Vítor Constâncio: ECB Annual Report 2010

Introductory statement by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the presentation of the ECB Annual Report 2010, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 2 May 2011.

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Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a great pleasure to present to you the European Central Bank's Annual Report for 2010 which forms a core part of our accountability towards the European Parliament. It is the first time for me to appear before your Committee in my capacity as the Vice-President of the ECB and I am looking forward to an enriching exchange of views.

I will first briefly review the economic and monetary developments over the past year, explain our monetary policy decisions, and summarise our current assessment of the macroeconomic outlook. I ask for your understanding that my remarks on the outlook should not be construed as providing indications on the prospective monetary policy stance, as we are in the so-called *purdah* period, where the members of the Governing Council refrain from comments on the current outlook for monetary policy. I will also briefly touch upon the current fiscal challenges in the euro area and issues related to financial stability and regulation. Before concluding, I would like to address the EU economic governance framework, following in particular the reports adopted by this Committee and the start of the trialogue discussions.

Economic and monetary developments and outlook

Monetary policy in 2010 and in early 2011 continued to operate in a very complex and challenging environment. Renewed tensions in some financial market segments in May 2010 posed new challenges for the conduct of monetary policy.

Since early 2010, the economic recovery in the euro area has gained momentum. This has been mainly driven by continued strong external demand. At the same time, domestic demand strengthened during the review period. Overall, following the 4.1% decline in 2009, euro area real GDP increased by 1.8% in 2010. This outcome was much more favourable than expected one year ago.

Looking forward, we expect the euro area economy to further benefit from the ongoing recovery in the world economy. At the same time, private sector domestic demand should increasingly contribute to economic growth, benefiting from the accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system. The Governing Council assesses the risks to this outlook to be broadly balanced in a context of elevated uncertainty.

As regards price developments in the euro area, inflation has been on an upward trend since early 2010, mainly reflecting rises in global commodity prices. The average annual inflation rate rose to 1.6% in 2010, and continued increasing in early 2011, reaching 2.7% in March and according to Eurostat flash estimate 2.8% in April. While domestic price pressures are still moderate, risks to the inflation outlook have moved to the upside. These relate mainly to higher than expected energy prices. In addition, increases in indirect taxes and administered prices may be greater than expected, owing to the need for fiscal consolidation in the coming years. Finally, the ongoing recovery in economic activity could result in stronger than expected domestic price pressures. While our monetary analysis indicates that the underlying pace of monetary expansion is still moderate and money based medium term forecasts show inflation subdued, monetary liquidity may facilitate the accommodation of price pressures stemming from other factors.

Under these conditions, the Governing Council of the ECB, at its meeting of 7 April 2011, decided to increase the key ECB interest rates by 25 basis points, after maintaining them unchanged for almost two years at historically low levels. This step was warranted to adjust the very accommodative monetary policy stance in the light of upside risks to price stability. Indeed, it is essential that recent price developments do not give rise to broad-based inflationary pressures over the medium term through second round effects. Our decision to raise rates will contribute to keeping inflation expectations in the euro area firmly anchored in line with the Governing Council's aim of maintaining inflation rates below but close to 2%, over the medium term. Such anchoring is a prerequisite for monetary policy to contribute to economic growth. Historically, interest rates remain low across the maturity spectrum. Thus, our current monetary policy stance remains accommodative, supporting economic activity and job creation.

In view of the ongoing financial tensions, the ECB kept several of its non-standard monetary policy measures in place in 2010 and early 2011, notably the full allotment of liquidity at a fixed interest rate in most refinancing operations. In addition, in May 2010, the ECB decided to launch the Securities Markets Programme, enabling the Eurosystem to purchase private and government bonds, with the aim of supporting the transmission of monetary policy. Liquidity effects stemming from these purchases have been fully neutralised by liquidity-absorbing operations. All the non-standard measures taken during the period of acute financial tensions are, by construction, temporary in nature and will be adjusted when appropriate.

