Yves Mersch: The European Central Bank's role in overcoming the crisis

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at the UniCredit Business Dialogue, Hamburg, 17 June 2013.

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Ladies and Gentlemen,

Many thanks for the invitation to the Business Dialogue.

When I last gave a speech in Hamburg – almost exactly two years ago – I also focused on overcoming the crisis. Though the crisis is indeed not over yet, much has certainly happened in the meantime:

- we have a powerful set of instruments for overcoming the crisis;
- the economic governance framework at European level has been reinforced;
- we are on the path towards a banking union that can break the negative feedback loop between banks and sovereign debtors.

The organisers have asked me to address the ECB's role in this context and I'm happy to honour their request. But let me make it quite clear from the start: the ECB has an explicit mandate. Our task is to ensure price stability in the euro area, and our non-standard measures have contributed to that objective. But monetary policy cannot be called on to overcome the crisis. A sustainable resolution to the crisis lies in the hands of the Member States.

So this evening I would like to look at two questions:

- First, what is the role of monetary policy in overcoming the crisis?
- Second, are the euro area governments living up to their responsibility to eliminate the causes of the crisis?

Let me begin with the role of the ECB.

The ECB's core task is to ensure price stability. That has not changed, nor will it change.

We have a clear mandate, which was conferred on us by the Member States' governments at supra-national level under the European treaties. It is virtually cast in stone. At the same time, we have operational leeway in choosing how to fulfil this mandate – provided that we stay within its limits.

During the crisis it emerged that, in some places, the transmission of our monetary policy signals to the real economy was restricted or uneven. In central banking we speak of a distorted monetary transmission mechanism.

We therefore took non-standard measures so that our monetary policy would be more effectively passed through to the financing conditions for the real economy. These non-standard measures complement our traditional set of instruments. Put simply: our interest rate decisions are aimed at price stability. The non-standard measures seek to ensure that the desired effect of these decisions also spreads across the entire euro area.

One of these non-standard measures is the policy of full allotment in our refinancing operations against appropriate collateral. We have also extended the maturities of our refinancing operations up to three years and have expanded the collateral framework. These measures are geared towards banks' refinancing conditions, which in turn make it easier for credit institutions to provide sufficient credit to the economy at favourable terms.

Last summer we decided on more far-reaching measures – notably the announcement of the Outright Monetary Transactions. Prior to this announcement, we had to observe that market financing conditions were increasingly characterised by the fears among market participants that Member States would revert back to their national currencies. The markets hence priced in a conversion risk premium. Owing in part to this premium, the refinancing conditions of many commercial banks – and thereby the real economy – deteriorated dramatically.

The ECB's monetary policy is committed to maintaining price stability in the euro area as a whole. So we had to take measures that would ensure that our single monetary policy would take effect in all Member States.

Since the summer of last year, financing conditions for the real economy in the euro area have clearly improved. The situation is clearly returning to normal. That is also felt by savers, pension funds and insurance companies here in Germany: the yields on German government bonds have increased, having previously been extremely low because some investors had been panicked into reshuffling their portfolios in favour of supposedly safer havens. These yields had even turned negative at times. The distortions of the monetary transmission mechanism have thus visibly receded.

At the same time, the influence of monetary policy on the return on savings is overestimated. For one, the real return is what primarily feeds savings in an economy. In the long term, the real return is mainly defined by production potential. By adjusting the interest rate, monetary policy only serves to smoothen developments in order to prevent the economy from overheating, causing an acceleration in inflation or – during a crisis, say – from entering a deflationary spiral.

Second, monetary policy behaves neutrally towards different savings instruments. It does not give preference to savings over investments in equities or in fixed income securities, both of which have gained considerably in value in Germany over the past few months.

All of our non-standard measures are only temporary. For a short time, an overly ample provision of central bank liquidity to the banking sector is not incompatible with our mandate to maintain purchasing power. We can adjust the interest rate for these operations at any time. And excessive liquidity is automatically returned: banks demand less liquidity as soon as the monetary transmission mechanism improves. This process is in full swing. The three-year longer-term refinancing operations that I referred to before will expire at the beginning of 2015. Many banks have, however, already repaid the funds they had borrowed. So the design of our non-standard measures is such that a special withdrawal strategy is not required.

At the same time, we are aware of the long-term risks to stability associated with extremely low rates and excessive liquidity over too long a period. It is hence imperative that repair efforts in other areas are carried out resolutely and thoroughly. The ECB is indeed making an important contribution to crisis management but it cannot resolve the crisis by monetary means. In the end, it can only win time for other policy sectors to carry out the necessary adjustments and reforms.

It is up to the governments of the Member States to live up to their responsibility. They need to remedy remaining deficiencies in the European governance framework. And they must gear their economic policies to the demands of an economic and monetary union.

Important steps have been taken since the outset of the crisis. The Member States must now single-mindedly continue on the path towards a new and more robust political economy.

