Vítor Constâncio: Presentation of the European Central Bank Annual Report 2017 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, 9 April 2018.

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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 for the last time before this Committee, to present the ECB Annual Report for 2017 in my capacity as ECB Vice-President. I would like to personally thank you for the fruitful dialogue we have had over these past eight years. The world has changed greatly over this period, and so has the ECB. The crisis, and in particular the need to deal with the risks of very low inflation or even deflation, required us to broaden our monetary policy toolkit to fulfil our mandate. Without those bold policies, within our legal mandate, monetary union may have collapsed. As an active participant in the ECB Governing Council for 18 years, including eight years as Vice-President, I am proud to have contributed to such policies. However, I wish to remind you that the extraordinary set of institutional reforms added to the initial minimalist design of monetary union is not yet complete and that existential threats still remain. As legislators, you have also contributed to those reforms and I hope you will continue to do what is necessary to complete a solid and successful economic and monetary union.

Over the years, you have entrusted the ECB with additional responsibilities. Your role in holding us to account has reflected this evolution, and this dialogue will continue to be a top priority for us. It is now a well-established practice that we provide written feedback on your resolution on our previous Annual Report. We published this feedback on our website today.

In my remarks, I will discuss the impact of our decisions on the euro area economy in 2017. Subsequently, I will stress the crucial role of the financial sector for the effective transmission of our monetary policy, and the conditions under which it can support growth.

The ECB's monetary policy and its impact on the euro area economy

In 2017, the euro area growth momentum became increasingly strong and broad-based. Inflation, on the other hand, remained subdued overall. It was – and still is – expected to rise only gradually over the medium term. Against this background, and reflecting the need to exercise patience, persistence and prudence in designing our monetary policy course, we recalibrated our monetary policy measures. This recalibration preserved the ample degree of monetary accommodation required to secure a sustained return of inflation rates towards our aim.

In early 2017, the recovery of the euro area economy was steadily firming, but risks to our outlook were still tilted to the downside. By mid-year, the growth momentum had strengthened further, and output was expanding somewhat faster than previously expected. The probability of very adverse scenarios, such as those related to deflationary risks, had largely vanished. We therefore adjusted our forward guidance and removed the reference to possible further interest rate cuts.

Later in the year, the unabated growth momentum offered reassurance that inflation was gradually converging towards our aim. Nevertheless, price developments continued to be subdued and underlying inflation measures had yet to show convincing signs of a sustained upward trend. This was the context for our decisions in October. In particular, we announced that we would scale down the intensity of our net asset purchases to a monthly pace of €30 billion, starting in January this year. At the same time, we extended the intended horizon of our asset purchases until the end of September 2018, or beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation aim. Moreover, we decided to extend the fixed rate tender procedures with full allotment, at least until the end of 2019 and reiterated our forward guidance on the key ECB interest rates and on our reinvestment policy.

Throughout 2017, our monetary policy measures continued to support borrowing conditions for firms and households, thereby strengthening credit flows across the euro area. Considering all the measures taken between mid-2014 and those decided upon in October 2017, the overall impact on euro area real GDP growth and inflation is estimated, in both cases, to be around 1.9 percentage points cumulatively for the period between 2016 and 2020.

The importance of the financial sector for the transmission of the ECB's monetary policy

Let me now turn to the role of the financial sector in the transmission of our monetary policy.

The funding structure of the non-financial private sector has significantly changed in the past ten years. It clearly plays a central role in the transmission of monetary policy to the real economy and in the degree of resilience to shocks. Unlike in the United States, where market-based financing prevails, euro area non-financial corporations have traditionally relied mostly on banks to finance their activities. This has undertaken a dramatic change, as non-bank financing sources have become much more important since the onset of the financial crisis. Total assets of investment funds in percentage of total bank assets increased from 16% in 2007 to 44% last year. The percentage of bank loans in the total stock of firms' external financing in 2017 was just above 12% (or 15%, if intra-company loans and trade credit are excluded from total external financing). For the same year, if only the stock of debt instruments is considered (excluding equity sources), bank loans represented only 28% of total debt financing (or 45%, if net of intra-sectoral financing). Before the crisis, back in 2007, bank loans represented 37% of total debt financing (or 60%, if net of intra-sectoral financing).[1]

See the Annual Report, Box n. 4, page 36

The monetary policy measures taken since mid-2014 have had a decisive impact on bank-based transmission: our estimates suggest that the annual growth in loans to non-financial corporations would have been roughly half as strong today without our measures. They have notably freed up balance sheet capacity, enabling banks to step up their lending to firms with limited access to bond-based financing. Moreover, our measures have increased the share of non-bank financing sources in the funding of euro area companies, particularly through the corporate sector purchase programme. This programme has encouraged corporate issuance volumes and contributed to lowering corporate bond yields. Reduced funding costs and better access to finance, for both small and large companies, are crucial for more investment. And more diverse sources of funding for the private sector can boost economic resilience.

