Yves Mersch: On European unity – economic and institutional challenges facing Europe

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, discussant Prof. Hannah Scobie, Chairman, European Economics & Financial Centre, European Economics & Financial Centre, London, 25 June 2015.

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Ladies and gentlemen,

David Laidler, the English economist and one of the foremost scholars of monetarism, once stated that "transparency is an asset that depreciates very rapidly, so communication has to be ongoing, and if it is to enhance accountability, it must be a two-way process as well".

As a central banker, I fully concur with this assessment. To explain our monetary policy measures – and to defend them when challenged – has become the state of the art in contemporary central banking communication.

The exchange with academia, financial market participants and the general public is the litmus test for how we succeed in managing expectations. This holds in particular for times of heightened uncertainty and complexity.

That is why I consider seminars like this one an important part of my professional duty – it provides an opportunity to explain the actions of the European Central Bank (ECB), to answer your questions and also to ask some questions of you, in order to benefit from your wealth of experience.

The euro area in particular has faced many questions since its inception and – as one of the foremost euro area institutions – the ECB has increasingly been drawn into debates that go beyond a very narrow definition of monetary policy. As a result, a criticism that is sometimes levelled at us is that we spend too much time talking about policies which are outside our mandate – namely structural reforms and euro area governance – and too little time focusing on actually delivering that mandate, i.e. returning inflation from its current low levels back towards below, but close to 2%.

You will not be surprised that I do not share this view. But the fact that it persists in some quarters suggests that there is a need to explain our position more clearly. Namely, to underline why the ECB has acted in the way it has in response to low inflation, and why we have insisted on others acting in their domains of responsibility as well, both at national level and European levels.

This is what I would like to do in my remarks today. There are ***three points*** in particular that I would like to address.

Implementing large-scale asset purchases

The ***first point*** relates to our monetary policy and our decision to enter into our APP in January. While in some quarters this was seen as excessive activism, in others – often on this side of the Channel – it was seen as excessively hesitant. The argument was that as a price stability-oriented central bank with a symmetric mandate, we should have followed other major central banks and deployed asset purchases sooner to push inflation back to our objective.

If one looks at the steps we have taken based on the data available in each period, it becomes clear that we acted based on an evolving medium-term outlook and taking into account the balance of risks at each moment – as any responsible policymaker should. The process in 2014 that led to the launch of our APP illustrates well this point.

At the start of 2014 we were confronted, on the one hand, with a consistent and broad-based downward trend in past inflation, falling from 3% at the end of 2011 to less than 1% at the beginning of 2014. But on the other, sentiment on the economic outlook was relatively positive for the year, with nearly all forecasters expecting the recovery to strengthen as the year progressed. In this context, we felt relatively comfortable that the medium-term inflation outlook was secure. While we were very alert to the risks to that outlook, there was no clear justification for a strong expansion of the monetary policy stance at that time.

Moreover, the use of large-scale asset purchases was unprecedented in the euro area and came with concerns that do not exist in other advanced economies. There was more uncertainty about the strength of the relative transmission channels given the euro area's financial structures; and there was more concern about the possible side-effects and redistributive effects of holding large amounts of government bonds in a monetary union that is not a fiscal union. All this created a further reason to be patient. In my view, deploying asset purchases had to be an *ultima ratio* decision. We had to see clear evidence of heightened deflationary risks either in the realised inflation data or in the movements of inflation expectations.

That evidence started to appear in the summer of 2014 as the macroeconomic situation worsened unexpectedly and the underlying impetus that we saw earlier in the year faded. This removed an important driver behind the reflation scenario we had expected. The sharp fall-off in oil prices that began in the late summer added then further disinflationary pressures, feeding also into core inflation. The result was that, by January 2015, the euro area was experiencing negative headline inflation rates. Crucially, there were also material signs that inflation expectations were becoming unanchored, which increased the likelihood that inflation would stay below our objective even when the oil price effect faded.

These data, especially measures of inflation expectations, were sufficiently decisive to warrant our shift to large-scale asset purchases in January this year. The prevailing macroeconomic outlook meant that the benefits of deploying that instrument in terms of delivering our mandate now clearly outweighed the costs in terms of potential side effects. But by waiting for adequate evidence, had we ended up "behind the curve" in counteracting the disinflationary trend? In my view the answer is clearly no.

First, we had taken a series of expansionary measures throughout 2014 in response to the incoming data, including cutting our main refinancing rate to its effective lower bound; introducing a negative rate on our deposit facility; launching our targeted long-term refinancing operations (TLTROs); and, importantly, in September 2014, with our decision to begin purchases of ABS and covered bonds.

