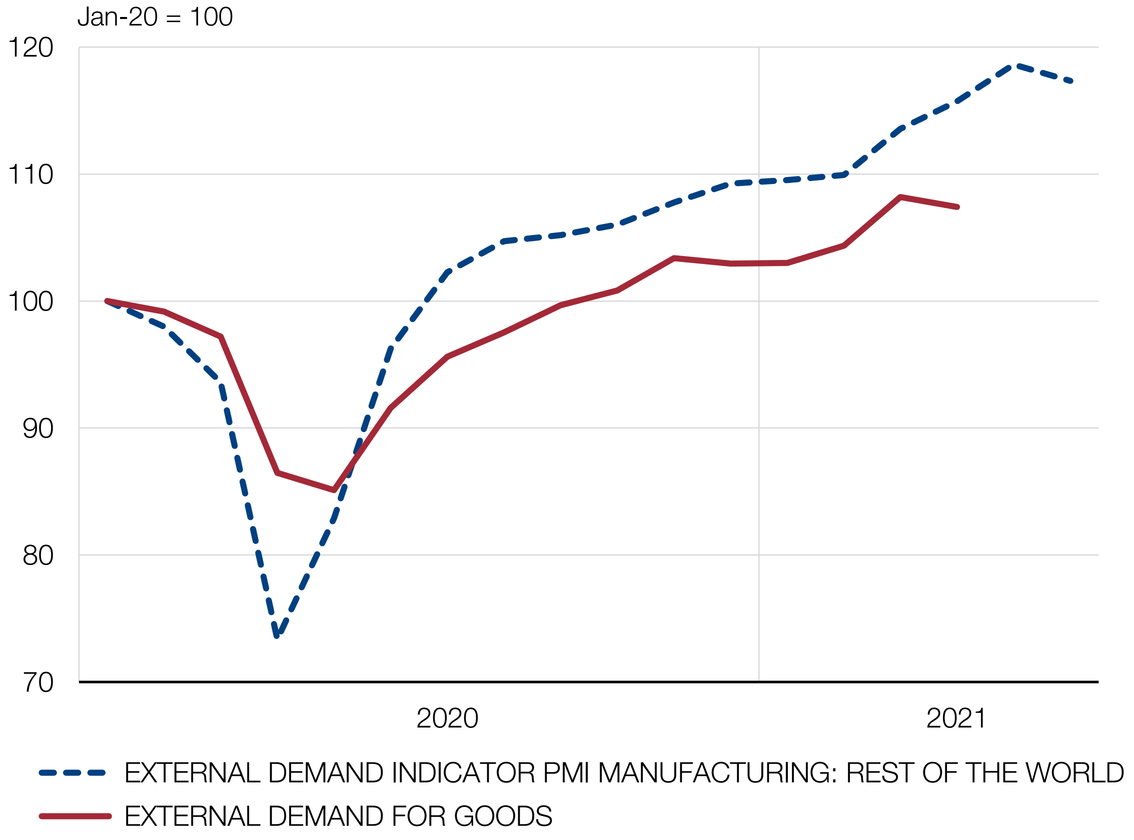
…UNDERPINNED BY THE GLOBAL ECONOMIC RECOVERY,…

- **Indicators point to a more dynamic international environment, in manufacturing and services, and to a recovery in world trade**

GLOBAL PMI EXCLUDING THE EURO AREA



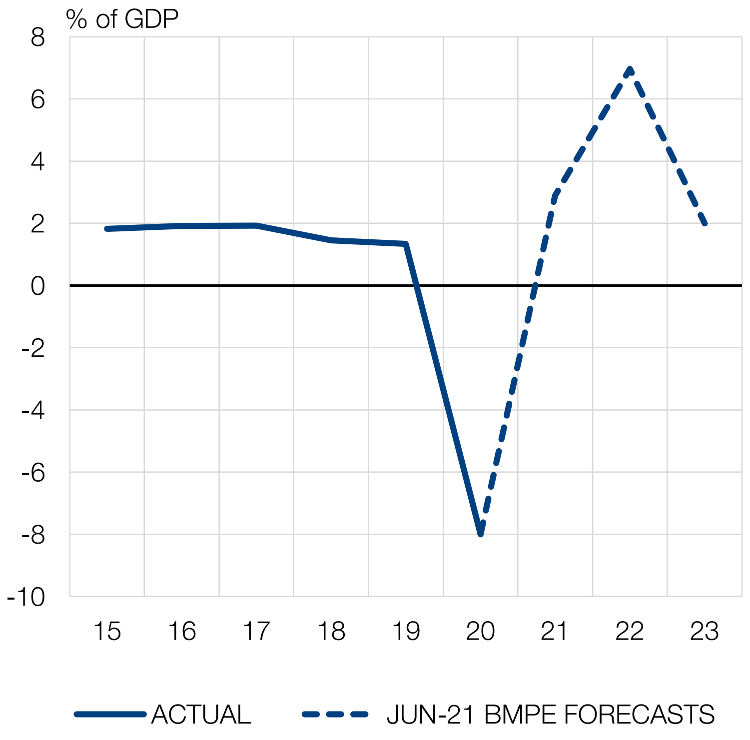
EURO AREA. GOODS EXPORT MARKETS



Sources: IHS Markit and CPB. Latest observation: PMI (June) and external demand (April).

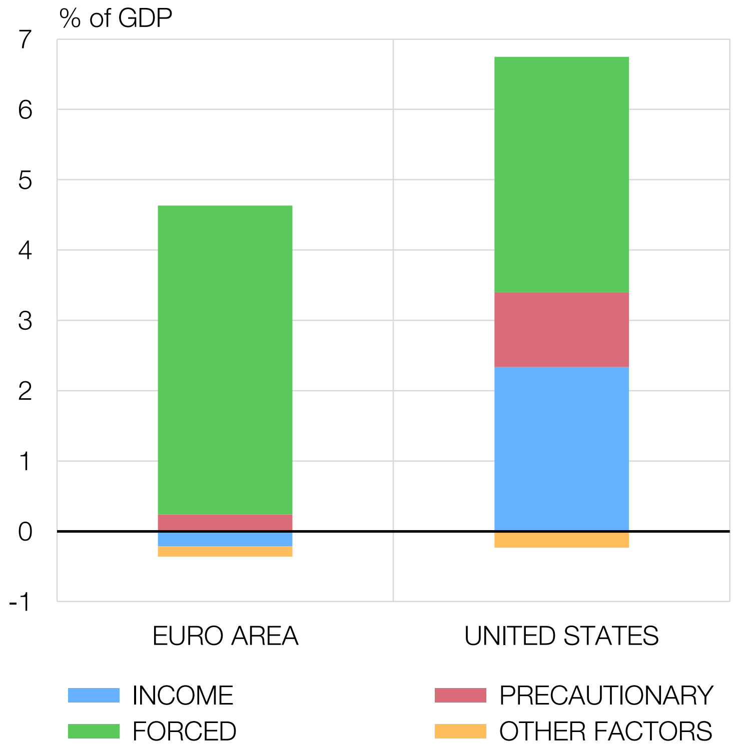
- **The gradual return to normal in consumption and the saving rate explains a large part of the pick-up expected in private demand, following the big build-up in "forced" saving (4.4% of GDP) during the worst stages of the pandemic**

