Yves Mersch: Ways towards more dynamic growth

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the DZ BANK Kapitalmarktkonferenz 2015, Frankfurt am Main, 14 July 2015.

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Ladies and gentlemen,

Today we are considering "Ways towards more dynamic growth".

As you have invited me in my capacity as a member of the Executive Board of the ECB, I'd like to start off with the role of monetary policy. The effectiveness of our monetary policy also depends, however, on decisions in other policy areas. I will thus cover reforms both at Member State level and European level a little later.

The Governing Council of the ECB is meeting this week to discuss euro area monetary policy. The result will be a joint decision which I cannot, nor may not, pre-empt. We have agreed that it is our duty to remain silent in respect of monetary policy in the week before the monetary policy meetings of the Governing Council. If I say something today about previous monetary policy decisions or point to theoretical relationships, it should *not* be interpreted as a sign of how we shall decide the day after tomorrow.

The ECB's monetary policy is appropriate and effective

In view of sluggish lending, growing uncertainty about the recovery and the ongoing cloudy outlook for inflation we agreed on a series of monetary policy measures last summer:

1. We lowered the key interest rates;
2. We shaped the longer-term refinancing operations so that they offer banks an incentive to grant more loans to the real economy; and
3. We started a new programme for the purchase of covered bonds and asset-backed securities (ABS).

First of all, our loose monetary policy last year led to a bottoming-out of the still negative lending by banks in the euro area amid ongoing gloomy growth prospects.

However, the inflation rate continued to fall and on an ever broader basis, which means that the decline was not only attributable to the fall in the price of oil. What's more, the inflation outlook worsened because of flagging demand and continued uncertainty about economic growth. That was reflected particularly in the market's inflation expectations.

The expectations threatened to become uncoupled from our medium-term objective – an inflation rate of below but close to 2%.

In these circumstances we had to react decisively. A central bank must act boldly before expectations of a further fall in the inflation rate become a self-fulfilling prophecy.

We have done exactly that: in January the Governing Council of the ECB decided to expand our existing purchase programme of covered bonds and ABS by including a wide-ranging purchase programme for public sector securities.

The decision was not only necessary. It was also expedient: we were able to bring to an end the fall in medium and long-term inflation expectations. Expectations have in fact now risen again. Our experts are forecasting an inflation rate of on average 0.3% this year, 1.5% next

year and 1.8% in 2017.[1] Lending is steadily recovering. And not only because interest rates are low, but also because companies' order books are better and the mood in the economy is improving. We are thus seeing a *cognitive turnaround* as well, a positive upwards spiral, to which our monetary policy is contributing. Incidentally that's the case here in Germany as well. And that applies despite the unintended – and undenied – side effects of our monetary policy stance. These are all positive signals. But we haven't reached our goal. According to Eurostat's flash estimate the inflation rate in the euro area in June fell to 0.2%.

Our forecast that the inflation rate over the medium term will rise to just under 2% is based on the assumption that we shall complete our purchase programme. We intend to continue our purchases until September 2016 and to maintain the programme in any case as long as inflation has adjusted in a sustainable way. For we have only fulfilled our mandate when we can clearly show that the inflation rate has levelled off in a sustainable way near to our definition of price stability.

Structural reforms are vital

Yet we cannot conceive of monetary policy as being isolated from other policy areas. In short, the more the structural conditions in the Member States vary, the more difficult it is to take care of price stability in the whole of the euro area with a single monetary policy.

That's why we don't tire of talking about structural reforms. This term occurs in around one-third of all the published speeches of the Executive Board members. By way of comparison, it occurs in only around 2% of speeches given by the Federal Reserve Bank Presidents.[2]

With our monetary policy we can support economic growth. But it will only have its full effect if the governments of the euro area countries carry out sensible reforms to improve their competitiveness and thus create conditions for sustainable growth. Only when the structural framework conditions permit profitable economic activity will businesses make full use of improved funding conditions.

It would therefore be naïve to believe that economic measures alone – including monetary policy – could lead to a lasting return to stability and growth.

Structural reforms are also necessary in order to counter any possible future shocks more effectively. More flexible labour and product markets increase the resilience of countries in which the adjustments are also made via prices. That means, for instance, that more flexible wages lessen the adjustments needed in the labour market in an economic downturn. The risks of long-term unemployment are reduced in this way and an economy recovery takes place more quickly. Above all, in a monetary union like that of the euro area – in which monetary policy cannot react to country-specific developments – such adjustments are key.

The structural reforms that make sense for individual Member States to implement depend on the respective national factors. It is up to the elected governments to decide.

As a central bank we only have an interest in each country *successfully* carrying out the respective necessary structural reforms. And that is certainly possible. For instance, Spain carried out a comprehensive reform package in 2012 and 2013. And it did so in a situation in which a quarter of the population was unemployed. Spain is now one of the countries in the euro area with the strongest growth.

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[1] ECB June 2015 Eurosystem staff macroeconomic projections for the euro area, https://www.ecb.europa.eu/pub/pdf/other/eurosystemstaffprojections201506.en.pdf.

