Lucas Papademos: The ECB's accountability towards the European Parliament

Introductory statement by Mr Lucas Papademos, Vice President of the European Central Bank, at the presentation of the ECB's Annual Report 2009 to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 27 April 2010.

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Dear Madam Chair,

Dear honourable Members of the Committee on Economic and Monetary Affairs,

It is a privilege to present to you today the ECB's Annual Report for 2009. This presentation is a cornerstone of the ECB's accountability towards the European Parliament. In my introductory statement, I will first briefly review the key economic and monetary developments in 2009, summarise our current assessment of the macroeconomic outlook and explain our monetary policy decisions. I will then focus on two highly topical policy issues, namely the current fiscal policy challenges in the euro area and the planned reform of financial regulation and supervision in the EU and globally.

Before doing so, I should like to highlight an important event in 2009: the entry into force of the Lisbon Treaty on 1 December 2009. The new Treaty substantially increases the powers of the European Parliament. It also gives the ECB the status of a Union institution and strengthens its independence by explicitly anchoring the ECB's institutional features and financial independence in primary law. Moreover, the Lisbon Treaty emphasises the importance of the Eurosystem's mandate by making its primary objective of maintaining price stability an objective of the EU as a whole.

Economic developments and monetary policy

In 2009 the European Central Bank performed its functions in an exceptionally challenging environment as the global financial crisis continued to unfold. Following the severe intensification of financial market tensions in autumn 2008, euro area real GDP contracted by 4.0% in 2009, largely driven by a sharp decline in exports and in private investment. The decrease in private consumption was relatively contained, although households increased their saving rates substantially. Economic activity in the euro area reached a trough in the second quarter of 2009 and has increased at a slow pace since then.

The significant macroeconomic stimulus, the measures taken to support the financial system, and the pick-up in global activity have underpinned the recovery of the euro area economy. Looking ahead, the Governing Council expects real GDP to continue to expand at a moderate pace in 2010 and to strengthen further in 2011. This expectation is in line with the latest ECB staff projections and the forecasts of other institutions. The recovery is likely to be uneven over time and across regions. The risks to this growth outlook are assessed to be broadly balanced, but uncertainty remains high.

With regard to price developments, average annual HICP inflation fell sharply to 0.3% in 2009, from 3.3% in 2008, largely due to substantially lower oil and other commodity prices as well as a result of the impact of the severe contraction in activity and rapidly deteriorating labour market conditions. In the course of 2009, annual HICP inflation turned negative for a few months, primarily as a consequence of the dynamics of commodity prices, particularly oil prices, and the associated base effects. Excluding energy and food prices, HICP inflation has been on a gradual downward trend since mid-2008, primarily reflecting a substantial moderation in labour costs and a sharp fall in profit margins over the course of 2009.

In March 2010, euro area annual HICP inflation rose to 1.4%, from 0.9% in February, mainly driven by energy and unprocessed food price developments. Nevertheless, in view of the projected slow economic recovery and high unemployment, inflation is expected to remain moderate in 2010 and over the rest of the policy-relevant horizon. Risks to this inflation outlook remain broadly balanced. Inflation expectations over the medium and long term continue to be firmly anchored in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term. The firm anchoring of inflation expectations to price stability reflects the high degree of credibility of the ECB's monetary policy.

The analysis of monetary and credit developments confirms the assessment of low inflationary pressures over the medium to longer term. In the course of 2009, the annual growth rates of the broad monetary aggregate M3 and of MFI loans to the private sector declined substantially and in parallel. Towards the end of last year, these growth rates were in negative territory. The continuous decline in annual M3 growth in the course of 2009 largely reflected the strong downward impact of the exceptionally steep yield curve, while the subdued levels of activity and trade, and the uncertainty surrounding the business outlook, dampened firms' demand for bank financing.

Overall, the latest developments in money and credit markets support the assessment of low inflation risks over the medium to longer term. In February 2010, the annual growth rates of M3 and of loans to the private sector both stood at –0.4%. The growth of M3 and loans to the private sector is likely to remain weak in the coming months as well. It is worth pointing out that the negative annual growth in bank loans to the private sector masks diverging developments in the annual growth in loans to households, which has been positive over the past few months, and in loans to non-financial corporations, which has been negative, although in February the flow of such loans was positive. These differences in sectoral loan developments are in line with past regularities: growth in loans to households tends to pick up early in the economic cycle, while lending to non-financial firms typically lags behind improvements in economic activity.