REAL PRIVATE CONSUMPTION
Annual change

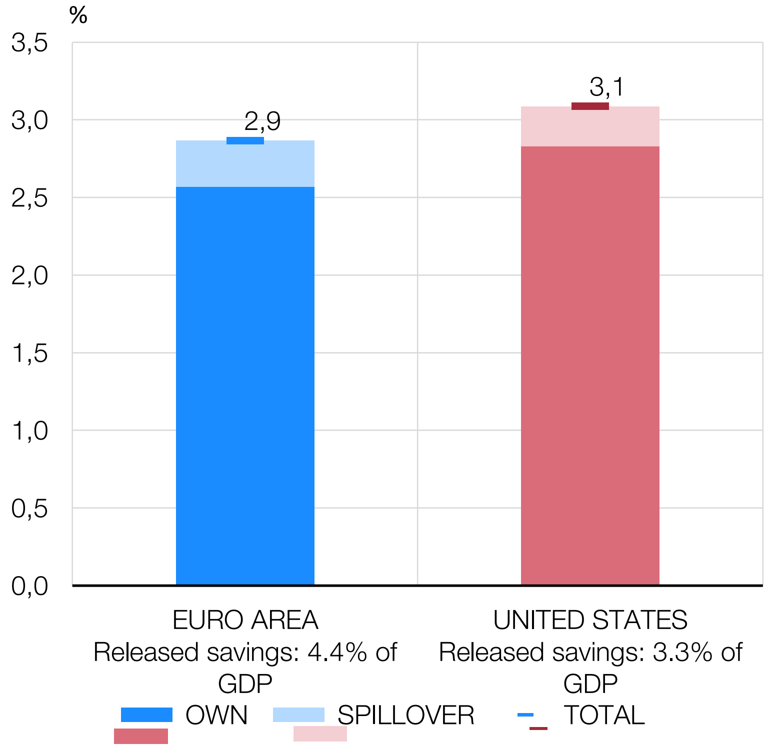


Sources: Eurostat and ECB.

SIZE OF THE STOCK OF SAVINGS



SIMULATION OF THE IMPACT ON GDP OF THE RELEASE OF FORCED SAVINGS (a)

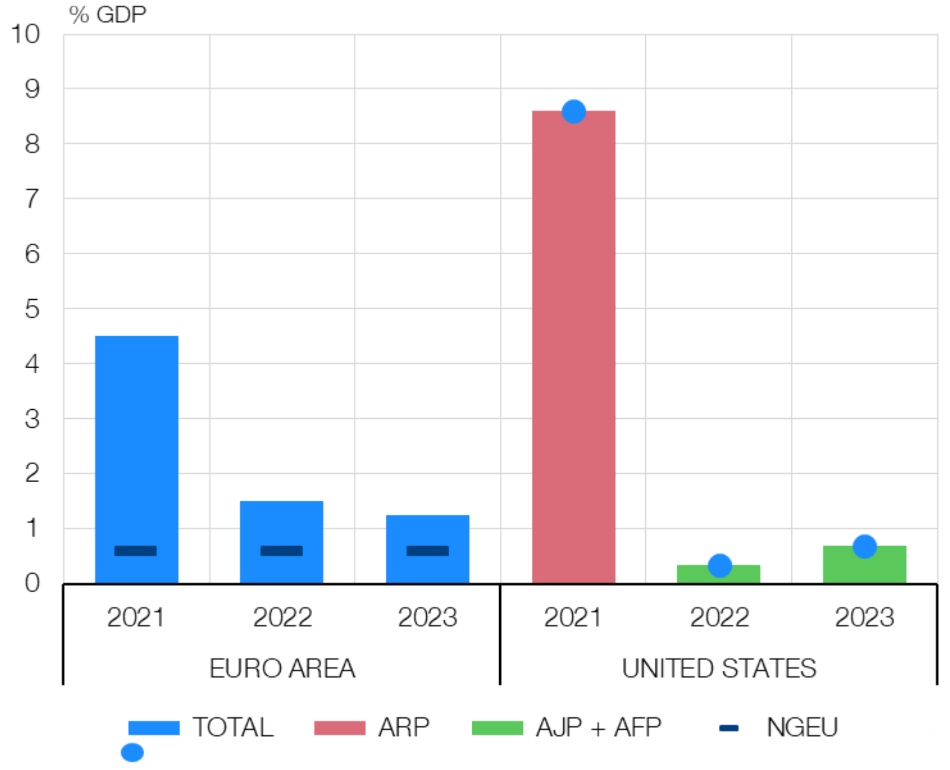


Source: Banco de España.
(a) Estimation based on the NIGEM model assuming that the stock of savings identified as "forced" in 2020 (4.4% of GDP in the euro area and 3.35% in the US) is released in full. The results show the impact on GDP for 2022.

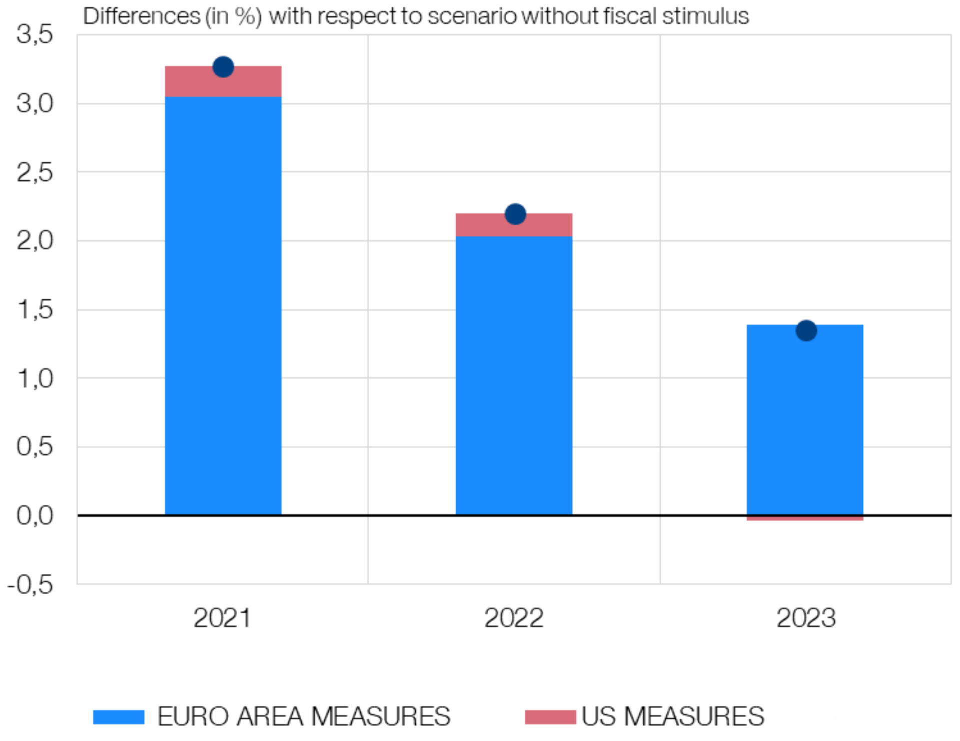
… AND FISCAL POLICY MOMENTUM, INCLUDING THE NGEU FUNDS

- **Implementation of the Stability and Growth Pact has been delayed for another year; the discussion about its subsequent application should be held at the same time as the debate on its review**

DISCRETIONARY FISCAL STIMULUS MEASURES IN THE EURO AREA AND THE UNITED STATES (a)



IMPACT OF FISCAL MEASURES ON EURO AREA GDP (b)

