Lucas Papademos: European Central Bank's Annual Report 2007

Introductory statement by Mr Lucas Papademos, Vice-President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Strasbourg, 21 April 2008.

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Madam Chair,
Honourable members of the Committee on Economic and Monetary Affairs,

It is a great pleasure and privilege to present to you today the ECB's Annual Report 2007. This presentation is a key pillar of the ECB's accountability relationship with the European Parliament. In my introductory statement, I will first review economic and monetary developments in 2007, summarise our current assessment of the macroeconomic outlook, and explain our monetary policy decisions and operations. I will then briefly address fiscal policies and structural reforms. Finally, I will focus on financial market conditions and prospects and will conclude by discussing envisaged policy measures aimed at restoring confidence and strengthening the resilience of the financial system.

Before doing so, I would like to highlight an important event: the third enlargement of the euro area with the adoption of the euro by Cyprus and Malta on 1 January 2008. Thanks to the meticulous preparations of all parties concerned, the changeover to the euro was very smooth and efficient in both countries. The single currency was received with great enthusiasm by the Cypriot and Maltese people and we warmly welcome them to the euro area.

Economic and monetary developments

2007 was a very good year for the euro area in terms of economic activity. Real GDP grew by 2.7%, mainly driven by domestic demand. Euro area exports also benefited from strong, albeit moderating, global growth. However, in the second half of 2007, the outlook for economic activity was clouded by unusually high uncertainty, stemming from the difficulty of ascertaining the potential impact on the real economy of the financial turmoil that erupted in August 2007. The balance of risks to the growth outlook tilted to the downside.

With regard to inflation, the year 2007 was characterised by a number of challenges. In the euro area, average annual HICP inflation last year was 2.1%, that is, slightly above the ECB's definition of price stability. However, in the last quarter of the year, annual inflation rates rose sharply, reaching a peak of 3.1%, driven largely by substantial increases in oil and food prices. Notwithstanding these price shocks, wage growth remained moderate and medium to longer-term inflation expectations firmly anchored at levels consistent with price stability. Nevertheless, risks to price stability over the medium term were clearly on the upside in 2007 in view of the potential adverse impact of several factors, particularly possible rises in commodity prices and the likelihood of second-round effects on the wage and price-setting.

Money and credit expansion remained very vigorous throughout 2007. In particular, bank loans to non-financial corporations continued to grow at a robust pace in the second half of the year, largely unaffected by the financial turmoil. The analysis of these developments confirmed the Governing Council's assessment that upside risks to price stability prevailed.

To contain upside risks to price stability, the Governing Council raised the key ECB interest rates by a total of 50 basis points in the first half of 2007, to 4%. Since the summer, the Governing Council has kept the key ECB interest rates unchanged, in view of the unusually high uncertainty surrounding the macroeconomic outlook as a result of the financial turmoil.

The latest information and analysis clearly confirm the Governing Council's assessment that upside risks to price stability prevail over the medium term. Most importantly, there is a risk that the current temporarily high annual inflation rates, which may persist for a rather protracted period of time, could have second-round effects on wage and price-setting, in a context of moderating but ongoing economic growth and continuing very vigorous money and credit expansion.

Although global economic growth is moderating this year, it is expected to continue to support euro area external demand, partly as a consequence of strong growth in emerging market economies. Both investment and consumption should continue to contribute to economic expansion as profitability has been sustained, credit growth remains robust and employment conditions have improved. At the same time, this outlook for growth is surrounded by unusually high uncertainty and downside risks, stemming in particular from continuing financial market tensions, which may last longer than initially expected, from further unanticipated rises in oil and food prices, which may dampen aggregate demand, and from protectionist pressures.

Against this background, the Governing Council believes that the current monetary policy stance will contribute to achieving price stability. As we have stressed, the firm anchoring of medium to longer-term inflation expectations is of the highest priority to the Governing Council. We remain strongly committed to preventing second-round effects and the materialisation of upside risks to price stability over the medium term. Especially in a period of heightened financial market volatility, such as the one we are experiencing at present, the ECB's solid commitment to do what is necessary to preserve price stability over the medium term can help to establish an environment of greater certainty for economic agents. Equally, our manifest dedication to be active in the money markets when required to ensure their orderly functioning can contribute to instilling confidence and dealing with stress in financial markets.

