Vítor Constâncio: Presentation of the European Central Bank Annual Report 2015 to the Committee on Economic and Monetary Affairs of the European Parliament

Introductory remarks by Mr Vítor Constâncio, Vice-President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 7 April 2016.

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Mr Chairman,

Honourable Members of the Committee on Economic and Monetary Affairs,

Ladies and gentlemen,

I am honoured to once again present the ECB's 2015 Annual Report to your Committee. Please allow me to take this opportunity to express my heartfelt thoughts, and those of the ECB's Executive Board and ECB staff, for the victims of the recent attacks in Brussels, in the heart of Europe. Our thoughts are also with their families and friends.

Events like this remind us that Europe must stand together. And our institutions have a role to play in this respect.

The presentation of our Annual Report to those representing the European Union's citizens is a key element of our accountability, which is a necessary counterpart to our independence. That is also why we have decided to publish our feedback to the input you provided in the Resolution on the 2014 Annual Report, together with this report. This is the first time we have done so. This decision reflects the importance of having a fruitful dialogue between our institutions, for the benefit of European citizens.

Today, I will first discuss the monetary policy measures that the ECB has taken to fulfil its mandate and what impact these have had on the real economy. I will then explain how steps to complete banking union and a capital markets union would not only support a strengthened EMU (along with fiscal and economic union, as well as democratic accountability) but also contribute to enhancing financial stability. As European developments need to be put into a wider perspective, I will also say a few words on ongoing discussions in international fora regarding global developments and international financial regulation.

Monetary policy and its impact on the real economy

2015 was characterised by a modest economic recovery. However, inflation dynamics were weak and continued to deteriorate throughout the course of the year. Thus, after adopting our credit easing measures in the middle of 2014, we took further decisive action in 2015 to pursue our price stability mandate.

Let me remind you that, in January last year, inflation in the euro area had moved into negative territory, the outlook on inflation had worsened significantly and market-based inflation expectations stood at historic lows. In this situation, we judged that our monetary policy measures had to be stepped up in view of our price stability mandate. Therefore, as of March 2015 we expanded our asset purchase programme (limited until then to covered bonds) to public sector securities.

These asset purchases, together with the measures taken since June 2014, have proved very effective by activating a broad range of channels to support growth and inflation in the euro area.

First, they have contributed to a tangible, broad-based easing of market funding conditions, transmitting the stimulus to the euro area economy at large.[1]

Second, through improving borrowing conditions for firms and households in the euro area, these measures have also promoted a recovery in lending that went back to positive growth in the second half of 2014, supporting expenditure on investment and consumption.[2]

Without these measures, the euro area would have been in outright deflation last year and prices would have fallen at an even faster rate this year. Growth would have been significantly lower.[3]

Towards the end of 2015, significant risks to the inflation outlook started to materialise. Headline inflation entered negative territory in September (–0.1%), slightly recovered in December (0.2%) and January 2016 (0.3%) before turning negative again in February (–0.2%).

This was partly due to a substantial decline in crude oil prices by 48% in euro terms from May 2015 to January 2016. The decline in oil prices reflected continued oversupply, weakening oil demand and the OPEC countries not cutting production targets. In particular, around half of the decline in headline inflation from January to February reflects that the already negative annual energy inflation turned even more negative.

To counteract the risks to our price stability objective, we first recalibrated our policy stance last December and then unveiled another comprehensive set of measures at our last monetary policy meeting in March 2016.

In discussing our recent monetary policy measures, it is essential to consider the global environment in which they were taken. This environment was characterised by subdued growth, historically weak trade developments and low inflationary pressures reflecting sharp falls in energy prices. The more recent developments have been affected in particular by the outlook for emerging markets contributing to global financial market volatility in the second half of 2015 and again in February this year.

In this respect, these developments are analysed in the box in the Annual Report entitled "Financial stress in emerging market economies" in order to understand their impact on the euro area economy. This is against the background of the discussions carried out in international fora, most recently at the meeting of G20 ministers and central bank governors, as well as at the BIS meetings in February in Shanghai. Risks to the global outlook and global financial stability will feature prominently on the agendas of the various meetings in the context of the IMF and World Bank spring meetings next week.

Consistent with this global scenario, the ECB has done and, within its mandate, will continue to do whatever is needed to pursue its price stability objective which now implies also trying to foster growth, in order to close the negative output gap that is putting negative pressure on inflation. However, other policies must also act to deliver a lasting and sustainable improvement in economic growth prospects.

Such a common European effort should entail a three-point action plan:

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1 Since June 2014, euro area government bond yields have fallen, on average, by around 120 basis points. Furthermore, funding conditions for banks and companies in the euro area have improved markedly: the respective bond yields have declined by around 65 and 55 basis points on average.

2 Bank lending rates for non-financial corporations in the euro area have fallen on average by some 80 basis points since June 2014. Lower lending rates, in turn, have triggered a marked response in the supply of, and demand for, bank credit: the volume of credit to both euro area households and firms has been on a steady recovery path since mid-2014.

3 ECB estimates suggest that, had there been no asset purchase programme (including the recalibration of December 2015), inflation would have been negative in 2015. ECB assessments also suggest that the asset purchase programme (including the recalibration of December 2015) will contribute to raising the GDP of the euro area by around 1.5% in the period 2015–18.

First, structural unemployment is still high and potential output growth low in the euro area. It is therefore imperative to make our economic structures more efficient. This calls for action to raise productivity and improve the business environment, also by providing adequate public infrastructure.

