Yves Mersch: Speaking points for an event organised by MNI Connect

Speech by Mr Yves Mersch, Member of the Executive Board of the European Central Bank, at an event organised by MNI Connect, New York City, 11 October 2016.

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Euro area economy

The euro area recovery continues yet remains moderate – with some loss of momentum over the third quarter – and uneven. In the first half of 2016, the euro area grew at an annualised rate of 1.7%, similar to last year's growth rate and has for the most part been driven by domestic demand.

At the same time, the recovery has consistently proved resilient to a series of adverse shocks over the past year and so far the flow of data and business confidence indicators suggest that any slowdown in growth emanating from the UK referendum should be contained.

This resilience reflects to a large degree the amount of actual and decided monetary expansion that is priced into financial markets. In fact, ECB staff analysis indicates that in the absence of our policies, the euro area economy would be notably weaker.

Propagation mechanism of our recent non-standard monetary policy measures

The ECB introduced its most recent monetary policy measures starting in June 2014, when inflation expectations gave their first initial indication of destabilisation.

The overarching motivation underpinning their introduction – as well as for all our non-standard monetary policy measures - has been to ensure the integrity of the monetary policy transmission mechanism and thereby, deliver on our mandate of an inflation rate of below, but close to 2%.

The transmission of these nonstandard measures through the financial system to the real economy essentially occurs via three interrelated channels: direct pass-through, portfolio rebalancing and signalling, with each of these three channels re-enforcing each other.

In terms of the first channel, specific credit easing measures such as the TLTRO I and II as well as the ABS and Covered Bond purchase programmes were introduced with the objective of directly affecting the funding cost of banks.

The TLTRO I and II allow all euro area banks to borrow at very low rates – negative at present – provided they attain their loan issuance targets. By allowing all euro area banks to take part in the TLTRO, it increases competition in the market for bank loans and consequently lowers the borrowing costs for firms and households. The ABS and Covered Bonds purchase programmes reduce the interest rate paid by the banks on the securities that they originate with a view to incentivising them to issue more loans so that they can be subsequently packaged into ABS or used as collateral for covered bonds. Overall, these three credit easing measures narrow the gap between the cost of borrowing for firms and households and the cost of borrowing for banks in financial markets.

Turning to the portfolio rebalancing channel, the Eurosystem asset purchases compress the term premium on long-dated securities. This encourages a generalised shift out along the maturity ladder, and down the risk spectrum. In a bank-centred system like the euro area's such a shift takes place primarily on banks' balance sheets, as the coupon on the securities holdings is reduced relative to the risk-adjusted return that banks can extract from loan creation, thus promoting an expansion of credit for the real economy. Our negative deposit facility rate enhances a bank's incentive to reduce its cash holdings in favour of longer-dated securities and loans.

In relation to the third channel, the signalling channel, our purchase programmes and forward guidance have certainly influenced expectations. In addition, the introduction of these measures corroborated our reaction function and as a result emphasised our commitment to deliver on our mandate of price stability.

Impact of our measures on financing conditions and growth

Since their introduction in summer 2014, the impact of our measures on financing conditions has been material.

The GDP-weighted euro area 10-year government bond yield has declined by about 150 basis points since June 2014, and the ECB staff estimate that approximately 80% of that decline can be attributed to our policy measures. At the same time, yields on bank and non-financial bonds have declined notably in response to our measures. Yields on bank bonds have declined by about 80 basis points while non-financial bonds have declined by around 100 basis points.

Credit spreads of sovereigns are not addressed though, they remain fully the outcome of markets' pricing.

