Lucas Papademos: Presentation of the ECB's Annual Report 2008 to the European Parliament

Introductory statement by Mr Lucas Papademos, Vice-President of the European Central Bank, to the European Parliament's Committee on Economic and Monetary Affairs Strasbourg, 21 April 2009.

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Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a privilege for me to present to you the Annual Report of the European Central Bank (ECB) for 2008. This presentation is an essential element of the ECB's democratic accountability and is therefore of the greatest value for us. In my introductory remarks, I will first briefly review the economic and monetary developments over the past year, present our current assessment of the macroeconomic outlook and explain our monetary policy decisions. I will then focus on a number of topical policy issues, in particular those pertaining to financial stability and supervision.

But before doing so, I would like to highlight some important events that have taken place over the previous 12 months. Last year the ECB, and at the beginning of this year the euro, celebrated their tenth anniversaries. We can look back at the past ten years with pride, and we can justifiably say that the euro has been a success. We have delivered a stable and credible currency that enjoys the confidence of now 329 million fellow citizens in 16 EU countries. I would like to take this opportunity to congratulate the citizens of Slovakia on having joined the euro area at the beginning of this year. The continuing enlargement of the euro area shows that Monetary Union is not a "closed shop"; it remains open to newcomers. However, even if the reasons for celebration are manifold, there is no room for complacency, as the challenging economic situation and outlook amply demonstrate.

Economic developments and monetary policy

For the euro area, 2008 was an exceptional year characterised by severe and increasing financial market tensions as well as by significant and abrupt changes in the economy. Following strong economic growth in the first quarter, economic conditions worsened progressively, especially after the extraordinary intensification of the financial turmoil in September. For the year as a whole, real GDP in the euro area grew modestly, by 0.8%. The latest available information suggests that in the first quarter of 2009 aggregate output recorded a further sizeable decline. We expect economic activity in the euro area to remain weak for the remainder of 2009 and to gradually recover in 2010. Taking into account the effects of the substantial macroeconomic stimulus in progress and the measures taken to restore the functioning of the financial system, the risks to this outlook are assessed to be broadly balanced over the medium term, but uncertainty remains unusually high.

As regards price developments, annual HICP inflation averaged 3.3% in 2008, which is much higher than in the previous two years and significantly above the ECB's definition of price stability. However, headline inflation rates fluctuated sharply in the course of the year, peaking at 4.0% in June and July, mainly as a result of developments in international commodity prices. During the second half of 2008, annual inflation declined steadily and rapidly. In March 2009, it stood at 0.6%. By contrast, HICP inflation excluding energy and food posted a much smaller decline in 2008 and early 2009. Looking ahead, HICP inflation is likely to remain well below 2% in 2009 and may reach negative levels around mid-year. Such a phenomenon is expected to be temporary, driven mainly by base effects from past energy price developments, and would not constitute an episode of deflation, that is, a protracted period of decline in the price level that can adversely affect inflation expectations and aggregate demand. Looking at the policy-relevant medium-term horizon, HICP inflation is in 2010 expected to rise again but remain below 2%, reflecting mainly ongoing sluggish economic activity in the euro area and beyond.

Monetary policy has been conducted in an extraordinary and rapidly changing economic and financial environment over the past year. In the first half of 2008, strong increases in commodity prices accompanied by signs of rising wage pressures and an upward drift of inflation expectations implied that risks to price stability over the medium term were increasingly on the upside. To counteract these upside risks and ensure the solid anchoring of inflation expectations, the Governing Council of the ECB raised its key interest rates by 25 basis points in July 2008.

With the intensification of the financial turmoil from mid-September last year, the macroeconomic situation and outlook changed fundamentally and suddenly. As the financial crisis deepened and broadened, global demand and economic activity weakened substantially, commodity prices declined markedly and, as a result, inflationary pressures and risks in the euro area diminished. Monetary growth and the expansion of credit to the private sector decelerated, confirming that upside risks to price stability were abating. In response, the Governing Council lowered the key ECB interest rates decisively, by an unprecedented 300 basis points between October 2008 and April 2009. The Governing Council will continue to do what is necessary to preserve price stability and ensure the firm anchoring of inflation expectations over medium to longer-term horizons. Such anchoring is indispensable to supporting sustainable growth and employment and also contributes to financial stability.