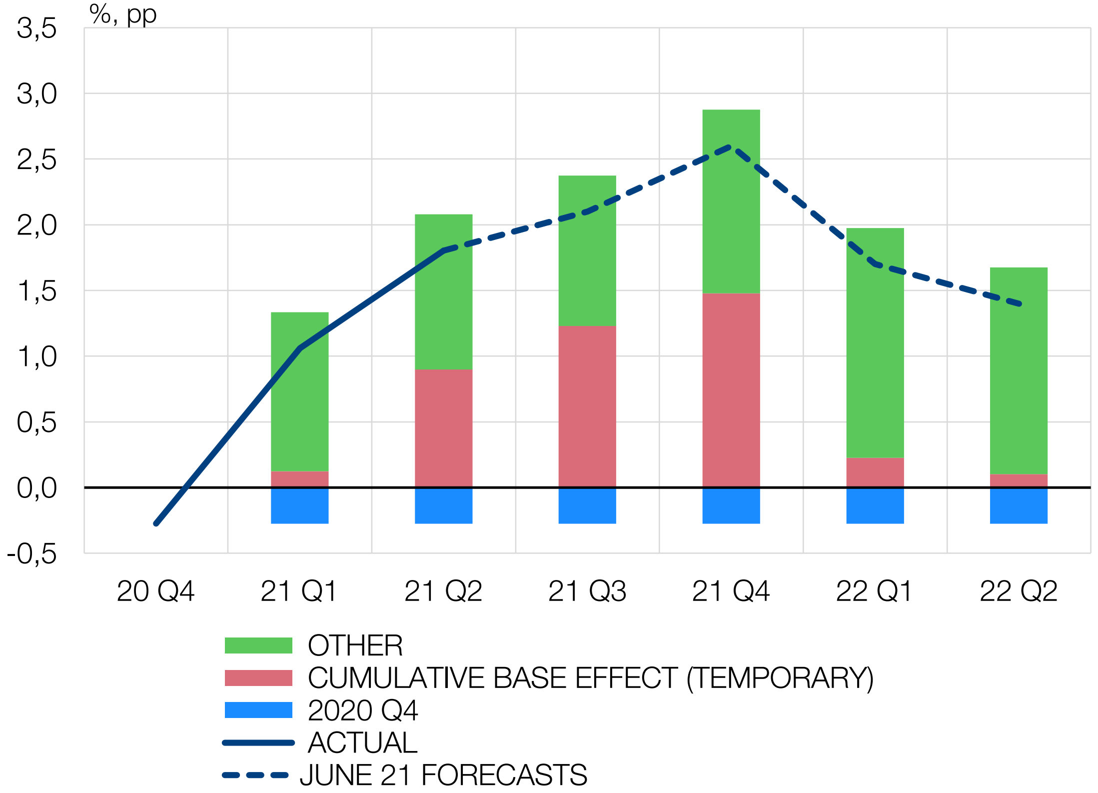


Sources: Banco de España and Eurosystem, drawing on Committee for a Responsible Federal Budget, Congressional Budget Office, the White House, Tax Policy Center, Tax Foundation and Penn Wharton Budget Model.
(a) The fiscal stimulus in each year is depicted. ARP (American Rescue Plan); AJP (American Jobs Plan); and AFP (American Families Plan).
(b) Own estimation of the impact. The impact of the euro area measures has been estimated in accordance with a standard multiplier, and that of the US measures drawing on NIGEM model simulations.

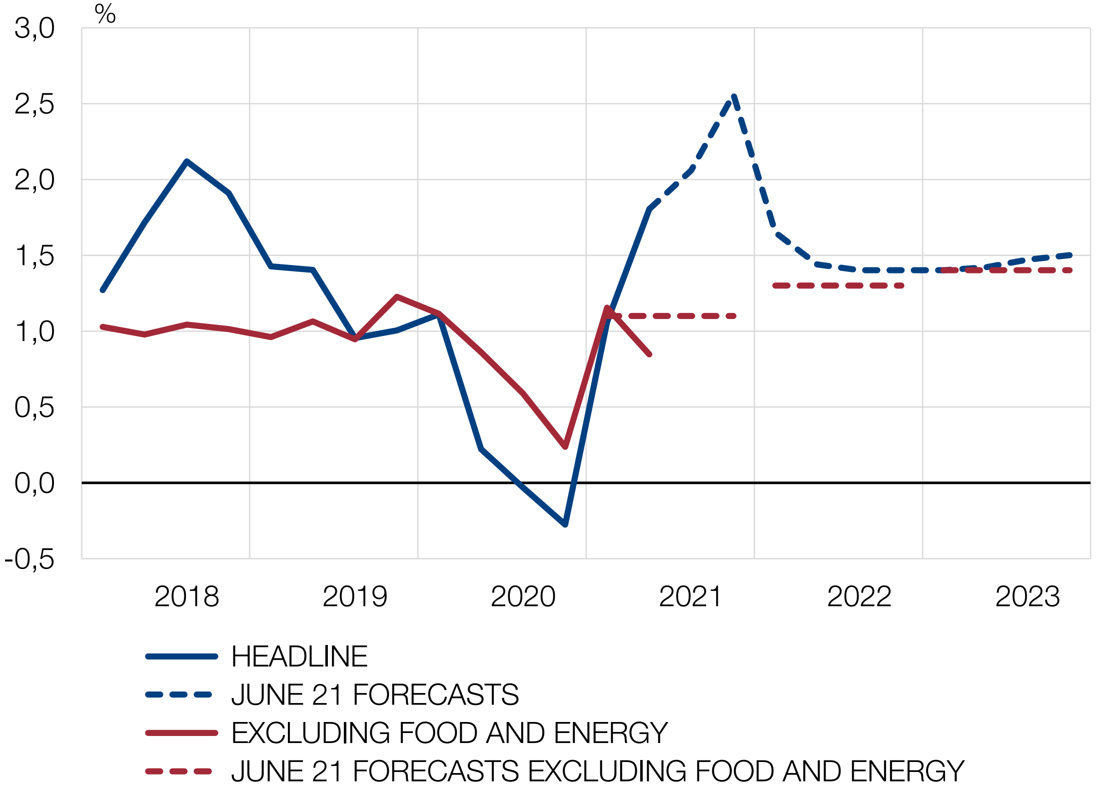
AFTER CLIMBING TEMPORARILY IN 2021, INFLATION IS EXPECTED TO MODERATE

- **Inflation will peak at 2.5% at end-2021, owing to temporary factors such as rising energy prices and the base effects of the VAT reduction in Germany in 2020**

HEADLINE INFLATION. BASE EFFECT AND OTHER



HEADLINE INFLATION AND EXCLUDING FOOD AND ENERGY



Sources: Eurostat, ECB and Banco de España.

MEDIUM TERM, THE GRADUAL REDUCTION IN THE DEGREE OF SLACK IN THE ECONOMY AND THE RECOVERY IN DEMAND WILL DRIVE UP CORE INFLATION, ALTHOUGH THE MEDIUM-TERM FORECAST IS STILL DISTANT FROM OUR TARGET