In an environment of subdued inflationary pressures, the Governing Council lowered, in four steps, the rate on the ECB's main refinancing operations between January and May 2009 by a further 150 basis points, to the historically low level of 1%, bringing the total reduction since October 2008 to 325 basis points. The interest rate on the deposit facility was reduced to 0.25%. The key ECB interest rates have not been changed since May 2009. The Governing Council is of the opinion that the current ECB interest rates remain appropriate and it expects price stability to be maintained over the medium term.

In addition to reducing the policy interest rates, the Governing Council adopted further enhanced credit support measures in 2009, in order to ensure the smooth functioning of the money market, improve financing conditions and foster the provision of credit to the economy. These non-standard measures have achieved the intended objectives. In particular, they have exerted significant downward pressure on term money market rates and bank lending rates, thereby supporting the financing of households and corporations. Overall, the timely and effective policy actions of the Eurosystem in response to the crisis and the ECB's credible commitment to price stability have been instrumental in fostering confidence, preserving price stability over the medium term and supporting economic recovery in the euro area in an environment of heightened uncertainty.

When the ECB adopted these non-standard monetary policy measures, it already had a phasing-out strategy in mind. As financial market conditions improved and economic activity started to recover, the Eurosystem initiated a gradual phasing-out of those non-standard measures that were no longer needed. The timely exit from these measures was and is appropriate, so as to avoid market distortions that could result from maintaining such measures longer than necessary and to provide incentives for banks to restructure and strengthen their balance sheets. Thus, in December 2009, and again in early March 2010, we decided to phase out gradually some of the extraordinary liquidity provision measures and scale back the number, frequency and maturity of longer-term refinancing operations. We conducted the last 12-month operation in December 2009 and the last 6-month operation in March 2010. In early March, the Governing Council decided to return to variable rate tender procedures for the regular three-month longer-term refinancing operations, starting with the operation to be conducted on 28 April 2010. At the same time, we will continue to provide adequate liquidity to the euro area banking system by conducting the main refinancing operations as fixed rate tender procedures with full allotment for as long as needed and, at least, until October this year, so as to facilitate the provision of credit to the euro area economy and further support its recovery. Needless to say, if upside risks to price stability were to emerge, the Governing Council would take timely and appropriate action.

Fiscal policies in the euro area

Let me now to turn to fiscal policies. Budgetary positions in the euro area deteriorated significantly in 2009 as a result of the economic contraction, fiscal policy stimulus and government support measures for the financial sector. Eurostat's latest estimates show that the average general government deficit ratio in the euro area increased from 2.0% of GDP in 2008 to 6.3% in 2009. Out of the 16 euro area countries, 13 are already subject to an excessive deficit procedure. This year, all euro area countries are projected to record deficits above 3% of GDP. According to the updated stability and growth programmes, a discernible improvement in fiscal positions is not foreseen in most countries until 2011 and 2012. The magnitude of the worsening of public finances is underscored by the official estimate that the average debt-to-GDP ratio is expected to reach 87% in 2012, compared with 66% in 2007 – that is 21 percentage points higher than five years earlier. Thus, fiscal imbalances are sizeable, broad-based and likely to persist for some time to come.

The deterioration in the fiscal position has been especially acute in a number of euro area countries, with Ireland, Greece and Spain having recorded double-digit deficit ratios in 2009. The large revisions to Greece's budget deficit for 2009 revealed a very serious fiscal imbalance and triggered adverse financial market reactions. Following the announcement of additional fiscal consolidation measures by the Greek authorities in March 2010, the ECB welcomed these measures as convincing steps towards achieving the ambitious but appropriate budgetary objectives for 2010. All these measures should be implemented in a timely and effective manner. Despite the commitment of the Greek government to fully implement the announced measures for 2010 and the statements by the euro area Heads of State or Government of 25 March and by the Eurogroup of 11 April, financial market pressures persisted and recently intensified. It is essential that the economic programme currently being prepared by the European Commission, the ECB and the IMF together with the Greek authorities specifies comprehensive fiscal measures and structural reforms that will address the root causes of Greece's fiscal imbalances and structural weaknesses, so as to ensure the sustainability of its public finances and improve the country's international competitiveness.

