Peter Praet: Europe's economic recovery - challenges and opportunities for the banking sector

Remarks by Mr Peter Praet, Member of the Executive Board of the European Central Bank, at the Association of Banks in Bulgaria, Sofia, 24 May 2017.

* * *

Accompanying slides

Europe’s economic recovery

Since June 2014, the ECB has introduced a range of unconventional measures, alongside our conventional ones, in pursuit of its price stability objective. Together, these measures have proved to be extremely effective in preventing a period of disinflation from spiralling into one of deflation. Nearly three years on, the risks of deflation have vanished and the transmission of our policy measures to the real economy is clearly evidenced by the strengthening cyclical recovery – a recovery that has shown a remarkable resilience to external shocks.

Before turning to price developments and monetary policy, let me say a bit more about the latest economic developments in the euro area.

The upswing is becoming increasingly solid, and continues to broaden across sectors and countries. Real GDP in the euro area has expanded for 16 consecutive quarters, growing by 1.7% year-on-year during the first quarter of 2017, according to Eurostat’s flash estimate. This compares with the latest potential growth estimates for the euro area of around 1%.[1] Moreover, recent survey data point to a strong start to the second quarter. For example, the composite output Purchasing Managers’ Index – which is strongly correlated with growth in the euro area – hit a six-year high in April and the forward-looking components of the survey point to growth in the quarters ahead. Moreover, economic sentiment is now at its highest level in nearly a decade and unemployment is at its lowest level in eight years.

The breadth of the economic recovery is also notable. The dispersion of growth rates across both countries and sectors is at its lowest level in two decades, reflecting a convergence of growth rates around higher levels. This is reassuring for the growth outlook because recoveries tend to be firmer and more robust when they are broad-based. It’s a similar picture for employment, with dispersion of employment growth rates across euro area countries at its lowest level on record.

The increasingly solid cyclical recovery reflects the success of our monetary policy measures, which have worked their way through the financial system and led to a significant easing of financing conditions for consumers and firms. Together with improving financial and non-financial sector balance sheets, this has strengthened credit dynamics and supported domestic demand.

Since June 2014, bank lending rates for both euro area households and non-financial corporations have fallen by around 110 basis points. Lending rates for very small loans, which can be taken as a proxy for loans to small and medium-sized enterprises (SMEs), have declined by over 180 basis points. The significant improvement in funding conditions for SMEs is especially encouraging as they provide two-thirds of total private sector employment in the euro area. Heterogeneity of lending rates across countries has also fallen sharply, indicating that our non-standard measures have been particularly effective in counteracting bank funding and financial fragmentation in some jurisdictions. For example, the difference between the median lending rate for firms in countries that were severely affected by the crisis versus other countries has narrowed by about 100 basis points over this three-year period.

The sharp reduction in bank lending rates has been accompanied by easier access to funding, as recent surveys have shown.[2] These positive developments have been supported by the second series of targeted longer-term refinancing operations, as a result of which banks are passing on the favourable funding conditions to their customers.[3] Moreover, these improvements are not limited to interest rates: bank lending volumes have also been gradually recovering since early 2014. Market-based funding conditions, too, have improved significantly in response to the corporate sector purchase programme launched in June 2016.

The easing of financing conditions has underpinned the recovery in domestic demand, which is now the mainstay of growth in the euro area. As the unemployment rate continues to decline despite a rise in labour force participation, households' real disposable income is improving. Given the broadly stable savings rate, increased labour income is translating into higher private consumption expenditure. Business investment is also picking up as a result of the favourable financing conditions, the need to modernise the capital stock after years of subdued investment and strengthening corporate profitability.

From today's point of view, there are signs of a stronger global recovery and a pick-up in international trade. The more synchronised economic upswing across regions should further support the euro area recovery.

As for price developments, after hovering at levels well below 1% for three years, with occasional dips into negative territory, euro area headline inflation has again edged higher towards the end of last year and reached 1.9% in April. This upward movement of inflation mainly reflects increases in energy and food prices. Underlying inflation – which relates more to domestic price pressures – continues to remain subdued, as unutilised resources still weigh on wage and price growth. In fact, the annual rate of HICP inflation excluding food and energy has mostly remained below 1% since late 2013.

Today, an important element keeping underlying price pressures subdued is muted wage dynamics, which are shaped by many factors. Besides weak productivity developments, the significant degree of remaining labour market slack acts to contain wage growth. Furthermore, the process of setting wages is to some extent backward-looking in a number of euro area countries, reflecting formal and informal indexation mechanisms.[4] Additionally, the timing of wage negotiations plays a role in postponing the point in time when growing confidence that inflation is approaching the ECB's intended medium-term level starts to become more visible in aggregate wage figures. Moreover, weak wage growth could also reflect previous downward wage rigidities: difficulties in reducing wages during earlier stages of the crisis may result, symmetrically, in a slower upward adjustment of wages as labour market conditions improve.[5]

Overall, while we are certainly seeing a firming, broadening and more resilient economic recovery, we still need to create a sufficiently broad and solid information basis to build confidence that the projected path of inflation is robust, durable and self-sustained. First, underlying inflation pressures still give scant indications of a convincing upward trend as domestic cost pressures, notably wage growth, remain subdued. And, second, the economic recovery and the outlook for price stability remain conditional on the very substantial degree of monetary accommodation, including our forward guidance. Without this support, the progress towards a sustained adjustment that we see in our projections will likely be slower or even stall.