[2] Structural reforms, inflation and monetary policy, introductory speech by Mario Draghi, President of the European Central Bank, at the ECB Forum on Central Banking, Sintra, 22 May 2015 http://www.ecb.europa.eu/press/key/date/2015/html/sp150522.en.html.

However, I see a need for reforms in *all* countries of the euro area – even those which are currently comparatively well positioned. Now is not the time to rest on the successes of previous reforms, let alone to go back on ambitious reforms.

An economy which is short of skilled labour, in which whole regions are shrinking and ageing, which does not overhaul its bridges and roads is living on its reserves. When a society uses up its wealth, it cannot credibly claim to want to grow dynamically or even sustainably. A society in which the number of over 80-year-olds is set to rise by almost 50% in the next 15 years runs the risk of losing its will to reform and thus its capacity to integrate. Then there's a tendency to protect vested rights and to acquire the conservatism of a closed society.

It's precisely for that reason that governments in Europe should not only call for structural reforms elsewhere but also, and above all, in their own countries in order to create a favourable economic climate – then the whole of the union will benefit. Our economies have been linked much too tightly for a long time for us to be able to conceive of the economic and fiscal policies of the individual countries as being completely independent of each other. The euro area is not a loose association of independent states but a monetary union.

Reform of the monetary union is necessary

Europe's heads of state and government made a conscious decision to establish such a monetary *union* instead of just simply adopting a system of fixed exchange rates. Now EMU must live up to this name.

Spurred on by the effects of the crisis, some progress has already been made. The euro area should now be subject to stricter budgetary rules and the economic policies of individual Member States better coordinated.

We have stricter supervisory rules for the financial sector at both European and global level. Naturally this also affects the financing environment. For example, the new liquidity requirements mean that some banks will have to rethink their traditional business models, which can also have an effect on companies' financing situations.

With the Single Supervisory Mechanism (SSM) and the Single Resolution Mechanism (SRM), we have finally taken a clear step towards integration on the way to a European banking union.

However, in the medium to long term, if we really want to live in a stable and prosperous union we must continue in an ambitious way. This is why the "five presidents" (Jean-Claude Juncker, President of the European Commission, Donald Tusk, President of the European Council, Jeroen Dijsselbloem, President of the Eurogroup, Mario Draghi, President of the European Central Bank and Martin Schulz, President of the European Parliament) produced a report which presents concrete, short-term measures – i.e. ones that can be implemented without treaty change – as well as longer-term ideas about how the monetary union should work in the future.

I would like to pick out two points from this report today which I find particularly important.

First, the five presidents argue the case for completing the banking union. A completed banking union will sustainably improve financing conditions for companies and increase the resilience of the European financial sector.

This requires reaching a quick agreement on bridge financing for the resolution fund. One option would be a line of credit from the European Stability Mechanism (ESM). It would have to be designed in a budget-neutral way. This means that advance payments from public authorities would be repaid through appropriate levies on the financial sector over the course of time.

This would help loosen the close connection between sovereigns and their banks. If it succeeds, it will noticeably relieve the pressure on monetary policy.

Second, the five presidents are in favour of sharing more sovereignty in economic and fiscal policy over the long term. The absolute prerequisite for this, however, is that the convergence mechanisms of the monetary union work better in the future. Those who deviate from this must be stopped earlier and more firmly.

If this succeeds in stabilising the euro area in such a way that it becomes more resilient, then common standards and decisions in fiscal policy matters are not just conceivable, but also necessary to a certain extent. It is not about the complete centralisation of all aspects of Member States' revenue and expenditure policies. But a genuine monetary union only functions smoothly if certain decisions are made jointly. A euro area-wide treasury could – at some point – provide the framework for this.

These are ambitious suggestions. They cannot be realised overnight because they must be borne by our democracies. But they show the direction in which the monetary union should develop in the medium to long term. And we can and should already be taking the first steps in this direction now.

It is now up to the European heads of state and government to consider the proposals, further substantiate the longer-term ideas and implement them in the interests of a deepened Economic and Monetary Union.

Final thoughts

The euro area economy is recovering slowly but steadily, thanks in part to our most recent monetary policy measures. These measures were

1. necessary,
2. appropriate and
3. they are effective.

I am confident that the economic recovery will continue to make progress.

Especially in a monetary union, neither individual policy areas nor the different political and decision-making levels should allow themselves to think in isolation from each other. The well-being of each individual Member State depends not just on the situation in each country, but also on the rest of the union. The crisis has demonstrated this all too clearly, and policy-makers have reacted. The institutional structure of the monetary union is significantly stronger. In the meantime, however, the enthusiasm for reform has clearly weakened. The five presidents' report should be reason enough to bring back more dynamism into the discussion about the further integration of the monetary union.

We will not be able to complete Europe's integration project today. Recent experience has made this clear: the convergence process is undermined if the claims to sovereignty of Member States gloss over their individual responsibility and even if compliance with agreed rules, which are in their own long-term interest, is refused.

Only if all members of the monetary union agree on a common way forward can we take the next steps in the right direction today – steps to more dynamic growth, greater prosperity and more stability.