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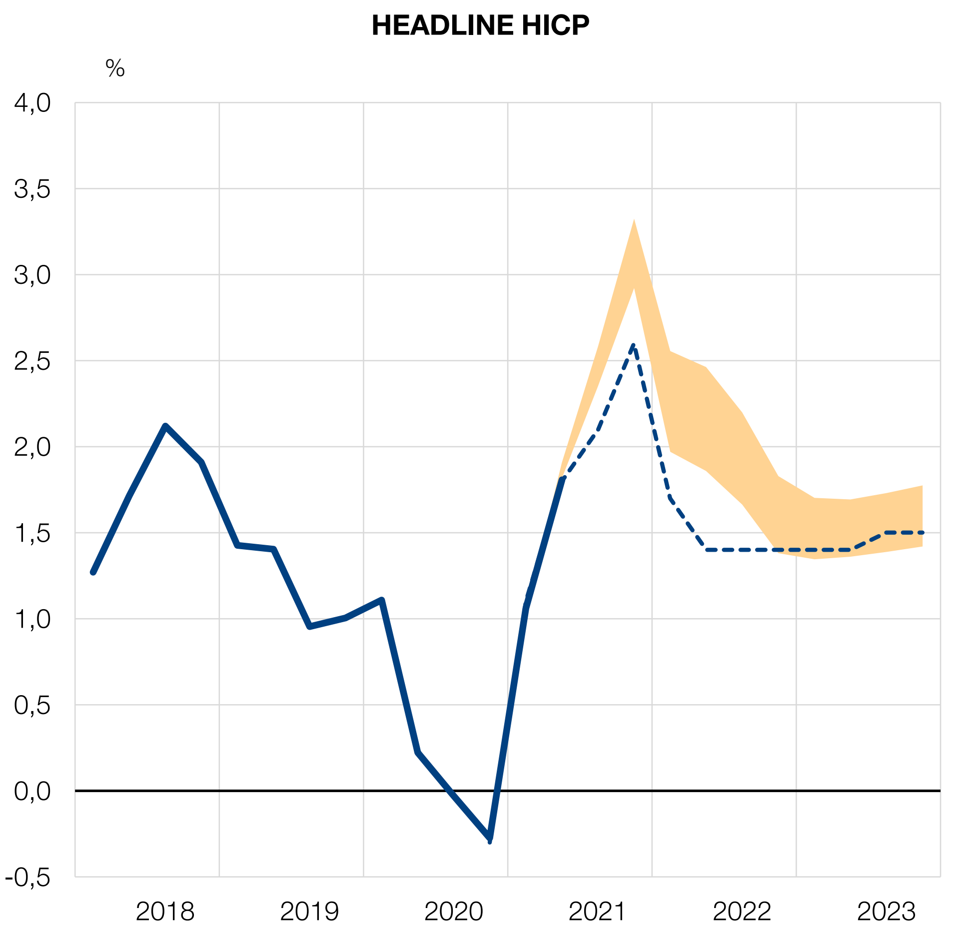

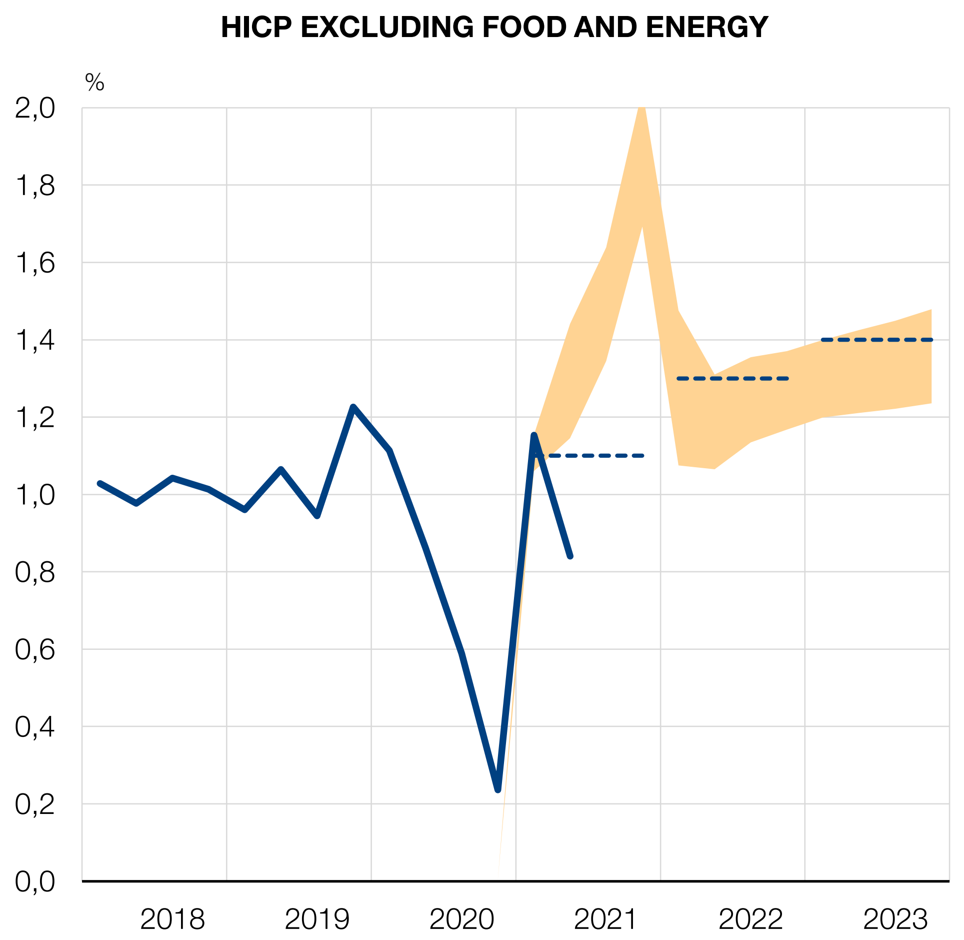

PHILLIPS CURVE ACTUAL JUNE 21 FORECASTS

Sources: Eurostat, ECB, Consensus and Banco de España.
(a) The average of nine models that consider different measures of inflation expectations (consumer, producer, financial market and trend inflation expectations), structure in expectations formation (backward-looking, forward-looking and hybrid) and slack (output and unemployment gap).

MONETARY POLICY HAS PLAYED A FUNDAMENTAL ROLE DURING THE CRISIS: THE PEPP AND THE TLTRO III HAVE PREVENTED FINANCING CONDITIONS FROM TIGHTENING

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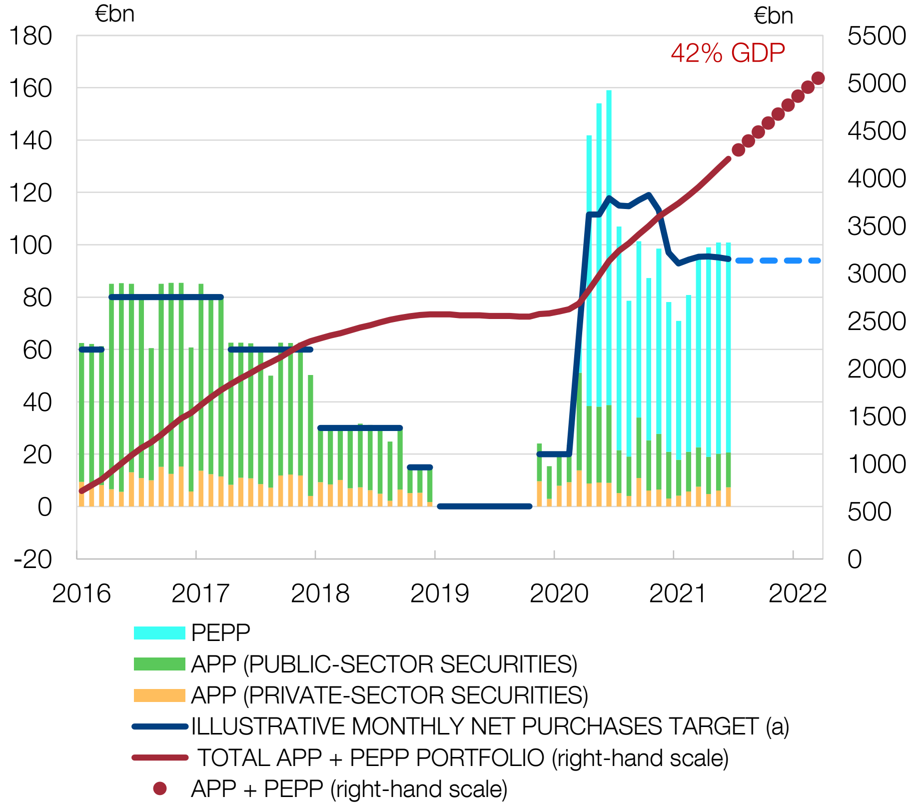
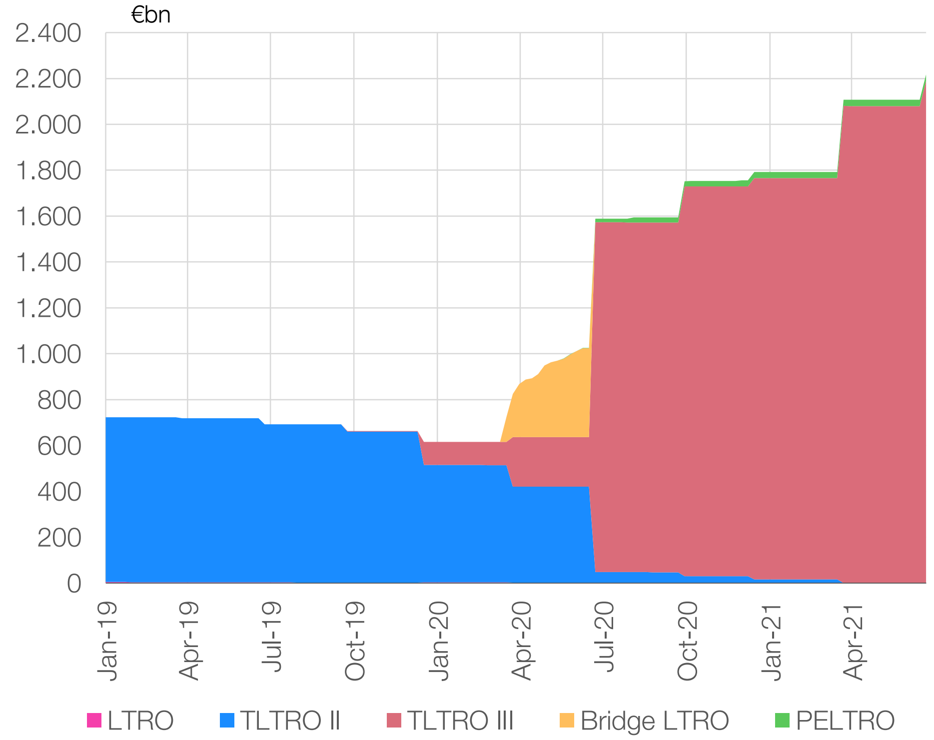
SECURITIES PURCHASE PROGRAMME (APP+PEPP)