Monetary policy and liquidity management

The Eurosystem has clearly distinguished between its decisions determining the monetary policy stance to maintain price stability and its money market operations conducted in order to implement this stance and provide liquidity to relieve pressures in interbank money markets.

Three features of the Eurosystem's operational framework have been essential in supporting the functioning of the euro area money market. First, a large set of counterparties has access to the Eurosystem's refinancing operations. Second, a wide range of high-quality collateral is eligible for Eurosystem operations. Third, the operations are of sufficient size to effectively facilitate the redistribution of liquidity among banks.

The Eurosystem's operational framework has proved sufficiently flexible and effective in dealing with the money market tensions caused by the financial market turmoil. The ECB has adjusted the distribution of liquidity over the reserve maintenance period, without, however, modifying the total average supply of bank reserves over the whole maintenance period. The ECB has also conducted fine-tuning operations more frequently and lengthened the average maturity of its open market operations. All these measures have allowed the ECB to keep very short-term interest rates close to the policy rate and to contain potential spillover effects to other segments of the financial markets and the real economy. In this way, the ECB has contributed to safeguarding financial system stability and to mitigating macroeconomic volatility.

Fiscal policies and structural reforms

Before I turn to financial market conditions, let me briefly address fiscal policy developments and structural reforms. Last year, I noted during my presentation of the Annual Report that the best time to repair the roof is when the sun is shining. A few countries did take advantage of strong economic growth to improve their structural fiscal position. Some other countries, however, did not capitalise on the good economic times to bring their fiscal house in order. With clouds gathering on the economic horizon, these countries will have to proceed with fiscal consolidation in line with the Stability and Growth Pact under potentially less favourable economic conditions. Those Member States that have been more prudent may let automatic stabilisers operate freely. In all countries, however, containing the share of public expenditure in total national income and enhancing the quality of public finances should receive greater attention.

Over the past decade, structural reforms in product and labour markets have paid off, contributing to a strong and steady increase in employment in the euro area. Lower taxes on labour, greater labour market flexibility and increased product market competition have supported job creation and potential output growth. Further progress with structural reforms, economic integration and cross-border competition are needed to address some countries' diverging competitiveness positions and support the smooth functioning of the euro area economy.

Financial stability and supervision

Since last summer, the global financial system has been undergoing a process of risk repricing and balance-sheet deleveraging. This process, which is still ongoing, did not come as a total surprise to us. Indeed, the ECB, in particular in its Financial Stability Review, as well as other central banks and international institutions, had issued repeated warnings about the potential underpricing of risks in a number of markets, including the US sub-prime mortgage markets. For instance, in my speech before this Committee last year, I noted that the unabated growth in the volume and complexity of new financial instruments could have made these markets vulnerable to disruptive adjustments, as it was not always clear where the risk exposures ultimately lay. But although we had pointed to the risks associated with the accumulation of imbalances and had identified several vulnerabilities in the financial system, it was difficult to foresee the specific nature and all the propagation channels of the market turmoil, as well as its intensity and duration.

At the current juncture, the outlook for financial stability in the euro area continues to be characterised by considerable uncertainty. The magnitude of the total valuation and income losses facing the global financial system and their distribution across individual financial institutions is uncertain, although several estimates have been made. It is also unclear what the impact will be on the intermediation of credit to the household and corporate sectors. Moreover, further tensions in structured credit markets cannot be excluded in view of the ongoing weakness in the US housing market, and there is a risk of adverse developments in the credit cycle.

All in all, the risks to euro area financial system stability have materially increased over the past eight months. Looking ahead, the ongoing adjustment of global financial markets is likely to last for some time, its interaction with the real economy could prove more wide-ranging and the shock-absorption capacity of the euro area financial system could be further tested. However, following a number of years of high profitability, the euro area banking sector has a strengthened financial position to face credit-cycle pressures.

