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Stability and recovery in the euro area

Fundación Caminos/Santander

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I would first like to thank the Association of Civil Engineers, the Fundación Caminos and its Chairman for kindly inviting me to take part in the opening of this Global Forum on Engineering and Public Works. You are about to spend two days debating various issues relating to a sector of activity as important, or even as decisive, for economic activity and growth as that of investment in public works and infrastructure, this being all the more so given the current state of the European economy.

The result of the recent referendum in the United Kingdom illustrates the complexity of the present situation for the European Union and the euro area.

Before this referendum, the macroeconomic outlook for the euro area was for stabilisation of economic growth at around 1.6% in 2016 and 1.7% in 2017 and 2018. The balance of risks, although holding on a downward trend given the existence of various contingencies (including the UK referendum), also showed a somewhat better balance in anticipation of a pick-up in the growth and inflation outlook on the back of the latest monetary policy measures. However the unexpected referendum result in favour of leaving the EU has impinged strongly on the financial markets and it is still too early to gauge how the stability and recovery of the euro area will be affected.

The global Great Recession and sovereign crisis combined to make the past decade that of the lowest growth of the euro area since the Second World War. It is what the International Monetary Fund has so graphically summarised with the expression “too slow for too long”. At the same time, inflation has remained far from the medium-term monetary policy target.

The exceptionality and nature of the imbalances built up, particularly the high private and public indebtedness, not only hinder the ability of economies to grow and reduce their unemployment levels, but also limit the room for manoeuvre of countercyclical economic policies, at least within their conventional framework. This has led the European Central Bank to assume leadership in the response to the crisis.

The magnitude of the structural challenges facing the euro area is notable. Some are due to design failures in the current operational framework of the Monetary Union and of the European Union itself, and others to the absence of a sufficient will to press for reform, all failures and absences that have eroded European citizens’ confidence in the integration process. Against this background, I would like to focus my comments on the difficulties facing economic policy as it attempts to put the euro area recovery on a firm footing.

First, I feel that the ECB deserves recognition for having been the European institution that provided the quickest and the most ambitious response to the crisis. It assumed, in exceptional circumstances, a key role in vanquishing doubts as to the continuity of the euro, in underpinning the recovery and, subsequently, in combating the risks derived from the current situation of near-zero or even negative inflation rates. Notably, the ECB’s unique role as the monetary authority of various states and economies did not weaken its resolve as it pressed ahead with its four broad lines of action:

First, key policy rates were reduced almost to the bottom of the possible range. Thus the marginal deposit facility rate, which had been negative since 2014, stood at -0.4% in March this year. In the current context of abundant liquidity, this rate is a key reference in monetary policy.

Second, the ECB Governing Council strengthened its communication policy through the publication of forward guidance.

Third, the liquidity-providing instruments used since 2008 were adapted to the new circumstances. In mid-2014 longer-term refinancing operations were commenced with the specific objective of stimulating credit expansion, i.e. making access by banks to very long-term funding from the ECB conditional on them granting credit to households and non-financial corporations. In March it was decided to extend this instrument to 2017.

And fourth, since 2014 the ECB has been implementing a quantitative easing programme entailing the large-scale purchase of private and public assets which, in its first two years of application, will reach an amount equivalent to 17% of total euro area GDP.

At present the purchase of assets under this programme covers nearly the whole range of marketable securities eligible as collateral in Eurosystem operations: secured bonds issued by banks; securitisations whose underlying assets are loans to the non-financial private sector; public debt of the central and regional governments; supranational agencies and institutions; and, more recently, non-bank corporate bonds. Since April this year the ECB has been purchasing €80 billion per month of these securities and the total amount of the portfolio built up for monetary policy purposes now exceeds €1.2 trillion.

I think it pertinent to add three additional comments on the measures set in train by the ECB:

The first is that they are no different from those adopted by other large central banks. Thus, for example, the key policy rate is now also negative in countries like Japan, Sweden, Denmark and Switzerland. Also, asset purchase programmes and the strengthening of liquidity provision are instruments shared with other G7 central banks, while the publication of forward guidance also forms part of the Federal Reserve's toolkit.

The second comment relates to potential undesirable side effects which these non-standard policies may have on financial stability, such as the overvaluation of certain assets or downward pressure on banking sector profitability. In this connection, it is advisable to specifically monitor the segments at risk and, if necessary, activate macro-prudential measures.

The third and last comment relates to the effectiveness of the measures adopted by the ECB over the last few years. Our latest Annual Report specifically devoted a chapter to analysing this matter.

The Banco de España's analysis concludes that monetary policy has contributed decisively to easing the credit conditions of euro area households and firms, improving the conditions of access to and cost of bank credit and significantly reducing the degree of financial fragmentation reached during the sovereign debt crisis between 2011 and 2013.

Bank lending rates have reached record lows. Surveys on access to financing by small and medium-sized enterprises, which are highly dependent on bank credit, reveal that these firms have benefited particularly from the improved credit conditions.

Our estimates suggest that the package of monetary policy measures adopted by the ECB Governing Council since mid-2014 has had a cumulative effect in 2015-2016 for the whole of the euro area of 1.4 percentage points on GDP and of 1.2 percentage points on prices. These figures are similar in Spain.

However, these positive results cannot give rise to complacency.