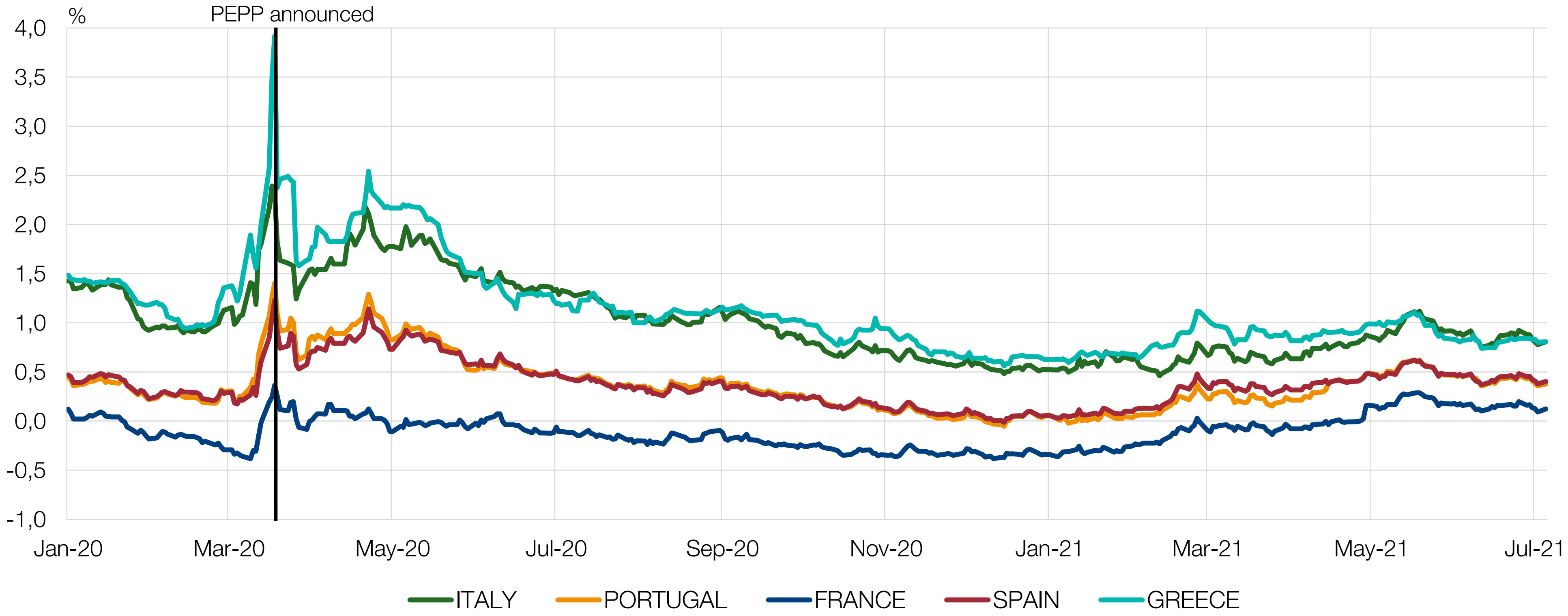
EUROSYSTEM LONG-TERM REFINANCING OPERATIONS (OUTSTANDING AMOUNTS)



Sources: ECB and Thomson Reuters Datastream. Latest observation: June 2021 (left-hand chart) and 25 June 2021 (right-hand chart).
(a) The monthly net purchase target as from July 2021 (broken blue line) includes, in addition to the €20 billion per month approved in September 2019, the unused portion of the maximum amount of €1,850 billion under the PEPP, prorated over time assuming, for illustrative purposes, that the net purchases will be distributed uniformly until March 2022 and that full use will be made of said maximum amount (in practice the purchases may be distributed flexibly over time and the maximum amount might not be used in full).

IN PARTICULAR, FLEXIBLE PURCHASES UNDER THE PEPP HAVE STAVED OFF FINANCIAL FRAGMENTATION PROBLEMS

10-YEAR SOVEREIGN BONDS



Source: Refinitiv Datastream. Latest observation: 05/07/2021.

AFTER THE DECEMBER EXTENSION, THE PEPP WILL LAST UNTIL THE CORONAVIRUS CRISIS ENDS, AND WE WILL MAKE PURCHASES SO AS TO PRESERVE FAVOURABLE FINANCING CONDITIONS

