

Yves Mersch: Opening remarks

Opening remarks by Mr Yves Mersch, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the “Getting to know the EU Institutions and Organisations in Luxembourg” event, Luxembourg, 11 November 2019.

* * *

The press is an important medium for the ECB to communicate and explain our decisions and policies to the wider public. I am happy for today’s opportunity to extend the usual exchange with the “ECB watchers” to Brussels-based journalists.

While I will devote most of this session to answering any questions you may have, I want to start by outlining the ECB’s role and its functions. I will then briefly touch upon challenges to the European economic outlook that explain the ECB’s latest monetary policy measures, before concluding with the priorities for Economic and Monetary Union from the ECB’s perspective.

The ECB and its functions

The primary task of the ECB is to maintain price stability, defined by the Governing Council as an inflation rate of “below, but close to, 2% over the medium term”.

Maintaining price stability supports sustainable economic growth and helps to create jobs and improve the living standards of euro area citizens.

In addition to defining and implementing the monetary policy for the euro area, we have a number of other tasks under the EU treaties, including promoting the smooth operation of payment systems.

We have an advisory role on European and national legislation in our areas of competence and we are frequently consulted on such legislation. We are also involved in the euro area accession process, preparing regular reports on the progress made towards the Maastricht convergence criteria by the Member States expected to eventually adopt the euro. In addition, we help manage the European exchange rate mechanism and ensure non-euro area Member States can participate smoothly in the banking union should they wish to join.

In 2014, the ECB was tasked with supervising about 120 significant banks in the euro area and it is responsible for the effective and consistent functioning of the Single Supervisory Mechanism as a whole.

To ensure that the ECB acts in the best interest of European citizens, we have strong safeguards in place to verify that we act in accordance with our mandate and that our independence is protected.

With regards to our mandate, we are subject to judicial review by the Court of Justice of the European Union and we are accountable to the European Parliament.

To emphasise our independence, members of the Governing Council are seated in alphabetical order by surname, rather than by nationality, showing that ECB decision-makers act in the interest of the euro area as a whole, rather than in their national interest, when deciding on monetary policy.

And the rationale of the latest of these monetary policy decisions is what I want to turn to next.

The euro area economic outlook and the ECB’s response

Since the beginning of this year, euro area growth momentum has slowed markedly, by more than we had previously anticipated. The September ECB staff projections expect the euro area economy to grow by just 1.1% in 2019, 0.6 percentage points less than estimated in the December 2018 staff projections, and by 1.2% in 2020, down by 0.5 percentage points from the December projections.

This slowdown is mainly due to the weakness of international trade in an environment of persistent uncertainties related to protectionist policies and geopolitical factors. These factors are increasingly weighing on economic sentiment and, in particular, on the manufacturing sector.

Accordingly, countries which have a relatively large manufacturing sector are more exposed to the current slowdown, with Germany a case in point.

The longer the weakness in manufacturing persists, the greater the risk that other sectors of the economy will be affected by the slowdown as well. Risks to the growth outlook remain on the downside overall.

Headline inflation remains well below 2%, while inflation excluding the more volatile food and energy components has been hovering around 1% for an extended period of time. This indicates that the weaker economic outlook may imply a delay in the pass-through of wages to prices. Firms are absorbing increases in labour costs in their profit margins rather than passing them on to customers. Meanwhile, indicators of inflation expectations are at low levels. Although the likelihood of deflation remains limited, market expectations of inflation over the medium term are settling around values that are not consistent with our inflation aim.

Inflation is currently expected to average 1.2% in 2019, 1.0% in 2020 and 1.5% in 2021, which is well below the Governing Council's medium-term aim of below, but close to, 2%.

So when the Governing Council met in mid-September to decide on monetary policy, it was confronted with a more rapid and extended slowdown than previously anticipated, persistent and prominent downside risks to the growth outlook, and a further delay in the convergence of inflation towards the ECB's aim.

The Governing Council decided on a comprehensive package of measures with a view to ensuring that inflation moves towards the ECB's aim in a sustained manner.