My second point is that the transmission of the ECB's monetary policy benefits from a safe and sound financial sector. Let me therefore turn to current financial stability risks and macroprudential policies in the euro area before elaborating on the necessary regulatory reforms.

The financial stability situation in the euro area evolved positively during 2017, supported by improving economic conditions. Nevertheless, four main risks persisted which continue to be closely monitored at present. First, the risk of a sudden and sizeable reversal in risk premia in global financial markets remained pronounced as the search for yield continued in 2017. Second, euro area banks continued to face challenging profitability prospects on account of cost inefficiencies and the legacy stock of non-performing loans. Third, the still high debt levels could give rise to concerns about public and private sector debt sustainability. Fourth, the euro area investment fund sector continued to expand and increase its risk-taking while facing liquidity mismatches.

Some of these risks depend strongly on global developments, whereas others – including real estate risks – are more specific and should be addressed through macroprudential policies. While we do not see misalignments in euro area real estate markets as a whole, price increases in some countries require the correct response by means of employing macroprudential policy measures. Given the uncertainty about the impact of individual measures, there is a need for an appropriate mix of tools, which can include both borrower-based measures, such as limits on loan-to-value or debt-to-income ratios, and tighter risk weights for bank exposures and capital requirements.

Most of these instruments are not foreseen in the CRD IV/CRR. We therefore hope that the ongoing review of the two documents will enlarge the set of macroprudential policy tools and simplify the activation procedure for the use of these tools provided for in Article 458 of the CRR. This would allow macroprudential authorities to act in an efficient, effective and timely manner.

Early detection of the build-up of systemic risks and the timely employment of measures, including macroprudential ones, is of paramount importance to maintain financial stability. A robust financial system can however, only be ensured if we have strong and appropriate financial regulation in place. Since the crisis, the international financial regulations have been comprehensively overhauled and have now finalised the Basel III framework. But the work is not yet complete.

Looking ahead, a fully-fledged banking union should be our key priority in order to enhance stability and increase the soundness of the system. And the European Parliament has a crucial role here. Significant risk reduction has been achieved: bank capital ratios stand now at comfortable levels, MREL is being implemented, bail-in as foreseen in the BRRD must take place before any possible ESM intervention, private sector debt and leverage has declined. This should, in our view, unlock the negotiations on a European deposit insurance scheme. As part of these negotiations, further qualitative risk reduction can be envisaged in three areas. First, by harmonising and improving insolvency frameworks. Second, by conducting regular reviews of progress towards reducing non-performing loans. Third, by suppressing unwarranted national options and discretions, as the ECB has been calling for since the inception of European banking supervision. I also think that the conditions for agreeing on the European Stability Mechanism as the solvency and liquidity backstop for the Single Resolution Fund are now within reach. It should be operationalised as soon as possible in order to increase the overall credibility of the resolution framework.

Turning to the non-banking sector, it is essential that its prudential framework be adapted to reflect its increasing role in financial stability and in the real economy. In this regard, I welcome the Commission’s proposal that large investment firms carrying out bank-like activities be considered credit institutions and be subject to European banking supervision.

Ensuring a growth-supporting financial sector

While the financial sector needs to be regulated to prevent it from causing instability and hampering the transmission of our monetary policy, it can also support growth.

Since the late 1990s, we have seen a marked slowdown in the growth of labour productivity and a corresponding reduction in estimates of potential growth amounting to approximately one percentage point. Some evidence attributes the slowdown to greater dispersion of productivity between frontier and laggard firms, capital misallocation and lower business dynamism.

Similarly, in addition to a healthy banking sector, well-functioning, diversified and deeply integrated EU capital markets can contribute to boost growth. This is why the ECB has been a strong supporter of the capital markets union project since its inception. By diversifying the funding sources of European non-financial corporations, thereby enhancing the smooth transmission of monetary policy, the capital markets union is an essential complement to the banking union. I thus call on all stakeholders to step up their efforts towards achieving a genuine capital markets union.

Conclusion

Let me conclude.

One of the key lessons from the crisis was that the ECB's monetary policy measures and the policies needed to address challenges in the financial sector were complementary. More efficient and stable banking and financial markets will further improve the efficiency of monetary policy transmission channels and thus support the ECB's policies in the coming years. It is therefore essential that we make further progress on the banking union and capital markets union. In order to achieve this, I trust that the strong relationship between the European Parliament and the ECB, to which I can attest after my eight years' experience, will continue to play a positive role.

Thank you for your attention.

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[1] See the Annual Report, Box n. 4, page 36