Vítor Constâncio: Presentation of the ECB Annual Report 2012 to the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mr Vítor Constâncio, Vice-President of the European Central Bank, to the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 24 April 2013.

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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 2012. The ECB has always stressed that its independence must be accompanied by the highest standards of accountability. The Annual Report is central to discharging this obligation.

In my introductory remarks, I will first give an overview of the economic and monetary developments in 2012. I will then set out our assessment of economic policies and governance. Finally, I would like to make some comments on future steps towards establishing a banking union.

Economic and monetary developments in 2012

Last year we were faced with a very challenging environment for monetary policy in the euro area. The sovereign debt crisis kept financial market stress high.

This confidence crisis has adversely affected growth and employment. Following two years of growth, GDP declined by 0.6% in 2012. Private consumption declined and investment faltered. Unemployment increased to unprecedented levels.

In this context, monetary and loan dynamics have been subdued. M3 growth strengthened moderately to 3.0% in 2012. But it essentially de-linked from credit creation, which instead became increasingly weak, with annual loan growth to the private sector turning negative over the course of the year to stand at –0.2% in December.

Annual HICP inflation reached an average of 2.5% in 2012. Inflation developments have been driven by high energy prices and increases in indirect taxes – which have been one element of well needed fiscal consolidation plans As we had forecast consistently throughout 2012, inflation rates have since declined rapidly standing at 1.7% in March this year.

The Governing Council remains strongly committed to its price stability mandate. Long-term inflation expectations have remained firmly anchored in line with price stability. Over the course of 2012 decisive measures were taken to support the transmission of the historically low key interest rates to the real economy. The three-year LTROs launched at the turn of the year have prevented that funding stress in interbank money markets led to a disorderly unwinding of bank balance sheets, which could have had serious consequences for price stability.

Towards the middle of 2012 unfounded fears of the reversibility of the euro led to a sharp increase in sovereign bond and bank lending rates in some countries. In order to safeguard the singleness of monetary policy and ensure a smoother transmission of interest rates to the real economy, the Governing Council announced in August its readiness to undertake Outright Monetary Transactions (OMTs) in secondary markets for sovereign bonds.

The announcement of OMTs has proven to be an effective backstop against unfounded fears of reversibility. However, the transmission channel cannot be fully repaired if governments do not address the root causes of the crisis; this includes ensuring sustainable public debt levels, improving competitiveness, strengthening bank resilience and further improving the institutional setting of EMU.

Economic policies and EMU governance

The financial and sovereign debt crises left significant scars on public finances in the euro area. The government debt ratio increased by around 25 percentage points between 2007 and 2012. This reflected the workings of automatic fiscal stabilisers and discretionary expansionary measures to sustain incomes in times of falling economic activity, the sizeable public support to the banking sector, and, in some cases, the continuation of unhealthy fiscal trends.

Since 2010 a number of euro area governments have embarked on a determined consolidation path. As a result, government deficit ratios declined significantly from their peak levels. In 2012, the euro area government deficit-to-GDP ratio was about 3 percentage points lower than the deficit recorded in 2009.

Fiscal adjustment has been particularly strong in countries under market pressure. In Greece, for example, the structural primary balance is estimated to have improved by more than 14 percentage points of GDP between 2009 and 2012. The improvement was 5.7 percentage points for Portugal, 4.3 for Ireland, 3.9 for Spain and 3.6 for Italy. Past and current consolidation efforts are gradually bearing fruit. Economic adjustment, both internal and external, has been significant, has implied high costs in terms of unemployment and should not put into risk of unraveling now. This will allow debt ratios to stabilise and subsequently to decline to safe levels. In order to generate growth and reduce unemployment, continued efforts to consolidate public finances should be accompanied by determined structural reforms, thereby promoting a mutually reinforcing process between restored fiscal sustainability, financial market access and future economic growth prospects.

The structural reforms should be ambitious, broad-ranging and with long-lasting effects. They should address product markets, network industries, labour markets, and the modernisation of public administration. To support employment, wage-setting should become flexible and aligned with productivity. These reforms will help to regain competitiveness, increase employment, set the foundations for sustainable growth and support the return of confidence. It is worth noting that several stressed countries already did significant reforms which are reflected in the competitiveness gains since 2008 in terms of relative unit labour costs (UCLs). In fact, since then and in relation to other Euro Area members, Ireland reduced its unit labour costs by 19.4%, Spain by 9.5%, Greece by 8.9% Portugal by 6.6%and Italy by just 0.1%. The reductions achieved against their more significant 36 trading partners were even higher and, more importantly, the gains since 2008 sizably reduced the cumulative evolution of their ULCs since 1999. The significant losses of competitiveness from the inception of the euro and the beginning of the crisis in 2008 have been meanwhile corrected. In fact, relatively to the other Euro Area members from 1999 to the end of last year Greece reduced its ULCs by 5.8% and Portugal by 2.4% whereas Spain increased theirs by only 2.9% and Ireland by 1.6%.