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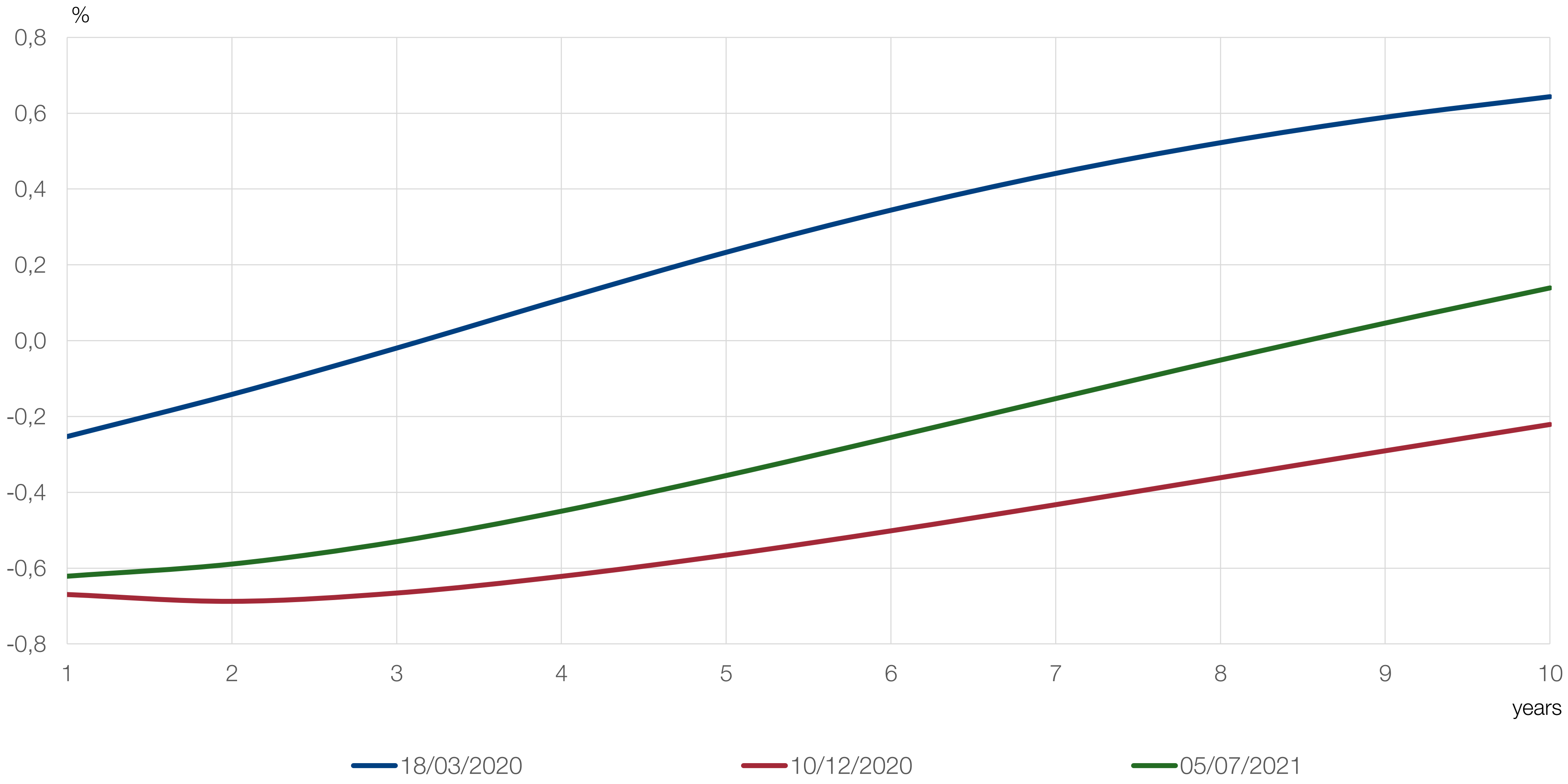
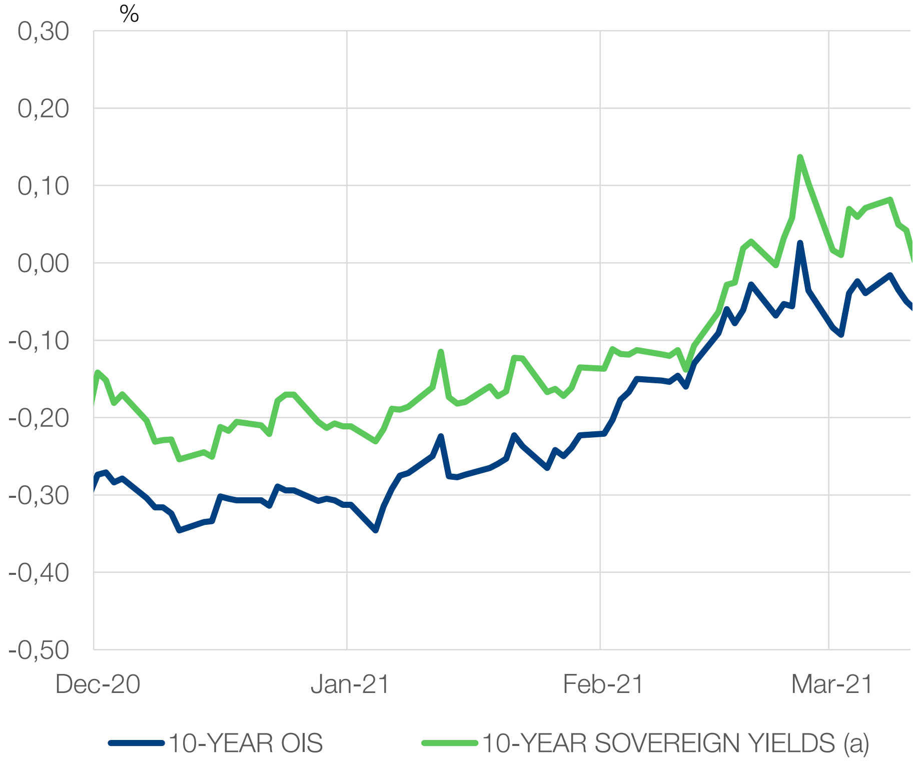
YIELD CURVE FOR EURO AREA GOVERNMENT BONDS (a)



Source: Refinitiv Datastream.
(a) Yields weighted by the GDP of Spain, France, Italy and Germany.

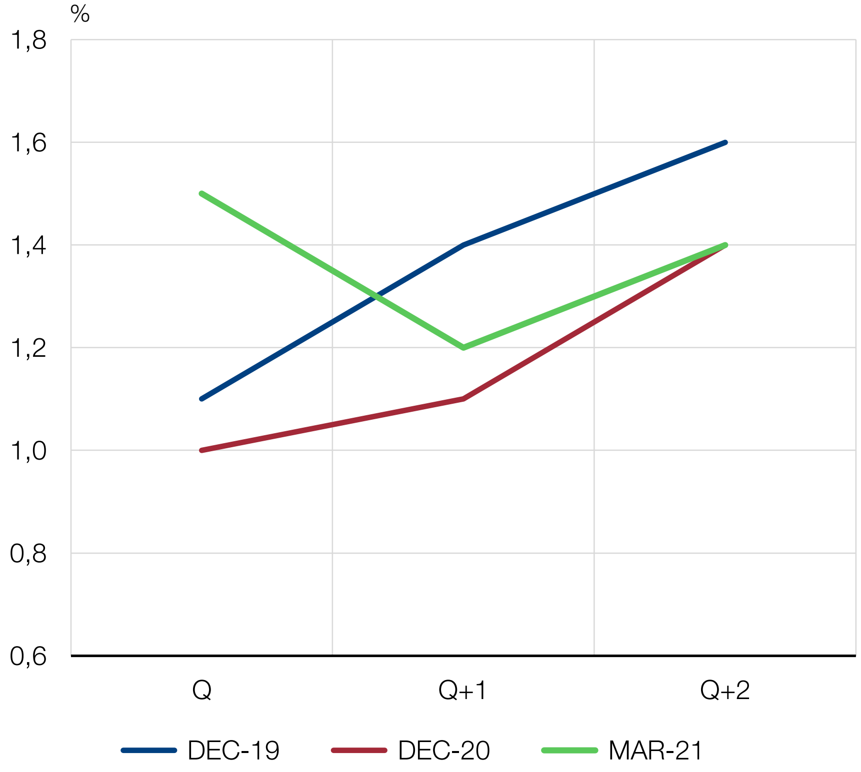
IN MARCH, AFTER LONG-TERM YIELDS ROSE, IN A SETTING IN WHICH INFLATION FORECASTS REMAINED UNCHANGED AND BELOW THEIR PRE-PANDEMIC LEVELS, WE DECIDED TO INCREASE OUR MONTHLY PURCHASES

10-YEAR OIS AND SOVEREIGN YIELDS TO 10 MARCH 2021. EURO AREA



Sources: Refinitiv Datastream and ECB. Latest observation: 10/03/21.
(a) 10-year sovereign yield weighted by the GDP of the four major economies (Germany, France, Italy and Spain).