Fiscal policies and bond markets

Turning to fiscal policies, fiscal deficit and debt ratios had deteriorated substantially in 2008 and 2009. In 2010 the euro area deficit to GDP ratio only broadly stabilised at a very high level, while the debt ratio continued to increase.[1] Individual countries experienced extremely high deficit rates.

Taking a broader view, the economic recession amplified imbalances in fiscal policies that had built up gradually long before the crisis. In particular, many countries failed to implement sound fiscal policies during good economic times. Temporary revenue windfalls were used to finance permanent expenditure increases and some countries failed to achieve structurally sound fiscal positions despite a long period of strong economic growth. On the institutional side, the EU fiscal framework (which had been revised in 2005) was too weak and not implemented with sufficient rigour.

Reflecting large fiscal imbalances and a loss of investor confidence, government bond spreads increased drastically for some euro area countries and became very volatile in 2010. The willingness of investors to support government financing needs declined. Greece and Ireland in 2010 required financial support by means of joint EU/IMF programs. Portugal also asked for assistance in April.

Looking ahead it is essential that these three countries undertake drastic reforms. Greece and Ireland have to fully implement the agreed programmes and for Portugal the approval of a convincing adjustment programme is now of the essence.

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[1] According to Eurostat's press release on the Spring 2011 deficit notifications the euro area deficit was 6.0% of GDP 2010, only slightly lower than 2009 (6.3%); the euro area debt ratio rose to 85.1% of GDP in 2010, from 79.3% in 2009.

More generally, all euro area governments need to achieve the consolidation targets for 2011. For the following years, consolidation targets need to be underpinned by concrete consolidation measures. The deadlines to correct excessive deficits agreed in the ECOFIN Council need to be respected. Estonia and Luxembourg are the only euro area countries currently not subject to an excessive deficit procedure. In view of very high expenditure ratios in the euro area, consolidation plans need to focus on expenditure reduction. Strengthening confidence in the sustainability of public finances is key, as this will reduce interest rate risk premia and improve the conditions for sound and sustainable growth.

Moreover, it is key to strengthen incentives for sound economic policies, notably in good economic times. I will turn to efforts in this area shortly.

Financial stability

I would now like to touch briefly on financial stability issues. The start of the preparatory work for the European Systemic Risk Board (ESRB) – the body in charge of macro-prudential oversight in the EU – allowed its smooth establishment in 2011, together with the European Supervisory Authorities. The ESRB is now fully operational, with its General Board having already met twice and its advisory committees in place.

The ECB has been entrusted with the provision of analytical, statistical, logistical and administrative support to the ESRB. Hence, the ECB is making the utmost effort to enhance its capabilities and analytical tools for conducting systemic risk analysis.

In the context of the Basel III framework, the ECB fully supports the European Commission's work on the Capital Requirements Directive (CRD) IV. The Commission's proposal by mid-2011, as envisaged, would provide the European Parliament and the Council with sufficient time to put the new framework in place by the end of 2012.

The ECB Annual Report highlights our support to the Commission's initiative regarding a crisis management and resolution framework for EU financial institutions. The EU clearly needs better tools with well designed triggers to tackle problems in the banking sector more effectively. National regimes should be harmonised as much as possible and arrangements for better coordination between Member States in crisis situations need to be devised.

The ECB shares the overriding policy objective of the new EU regime to provide a framework within which financial institutions can fail, while at the same time safeguarding the stability of the EU financial system as a whole and minimising public costs and economic disruption. From this perspective, a credible resolution framework that disciplines large and cross-border financial institutions, in particular, is essential. In this context, the setting up of a network of national resolution funds that could evolve, in the medium to long term, to a European Resolution Fund, is undoubtedly very important. The ECB is also actively contributing to the discussions in the FSB and the G20 to putting in place arrangements that will reduce the systemic risk emanating from so-called global systemically important financial institutions.

As regards the new round of the EU-wide stress test, which will be conducted under the aegis of the newly established European Banking Authority (EBA), it is designed as a sufficiently severe and rigorous exercise to be credible. It is expected to reduce uncertainty among market participants concerning the health of European banks.