At our last policy meeting in April, the Governing Council took into account all available information and concluded that there was insufficient evidence to warrant a scaling back of the exceptional degree of monetary accommodation. We also reasserted our forward guidance, which is structured around conditionality and sequencing. Looking ahead to our policy meeting in June, the Governing Council will draw on the latest information and will have new projections as well as an updated assessment of the distribution of risks surrounding the economic outlook.

Challenges and opportunities for the European banking sector

Almost ten years have elapsed since the turn of the financial cycle. While European banks still face a number of challenges stemming from the financial crisis, the firming economic recovery presents opportunities for them. Overall, the process of balance sheet adjustment in the household and corporate sectors is gradually being completed, not least as the result of our monetary policy response.

Turning to the financial sector[6], European banks have shored up their capital position, with average Tier 1 capital reaching 15.1% in the third quarter of 2016, an increase of about 2.0 percentage points from 2013 and of 7.1 percentage points since 2007. Banks have disposed of non-core assets, reduced their exposure to market risk and generally refocused their activities on more traditional business models. Looking at asset quality, the NPL (non-performing loan) ratio has declined from 6.7% at its peak in the third quarter of 2014 to 5.1% in the last quarter of 2016, albeit with large heterogeneity across countries. Yet the profitability of European banks remains weak, below that observed in the US or in Asia. This can be partly explained by the cyclical challenges the banks have been confronted with. The combination of low economic growth with a protracted period of low interest rates has clearly weighed on their profitability by exerting downward pressure on net interest margins. More fundamentally, however, European banks suffer from structural challenges, partly attributable to their high costs. Their average cost-to-income ratio, which increased from 55% in 2010 to 63% in 2016, is very high by historical standards.

European banks need to move towards sustainable business models. In this respect, we believe that cross-border consolidation has an important role to play. Consolidation is important for reaping economies of scale, supporting the integration of retail credit markets without creating competition issues in local loan and credit markets. This would also increase the resilience of the European economy through cross-country private risk-sharing.

The banking union has created an enabling environment for cross-border integration. The post-crisis regulatory framework has been designed to cater for large cross-border institutions, addressing concerns of renewed too-big-to-fail problems or a greater risk of cross-border contagion. Looking forward, we think that an increase in the number of pan-European banks has the potential to improve the efficiency and resilience of Europe's banking sector. Today's banking landscape still too closely resembles a collection of banking systems highly exposed to their domestic economies, with limited cross-border private risk-sharing. The future banking landscape should ideally consist of a diverse range of banking institutions, with pan-European banks playing an important role in private risk-sharing.

For this to happen, it is essential to complete the banking union. In this union, both supervisory responsibility and the fiscal backstop need to be at European level to underpin confidence in the area-wide financial system in a sustainable way. Just as necessary is the establishment of a European Deposit Insurance Scheme. The current situation, where supervision is common, but the consequences of any bank failures are still predominantly national, should not last. In this incomplete framework, national considerations inevitably continue to affect supervisory decisions. This acts as a disincentive for banks to become more European. Concrete examples include a lack of fungibility of liquidity or capital. The fact that the euro area is not considered as a single jurisdiction may result in the application of higher capital buffers to global systemically important banks in the region.

The banking union is both an objective and a process of fundamental structural change in the EU financial architecture. The next steps are clearly set out in the ECOFIN roadmap to complete the banking union. Agreement on an ambitious timetable for its implementation is now urgently needed.

[1] See, for example, OECD Economic Outlook, Volume 2016, Issue 2 and European Commission, European Economic Forecast, Winter 2017.

[2] See the ECB's euro area bank lending survey, April 2017, and the ECB's Survey on the Access to Finance of Enterprises in the euro area, October 2016 to March 2017.

[3] For more details on the impact of the TLTROs, see "The targeted longer-term refinancing operations: an overview of the take-up and their impact on bank intermediation", Economic Bulletin, Issue 3, Box 5, ECB, 2017.

[4] For further discussion, see "Recent wage trends in the euro area", Economic Bulletin, Issue 3, Box 2, ECB 2016.

[5] See, for example, "Wage dynamics amid high euro-area unemployment", Deutsche Bundesbank Monthly Report, December 2016.

[6] See Financial Integration in Europe, European Central Bank, May 2017 and European Financial Stability and Integration Review 2017, European Commission, May 2017.