Second, fiscal policies should play their role in the economic recovery. Of course, the fiscal rules of the European Union must not be called into question. But all Member States can and should strive to make the composition of their fiscal policies more conducive to growth and, where available, countries with fiscal space should use it.

Finally, we need a clear vision for EMU. I am aware that political attention is focused elsewhere right now. But leaving EMU unfinished will leave us too fragile and vulnerable to be able to deal with future shocks.

Completing banking union and financial union

One area that deserves particular attention is the finance sector. This year's ECB Annual Report outlines the key challenges the euro area is facing, namely (i) a further increase in risk premia, a decline of financial asset prices inducing capital losses, in the context of possible emerging market stress and persistently low commodity prices; (ii) weak profitability for insurers and for banks, aggravated for some banks by non-performing loans (NPLs) inherited from the crisis; (iii) sovereign and corporate debt sustainability concerns; and (iv) the potential for stress in the investment funds sector – and shadow banking more broadly.

In the past few months, a discussion has started about the need for a new risk reduction agenda. But, before discussing such further steps, it is worth recalling that we have already made significant progress – since the beginning of the crisis – in "de-risking" Europe's financial system. We enhanced and implemented the single rulebook; defined a common resolution framework for banks to protect European taxpayers; established the Single Supervisory Mechanism and Single Resolution Mechanism, and conducted a Comprehensive Assessment of banks to deal with legacy issues before the start of Banking Union.

The results are tangible. The Common Equity Tier 1 ratio has risen, on average, from around 9% to 13% since 2012 for significant institutions. Most European banks have managed to meet the fully-loaded capital requirements by now.

While a lot has been achieved, there is no room for complacency: too many of our banks are still troubled by the ghosts of the past, legacy assets and NPLs. The ECB as supervisor is actively looking into this and has identified the issue as a priority.

So, what is left to be done to mitigate the remaining risks and make the financial system more resilient?

It is important to further improve and fine-tune what we have started.

First, there is still room for improvement when it comes to establishing a truly level playing field, for example by creating a truly single rulebook. The ECB is contributing here with its work on options and discretions in the CRD IV/CRR framework, but you as legislators can also play an important role to complement our action.

Second, we should implement the missing elements of the international regulatory agenda. I will come back to this.

Third, we need to complete the banking union with the European Deposit Insurance Scheme (EDIS). The European Commission's proposal sets out a clear roadmap towards a single EDIS, which I strongly welcome. It already provides safeguards against moral hazard, and ensures that banks pay for their own risks. I understand that you will discuss the proposal later today. I am sure that the European Parliament as co-legislator will play a decisive role in this process of strengthening and completing the banking union.

Fourth, progress needs to be made to foster private risk-sharing via financial markets. We have therefore strongly supported the European Commission's initiative to establish a capital markets union (CMU) from the very start, as you will remember from my introductory remarks to this Committee last year.

A well-functioning, diversified and integrated capital market would support the transmission of our monetary policy, create deeper and more liquid markets, and increase the shock-absorbing capacity of the European economy, thereby contributing to financial stability. The revitalisation of the securitisation market is an essential element of this agenda, as it can free up capital for lending and thus increase funding for the real economy. Therefore, the ECB strongly welcomes the Commission's proposed regulations, which strike the right balance between the need to revive the European securitisation markets and yet maintain the prudential nature of the framework. Timely adoption of the final rules is essential for creating regulatory certainty for issuers and investors alike, thus supporting the revitalisation of the market.

The ECB's contributions to regulatory initiatives at international level

Let me now turn to the international regulatory agenda, also in response to the call by ECON to receive more information on these issues. As I argued before, initiatives at European level are not taking place in isolation.

Last November, the Financial Stability Board finalised the total loss-absorbing capacity (TLAC) standard for large, complex, global systemically important banks. TLAC is an important milestone in overcoming the "too big to fail" problem. It now needs to be implemented in the European framework.

To further reduce risk-taking and strengthen the resilience of the banking system, the finalisation and implementation of the leverage ratio and the strategic review of the capital framework should be matters of priority. The Basel Committee concluded its work on the definition of the leverage ratio, the trading book requirements and is working to conclude the revision of risk-weighted assets framework both for the standardised approach and for the use of banks' internal risk models before the end of the year.

Swift legislative action on the key unfinished parts of the Basel III agenda will provide clarity to the financial system and support the latter in financing the recovery. As confirmed by G20 Finance Ministers and Governors at their meeting in Shanghai, the aim is now to focus on making Basel III effective without further increasing regulatory capital requirements.

In addition, in 2015 the Basel Committee initiated a review of the prudential treatment of banks' exposures to sovereign risk. This review – which is being conducted in a "careful, holistic and gradual manner" – is meant to take into account several broad issues relating to the role of sovereign debt markets and the impact that any changes may have on this role and on certain market segments.

In particular, in reviewing the existing regulatory treatment of sovereign risk, due consideration should be given to the liquidity function of sovereign bonds and to its potential implications for monetary policy implementation and transmission. Given the widespread reach and impact of any policy action in this area, consistency at the global level is key to ensuring a truly international level playing field as it is stated in the Five Presidents Report.

Conclusions

Let me conclude.

Europe is facing a number of challenges simultaneously, in the economic sphere and beyond. Addressing these challenges requires a joint response. The ECB is doing, and will continue to do, its part by taking the necessary measures to fulfil its mandate. However, further work is also required in other policy areas to cement the foundations of the European Union, foster innovation and productivity, and put the economy back on a path of robust, sustainable growth and job creation.

Thank you for your attention. I look forward to taking your questions.