Peter Praet: Remarks at the FIBI Annual Lunch

Speech by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Federation of International Banks in Ireland (FIBI), Dublin, 23 September 2015.

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In recent years the global economy has witnessed a set of economic and financial conditions that were considered barely possible in the years of the "Great Moderation". Interest rates across advanced economies have fallen to very low levels. In the euro area we have even seen negative yields out along the yield curve: at one point in April 2015 up to about 36% of euro-denominated government bonds were in negative territory. And inflation in most advanced economies has remained subdued: in our case it has followed a prolonged downward drift since late 2011 and still remains stubbornly low.

What I would like to explain in my remarks is how we arrived at this situation, and how we can return to a situation that, looking retrospectively, would be considered "more normal". My main message is that the euro area is still going through the correction phase of a pronounced financial cycle, and while monetary policy has a vital to role to play in supporting demand through that transition, it must be complemented by other policies to achieve a strong and sustained recovery from the crisis.

The causes of the current situation

The low growth and low interest rate environment we see in the euro area today is in part a *secular* phenomenon. The growth rate of total factor productivity (TFP) has been slowing in the euro area for decades. Population growth has also declined from about 0.7% in the early 1970s to around 0.3% in recent years. This has been mirrored in the long-term decline of real interest rates, as lower TFP and population growth implies lower demand for investment and for loanable funds.

But secular trends do not explain fully the current situation. *Cyclical* forces also lead to fluctuations around secular trends, especially when driven by the financial cycle, and such forces are still at play in the euro area today. Demand conditions, while improving, appear relatively weak for the early stage of the business cycle. This is largely explained by the legacy of the financial crisis.

Specifically, the euro area is coming out of a "balance sheet recession", where a build-up of excessive debt set the conditions for a sharp downturn, which in turn created the need for substantial deleveraging and balance sheet repair, prolonging the length of the slump. The fact that financial excesses were associated with significant sectoral resource misallocation, especially into construction, further hindered the pace of recovery.

The duration of the downturn has also itself exacerbated the damage to output. Long-term unemployment has risen, with "hysteresis" effects estimated to have reduced potential growth. This in turn appears to have induced some negative sentiment about long-term growth: for example, businesses currently perceive themselves to have limited excess capacity, despite a large estimated output gap. Such uncertainty feeds back into weaker demand today through expectations and confidence channels. Investment, while gradually picking up, still remains well below pre-crisis levels.

Such post-debt crisis effects have, to some extent, been common among advanced economies that were strongly hit by the global financial crisis. Yet most observers would agree that the costs have been especially high for the euro area. This is due to a third factor particular to the euro area: an incomplete *institutional* construction, which has made working through the aftermath of the financial cycle harder.

Crucially, the euro area lacked a truly integrated banking system that could share risk across countries not just in good times, but also in bad times. Without a harmonised, effective and predictable resolution framework to involve the private sector, and a European public backstop to preserve financial stability, the onus fell onto sovereigns to support their national banking sectors. And as banks in some of the most vulnerable countries remained heavily exposed to their sovereigns, this fed back into systemic banking crises in certain jurisdictions via the "diabolical loop" between banks and sovereigns.

Other institutional mechanisms that could have cushioned the shock also turned out to be weak. Notably, mechanisms to accelerate balance sheet restructuring while minimising its fallout on the economy were inoperative due to shortcomings in the legal frameworks in many countries. Weak national insolvency regimes and slow judicial systems reduced the scope for debt re-absorption through write-offs and resolution of bad loans in the euro area, especially compared with other post-crisis experiences. The upshot has been a slower and more painful deleveraging.

To sum up, though secular forces are certainly at play in the euro area, the current situation is also explained by cyclical factors linked to the financial cycle, which have in turn been exacerbated by institutional failings. A strong and sustained recovery therefore depends on a comprehensive response that addresses each of these policy challenges. That is now underway.

The response of monetary policy

On the cyclical side, monetary policy has played, and will continue to play, an important role in responding to demand weakness and the disinflationary pressures it creates. But with fiscal policy largely unavailable due to fragile public finances, this has required a determined monetary policy stance. Implementing that stance has increasingly implied unconventional measures as short-term interest rates run into the effective lower bound. We have also had to design our policy to address serious disruptions in monetary transmission caused by the financial fragmentation of the euro area.