The risks of de-anchoring of inflation expectations remain a cause for concern. It is true that the sharp fall in oil prices since mid-2014 has exerted downward pressure on inflation, but it is no less true that weak domestic demand has played a vital role, keeping core inflation below 1% over the last two years. Inflation expectation indicators also remain low over all horizons, far from the ECB's 2% benchmark.

However, it must be emphasised that monetary policy's ability to address the challenges posed by a situation such as that we face today is not without limits. Laying the foundations for a sound and long-lasting recovery in activity, investment and employment requires an approach in concert with other economic policies, especially fiscal policy, along with institutional reform, labour and product market reforms and strengthened European governance.

Thus, according to their individual circumstances, euro area countries should use the room for manoeuvre provided for in the Stability and Growth Pact to bolster aggregate demand and growth in activity.

Admittedly, in many cases, the precarious state of public finances leaves little room for stimulus measures, such as tax cuts or higher public spending, especially because the countries with most spare capacity are also those with the highest levels of public debt. However, fiscal policy's contribution to growth is not only determined by revenue and expenditure levels, but also by their composition. In that respect, there is some scope (broader in some countries than in others) for a shift in the tax structure towards taxes that are less distortionary and more favourable to growth.

A further objective is to make public expenditure more efficient and direct it to those components that are more favourable to growth. In particular, public investment should be boosted, especially in infrastructure, an area in which various countries that have fiscal space have built up a considerable investment deficit in the past. Those countries could improve their potential growth, given the positive correlation between this type of public expenditure and productivity (at least when investment projects are efficiently selected, designed and implemented) and, at the same time, support the recovery in the euro area as a whole in the short term.

All in all, the coordination of fiscal policies should be reinforced, to encourage the countries that have fiscal space to use it, while those that have higher debt levels continue with their fiscal consolidation.

In the medium term, as indicated in the Five Presidents' Report of June 2015, a fiscal capacity for the euro area as a whole needs to be developed, to prevent overburdening monetary policy at times, such as now, of major economic difficulties. In the absence of more ambitious mechanisms, it would be advisable to reinforce the instruments already available, such as the European Investment Plan (the so-called Juncker Plan).

Redirecting unused structural funds towards that Plan could help to launch projects that are unable to find funding in the present uncertain environment and to trigger productive investment, which continues to show signs of weakness in the euro area as a whole.

In the more medium term, the combination of negative demographics, low productivity growth and high levels of public and private debt constrains the euro area's ability to regain pre-crisis growth rates, creating a breeding ground for disillusionment with and distrust of the European project. It is, therefore, essential that governments revive the reform momentum, to optimise the working of production factors and product markets, improve the business environment and complete the euro area governance framework.

Important labour market reforms have been undertaken in recent years, especially in the countries hardest hit by the crisis. Empirical evidence shows the positive impact that those reforms have had on growth and employment. But preventing high unemployment rates from becoming entrenched and long-term unemployment from growing remain a priority.

Where least progress is perceived is perhaps in reform of the product and service markets. Recent experience shows that it is important to implement the reform agenda in the right order, since early reforms, tending to enhance competition, may be vital to ensure that labour market reforms have the desired positive effects.

In various euro area countries, product market reforms should aim to improve the business environment, remove administrative barriers and increase competition. Revamped insolvency proceedings would help to improve management of the loan write-offs that currently place such a heavy burden on banks' balance sheets. Insolvency proceedings, if well designed, can be an efficient way to reallocate resources to sectors and firms that offer higher growth potential.

In the case of services, European Commission studies suggest that full implementation of the Services Directive would deliver significant productivity gains and growth potential. Efficiency gains may also be achieved through the creation of a single energy market. Regarding the free movement of persons, we should be aware of the risk of the spread of an uncoordinated response that may ultimately fragment the Schengen area.

The introduction of reforms and deepening of the single market are clearly crucial to achieve the structural convergence needed to improve the functioning of the euro area and make further progress towards a more robust monetary union.

Our aim is to achieve sustainable activity and a recovery in employment, while maintaining the essential bases of the welfare state which is naturally one of the pillars of the construction of Europe. Clearly the result of the referendum held on 23 June in the United Kingdom is a major setback along that road, with consequences for the medium and long term that are still difficult to gauge but which, in any event, obliges all of us, economic agents, citizens and governments to reflect on the future of the European Union and its governance.

In light of the uncertainties unfolding in this new scenario, it is now more important than ever to achieve sufficient and sustainable economic growth that will boost income and employment.

The message reiterated by the ECB over the last two years at least is that monetary policy cannot be the only economic policy instrument. Monetary policy is no substitute for reforms designed to improve competition and the functioning of markets, nor can it directly help to improve the quality of fiscal policy or improve governance at the European institutions.

Together with the continued need for reforms implemented in the right order, so as to take advantage of the synergies that may be obtained, for instance, from a combination of structural reforms and monetary policy, political and institutional stability are clearly essential. In that respect, it must be admitted that the latest developments in the European Union have not been particularly favourable. However, it is also true that in recent years the European Union, its institutions, and most certainly the ECB, have tackled serious difficulties – the sovereign debt crisis, the euro crisis and now the UK crisis are all fine examples – and this instils us with confidence that we will also overcome this situation and set the EU economy back on track for sustainable growth.

Thank you very much.