Second, by communicating clearly the conditions under which we would use large-scale asset purchases – our so-called reaction function – we had already initiated a gradual easing of financial conditions as markets anticipated our measures. Long-term nominal interest rates fell by around 100 bps from mid-2014 to January 2015. Because we were predictable and credible, our policy was taking effect before it was actually announced in January.

Third, even though our measures were partly priced-in, when they were launched the initial impact was stronger than many expected and the response of macroeconomic indicators was quicker. We have seen strong signalling effects, reflected in rising inflation expectations, a rebound in consumer and business confidence and higher equity prices. And we have also seen evidence of significant portfolio rebalancing effects, both across assets classes (i.e. towards more risky assets) and across jurisdictions, producing a fall in the effective exchange rate.

As a result, the economic recovery has broadened and the June ECB staff projections now envisage inflation to average at 0.3% in 2015, 1.5% in 2016 and 1.8% in 2017. Our actions have proven timely and provide us, so far, with comfort that the medium-term inflation outlook is secure. Both output and inflation forecasts are broadly balanced.

These forecasts are however contingent upon a full implementation of our programme. We intend to carry out our public sector purchases until end-September 2016 and, in any case, until we see a sustained adjustment in the path of inflation. Only once we see convincing evidence that inflation has returned sustainably to levels in line with our objective will we be able to declare success.

Monetary policy and structural reforms

But this begs the question: if our measures are working well, why do we put so much focus on other policies? This is the ***second point*** that I would like to address – why structural reforms are relevant for monetary policy and why it is legitimate that, as a central bank, we take a view on them. In a nutshell, in the euro area, the more divergent economies become in terms of their structural conditions, the harder it ultimately becomes to achieve price stability at the euro area level.

First, structural reforms have a direct link to inflation, inflation expectations and real interest rates through their effect on the adjustment process.

When a country is hit by a shock, output will be less affected if relative prices can adjust quickly, and the recovery in output will be faster if the economy is able to reallocate resources in a more efficient way. This depends critically on structural features of the economy – for example, how labour markets adjust (i.e. the relative contributions of wage and employment adjustment), whether product markets are competitive and allow the entry and growth of new firms, and how quickly labour and capital can redeploy to more productive uses. This is related to issues such as the strength of insolvency regimes and effectiveness of active labour market policies.

How adjustment takes place in turn has implications for euro area price stability. A fast price adjustment will cause inflation to fall steeply initially, but then agents will expect it to rise again. This ensures a firm anchoring of medium-term inflation expectations and does not affect perceptions of real interest rates going forward. A slow employment adjustment, by contrast, will create more prolonged downward pressure on inflation, which is more likely to weigh on inflation expectations. This in turn can lead to higher expected real interest rates and exacerbates the effect of the shock, thus complicating the achievement of price stability at the euro area level.

Second, structural factors can compound adjustment difficulties by affecting the transmission and effectiveness of monetary policy across different countries.

That is because if economies recover very slowly from shocks, it is more likely to produce financial fragmentation and impair the transmission of monetary policy to those areas. For example, a prolonged downturn with higher unemployment will tend to create higher loan-losses for banks, which impairs the bank lending channel of transmission as banks are forced to rebuild their capital. Such an economic slump is also likely to worsen the fiscal position for the government, which can further exacerbate fragmentation via the bank-sovereign nexus.

Moreover, even if transmission works smoothly on the supply side, structural reforms also affect the demand side: the willingness of entrepreneurs to take on credit for new investment. Insofar as structural factors create an unattractive investment environment, they can impede credit demand and thereby hamper the effectiveness of monetary policy. By the same token, structural reforms and accommodative monetary policy can be complementary in boosting investment.

That would include, at the micro level, opening up protected sectors where there is pent-up investment demand or reducing administrative burdens on entrepreneurship; and at the macro level, lifting expectations of future growth and hence “animal spirits”, especially where firms are constrained by a debt overhang. This psychological dimension of reforms is particularly important for the euro area given that 5 years ahead growth expectations among forecasters have been falling continuously since 2001, from around 2.7% then to 1.4% today.

Third, if due to structural factors shocks leave deep scars on some economies, it can affect the long-term cohesion of the Union.

Divergence in structural unemployment is more likely to become entrenched across the Union, which of course cannot be offset, like in other federations, by fiscal transfers between the constituent members. And to the extent that this weakens the political rationale for monetary union – that all members are better off over time inside the Union than they would be outside – it also weakens its long-term cohesion. This undermines the integrity of the currency union.