These improvements in competitiveness were also reflected in significant reductions of the external accounts of all the stressed countries. The latest Commission economic forecast indicates that for 2013 all stressed countries will have an external surplus with the exception of Greece with a deficit 2% of GDP well below previous results.

The adjustment efforts of the countries under market stress have been positive and certainly have also contributed to the improved financial market conditions.

Looking back at 2012, reforms at the European level implied that significant progress has been made in putting in place the necessary building blocks for a deeper and more stable EMU. Europe’s leaders recognised the need to complement EMU with a banking union, a fiscal union, a genuine economic union and eventually a deeper political union. We now have an ambitious agenda and a clear long term vision. The progress towards sound public finances has been underpinned by institutional reform. New rules were applied to strengthen oversight of budgets and to monitor emerging macroeconomic imbalances more effectively. The signature of the fiscal compact was a significant milestone in this regard.

Looking ahead we need to remain ambitious, with the ultimate aim to secure stability and prosperity for the euro area. This year should be aimed toward putting these decisions into practice by focusing on their proper implementation.

Completing banking union

I would now like to make some remarks on further steps towards establishing a banking union. The recent agreement in the trilogue on the single supervisory mechanism (SSM) represents a very important step. It is of crucial importance for the efficient functioning of the euro area and represents a major step forward in European integration. The necessary preparations for the SSM are underway at the ECB. However, key organisational decisions can only be taken once the legal text has entered into force and the Supervisory Board has been set-up. Therefore the timely adoption of the Regulation by early summer is crucial.

We look forward to constructive discussions with the European Parliament on the agreement covering the modalities of accountability and confidentiality on supervisory matters. We are confident we will be able to strike the right balance between thorough democratic accountability, confidentiality, operational effectiveness and the respect of the ECB's independence.

Another priority is the establishment of a single resolution mechanism. This is a necessary complement to the SSM and fundamental to the creation of a banking union. I see three key features of a single resolution mechanism which I want to emphasise today: a set of instruments, an authority and a fund.

First, the single resolution mechanism requires a comprehensive set of enforceable resolution tools and powers. The Bank Recovery and Resolution Directive provides a harmonised resolution framework for Europe and a clear tool-kit of powers and instruments in all Member States. It should include provisions on bail-in and introduce depositor preference. This will contribute to predictability, avoid disruption to essential banking services and shield taxpayers from excessive exposure. The urgent adoption and implementation of this Directive is therefore of paramount importance.

Second, the single resolution mechanism requires a strong authority at its centre. Mere coordination between national authorities is not sufficient for cross-border resolution in crises. This single resolution authority should have independent decision-making powers that would enable prompt and decisive action. It should ensure that we re-shift the balance between bail-outs and bail-ins, where the private sector is held responsible for its risk-taking decisions. Those that benefit from the gains should also pay for the losses. The single resolution authority should ensure a resolution strategy that takes account of all relevant factors, notably financial stability, the impact on the real economy and a least cost principle for the taxpayer.

To do this, the single resolution authority should ensure costs are first borne by shareholders and creditors. However this may not be sufficient, therefore the single resolution authority should have a privately-funded European resolution fund at its disposal. Only then, and as a last resort, should it have access to a temporary and fiscally neutral public backstop, the contributions to which should be paid by the private sector either via *ex post* levies or, more normally, as a result of the reprivatisation of the intermediary institutions (e.g. bridge banks) or other good assets resulting from the resolution process.

Progress in these elements of a future banking union is very important in the present economic environment of low growth. Part of the European problem has to do with the situation of the banking sector: pressed for capital, intending to deleverage and risk averse in managing credit risk. Consequently, credit is being contained although it is virtually impossible to disentangle the contribution of supply restrictions versus weak demand in explaining the average decline of credit to the economy.

In the markets there is the suspicion that banks' balance-sheets need more repair with full recognition of potential losses and that is also affecting the lending behaviour of banks. No one has provided clear evidence that this is true and that is why the balance-sheet assessment that the SSM has to conduct before actually starting supervision is so important to re-establish market confidence in our banks to reduce their funding costs.

Therefore, the establishment of the SSM, the possible use of direct European recapitalisation and the creation of a single resolution mechanism will decisively contribute to the desirable separation of banks and sovereigns. To regain market confidence, restoring full banking sector health must be a priority in order to create improved growth prospects. This is why the banking union project is crucial at this particular moment.

Economic growth in Europe is now essential to complete the adjustment and the rebalancing that have been going on. Therefore, it is of paramount importance that the momentum is maintained towards implementing structural reforms at national level and towards building a stronger Economic and Monetary Union through European institutional reforms. I trust that the European Parliament will continue to play an active and positive role in this process.

I thank you for your attention and stand at your disposal for questions.