Vítor Constâncio: Euro area - economic outlook and financial sector challenges

Speech by Mr Vítor Constâncio, Vice-President of the European Central Bank, at the 19th Euro Finance Week: Opening conference, Frankfurt am Main, 14 November 2016.

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It is with pleasure that I take part again in this year's opening conference of the Euro Finance Week in Frankfurt. One year on, with another round of unconventional monetary policy measures introduced, the situation has changed for the better but some challenges persist and new risks have emerged.

World economy faces once again an abnormal degree of uncertainty. The consequences may not be immediate. The markets' perception that the U.S. is embarking into a new phase of expansionary budgetary policy has lifted optimism, with visible effect in financial markets last week. Markets are driven by the insight from the macroeconomic theory that fiscal stimulus, at this stage of the cycle, can break the liquidity trap that has hampered growth in the advanced economies.

Consequently, we saw a beginning of a shift from bonds to equities last week. In spite of their rich valuations in the U.S., equity prices jumped whereas bond valuations worldwide lost close to 1 trillion euros. These movements result from the understanding that fiscal stimulus will increase growth and inflation down the road, in turn allowing a normalisation of U.S. monetary policy at higher interest rates. Anticipating this development, markets sold bonds thus leading to an increase of medium to long-term yields, steepening the yield curve, which is a positive development for financial institutions' profitability. This expectation was indeed reflected in their share prices amid the general increase of stock valuations last week.

Many commentators have hasted in concluding that the recent geo-political developments will have, after all, economic benefits. This may be the case in the short-term but the real negative effects of heightened uncertainty can come later. We should be cautious in drawing hasty, positive conclusions from those market developments because they may not necessarily indicate that the world economy will have an accelerating recovery with higher growth. So far, those developments point to a U.S. rise in economic growth, but in the context of an "America first" policy. Three factors may contribute to mitigate or even reverse its international spillovers.

The first is the possibility of rising protectionism – hard or soft – that can substantially reduce the effect of higher growth into higher U.S. imports. World trade, already quite weak, may continue to collapse, hurting all open economies dependent on exports.

The second are the negative effects that we are already witnessing in emerging market economies (EMEs). In fact, significant capital outflows and exchange rate depreciations already underway can hinder future growth. Protectionist measures directed particularly against large emerging economies may further decelerate world economic growth and create instability in foreign exchange markets.

The third factor concerns Europe. In this first wave, Europe apparently benefited from positive contagion with some increase in equity prices and a steepening of the yield curve, favouring financial institutions. As concerns equities, the low starting point seems favourable for European markets. Share price levels are relatively subdued in Europe with, for instance, a Cyclically Adjusted Price Earnings (CAPE) Shiller index of just 14 against 27 in the U.S. This means that European shares, including those of banks, are undervalued with respect to other parts of the world and could thus attract investors. However, we already observed a slight drop in European share prices last Friday. According to market analysts, this was explained by fears concerning

protectionism and EMEs' growth prospects as well as the possible resulting decline in global trade.

Besides these external concerns, Europe's internal problems may deter it from fully reaping the benefits from the expected expansion in the U.S. Indeed, a range of political risks may induce economic shocks. To face heightened world uncertainty, Europe would need to deepen its unity and integration, relying more on its domestic market to underpin higher growth. In turn, this implies that Europe needs more expansionary macroeconomic policies and more reforms in the regulatory and competition policy fields, in order to improve the economy's supply side. Without higher real and nominal economic growth, Europe will have greater difficulty in overcoming its challenges.

Euro area outlook

So far, monetary policy has been the only expansionary macroeconomic policy in support of the recovery. Yet, securing sustained economic growth and employment cannot be dependent on monetary policy alone. At the national and European levels, a much more comprehensive policy response, than has been the case to date, is needed. Mainly, structural reforms and fiscal policy have yet to deliver their share to support economic activity and counteract the "low growth trap" dynamics faced by advanced economies at present.

The euro area recovery is continuing its moderate but steady pace, supported by the ECB's policies. These have significantly improved financial conditions, reduced financial fragmentation and fostered economic activity and inflation.

In the first half of 2016, the euro area grew at an annualised rate of 1.7%, similar to last year's growth rate. This figure is far from impressive, especially considering that the euro area is in the early phase of a recovery, after the second recession in 2012 and 2013. On the other hand, the unemployment rate, albeit falling, still remains above 10%, amid a continuous increase in the participation rate in the labour force since the crisis. One positive aspect is that our policies have contributed to a decrease in financial fragmentation and that the dispersion of GDP growth and inflation across euro area countries is at the lowest level since the beginning of monetary union in 1999. Another positive note is that the recent growth was largely driven by domestic demand. Moreover, the recovery has proved resilient to a series of adverse shocks over the past year: the slowdown in China last summer, the acute stock market turbulence in the early part of this year and, most recently, the uncertainty created by the U.K. referendum.

This resilience reflects, to a large degree, the amount of monetary expansion – actual and expected – that is embedded in financial prices. Indeed, with the five packages of measures adopted since June 2014, we have been able to: reduce the cost of capital, produce rebalancing effects in broader asset markets, improve credit supply conditions and restore credit volume growth since the latter part of 2014, after two years of negative developments. In the latest move in March 2016, a powerful set of measures was taken, comprising an increase in the asset purchase programme, its extension to corporate bonds and the introduction of a new medium-term liquidity facility with interest rates that can go as low as our negative deposit facility rate, contingent on the banks reaching a credit growth benchmark.