The first step taken was the establishment of an effective set of instruments for the management and resolution of crises in the euro area. Initially, crisis-related measures by the Member States and the International Monetary Fund (IMF) had had to be arranged ad hoc. Since October last year, the European Stability Mechanism (ESM) has replaced the European Financial Stability Facility (EFSF) that had been designed as a temporary measure. The ESM has the organisation structure of an intergovernmental body. With a view to the progressive deepening of European integration, its further development into a truly federal institution would certainly be more appropriate that any questioning of the ECB's mandate.

The new measures taken at the European level have proved to be effective in countering contagion in the euro area in the most serious stages of the crisis. Financial markets and consumers are gaining renewed confidence in the euro area, even though the prospects for growth and employment remain weak over the medium term.

Combining financial assistance with strict conditions has brought the negative economic trends in the programme countries to a halt. The economic downturn in some of the most strongly affected countries may even have bottomed out in the near future. What is crucial now is to ensure that the programme countries do not stray from the path of essential fiscal, financial and structural adjustment.

The second step undertaken was the strengthening of the framework for steering economic policy at the European level. It is aimed at preventing dangerous imbalances in both public budgets and current accounts more effectively in future. The Governing Council of the ECB has urged time and again that economic governance in the euro area be improved, calling for the Stability and Growth Pact to be strengthened, for procedures to be put in place to counter macroeconomic imbalances and for the ceilings on public debt and deficits set out in the Stability and Growth Pact to be transposed into national legislation in all Member States. We welcome that the regulatory framework has been reformed accordingly.

However, the regulatory framework alone cannot ensure that economic policies are sound. Paper doesn't blush, as clearly evidenced by the failure of the original Stability and Growth Pact. The new governance framework can only be successful if it is implemented consistently, according to both the letter and the spirit of what has been agreed. Its success thus depends on the action taken by the European Commission and the Council of Ministers.

All this is confirmed by taking a brief look at the current "European semester", the new process for the coordination of economic policy in the European Union. I fear that the unsound economic policies in some Member States are once again not being opposed decisively enough. The rules of the new European governance framework can only be effective if they are strictly applied.

In particular, deadlines for the correction of excessive budget deficits should, for instance, only be extended, by way of exception, in the event of exceedingly adverse circumstances. Extensions should not become the rule.

The third set of measures is to be found in the first steps undertaken towards a banking union. The measures are aimed, in particular, at disrupting negative feedback loops between banks and public sector debtors, and at halting the increasing fragmentation of European financial markets.

All banks in the euro area, as well as the credit institutions in Member States that have arranged for close cooperation with the ECB, will be subject to European supervision, the "Single Supervisory Mechanism". Although the ECB will be responsible for the direct supervision of only large, systemically important credit institutions, this does not mean that other banks will not be covered by the ECB's supervisory framework. National supervisory authorities will have to comply with the regulations, guidelines and instructions of the ECB. Moreover, the ECB will be able at any time to take over the direct supervision of smaller credit institutions. Current plans envisage that common supervision will commence in the second half of next year.

However, common banking supervision is only one element of a true banking union. In parallel, we also need a common resolution mechanism. The two elements are somewhat like Siamese twins – one cannot survive without the other. Their combination is the only way in which negative feedback loops between the banking sector and public budgets can be disrupted.

The detailed design of the "single resolution mechanism" is still the subject of debate in Brussels and the Member States' capital cities. Without prejudice to any decisions thereon, I would like to highlight two elements that I regard as being particularly important when designing the single resolution mechanism: on the one hand, the geographical and institutional scope of applicability of the single resolution mechanism should be the same as that of the Single Supervisory Mechanism. A European resolution authority would ensure that decisions are taken in a timely and objective manner. A network of national authorities would fall short of what is necessary in this respect. Cases where a bank finds itself in a precarious situation call for swift and efficient action. A European resolution authority would be able to avoid unnecessary delays and overcome coordination-related constraints. That would also keep the resolution costs low.

On the other hand, the use of taxpayers' money should be limited to exceptional cases. The first step should be to use equity and bail-ins of shareholders and creditors to the greatest extent possible. The next step should then be to tap a European resolution fund financed through bank contributions. Public funds such as those of the European Stability Mechanism (ESM) should only be used temporarily in emergencies. Such temporary assistance should be covered by subsequent levies on banks, so that it ultimately has no fiscal policy impact.

The European Commission will be submitting draft legislation on a common resolution mechanism at the end of the month. Thereafter, the Member States will need to ensure that we establish an effective resolution mechanism in addition to common supervision.

That brings me back to where I started my speech today: it is the Member States who are responsible for finding a lasting solution to the crisis.

What the central bank has to do is to ensure that the transmission of monetary policy functions properly again. The instruments we need for doing so are at our disposal. However, our hands are tied where disruptions to the socio-economic transmission mechanism are concerned. Returning to more realistic views when making election promises and both explaining and implementing unpopular measures wherever necessary are the prerogative and responsibility of the – national – political domain.

Werner Schneyder, an Austrian political satirist, once said that Europe consists of countries that do not want to be ruled by what they themselves have decided. That must change. Only then will it be possible to sustainably resolve the crisis.