- ♦ **The interest rate on the deposit facility was lowered from –0.40% to –0.50%.** Lowering the deposit facility rate helps to further improve the borrowing conditions of households and businesses. Negative rates also encourage banks to lend to the real economy instead of holding onto liquidity.
- ♦ **The forward guidance on the likely future direction of the ECB's monetary policy was strengthened.** Specifically, it clarified that the ECB expects its policy rates to stay *“at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics”*. By reassuring markets that policy rates will stay *“at their present or lower levels”* until there has been an improvement in the inflation outlook, the ECB reinforced the impact of the cut in the deposit facility rate.
- ♦ **The Governing Council further decided to restart net asset purchases at a monthly pace of €20 billion from November onwards.** These purchases are expected to run for as long as necessary to reinforce the accommodative impact of the ECB's policy rates, and to end shortly before the ECB starts raising its key interest rates. This is in addition to the reinvestment of the sizeable stock of assets the ECB has already purchased under the asset purchase programme.
- ♦ **The modalities of the new series of targeted longer-term refinancing operations (TLTRO III) were eased.** Banks can now obtain this long-term funding at lower rates with a

longer maturity. This should also help to ensure that the ECB's accommodative policies pass through entirely to the funding costs of households and firms.

- ♦ **Finally, the Governing Council announced a two-tier system for reserve remuneration, in which part of banks' excess reserves held with the ECB will be exempt from negative rates.** The two-tier system is designed to strike a balance between preserving the incentives for banks to pass through the stimulus generated by the negative interest rate on their reserves, and mitigating the adverse effects that these negative rates might have on banks' lending behaviour by affecting their profitability. The new two-tier system will make sure that banks' ability to extend loans to their customers at favourable terms remains unimpaired.

The different elements of this comprehensive package will together support favourable financing conditions for businesses and households, which will sustain investment and consumption. Greater business and household expenditure will, in turn, support inflation dynamics and make sure that they durably converge to the ECB's aim.

Priorities for the ECB and Economic and Monetary Union

The conventional and unconventional measures the ECB has taken over the past decade have been successful in addressing deflationary risks, restoring the functioning of the monetary policy transmission mechanism and providing vital support to the euro area economy.

But the ECB does not operate in a vacuum and other economic policies matter too. A better policy mix, including fiscal policy, structural reforms and prudential measures, can help achieve this objective faster and with fewer side effects.

In other words, we need a coherent economic strategy in the euro area that complements and enhances the effectiveness of monetary policy.

This is why there was unanimity in the Governing Council that fiscal policy must make a more decisive contribution. In view of the weakening economic outlook and the continued prominence of downside risks, governments with fiscal space that are facing a slowdown should act in an effective and timely manner. As long as fiscal sustainability is ensured, countercyclical fiscal policy could be very effective in the current environment, given that fiscal multipliers are higher when interest rates are low. At the same time, governments in countries with high public debt should pursue prudent policies and deliver on structural balance targets.

In addition to better national policies, work on completing the architecture of Economic and Monetary Union needs to continue. In the short term, projects that are already under way must be completed, such as making the backstop to the Single Resolution Fund operational, finishing the reform of the European Stability Mechanism and passing legislation for the Budgetary Instrument for Competitiveness and Convergence before the next multiannual financial framework.

Beyond these steps, advancing the banking union and capital markets union has become even more urgent in view of Brexit, as Europe needs to avoid capital market fragmentation.

Progress requires the removal of the remaining barriers to the free flow of capital and liquidity across borders and banking groups. A more integrated single market for financial services can make a decisive contribution to private risk-sharing and the absorption of shocks through cross-border holdings of investments.

In the long run, work on a European deposit insurance mechanism needs to continue, combined with action on a host of legislative files, from the forthcoming updates of the banking packages – the Capital Requirements Regulation and Directive and the Banking Resolution and Recovery Directive (CRR III/CRD VII/BRRD III) – to the review of the fiscal and economic rules – known as the two-pack and six-pack – which is scheduled for the end of this year.

Conclusion

Recent experience shows that policy answers need to evolve in line with the challenges of the time and that all policy areas need to contribute. Within their mandates, central banks will continue to take policy challenges into account to ensure their measures are effective.

The press plays an important role in informing the public about the ECB's measures and critically challenging its decisions. In my view, this dialogue with you, the press, supports the effectiveness of the ECB's measures. So let's start this dialogue here and now.