Yields on bank and non-financial bonds have eased in response to the measures taken, testifying to the effectiveness of the current monetary policy. Funding conditions for banks improved as wholesale money market rates turned negative and as banks received direct support from new liquidity facilities with four-year maturities and low rates (TLTRO-I and II). These developments have stimulated the pass-through of this funding cost relief to borrowing costs for both firms and households.

As a consequence, bank lending rates to non-financial corporations (NFCs) and households are now at historical lows, and there has been a significant reduction in the fragmentation of lending rates across euro area countries both for large and for small loans.

Against this background, in the most recent ECB staff projections, real GDP is forecasted to grow at an annual rate of 1.7% in 2016 and 1.6% in 2017. Since the projections cut-off date, the flow of short-term economic indicators has been consistent with the materialisation of this baseline scenario, and point to a continued positive contribution from domestic demand (alongside a negative contribution from net trade). According to Eurostat's flash estimate, real GDP increased by 0.3% in the third quarter with respect to the second quarter, (as was the case in the previous quarter). This has been accompanied by increases in the flash composite output PMI in October, with respect to September, as well as a rise in consumer confidence. Crucially, the projection is predicated on the current supportive financial conditions persisting. In fact, it is estimated that, cumulatively, the impact of our measures will contribute more than one and a half percentage points to real GDP growth between 2015 and 2018.

Regarding inflation, the latest ECB staff projections foresee a rise to 1.2% in 2017 and 1.6% in 2018. The contribution of our measures to this increase in inflation, to levels closer to our objective, represents on average, an impact on the inflation rate of about half a percentage point each year between 2016 and 2018. Likewise, short-term indicators are consistent with the projections. The October flash estimate annual HICP inflation stood at 0.5% from 0.4% in September. However, annual inflation for HICP excluding food and energy remained unchanged (at 0.8%). This is a cause of concern since core inflation, depending on domestic factors, is not recovering which may affect the dynamics of headline inflation going forward, affecting our monetary policy. A more satisfactory evolution of wages is needed, now that inflation and productivity are increasing. Wages are a crucial driver of prices in a service-dominated economy. In countries with large external surpluses, wage-dynamics should finally start showing more favourable developments.

Overall, assuming that the potential negative effects of the present worldwide uncertainty will not manifest themselves in the short term, I am confident that the euro area economic recovery will continue its path and that unemployment will come down to single digits next year, for the first time in many years. Inflation will also continue to normalise and we will see headline inflation well above 1% as from next spring.

However, considerable risks and uncertainties to financial stability remain. The main risk is related to my initial considerations specifically, to a possible worldwide reversal of risk premia that could induce contagion and affect asset prices. We have just started to see this in the bond market and this is exacerbated by the present heightened political uncertainty in advanced economies.

A second risk regards the challenges to European banks' profitability resulting from cyclical and structural factors. European banks have steadily increased their robustness and resilience since the financial crisis. Solvency positions of euro area banks, measured by the highest quality capital (Common Equity Tier 1 ratio) increased, on average, from 7% in 2008 to 9% in 2012 and 14.4% in June this year.

The present low profitability levels have, however, put bank stock prices under severe market pressure, leading to price-to-book ratios well below 1. Different causes stand behind banks' profitability challenges: legacy non-performing loans, excess banking capacity, growing competition from non-banks, ineffective cost-control and slow adjustment to new business models in the context of a low interest rate environment, are among the most important ones. Return on equity stood at 5% in the first half of 2016, against 5.5% for the whole of last year, which is worryingly well below the cost of equity resulting from share prices determined by investor's expectations.

As already mentioned, monetary policy responses are supporting and accelerating the economic recovery and the normalisation of inflation and interest rates. Since March this year, the interest rate on main refinancing operation is at 0% and the interest rate on the deposit facility has been further lowered to -0.40%. The impact of low rates on bank profitability might not be negligible. The overall impact is however so far positive, even if heterogeneous. Monetary policy has had a positive effect on bank profitability since 2014 by reducing funding costs, generating capital gains on higher prices of financial assets affected by the asset purchase programme, reducing bank impairment costs and increasing credit volumes as a result of a strengthening recovery. The impact on net interest margins depends on banks' capacity to re-price deposits and loans and on the predominance of floating and fixed rate loans in banks' balance sheets.

The ECB is aware that some of the positive effects of our policy on banks' profitability will wane with time. However, low or negative interest rates cannot be blamed for low profitability per se. With lower interest rates, (-0.50% and -1.25% for the repo rate and deposit rate, respectively) which have been in negative territory almost for two years now, Swedish banks, for example, have been able to sustain ROE levels of close to 12%. There are several explanations for this difference but a sizeable contribution comes from cost control stemming from adjusted business models. In fact, cost per banks total asset is at 0.92 for Swedish banks against 1.42 for the euro area, on average. This clearly shows that European banks have to adjust their business models to improve their profitability prospects.

However, to face bank profitability challenges, the euro area needs to develop and implement a joint strategy, over a determined period of time, to overcome excessive non-performing loans and/or excessive banking capacity in some jurisdictions. We need a stronger banking sector which is essential to better transmit monetary policy impulses and support the economic recovery.

In this, as in other domains, Europe must endeavour to work together to face a more challenging world that threatens European values of open and tolerant societies.

Thank you for your attention.