Yves Mersch: The ECB’s monetary policy stance

The global recovery is firming and broadening. And the ongoing economic expansion in the euro area provides confidence.

But while inflation will gradually head to levels in line with our definition of price stability in the mid-term, it has yet to translate into stronger inflation dynamics. Headline inflation is dampened by the weakness in energy prices. Moreover, measures of underlying inflation remain overall at subdued levels. Therefore, as I pointed out yesterday in my oral presentation at the Bank Negara Malaysia Monetary Policy Conference, a very substantial degree of monetary accommodation is still needed for underlying inflation pressures to gradually build up and support headline inflation developments in the medium term.

Let me provide you with some details of the ongoing recovery. Euro area real GDP increased by 0.6%, quarter on quarter, in the first quarter of 2017, after 0.5% in the last quarter of 2016. Incoming data, notably survey results, continue to point to solid, broad-based growth in the period ahead. The pass-through of our monetary policy measures is supporting domestic demand and has facilitated the deleveraging process. The recovery in investment continues to benefit from very favourable financing conditions and improvements in corporate profitability. Private consumption is supported by employment gains, which are also benefiting from past labour market reforms, and by increasing household wealth. Moreover, the global recovery should increasingly lend support to trade and euro area exports. However, economic growth prospects continue to be dampened by a slow pace of implementation of structural reforms, particularly in product markets, and by remaining balance sheet adjustment needs in a number of sectors, notwithstanding ongoing improvements.

The risks surrounding the euro area growth outlook might be upward in the short term, but are overall broadly balanced. On the one hand, the current positive cyclical momentum increases the chances of a stronger than expected economic upswing. On the other hand, downside risks primarily relating to global factors continue to exist.

The thread of deflation is gone and reflationary forces are at play. Prices pressures in the early stages of the pricing chain remain strong but have still not transmitted to the later stages. Euro area annual HICP inflation was 1.3% in June, down slightly from 1.4% in May, mainly due to lower energy price inflation. Looking ahead, on the basis of current futures prices for oil, headline inflation is likely to remain around current levels in the coming months. In these conditions, we can be more assured about the return of inflation to our objective than we were a few years ago. At the same time, measures of underlying inflation remain low and have yet to show convincing signs of a pick-up, as domestic cost pressures, including wage growth, are still subdued: although compensation per hour worked is rising, compensation per employee remains flat. This divergence goes back, at least in part, to the increased fragmentation of labour time. In the labour market technological advance, in particular the use of the internet allows for more services being offered with less intermediation at lower prices.

Underlying inflation in the euro area is expected to rise only gradually over the medium term, supported by our monetary policy measures, the continuing economic expansion and the corresponding gradual absorption of economic slack.

Also broad money (M3) continues to expand at a robust pace, with an annual rate of growth of 5.0% in May 2017, after 4.9% in April. As in previous months, annual growth in M3 was mainly supported by its most liquid components, with the narrow monetary aggregate M1 expanding at an annual rate of 9.3% in May 2017, unchanged from April.

The recovery in the growth of loans to the private sector observed since the beginning of 2014 is proceeding. The annual growth rate of loans to non-financial corporations remained stable at 2.4% in May 2017, while the annual growth rate of loans to households increased to 2.6%, from 2.4% in April. The euro area bank lending survey for the second quarter of 2017 indicates that credit standards for loans to enterprises and loans to households for house purchase have further eased and that loan growth continues to be supported by increasing demand. The pass-through of the monetary policy measures put in place since June 2014 continues to significantly support borrowing conditions for firms and households and credit flows across the euro area.

The cross-check of the outcome of the economic analysis with the signals coming from the monetary analysis confirmed the need for a continued very substantial degree of monetary accommodation to secure a sustained return of inflation rates towards levels that are below, but close to, 2%.

In order to reap the full benefits from our monetary policy measures, other policy areas must contribute decisively to strengthening the longer-term growth potential and reducing vulnerabilities. Political winds are becoming tailwinds. There is newfound confidence in the reform process, and newfound support for European cohesion, which could help unleash pent-up demand and investment, if confirmed by decisive action.

Still, the implementation of structural reforms needs to be substantially stepped up to increase resilience, reduce structural unemployment and boost productivity growth. Regarding fiscal policies, all countries would benefit from intensifying efforts towards achieving a more growth-friendly composition of public finances. A full, transparent and consistent implementation of the Stability and Growth Pact and of the macroeconomic imbalances procedure over time and across countries remains essential to bolster the resilience of the euro area economy.