Vítor Constâncio: Presentation of the ECB's Annual Report 2011 to the European Parliament

Introductory statement by Mr Vítor Constâncio, Vice-President of the European Central Bank, to the European Parliament's Committee on Economic and Monetary Affairs, Brussels, 25 April 2012.

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Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a great pleasure to present to you the European Central Bank's Annual Report for 2011 which forms a core part of our accountability towards the European Parliament. I will first very briefly review the economic and monetary developments over the past year and explain our monetary policy decisions. I will then touch upon the current fiscal challenges in the euro area and progress made to reinforce the EU economic governance framework. Finally, I would like to address issues related to financial stability and regulation, with which your Committee deals extensively.

Before doing so, I should like to highlight an important event in 2011: the enlargement of the euro area to a seventeenth member, Estonia. There is no better way to demonstrate the pivotal role in the wider European integration process of the euro area, which is open to those countries and economies that are fully compliant with the entry criteria in a convincing and sustainable manner.

Economic and monetary developments in 2011

2011 continued to be an exceptional year, confronting the ECB again with rather challenging economic and financial conditions.

In the earlier part of the year, the economic recovery in the euro area continued, supported by global growth and strengthening domestic demand. Headline inflation rates rose significantly in early 2011 due to energy and commodity price increases, and the balance of risks to the inflation outlook shifted to the upside. To preserve price stability and retain inflation expectations in the euro area firmly anchored, the Governing Council raised the key ECB interest rates in April and July 2011 by 25 basis points on each occasion, after having kept them at very low levels for almost two years.

As of mid-July, tensions in financial markets again intensified, fuelled mainly by market participants' concerns about the evolution of public finances in several euro area countries. The resulting tighter financial conditions and rapidly deteriorating economic confidence, together with lower global demand, dampened euro area economic activity in the second half of 2011. High financial market uncertainty together with deleveraging pressures on banks' balance sheets also affected money growth, which diminished towards the end of the year. In view of this, the Governing Council subsequently reduced the key ECB interest rates in November and December by a total of 50 basis points. Since then, rates have remained at the historically low level of 1.0%.

As financial market tensions adversely affected the monetary policy transmission mechanism, the Governing Council also adopted a range of non-standard monetary policy measures as of August 2011. These included the reactivation of the Securities Markets Programme, the launch of a second covered bond purchase programme and measures to provide liquidity in foreign currencies. Furthermore, the Eurosystem decided to maintain the fixed rate full allotment procedure in all refinancing operations until at least the end of June 2012.

In December the Governing Council adopted additional enhanced credit support measures, including the conduct of two longer-term refinancing operations with a three-year maturity, increased collateral availability and a reduction in the reserve ratio to 1%. The main purpose of these measures was to address the short-term funding needs of the euro area banking sector so as to mitigate the effects of strains in financial markets on the supply of credit to households and businesses.

Fiscal policies, bond markets and economic governance

The crisis has shown that ensuring sound public finances is a prerequisite for macroeconomic and financial stability, as well as for the smooth functioning of monetary union. In response to the sovereign debt crisis and negative spillover effects, and in order to restore credibility, several euro area countries, including the most affected, implemented bold fiscal consolidation and structural reform measures, and strengthened their budgetary frameworks in 2011.

As a result, the aggregate general government deficit for the euro area fell significantly from 6.2% of GDP in 2010 to 4.1% of GDP in 2011. This reduction in the budget deficit was driven both by consolidation measures (notably cuts in government investment and employment, as well as increases in indirect taxes) and some favourable revenue developments stemming from more supportive cyclical conditions. The improved fiscal situation was reflected also by bond markets: on average, government bond yields declined in the euro area as a whole between the start and the end of the year.

A key feature of the euro area government bond markets in 2011 was the diverging development in yields across countries mainly as a consequence of the markets' perceptions of the individual countries' fiscal fundamentals. The actions of Central Banks to support liquidity in the global financial system contributed to ease tensions in the sovereign debt markets. In the context of the Euro Area other measures operated also to reduce those tensions. I am referring to the re-activation of the SMP programme in August 2011, the outcome of the meeting of the euro area Heads of State or Government on 9 December, which led to the adoption of the "fiscal compact", and finally to the ECB decisions to reduce key interest rates and organize two 3 year Long Term Refinancing Operations.

Finally, progress has been accomplished to reinforce the economic governance framework of EMU – both as regards crisis prevention and crisis resolution. The EU rules guiding the design and implementation of national fiscal policies have been strengthened as well as in the legal frameworks of Member States. A new macroeconomic surveillance framework has been created. The new provisions included in the elements for EU fiscal governance framework are important steps in the right direction. However, the devil lies in the details of the implementation. Most notably, the 2012 European Semester should be used to enforce rigorously the reinforced fiscal and macroeconomic surveillance mechanism.

The ECB will play a significant role in the crisis management framework. Together with the Commission and the IMF, ECB staff will undertake a rigorous debt sustainability analysis of a Member State requesting financial stability support in the context of the European Stability Mechanism (ESM). The ECB will also be involved in the programme design and monitoring. EFSF and ESM interventions in the secondary bond market will be performed on the basis of an ECB analysis recognising the existence of exceptional financial market circumstances and risks to financial stability. The ECB welcomes the Eurogroup's recent decision to increase the total size of the euro area firewall to around 800 billion. However, let me be clear on one point: no firewall will be high enough to be a substitute for the required fiscal and structural adjustments in euro area Member States.