Let me also stress that, from the onset of the financial market tensions, the ECB has taken forceful action in its liquidity management, also through non-conventional measures, to make sure that banks are able to refinance themselves. Our policy-making has been in a “non-standard mode” for a considerable period of time. In October last year, we adopted a fixed rate tender procedure with full allotment for all main refinancing operations and longer-term refinancing operations with maturities of up to six months. In addition, the ECB expanded its list of assets eligible for use as collateral in Eurosystem credit operations.

As a result, the size of the Eurosystem balance sheet has increased substantially during the financial turmoil, by around €600 billion between June 2007 and March 2009, mainly reflecting the expansion of liquidity provision to the banking system since last autumn. This is of particular significance for the euro area because the banking system plays a more important role in the financing of the private sector than in other major economies. At the same time, owing to the ECB’s liquidity management, overnight money market rates have fallen even more steeply than the key ECB interest rates since last October. Money market rates in the euro area are now very low, also in an international comparison.

Overall, the provision and management of liquidity by the ECB have played a crucial role in the implementation of the ECB’s monetary policy. They have ensured that banks have adequate access to central bank funding so as to continue financing the economy and that liquidity constraints and perceived risks have not triggered a systemic crisis. The ECB will continue to foster the orderly functioning of money markets and the intermediation of funds by the banking system by taking appropriate measures, be they standard or non-standard. At the same time, the medium-term orientation of our monetary policy provides a clear and unambiguous signpost that will allow us to pursue a credible exit strategy from the current conditions of very low interest rates and extraordinary short-term liquidity support as the economic situation normalises.

Fiscal policies

The economic downturn, discretionary fiscal measures to stimulate economic activity and government intervention to support the financial sector have had a substantial impact on public finances. According to the European Commission's January 2009 interim forecast, which is cited in the ECB's Annual Report, the euro area general government deficit was expected to increase from 1.7% of GDP in 2008 to 4.0% in 2009 and 4.4% in 2010, with ten euro area countries forecast to be above the 3% of GDP reference value in 2010. More recent information indicates an even stronger fiscal deterioration. The current focus of fiscal policy on economic recovery is certainly warranted; but this should not undermine the integrity of the EU fiscal framework. Especially in challenging times such as these, it is crucial to preserve the public's trust in the sustainability of public finances. This requires that governments are credibly committed to achieving sound fiscal positions as soon as possible and to fully applying the provisions of the Stability and Growth Pact, which provides sufficient flexibility to deal with adverse economic circumstances.

Financial stability and supervision

Let me now focus on the financial sector and issues related to its regulation and supervision. The synchronised deceleration in activity in all economies has added to the stresses on the financial system in Europe and the euro area. The weakening of economic activity has impaired the quality of bank loans, which has adversely affected banks' capital positions. As financial institutions continue to deleverage their balance sheets, they reduce their securities holdings and tighten the credit standards applied to new loans. This feeds back to the real economy and in turn constrains the ability of the private sector to service its debts. Therefore, there are emerging signs of a negative feedback loop between the real economy and the banking sector.

Initially, the banking system in Europe faced the financial turmoil with solvency positions generally well above regulatory minimum requirements, following several years of strong profitability. However, as the financial market tensions intensified in the autumn of 2008, banks' balance sheets came under significant pressure, as the values of structured finance products declined further, securitisation activity came to a virtual standstill, credit losses started to rise and income from fees and commissions as well as trading dropped. As a result, the banking sector has been facing significant challenges. For example, the declared cumulated write-downs and credit-market losses of European banks so far[1] amount to almost USD 358 billion – of which euro area institutions account for less than USD 173 billion. At the same time, a total of USD 382 billion of fresh capital has been raised by European banks, while capital newly injected into euro area banks has reached USD 190 billion, thus exceeding the declared losses and write-downs.

Unfortunately, more write-downs can be expected in the coming quarters. The total write-downs of banks globally since the eruption of the turmoil are estimated by the International Monetary Fund to reach USD 2.8 trillion, of which USD 737 billion would be borne by European banks.[2] These estimates depend on the underlying projection of the path of economic activity and assumptions about future asset market developments. Coping with this stress will pose a particular challenge for financial institutions – and this at a time when their shock-absorbing capacity has already been severely tested. A number of risks lie ahead, stemming from the external environment, notably a deeper and more prolonged recession in advanced economies, as well from the subdued economic activity in the euro area and its effect on banks' balance sheets, notably on the quality of loans to non-financial corporations,

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1 Figures are up to 19 April 2009 and include non-EU banks.