More generally, there is concern that the persistence of sizeable fiscal imbalances in Europe and elsewhere may undermine the public's trust in the sustainability of public finances and entail risks to economic growth and to financial stability. In the current circumstances, the Stability and Growth Pact, which has been put in place to safeguard sound and sustainable fiscal positions, is facing its biggest challenge since its adoption in 1997. Therefore, it is now imperative that all euro area countries strictly adhere to the Pact's provisions. On the positive side, it is promising that, according to the updated stability programmes, all euro area countries subject to an excessive deficit procedure plan to correct their deficits in line with the Council's deadlines. It is also encouraging that most of these programmes focus on containing government expenditure, as the available evidence demonstrates that this is the most effective way to achieve a lasting reduction in fiscal imbalances.

Nevertheless, in several stability programmes, the fiscal strategies presented are not underpinned by adequately specified measures, in particular for the latter years of the projection horizon. Moreover, in a number of cases, the stability programmes are based on optimistic macroeconomic assumptions that put the correction of the excessive deficits, according to the Council's deadline, at risk.

In this context, let me stress that the ECB welcomes the statement by the European Council on 25 March, expressing its commitment to strengthen and complement the existing institutional framework so as to foster budgetary discipline and ensure fiscal sustainability. The establishment of a task force, which will be chaired by the President of the European Council, to make proposals to achieve this objective and to explore all options to reinforce the legal framework, is an important step forward. In particular, it is essential to improve the incentives for national authorities to pursue policies, particularly in good times, that support the sustainability of public finances, and to ensure that economic surveillance results in effective policy actions that prevent budgetary risks and address structural problems to promote the competitiveness of the European economies.

Towards a more resilient financial system

Let me now conclude by addressing issues concerning financial regulation and supervision. As regards the regulatory reform agenda defined by the G20 leaders, significant and wide-ranging work has already been carried out or is under way, but we should not be complacent. It is crucial that the momentum for regulatory reform does not wane. There is still much to do: First, it is essential that the planned reforms effectively lead to a harmonised global regulatory framework. Second, it is an urgent priority that the Basel Committee proposals on capital requirements and liquidity standards are properly calibrated and finalised by the end of 2010. Third, we need to ensure that the regulatory framework effectively captures all systemically important financial institutions, and that moral hazard problems related to them are fully addressed.

In the European Union, the enhancements to the Capital Requirements Directive should be swiftly adopted and an agreement on the Directive on Alternative Investment Fund Managers be promptly reached. As regards the establishment of the new EU financial supervisory framework, it is important that the legislative process concerning the proposals made by the Commission in September 2009, which are currently being discussed by your Committee, is completed as expeditiously as possible and that all relevant parties reach an agreement on the legal texts so that the European Systemic Risk Board (ESRB) and the three new European Supervisory Authorities (ESAs) are operational by 1 January 2011. We should not risk losing momentum.

The ECB has made good progress with its preparations to ensure that the ESRB will efficiently and effectively perform its tasks from the moment of its inception. Let me assure you that the support to be provided by the ECB and the ESCB to the ESRB and the future links between them will not affect the ECB's objectives and the performance of its tasks, which are clearly defined in the Treaty. The primary objective of the ECB is to preserve price stability, and the conduct of the single monetary policy is geared towards achieving this goal. Moreover, the ECB and the NCBs are fully independent in carrying out the tasks conferred upon them by the Treaty. Thus, there cannot be, and will not be, any potential conflict between the conduct of the ECB's monetary policy that aims to preserve price stability and the performance of its tasks that contribute to the safeguarding of financial stability. The ESRB's recommendations will not concern the definition and implementation of the monetary policy of the ECB nor the monetary policies of the EU central banks that are outside the euro area. At the same time, macro-prudential supervision can facilitate the conduct of monetary policy by helping to prevent systemic risks and mitigate their effects, if they materialise.

Before concluding, let me stress that the timely and consistent implementation of the regulatory and supervisory reforms, and, in particular, the establishment of a new framework for macro-prudential supervision, will greatly contribute to containing systemic risks and to strengthening the resilience of the European financial system. For the ECB, it is a privilege to have been entrusted with a very special role in the performance of macro-prudential supervision in the EU. Although, we have ahead of us a very challenging task to carry out, I am fully confident that the ECB, in collaboration with the NCBs and the other members of the ESRB, will successfully meet this challenge.

Madame Chair, honourable Members of the Committee, my presentation today before your Committee is the last in my capacity as Vice-President of the ECB. I should like to warmly thank you for our enriching and constructive exchange of views. Over the past eight years, I have always appreciated the cooperation and the fruitful dialogue with the Committee on Economic and Monetary Affairs of the European Parliament.

Thank you for your attention. I am now at your disposal for questions.