Vítor Constâncio: Presentation of the European Central Bank Annual Report 2016 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, 10 April 2017.

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Mr Chairman,

Honourable Members of the Committee on Economic and Monetary Affairs,

Ladies and gentlemen,

I am honoured to be here today before your Committee to present the ECB Annual Report for 2016.

The Annual Report is an essential element of our democratic accountability. It supports the democratic debate regarding our decisions. And our accountability does not stop with our reporting obligations. This occasion ensures that our Annual Report will be discussed by the representatives of the people of Europe.

We take our accountability to the European Parliament extremely seriously. This is the beginning of a well-established process. Our exchange today, and the regular dialogue between our two institutions, will feed into the European Parliament resolution on the ECB Annual Report. This is very important for us because we want to make sure that we deliver on the democratic mandate that was conferred upon the ECB. The ECB is independent so that it *can* act in line with this mandate, without political interference. And it is democratically and legally accountable to ensure that it *does* act in line with this mandate. As is customary, today we are also publishing our feedback concerning your resolution on our previous Annual Report.

In introducing our discussion, I will touch upon our monetary policy decisions over the past year and their contribution to the ECB's primary objective of maintaining price stability – a precondition for sustainable growth and job creation. That objective – which serves as a performance benchmark – supports both our independence and the accountability of our actions. I will then continue by emphasising the importance of a strong financial system for a prosperous euro area.

The euro area recovery and the support provided by the ECB's monetary policy

2016 was, in many ways, a challenging year. The last time I spoke before this Committee, in April 2016[1], the global economy was emerging from an acute episode of financial instability. That episode had once again given rise to another phase of deep pessimism concerning not only the capacity of the world economy to generate positive growth, but also the ability of central banks to steer their economies by applying unconventional monetary policy tools. Inflation was heading towards new lows, dragged down by a renewed sharp fall in commodity prices.

Twelve months on, in part thanks to the measures that we took at that time[2] (and disproving the policy sceptics), macroeconomic conditions have improved and the euro area has been a major source of positive news. Fears of deflation have receded. Despite a still weak international backdrop, GDP grew at a solid rate of 1.7% in 2016 and in the first quarter of 2017, economic sentiment climbed to the highest levels since 2011. Unemployment is at its lowest point since May 2009. Over four and a half million more people are now employed than was the case three years ago. Our measures have also reduced fragmentation among Member States: the dispersion of both GDP growth and inflation rates is at the lowest level since the beginning of the monetary union.

Looking back, we can see how the measures that we took in March 2016 have effectively fed through to the broader economy, adding to the substantial monetary stimulus already in place at the time. They have built a new cushion that helped to firm up the recovery and make it more resilient to external shocks and uncertainties. In December 2016 we decided to extend our asset purchases until December 2017, though at a reduced pace of €60 billion per month from April 2017 onwards, in line with the diminished risks to price stability. This safeguards the financing conditions that are still necessary to foster a return of inflation rates towards levels below, but close to, 2% over the medium term.

The measures the ECB took in March 2016 have supported the improvement in financing conditions. They have facilitated the continued fall in composite bank lending rates for loans to non-financial firms and for housing loans. Both have fallen to historically low levels. Overall, since May 2014, i.e. immediately before our decision on a combination of measures to provide additional monetary policy accommodation and to support lending to the real economy, the decline in bank lending rates has amounted to almost 120 basis points for loans to firms, and around 110 basis points for housing loans. Likewise, lending volumes have increased considerably as growth in loans to firms recovered to 2.0% in February 2017, from –2.9% in May 2014, and for households to 2.3% from –0.1% over the same period. Small and medium-sized enterprises, the backbone of the euro area economy, have greatly benefited: their access to financing has significantly improved and their borrowing costs have dropped by around 40 basis points since March 2016 and around 180 basis points since May 2014.

By the end of 2016, the recovery was clearly firming and further broadening across sectors and countries. Incoming data and sentiment indicators in the first quarter of this year suggest that the pace of growth may be gaining momentum.