Financial sector issues

As regards the on-going financial regulatory reform, the EU has taken important steps in 2011. I would like to highlight three areas.

Let me start off with banking regulation. With the introduction of the CRD IV/CRR the European Union will be among the first to implement the Basel III framework, a cornerstone development for strengthening financial stability.

As the CRD IV is advancing towards finalisation, I would mention that the ECB strongly supports the establishment of a single European rulebook for financial institutions – mitigating regulatory arbitrage and competitive distortions – which at the same time allows for flexibility at national level by Member States to apply more stringent prudential requirements where systemic risks arise. To this aim, it is important that Member States are able to tighten temporarily, i.e. while those specific risks remain, the quantitative ratios and limits of some prudential policy requirements while leaving the definitions intact. The ECB favours the inclusion in that list of instruments: the capital ratio, the large exposures, the liquidity ratios and the leverage ratio, as expressed in our published opinion. This availability of differential calibration of macroprudential tools is particularly important in the euro area where the single monetary policy focused on average conditions does not allow member countries to use monetary policy instruments to avoid specific excessive credit booms and/or asset price misalignments.

I would hope that EU institutions will be able to reach an agreement on these and other CRDIV matters by the summer of this year.

Let me now turn to the comprehensive reform of the EU framework for securities and derivatives regulation, which gained momentum in 2011. The ECB welcomes the recent agreement on EMIR, which will implement the G20 mandate to enhance the safety and resilience of OTC derivatives markets and will establish common EU rules for Central Counterparties and Trade Repositories. At the same time, the ECB sees a continued need for monitoring inconsistencies of EU rules with the global CPSS-IOSCO principles. We will also keep a close monitoring of potential risks to central bank independence arising from future proposals on CCP access to central bank liquidity. Finally, there will be a need to address potential divergences in the supervision and oversight of Trade Repositories, given the lack of cooperation with central banks on TRs under EMIR.

Moreover, the ECB welcomes the review of the Markets in Financial Instruments Directive and supports the objective pursued in the Commission’s proposal on credit rating agencies. Reducing reliance on credit ratings is of utmost importance. The Eurosystem itself does not mechanically rely on these assessments, as it is aware of the limitations in terms of methodologies. I would, however, add a strong word of caution against imposing legal constraints on the use of ratings by the ECB in its collateral framework. The Treaty provides the ECB with the exclusive competence to determine independently the conditions under which credit operations should be conducted.

These regulatory initiatives to strengthen the Single Financial Market and its infrastructure will be complemented by an important Eurosystem project, the Target2 Securities, the future IT platform for securities settlement in central bank money. The development of the platform is well on track and its go-live is set in 2015. After two years of negotiations, central securities depositories (CSDs) have now been asked to sign – by June 2012 at the latest – a binding legal contract to participate in T2S. This will mark a key milestone in the project. Combined with the future legislation on CSDs and CCPs as well as MiFID, T2S will provide the operational framework to stimulate competition in the post-trade environment.

Moving on to banking crisis management, we fully support the Commission’s initiative to introduce an EU bank recovery and resolution framework that should contribute to address current obstacles to the effective crisis management of EU cross-border financial institutions. Every Member State should have a broad set of tools, such as recovery and resolution plans, asset separation and bridge banks. As regards more specifically bail-in, a right balance needs to be struck between the need to comply with international standards (FSB Key Attributes for Resolution) and the need to avoid undesired negative effects on bank funding also in light of current market conditions. In this perspective any decisions about the use of "bail-in-able" securities should be delayed for some years. At the same time, any mandatory issuance of "bail-in-able" instruments should be reserved to systemically relevant institutions at the national and European levels. Smaller institutions would have difficulties in placing such securities in the market and are easier to resolve without such instruments. For systemic institutions I see "bail-in-able" debt securities as an important tool being capable of supporting the resolution process by absorbing losses with an efficient burden sharing within the private sector thereby reducing taxpayers' support.

Another important dimension of the resolution regime refers to the desirable creation of Resolution Funds that would be financed by the financial sector and would play an important role, particularly in resolution of cross-border institutions. In this perspective, we said in the ESCB opinion, published in May last year, that: "…the establishment of a network of national funds should not exclude the possibility of establishing, at a later stage, an European Fund-of-Funds to address the issues which may arise in respect of cross-border banks. … it should also not be excluded to move the establishment of an European Resolution Fund up in the agenda."

In view of the importance of the adoption of a clear resolution regime to banks and to eliminate uncertainty, it would be important that the Commission's proposals are released before the summer.

Finally, let me say a few words on the EBA Capital Exercise. We support the EBA's efforts to strengthen the resilience of the European banking sector against the broader distress in financial markets. We have taken note of the EBA's deliberations about banks' capital plans to comply with the requirements of the exercise and are satisfied with the message that bad deleveraging for the financing of the economy will be very limited. The actions of banks to comply with the requirements by the end-June 2012 deadline should be closely monitored by the relevant authorities.

Conclusion

Madam Chair, Honourable Members,

2011 has been undoubtedly once again a challenging year for the euro area, especially due to the negative interplay between the sovereign debt problems and the financial sector. I trust that the vast programme of economic governance and financial regulatory reforms that you, as EU co-legislator, have been or are currently adopting will contribute to strengthen the stability and resilience of the euro area. One crucial condition must, however, be met to reap the benefits of all these legislative reforms: their swift and faithful implementation. I am confident that the European Parliament will fully play its role for the rigorous achievement of that goal.

Thank you for your attention.