As a result, bank lending rates to non-financial corporations (NFCs) as well as households are now at historical lows and there has been a significant reduction in the fragmentation of lending rates across euro area countries as well as for large and small loans. For example, since May 2014, the cost of borrowing for NFCs in Italy and Spain has declined by more than 160 basis points and 140 basis points, respectively. We calculate that a change in lending rates of that magnitude in such a compressed period of time would have required a reduction in policy rates by about 110 basis points on average in normal times, given the particularly inertial transmission of policy innovations through the bank lending channel. The euro area banking sector is now in a much stronger position to transmit our monetary impulses on account of the establishment of the Single Supervisory Mechanism (SSM) in 2014.

The improvements are not just visible on the price side, loans to NFCs and households continue to recover, notably in so-called core jurisdictions, albeit remaining weak from an historical perspective. The latest Bank lending Survey (BLS) indicates that the persistent easing of credit standards on loans to firms and households is to a large extent driven by increasing competition among banks for good credit, which in turn to a large extent is the result of our measures having eased banks' access to funding and liquidity conditions in general. Also encouraging is the ECB survey on the access to finance of enterprises (SAFE) which points towards improving credit conditions for euro area SME's, the bedrock of the euro area economy.

While the impact of our policies on financing conditions has surpassed our expectations, the euro area recovery has been sluggish. This can be explained in part with the considerable global headwinds, weak world trade and the high public and private sector debt levels sapping confidence and eroding especially the elasticity of investment to the borrowing conditions faced by companies. In term of risks to the outlook, they remain on the downside. However, the economy is in far better shape now than it was some quarters ago and it should be noted that the risk of deflation today is very low.

The outlook for a continued yet moderate recovery is largely reflected in the latest ECB staff September 2016 macroeconomic projections for euro area activity. Real GDP is projected to grow at an annual rate of 1.7% in 2016, 1.6% in 2017 and 1.6% in 2018 with this projection based on the assumption that the current supportive financial conditions persist. ECB analysis suggests that the impact of the measures taken since mid-2014 on euro area real GDP growth has been sizeable, increasing real euro area GDP growth by more than one and a half percentage points cumulatively between 2015 and 2018.

The hesitant pace of recovery has weighed on inflation dynamics which remain subdued. We expect headline inflation to pick-up in the coming months on account of the base-effects in the annual rate of change of energy prices. According to the latest ECB staff projections, inflation is expected to rise to 1.2% in 2017 and 1.6% in 2018 with a significant contribution coming from our measures taken since June 2014, namely 0.5 percentage points per year.

Overall, the implementation of our measures has been smooth.

Some considerations regarding our measures

Notwithstanding the effectiveness of our measures, we also need to consider their potential side-effects.

A protracted period of low interest rates weigh on banks' profitability via lower net interest income and this can potentially impinge on the transmission of monetary policy given the key role played by banks. Although, banks on the whole, have been able to weather the declining margins by increasing lending volumes, lowering provisioning needs and attaining capital gains from their fixed income holdings. That being said, euro area banks need to do their part in terms of improving profitability. Such measures include reducing operational costs, a greater use of financial technology and addressing the stock of non-performing loans in a more resolute manner.

We also need to be mindful of the risk that a protracted period of low-interest rate environment may create financial imbalances and foster asset price bubbles, particularly in the real estate market. While there is no single metric to assess the sustainability of real-estate valuations, to date there is no indication suggesting overheating in this sector.

Role of other policies

Monetary policy aims to put the economy on a sustainable growth trajectory where cyclical slack is reabsorbed. But it is supply-side factors- such as productivity and high quality public institutions - which will determine long-run economic growth. Therefore, it is imperative that euro area governments implement a focused suite of policies to boost long-term growth prospects.

Fiscal policy needs to play a larger role in countries with fiscal space in supporting the recovery than it has to date. All countries should explore ways to enhance the composition of their fiscal policies with a view to making it more growth-friendly, especially in the area of taxation and the share of public investment.

There also needs to be greater clarity over the future institutional set-up of the euro area, which remains incomplete in key areas, such as banking union.

Finally, by implementing these policies it will complement our monetary policy measures in supporting the recovery and accelerating the return of inflation to values more consistent with our aim of price stability.