The ECB's interest in structural reforms therefore has two dimensions: achieving an efficient implementation of monetary policy in the short-term, and maintaining the integrity of the currency over the longer-term. Both of these feed into euro area price stability. However, our interest is not in *how* countries implement reforms. This is a national question and there are different models that can work in a monetary union. Our interest is in *whether* they succeed in doing so, as it is this that has implications for the whole euro area. It is in this context that we at the ECB have recently called for stronger common governance in this area.

This call reflects the fact that some of the original expectations on how monetary union would function have, I think, now clearly been shown as over-optimistic. In particular, when the Maastricht Treaty was signed, it was evident to most policymakers that monetary union would ultimately need to be accompanied by integration in other policy areas too. But it was widely expected that, following the functionalist logic, sharing a single currency would automatically trigger that integration. We know this did not happen. And while the role of common institutions, rules and procedures has increased, the institutional equilibrium in the euro area is still fragile.

Institutional responses to our economic challenges

So my ***third point*** is that we need to reflect seriously on the key features of a well-functioning monetary union, and how we can progress towards establishing them. A lot of progress has already been made in strengthening our rules and institutional architecture. We have reinforced our fiscal rules and improved the coordination of our economic policies. And we have made a huge institutional leap with Banking Union, establishing the Single Supervisory Mechanism (SSM) within the ECB and a Single Resolution Mechanism (SRM). But we know that the architecture of EMU is not yet complete, and the 5 Presidents' Report published this Monday describes how to take this process to the next level.

Though like Rome a complete EMU cannot be built in a day, I believe we have to be ambitious both in the short and longer term. We have to show that we are building a bridge towards a more stable and prosperous union. This is what the report does. It fleshes out a number of quick-wins that can be implemented in a first stage without Treaty change. The Commission will come forward with concrete proposals on these still this year. And it sets the priorities for more fundamental changes to how monetary union operates in the future. The ECB fully supports this process and will continue to actively contribute to it. Let me highlight what we see as two crucial aspects of the report.

First, the report makes a strong case for completing Banking Union. It calls for finding a swift agreement on bridge financing and a permanent backstop for the Single Resolution Mechanism (SRF), with the ESM identified as the natural institution to act as a backstop for the SRF, while remaining fiscally neutral. These measures would help further sever the bank-sovereign nexus, which would in turn complement the functioning of monetary union – by reinforcing the singleness of money within the euro area, and by supporting the even monetary policy transmission across jurisdictions.

Second, the report advocates a long-term sovereignty shift in both economic and fiscal policies – a 'move from rules to institutions'. Most importantly, the report calls for a new economic convergence process to make the euro area more resilient against shocks, which would in turn make further sharing of sovereignty in the fiscal domain possible. It also proposes eventually establishing a euro-area treasury to take decisions jointly on certain elements of national budgets. This is certainly not for tomorrow, but this is the direction our Economic and Monetary Union ultimately needs to move in. In order to maintain the momentum, this process needs to start now.

It is now up to the European leaders to reflect on these proposals and carry them forward. As a matter of fact, they are discussing the report at the European Council in their meeting tonight and tomorrow. I trust that the wider context will not be lost in those discussions.

Conclusion

Let me conclude.

Our forceful monetary policy measures were first, necessary, second, timely, and, third, effective. The economic recovery is now proceeding at a moderate pace. And we see encouraging signs that it is broadening.

Monetary policy accommodation is a necessary condition for the recovery to keep on track. This implies that we will deliver what we announced. But it is not a sufficient condition. Member states have to do their part. Structural reforms are needed to strengthen the supply side and help economies regain a competitive edge in a globalized economy. And only with such an increased growth potential will the cyclical recovery become a sustained, structural recovery.

Neither monetary policy nor economic policy takes place in an institutional vacuum. The institutional refurbishment of the European house has so far achieved a lot. But the ambition to do so was often driven by the urgency of crisis. And now that the worst may lie behind us, we have to keep the momentum of further integration. The 5 Presidents' report is a useful roadmap for the way ahead.

A strong commitment to completing Banking Union will ease financing conditions for enterprises sustainably, and increase the resilience of Europe's financial landscape with a view also to hemming in contagion. Likewise, a long-term sovereignty shift in both economic and fiscal policies will stimulate convergence towards similarly resilient economic structures, based on common standards. Not everything can be achieved today, but all countries agreeing on the same way forward is a key element for higher confidence and a lasting end to this crisis.