Nevertheless, the legacy of the financial crisis still determines today's economic performance in many respects. Owing to a considerable amount of unutilised resources underlying inflation continues to lack a convincing upward trend. Headline inflation has increased but that mostly reflects rising energy and food prices. The March flash estimate shows that headline inflation dropped to 1.5% from 2% in February and that underlying inflation decreased from 0.9% to 0.7%. We had previously warned that headline inflation could decline after March-April as a result of the reduced statistical base effect of comparing this year's price levels of oil and other commodities with their levels a year ago.

The decrease in underlying inflation, however, was disappointing. The domestic drivers of inflation, namely wages, are not yet responding to the recovery and the narrowing output gap. According to our latest staff projections, inflation is expected to move towards 1.7% in 2019, but that assumes underlying inflation at 1.8% and wage growth at 2.4%. The foreseen increase in wages in the baseline scenario is thus essential for the staff projections for growth and inflation to materialise in 2019.

Furthermore, while near-term projected inflation has been subject to sizeable upward revisions due to energy and food price rises, the medium-term outlook remains largely unaffected. More importantly, the upward path of headline inflation over the coming years remains highly dependent on monetary policy support.

Against this background, it is appropriate to preserve the degree of monetary accommodation we are currently providing.

Ensuring a safe and growth-supporting financial system

While our monetary policy is primarily geared towards maintaining price stability, the ECB is also tasked with identifying and assessing the potential impact of systemic risks on the stability of the euro area financial system. Our Annual Report sets out four key risks.

First, the possibility of a rise in global risk premia has increased in an environment of political uncertainty and benign pricing in the markets. Second, possible rising negative feedback loops between weak bank profitability, in the face of structural challenges in a low interest rate environment, and low nominal growth. Third, political uncertainty which undermines reform efforts, with debt sustainability concerns resurfacing for the sovereign and non-financial private sectors in some countries. Fourth, liquidity risk is increasing in the rapidly growing investment fund sector, with potential spillovers to the broader financial system.

Beyond systemic risks at the aggregate euro area level, we are also closely monitoring risks arising at the country and sectoral levels. Targeted macroprudential policy measures are the appropriate policy instruments to address these country or sector-specific risks. As you know, responsibility for decisions on macroprudential measures in the euro area is shared between national authorities and the ECB. This means that we can top up the macroprudential measures taken by national authorities for those instruments that are envisaged in EU legislation.

The ECB strengthened its role in macroprudential policy in 2016 and also took action to improve transparency – the Governing Council published its first macroprudential statement in December 2016.[3] Besides the risks in some countries' real estate sectors, we noted that cyclical systemic risks in the euro area remained contained and, therefore, a broad-based increase in countercyclical capital buffers in the euro area was not warranted. This view was in line with the decisions of the national authorities, with whom we enjoyed excellent cooperation over the past year. Transparency in the macroprudential policy domain was also enhanced by the launch of the new biannual ECB Macroprudential Bulletin in March 2016.

Our 2016 Annual Report also focuses on the actions necessary to overcome the legacy of the crisis in the banking sector. Decisive action is needed at the sectoral, national and European levels.

First, banks need to continue adjusting their business models to better cope with the low interest rate environment. As we show in a dedicated analysis contained in the Report, the optimal strategy is likely to depend on each bank's core characteristics.[4] Adjustments may include cross-border mergers and acquisitions where they allow efficiency gains.

Second, significant effort is needed to solve the problem of non-performing loans (NPLs). The extent and macroprudential nature of the problem calls for a comprehensive and coordinated response at EU level. While actions should be taken by stakeholders at the national level, these should be harmonised in a European blueprint for asset management companies (AMCs), among the strategies to reduce the stock of NPLs on banks' balance sheets. The issue is also being addressed as a matter of priority from a microprudential perspective.[5]

Further enhancing the European financial framework

Turning now to financial regulation, the ECB is involved in shaping the regulatory framework at the international and European levels to ensure that it takes appropriate account of both macro- and microprudential considerations.

In 2016, the Basel Committee on Banking Supervision (BCBS) agreed on several reforms, including the treatment of interest rate risk in the banking book, revisions to the securitisation framework, and a standard for the regulatory capital treatment of banks' investments in total loss-absorbing capacity. It also issued public consultations on the regulatory treatment of accounting provisions and Pillar 3 disclosure requirements.