Authorities, at the EU and global levels, have taken measures to facilitate the adjustment of financial markets and address the revealed weaknesses in the financial system. Private sector initiatives have also been launched with the same objective. Further policy responses are being prepared to restore confidence and to strengthen the resilience of the financial system. The roadmap of objectives and actions agreed by the ECOFIN Council and the recommendations of the Financial Stability Forum, strongly endorsed by the G7 finance ministers and central bank governors, are consistent and converge to a very large extent. What is essential is the effective and timely implementation of the recommendations and envisaged actions. Let me highlight the importance of two major areas where prompt implementation is warranted in order to restore confidence and improve market functioning.

First, improving transparency and enhancing valuation practices should be a top priority, as the lack of adequate, relevant and timely information about risk exposures, valuations of complex illiquid instruments, write-downs, and the ultimate holders of risk has contributed to the loss of confidence and has impaired market functioning. Financial institutions are called upon to make full and immediate disclosure of on and off-balance-sheet risk exposures and losses, following the leading market practices as well as the guidance provided by supervisors and accounting standard-setters. In the medium term, it is of the utmost importance to converge towards best practices on risk valuation and disclosure in order to facilitate the assessment of the risk profile of financial institutions by investors, markets and public authorities.

Moreover, the turmoil highlighted the implications of the increased exposure of some banks to complex financial instruments, which, unfortunately, was not always matched by a full understanding of the inherent risks and their possible impact on banks' capital and liquidity positions. This underscores the importance of having in place robust risk management practices, including liquidity risk management, stress-testing and contingency funding plans. The role and use of credit ratings should also be reassessed. Credit rating agencies should expand the information provided on the risk characteristics of structured finance products and differentiate their ratings by introducing a separate rating scale for such products.

Thankfully, a number of necessary improvements in rules, procedures and practices are already in the pipeline. The Basel II framework is expected to improve transparency and foster more sophisticated internal control and risk management systems. Supervisors will monitor the effective implementation of the new framework to ensure that relevant information is actually disclosed and that banks retain adequate capital and liquidity buffers, commensurate to their risk profile, throughout the economic cycle. That said, the lessons drawn from the financial turmoil also point to certain aspects of the framework that need to be revisited, such as the treatment of exposures to structured finance products and to off-balance-sheet vehicles.

The financial industry retains a primary responsibility and has strong incentives to promote the smooth functioning of the financial system. It thus has to demonstrate its capacity to implement actions regarding transparency, valuation and risk management practices so as to finally turn the page on this difficult episode. Supervisors and central banks around the globe will be monitoring very closely the adequacy of the actions taken by the financial industry to restore market confidence. In this context, an appropriate balance needs to be struck between market discipline and sound regulation that does not stifle financial innovation.

Finally, the experience of the turmoil also showed that EU arrangements for financial stability should be enhanced. An important element of this process is the strengthening of the cooperation and exchange of information between central banks and prudential supervisors in both crisis prevention and crisis management. In situations of financial stress, enhanced cooperation is important to allow both central banks and supervisory authorities to perform their respective functions more effectively.

Payment and securities settlement systems

Before closing, I would like to say a few words on developments in the field of payment and settlement systems, where the year 2007 was marked by major achievements. As you are aware, the Eurosystem is engaged in four big projects to ensure well-functioning payment and securities settlement systems in the euro area: TARGET2, TARGET2-Securities, the update of the correspondent central banking model (CCBM2), and SEPA. In tandem with these efforts to promote the integration of payment and settlement systems, the ESCB and the Committee of European Securities Regulators are currently developing recommendations to ensure the soundness and safety of the European post-trading sector.

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Ladies and gentlemen, the ECB places the greatest value on the fulfilment of its accountability obligations. In last year's Resolution you made a number of suggestions to the ECB and requested us to report back on the follow-up given to them. We carefully considered these suggestions and I am pleased to inform you that in his letters of transmission of this year's Annual Report to President Pöttering and to you, Madame Berès, as Chair of this Committee, President Trichet has provided an overview of the follow-up measures taken by the ECB.

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