The unconventional measures we have adopted include, most recently, the Targeted Long-Term Refinancing Operations and our expanded Asset Purchase Programme. These measures support demand through several transmission channels, but crucially they have helped unclog the bank lending channel of monetary policy, thereby producing a virtuous circle between credit supply and demand which lends momentum to the recovery.

In particular, the incentives embedded in the TLTRO have led banks to compete more for credit to support growth, by cutting margins and lending rates. Lower rates have in turn created higher net demand for borrowing, allowing banks to expand their overall lending volumes and keep interest income on a rising path. This has then initiated a gradual easing of credit standards, further strengthening competitive pressures. And at the macroeconomic level, this virtuous circle leads to an improvement in the outlook for economic growth that helps to contain non-performing loans.

Through meeting its mandate in this way, monetary policy has also supported an orderly deleveraging. Accommodative policy reduces interest payment burdens while raising nominal growth.

Yet monetary policy alone cannot solve a debt overhang. That requires a mix of higher real growth rates and lower nominal debt. In both areas, the institutional incompleteness of the euro area has hindered the process of balance sheet adjustment. But in both, substantial progress is now being made. This is where the efforts to tackle secular and institutional challenges come in.

The role of other policies

To begin with, many countries have been implementing structural reforms to lift potential output and temper secular drags on growth. Particularly important here are policies that help reverse resource misallocation and thereby increase employment and TFP. Such policies include product market reforms that strengthen competitive pressures and encourage the reallocation of capital towards the most productive firms; and labour market reforms, especially active labour market policies, that help provide workers with the skills they need to move to more innovative sectors. Successful examples of such measures have been introduced in Spain, Ireland and other reforming countries.

The process of private sector debt workout is also advancing. The ECB's Comprehensive Assessment has accelerated the crucial step of acknowledging and provisioning for NPLs. What is now key is that, where necessary, those NPLs are further restructured through more efficient insolvency proceedings or removed from banks' balance sheets altogether. Several countries have taken national initiatives to improve in- and out-of-court restructuring frameworks and establish asset management companies for NPLs. This could be supported at the European level by progressing with Capital Markets Union, which should induce greater legal convergence and deepen markets for distressed debt.

Supporting the deleveraging process in these ways – by raising real growth and working out private debt – would provide further momentum to the recovery, while raising confidence in long-term growth prospects. But importantly, balance sheet repair also creates the pre-conditions to address definitively one of the euro area's key institutional weaknesses: the incomplete Banking Union.

A great deal of progress has been made in this area in recent years. With the Single Supervisory Mechanism we now have a system of supervision that is less liable to capture or forbearance. The Bank Recovery and Resolution Directive provides a harmonised and predictable framework for private sector risk-sharing across the Union. And governments are on the way to establishing a European public backstop for the Single Resolution Mechanism. But if we are to complete Banking Union – notably in terms the backstop to the SRM and establishing a common deposit guarantee scheme – legacy assets need first to be fully addressed. That is why balance sheet repair is pivotal.

Completing Banking Union also requires removing any remnants of the regulatory framework that implicitly support home bias. For example, how much national discretion is allowed in implementing rules; how fungible are liquidity and capital across borders; how regulations, such as those on loss-absorbing capital, affect the choice of subsidiaries versus branches – all these decisions will crucially shape the microeconomic incentives of banks to become European. And the macroeconomic consequences for the Union are significant.

Conclusion

To conclude, working through the aftermath of a financial cycle requires a comprehensive response. Monetary policy will play its part for as long as needed, which means the full implementation of the asset purchase programme and, if necessary, adjustments to its size, composition and duration. And by meeting our objective, we support growth and inflation, which in turn creates the conditions for interest rates to "normalise" once more.

But monetary policy can only do so much. It is for other policymakers to address the secular and institutional factors that are preventing a stronger and more sustained recovery. Efforts are now well underway. But longer they take, the higher the hurdles that all policymakers will ultimately have to climb.