ECB/EUROSYSTEM INFLATION PROJECTIONS FOR THE EURO AREA



Source: ECB.

IN JUNE, AFTER ANALYSING FINANCING CONDITIONS AND INFLATION FORECASTS, WE DECIDED TO HOLD OUR MONTHLY PURCHASES AT THE Q2 LEVEL

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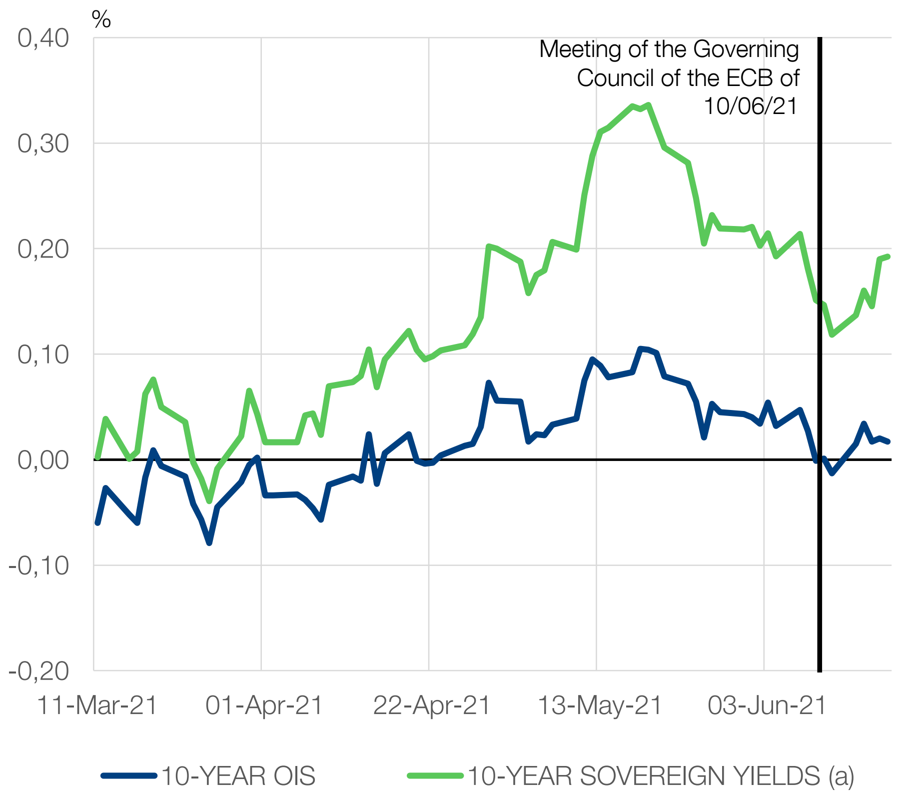
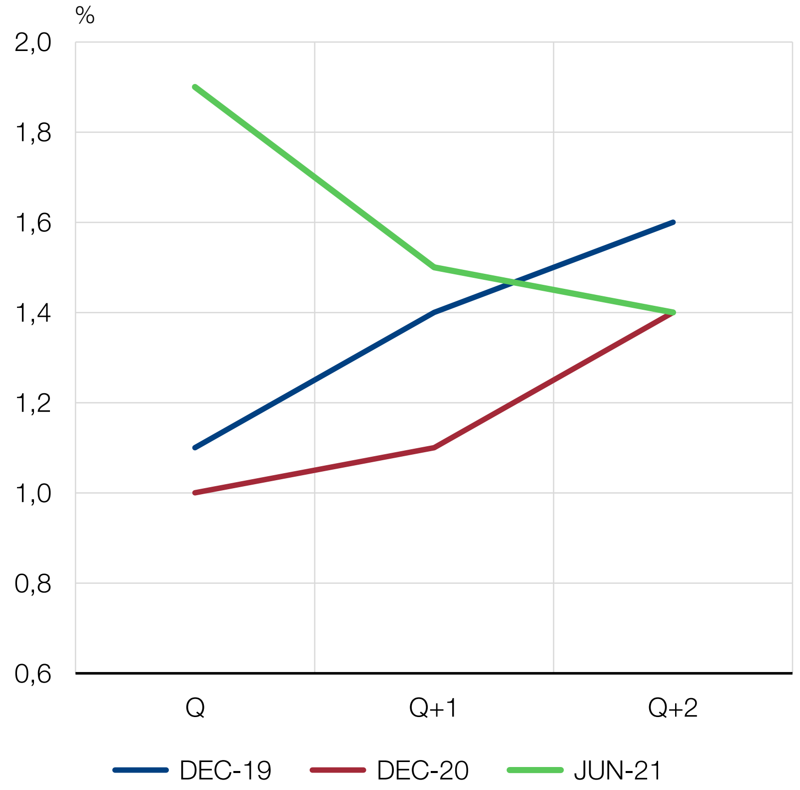
10-YEAR OIS AND SOVEREIGN YIELDS SINCE 11 MARCH 2021. EURO AREA



Sources: Refinitiv Datastream and ECB. Latest observation: 18/06/21.
(a) 10-year sovereign yield weighted by the GDP of the four major economies (Germany, France, Italy and Spain).

ECB/EUROSYSTEM INFLATION PROJECTIONS FOR THE EURO AREA



Source: ECB.

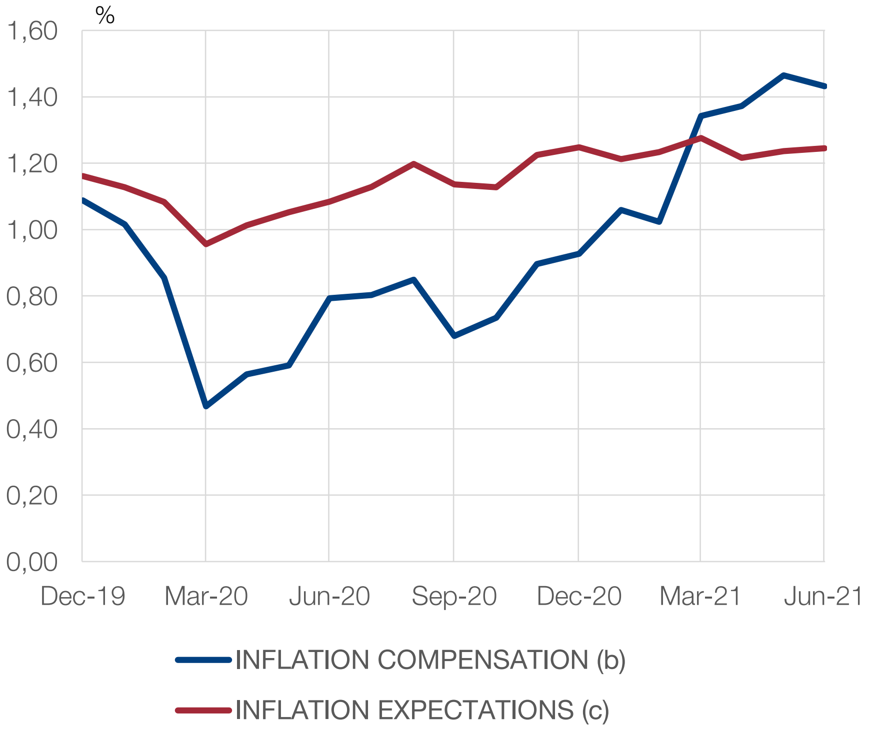
MARKET INFLATION EXPECTATIONS HAVE RISEN, BUT ESPECIALLY AS A RESULT OF AN INCREASE IN THE INFLATION RISK PREMIUM; IN ANY EVENT, THEY REMAIN WELL BELOW OUR MEDIUM-TERM INFLATION TARGET

- **Market indicators point to an increase in inflation compensation; this could reflect an increase in inflation risk premia rather than an increase in genuine inflation expectations**

INFLATION COMPENSATION. EURO AREA (a)

Source: Refinitiv Datastream. Latest observation: 05/07/2021.
(a) 2-year forward rates 2 years ahead implied by inflation swaps.