As part of the process to finalise the Basel III package, the Group of Governors and Heads of

Supervision (GHoS), the oversight body of the BCBS, set out a work programme for the Committee to finalise its work to reduce excessive risk weight variability in risk-weighted assets, as well as the calibration of the leverage ratio. In January 2017, the GHoS welcomed the progress made by the BCBS towards completing the post-crisis reforms. While more time is needed to finalise the reforms, the work is expected to be completed in the near future.

It is crucial that we complete the post-crisis reform package and do not undo the progress made in recent years. The ECB will continue to support work at the international level to achieve an appropriate regulatory framework that establishes a level playing field.

Over the last four years, we have also made significant progress at the European level, namely with the establishment of the banking union. At this stage, it is crucial to take the remaining additional steps which are necessary to complete it. The ECB has helped, and will continue to help, to bring forward the two processes of risk reduction and risk sharing, within its mandate as a central bank and supervisor.

In this context, accelerating the work on creating a European deposit insurance scheme is essential, as is introducing a common backstop for the Single Resolution Fund. In parallel, the European Commission's package reviewing the current EU regulatory framework for banks is moving in the right direction in terms of risk reduction measures. It is expected to make a significant contribution to strengthening banking regulation, supervision and resolution, even if there are some areas for improvement.

These achievements in the regulatory framework for banks will be accompanied by regulatory initiatives for financial markets and financial infrastructures, in order to cope with the changing landscape in the euro area financial system.

From this perspective, acting decisively to build a fully fledged capital markets union (CMU) is a priority for the EU as whole, and also for the ECB. A CMU with deeper, more integrated and well-supervised capital markets can increase risk sharing via cross-border investment, contribute to macroeconomic and financial stability and ultimately facilitate the transmission of monetary policy in the euro area.

It is also important to establish the legal basis for macroprudential tools that can be used to address risks to financial stability that emerge from outside the banking sector, as well as to include a macroprudential perspective in the regulation of non-bank financial institutions across the EU.

Greater financial risk sharing, diversification and heightened competition between banks and non-banks, and across borders, bring material economic benefits. Indeed, capital markets can be an important complement to banks when it comes to providing finance to the economy. At the same time, such developments inevitably call for heightened financial stability surveillance outside the banking system perimeter and the appropriate policy toolkit to address related risks.

Conclusions

Let me conclude.

The euro area economy demonstrated substantial resilience in 2016. The recovery is progressing and is now gaining momentum. Our monetary policy stance is appropriate and a reassessment is not warranted at this stage. However, we continue to stand ready to react to downside shocks. While cyclical conditions have improved, we still need to address, without delay, the legacy of the crisis and reinforce the structural underpinnings of our Union.

Tomorrow would have been the 97th birthday of a former President of the European Parliament, Emilio Colombo. Let me recall his words of almost 40 years ago, which have particular resonance now, when one Member State has given notice of its intention to leave the Union:

We have no reason for complacency about the present state of Europe in spite of the efforts we have made. […] as Europeans we can make a real impact when we manage to find the right joint solutions to the problems of our time.[6]

These words remind us of the importance of our responsibility as a Union to steadily strive, together, towards achieving better economic outcomes for our citizens.

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[1] See Presentation of the ECB Annual Report 2015 *to the Committee on Economic and Monetary Affairs of the European Parliament – Introductory remarks by Vítor Constâncio, Vice-President of the ECB*, Brussels, 7 April 2016

[2] In March 2016, the ECB decided on a powerful set of monetary policy measures. They included lowering the key ECB interest rates, expanding the asset purchase programme, including corporate bonds in the programme, and creating a new medium-term liquidity facility to support bank lending.

[3] See the Governing Council statement on macroprudential policies from 15 December 2016

[4] See the box entitled "Diversity of banks' business models and adjustment to the low interest rate environment", *Annual Report 2016,* ECB, 2017.

[5] See Presentation of the ECB Annual Report on supervisory activities 2016 *to the European Parliament's Economic and Monetary Affairs Committee – Introductory statement by Danièle Nouy, Chair of the Supervisory Board of the ECB*, Brussels, 23 March 2017

[6] "The decisions facing Europe", *Second Jean Monnet Lecture by the President of the European Parliament, Emilio Colombo*, Florence, 9 November 1978