Let me just mention some of the enhanced features. First, the assumed macroeconomic shock is stronger than in the previous exercise. In addition, the EBA has provided more rigorous guidance to banks on the cost of funding and static balance sheet assumptions. Second, the capital metrics is now Core Tier I capital ratio instead of the broader concept of Tier I capital used previously. Third, a stricter peer review will be performed, with enhanced disclosure of results. Finally, Member States have committed to specific and ambitious strategies for the reinforcement of vulnerable institutions. In this context, it is important that appropriate backstops be in place for those banks which do not pass the test.

Economic governance

Let me finally congratulate your Committee on its recent vote on the economic governance package. ECON has undoubtedly taken an important step towards the much needed strengthening of economic and budgetary surveillance in the EU and the euro area.

In particular, I very much welcome the fact that the automaticity of procedures has been stepped up by extending the use of reversed qualified majority voting. The room for halting or suspending procedures against those Member States breaking the rules must be reduced. The strengthening of the Commission's role in the procedures that the approved reports propose in this context are therefore welcome. Moreover, the political and reputational measures that you are proposing are necessary to foster early compliance with the surveillance framework. An earlier and more gradual application of financial sanctions within the macroeconomic surveillance framework goes in the same direction. Your support in the same framework for a clear distinction between Member States belonging or not to the euro area is also positive. The requirements of avoiding negative imbalances must be more demanding for members of the monetary union. This type of distinction, making full use of the Treaty's new Article 136, has to be to be applied in different domains, drawing the appropriate lessons of the crisis for the functioning of the monetary union. Finally, compliance by Member States with the obligations under the Stability and Growth Pact is facilitated by the strong national budgetary frameworks that you want to establish within the euro area by proposing several concrete mandatory features. The proposal of a financial sanction for the manipulation of data is also to be welcomed, as well as the institutional provisions for reliable, timely and accurate statistical information.

At the same time, there are certain aspects of the Committee's position, on which we have concerns. Most importantly, the Stability and Growth Pact should not be softened by introducing further exceptions and a longer list of "relevant factors" (including cyclical developments to some public investments or state aid measures for the financial sector), that can be invoked in the assessment of compliance with the deficit and debt criteria. This could create further room for unwarranted discretionary decisions and may open the door to lax fiscal policies at a time of much needed fiscal consolidation.

As regards macroeconomic surveillance, we have often emphasised that, in order to be effective, it should have a clear focus on a restricted number of indicators capturing macro-economic imbalances per se. This procedure is specifically targeted at macroeconomic imbalances, meaning extreme and persistent divergences from a sustainable trend that threaten the proper functioning of monetary union. It is not about achieving higher growth potential which is of course highly desirable and is the goal of the EU 2020 strategy. This does not imply that I do not recognise the need to co-ordinate all the dimensions of economic policy under the umbrella of the European Semester.

Overall, the Reports approved by your Committee are a positive contribution for the trialogue that follows and that, I hope, can be successfully finalised so that the economic governance package can be adopted and implemented as soon as possible.

Conclusion

Madam Chair, honourable Members,

The lessons of the financial crisis for Europe are responsible for the vast programme of reforms that we have been implementing. Last year, focused in the euro area, the crisis highlighted the interplay between the sovereign debt problems and the financial sector, since they represent two faces of the same crisis. Weak financial sector can have an adverse impact on public finances, while deficient fiscal policies and macro imbalances can have negative repercussions on the financial sector. Resolving both problems will put the euro area on a track of renewed sustainable growth, leaving this crisis behind us. This requires the implementation of effective economic governance that can ensure fiscal sustainability, competitiveness and growth, the completion of the permanent European Stability Mechanism and the efficient functioning of the new European System of Financial Supervision. In all these endeavours, the European Parliament and the ECB share common values and goals and will, I am sure, continue to collaborate in order to ensure the success of Europe.

Thank you for your attention.