INFLATION COMPENSATION AND INFLATION EXPECTATIONS. EURO AREA (a)



Sources: Refinitiv Datastream and Banco de España calculations.
Latest observation: June 2021.
(a) Implied 2-year forward rates 2 years ahead.
(b) Calculated using Datastream inflation swaps.
(c) Calculated using a similar model for inflation swaps.

OUR FORWARD GUIDANCE SUGGESTS THAT THE DEGREE OF MONETARY ACCOMMODATION WILL LAST

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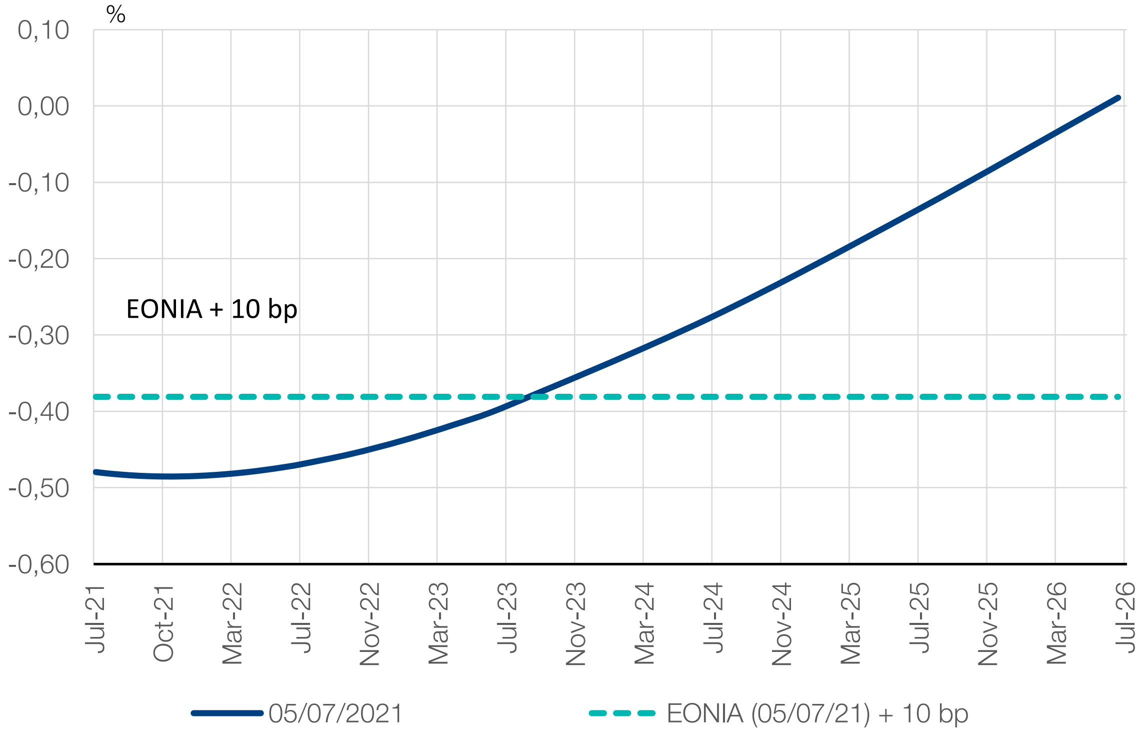
- The Governing Council expects the **ECB's policy rates to remain at their present or lower levels**, until the **inflation outlook robustly converges** to a level sufficiently close to, but below, 2% within the projection horizon, and such convergence has been **consistently reflected in underlying inflation dynamics**.
- Net purchases under the asset purchase programme (APP) will continue at a monthly pace of €20 billion. The Governing Council continues to expect **monthly net purchases under the APP to run for as long as necessary** to reinforce the accommodative impact of its policy rates, and **to end shortly before it starts raising** the key ECB **interest rates**.
- The Governing Council also intends to **continue reinvesting, in full, the principal payments from maturing securities purchased under the APP** for an extended period of time past the date when it starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

INSTANTANEOUS FORWARD OIS. EURO AREA



Source: Refinitiv Datastream. Latest observation: 05/07/2021.

THE ECB'S GOVERNING COUNCIL ANNOUNCED ITS NEW MONETARY POLICY STRATEGY ON 8 JULY

- The strategy review was prompted by structural changes in the euro area since the previous strategy review in 2003, mainly **equilibrium real interest rates** (i.e. those enabling economic activity to be maintained at its potential level and inflation at its target) being driven down by slower productivity growth, demographic factors and the legacy of the global financial crisis, among other factors.
- This decline means that the **lower bound on interest rates** will more frequently constrain the ECB's ability to attain its goals via its policy rates.
- To address this difficulty, the new strategy includes **two key changes**:
  - **Symmetric 2% inflation target over the medium term**
    - Symmetric means that negative and positive deviations from this target are considered equally undesirable
  - Need for **especially forceful or persistent monetary policy action when the economy is operating close to the lower bound** to avoid negative deviations from the inflation target becoming entrenched
    - The Governing Council thus recognises the importance of taking into account the implications of the lower bound in order to maintain the symmetry of the inflation target
    - This may also imply a transitory period in which **inflation is moderately above target**
- As regards **monetary policy instruments**, the primary monetary policy instrument remains the set of **ECB interest rates**. The Governing Council will also use other instruments, in particular **forward guidance, asset purchases and longer-term refinancing operations**, as appropriate. Furthermore, where necessary, it will consider new policy instruments to achieve its price stability objective.

THE ECB'S GOVERNING COUNCIL ANNOUNCED ITS NEW MONETARY POLICY STRATEGY ON 8 JULY (CONT'D)

- The Governing Council confirmed the **medium-term orientation** of its monetary policy strategy. This allows for inevitable short-term deviations of inflation from the target, as well as for lags and uncertainty in the transmission of monetary policy. It also allows the Governing Council to take into account the origin, magnitude and persistence of the deviations, and other considerations relevant to the pursuit of price stability.
- Monetary policy decisions will be based on an **integrated assessment of two interdependent analyses: the economic analysis and the monetary and financial analysis.**
- The Governing Council confirmed that the **Harmonised Index of Consumer Prices** (HICP) remains the appropriate price measure for assessing the achievement of the price stability objective. It recognised that the inclusion of the costs related to **owner-occupied housing** in the HICP would better represent the inflation rate that is relevant for households. Full inclusion in the HICP is a multi-year project. It must enable separation of the consumption component from that of investment, the former being the relevant component for monetary policy.
- Commitment to ensuring that the Eurosystem fully takes into account the implications of **climate change** and the carbon transition for monetary policy and central banking. Commitment to an ambitious **climate-related action plan**: comprehensive incorporation of climate factors into its monetary policy assessments and adaptation of its monetary policy operational framework in relation to disclosures, risk assessment, corporate sector asset purchases and the collateral framework.
- Adaptation of the **communication of monetary policy decisions** to reflect the revised monetary policy strategy. Monetary policy communication (the Monetary Policy Statement, the press conference, the Economic Bulletin and the monetary policy accounts) will be complemented by layered and visualised versions of monetary policy communication geared towards the wider public. Outreach events will be made a structural feature.
- **Periodic assessments** of the strategy. Next review expected in 2025.

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THANK YOU FOR YOUR ATTENTION