Yves Mersch: Economic and monetary policy at a turning point – where is the economy heading in Europe, the United States and China?

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the Petersberger Sommerdialog, Königswinter, 29 June 2019.

* * *

Despite the escalating trade dispute between the United States and China, the global economy continues to grow robustly, albeit at a slower pace.

Looking at developments in major economies beyond the euro area, activity in the United States is supported by the strong labour market, accommodative financial conditions and current fiscal stimulus. However, economic growth is expected to decelerate.

At the same time, in China the slowdown in domestic demand has been cushioned by the implementation of a series of fiscal and monetary policy measures. Although the escalation in the trade dispute with the United States is foreseen to weigh on trade, China is expected to continue its orderly transition to a more balanced growth path.

The incoming data for the euro area in the first quarter of 2019 have been somewhat better than expected. Euro area real GDP increased by 0.4% quarter on quarter in the first quarter of 2019, bolstered by resilient domestic demand.

However, survey information and economic indicators point to somewhat weaker growth in the second and third quarters of this year. This reflects the ongoing weakness in global trade and the prolonged presence of uncertainties that continue to weigh on euro area growth, in particular in the manufacturing sector.

Consequently, the Eurosystem staff projections see euro area real GDP growth of 1.2 % in 2019, which will accelerate further, to 1.4 %, in both 2020 and 2021. Compared with the March 2019 staff projections, the outlook for real GDP growth has been revised up slightly for 2019, largely owing to a stronger than expected first quarter. At the same time, real GDP growth has been revised down for 2020 and 2021, mainly reflecting a somewhat weaker contribution of foreign demand.

The fundamental factors supporting the euro area expansion remain broadly in place. Labour market dynamics remain robust, with unemployment at 7.6% in April, the lowest level since August 2008. Employment increased by 0.3% quarter on quarter in Q1 2019, as in the previous quarter. The cumulative increase in the number of people employed between Q2 2013, the trough of euro area employment, and Q1 2019 amounts to 10.8 million.

Nevertheless, the risks surrounding euro area growth are tilted to the downside, on account of the prolonged presence of uncertainties related to geopolitical factors, the threat of protectionism and vulnerabilities in emerging markets.

Turning to inflation, headline inflation was 1.2% in June, according to Eurostat's flash estimate, unchanged from May, which conceals lower energy prices and a recovery in services inflation, while measures of underlying inflation remained very subdued. On the basis of current futures prices for oil, headline inflation is likely to decline over the coming months before rebounding towards the end of the year. Oil prices (as measured by the USD price of Brent crude oil) have risen by more than 20% since the start of the year.

This scenario is broadly in line with the latest Eurosystem staff projections, which foresee annual headline inflation of 1.3% in 2019, rising gradually to 1.4% in 2020 and 1.6% in 2021, broadly confirming the March outlook.

At the same time, labour cost pressures have strengthened and broadened. In Germany, for example, wages rose in the first quarter of 2019 by 2.5% in nominal terms, and by 1.2% in real terms. This is due to high levels of capacity utilisation and tightening labour markets, which is translating into a pick-up in wage growth.

Summing up, although the incoming data for the first quarter of 2019 have been somewhat better than expected, weak global trade and the prolonged presence of uncertainties continue to act as a drag on euro area growth.

The monetary policy stance

This led the ECB's Governing Council, at its meeting on 6 June, to take a series of decisions in pursuit of its price stability objective.

First, we decided to adjust our forward guidance on the key ECB interest rates. We now expect them to remain at their present levels at least through the first half of 2020, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term.

The decision to shift the date-based part further into the future, from "at least through the end of 2019" to "at least through the first half of 2020", transparently conveys to the public the Governing Council's genuine expectation that the current outlook for price stability very likely will not warrant a tightening of monetary policy at least for another year.

Second, we confirmed the ongoing full reinvestment of the principal payments from the maturing securities purchased under the asset purchase programme for an extended period of time past the date when we start 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.

Finally, we determined the modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III), which were announced in March. TLTRO III operations will start in September 2019 and end in March 2021, each with a maturity of two years. We decided that the interest rate in each operation will be set at a level that is 10 basis points above the average rate applied in the Eurosystem's main refinancing operations over the life of the respective TLTRO. For banks whose eligible net lending exceeds a benchmark, the rate applied in TLTRO III will be lower, and can be as low as the average interest rate on the deposit facility prevailing over the life of the operation plus 10 basis points.

The schedule defining the borrowing costs under TLTRO III is marginally less generous than that applied under the outstanding TLTRO II, in line with our intent of not discouraging banks that can afford to fund themselves in the market on attractive terms from doing so at TLTRO II maturity. At the same time, the pricing schedule incorporates features that can greatly enhance our accommodative monetary policy stance, as banks with strong lending performance will retain the opportunity to borrow at negative interest rates.

The pricing remains sufficiently generous – especially when compared with alternative sources of funding – for banks to keep credit flowing to firms and households on a scale that can continue to support the economy and inflation.

All in all, this set of decisions will provide the monetary accommodation necessary for inflation to remain on a sustained path towards levels that are below, but close to, 2% over the medium term, while also preserving favourable bank lending conditions and supporting a smooth transmission of our monetary policy. This being said, the Governing Council remains ready to act in case of adverse contingencies and to use its instruments – as appropriate – to ensure price stability.

A reliable strategy is an anchor for credible monetary policy. Erratic policy debates for the purpose of creating short-term stimulus risk undermining that credibility in the long run.