2 See IMF, *Global Financial Stability Report*, 21 April 2009, p. 28.

as well as to the commercial and residential property sectors. Moreover, financial markets – despite recent positive developments in equity markets worldwide – remain vulnerable to swings in investor confidence and risk aversion, which could adversely affect liquidity and asset prices in some markets.

Against the background of these very difficult conditions, significant policy measures have been taken by central banks and governments in Europe to improve market liquidity and replenish capital buffers. Governments created schemes for guaranteeing new bank debt, injected capital and, more recently, provided asset relief. These measures were successful in preventing a meltdown of financial systems and they helped to bolster confidence. The Eurosystem provided important input into the design of these measures, in the form of recommendations aimed at ensuring that such measures would help to safeguard financial stability and restore the provision of credit to the private sector, while at the same time maintaining a level playing-field within the Single Market to the maximum extent possible, and also containing their impact on public finances.

It is still early to accurately assess the impact of these government measures on the longer-term funding and the recapitalisation of banks as well as their effectiveness in fostering bank lending to the private sector. This is because the evidence is relatively limited, as the implementation of the measures has been gradual over the past few months. Moreover, it is difficult at this stage to disentangle the positive impact of the bank support measures from the effects of other developments, notably those related to the deteriorating economic environment.

The causes and contributing factors of the financial turbulence are manifold. The crisis revealed several weaknesses in the financial system, but it has also highlighted inadequacies in the current system of prudential supervision and oversight that prevented the nature and magnitude of the accumulating risks from being identified in good time and appropriate remedial action from being taken. At the initiative of the European Commission, the group chaired by Jacques de Larosière undertook a comprehensive review of the EU framework for financial supervision and proposed, among other innovations, the creation of a European Systemic Risk Council with responsibility for macro-prudential supervision. The ECB welcomes the group's report and broadly supports its recommendations for macro-prudential supervision, as well as the related communication issued by the European Commission. The proposed establishment of the Systemic Risk Council under the auspices of the ECB and the Council's composition are a recognition of the extensive analytical capabilities developed by central banks in the fields of monetary and financial-stability analysis, their relevant expertise, and their closeness to the financial markets. The work of the Council will also benefit from the use of the technical infrastructure already in place.

The ECB and the entire European System of Central Banks stand ready to assume the macro-prudential supervision tasks envisaged in the report by the de Larosière Group and to provide the necessary analytical and logistical support to the Systemic Risk Council. For the new Council to function effectively, three key requirements will need to be fulfilled: *First*, in order to identify and assess the risks and vulnerabilities in the EU financial system as a whole, to issue risk warnings and to adopt related macro-prudential policy recommendations, the Systemic Risk Council will need to have an information base that draws on both macro- and micro-prudential supervisory information. This will allow the use of all relevant information for assessing, among other things, the "interconnectedness" of financial institutions and markets and its implications for financial system stability. Close cooperation and well-functioning information-sharing mechanisms between the new Council, micro-prudential supervisors and the proposed European System of Financial Supervision will therefore be indispensible. *Second*, adequate institutional mechanisms need to be in place to ensure that the risk warnings and the related recommendations issued by the Systemic Risk Council are translated into effective action. The days when risk warnings were issued and very few listened – or wanted to listen – should be over! *Third*, for the Systemic Risk Council to be effective, legitimate and independent in its decision-making, a solid legal basis is essential. Such a basis will also provide legal clarity regarding the necessary access to EU-wide macro-prudential information as well as to supervisory data concerning individual institutions, subject to adequate confidentiality arrangements.

The next steps towards the implementation of the de Larosière Group proposals will require a number of legal, institutional and organisational issues to be addressed. In this regard, the ECB stands ready to contribute to the necessary preparations in a constructive and timely manner. We look forward to the communication from the European Commission and the decision of the European Council in June that will lay the foundations of a new system of macro-prudential supervision in the EU. Speedy progress towards that goal is of the essence, for the strengthening of macro-prudential supervision in Europe is an important and urgent policy objective – and one which the members of this Committee have strongly supported in a consistent and, indeed, visionary manner.

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Madam Chair, honourable members of the Committee, I would like to thank you on behalf of the Executive Board and the Governing Council for our enriching exchanges of views over the past five years. Owing to the forthcoming elections to the European Parliament, today's presentation of our Annual Report is the last before your Committee in its current composition. I have always appreciated your cooperation and our fruitful dialogue. Thank you for your attention.

I am now at your disposal for questions.