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European Central Bank

Statement by Mario Draghi, President of the ECB, at the fortieth meeting of the International Monetary and Financial Committee, Washington D.C., 19 October 2019

Euro area developments and outlook

The euro area economy has expanded at a slower pace since the beginning of last year, marking a sizeable moderation in the pace of economic expansion. According to the latest Eurostat release, quarterly GDP growth was 0.2% in the second quarter of 2019. This slowdown in growth mainly reflects the prevailing weakness of international trade in an environment of prolonged global uncertainties, which are particularly affecting the euro area manufacturing sector. These developments are also reflected in economic sentiment indicators that have continued to worsen over recent months. At the same time, the unemployment rate in the euro area has continued its downward trend, falling to its lowest level since May 2008. The number of people in employment has increased by more than 11 million since mid-2013. The services and construction sectors show ongoing resilience and the euro area expansion is also supported by favourable financing conditions, further employment gains and rising wages, the mildly expansionary euro area fiscal stance and the ongoing – albeit somewhat slower – growth in global activity.

Since the IMF Spring Meetings in April 2019, short-term economic projections have been revised downwards. The latest ECB staff macroeconomic projections for the euro area, published in September, put annual real GDP growth at 1.1% in 2019, 1.2% in 2020 and 1.4% in 2021. The risks surrounding the euro area growth outlook remain tilted to the downside and mainly pertain to the prolonged presence of uncertainties related to geopolitical factors, the rising threat of protectionism and vulnerabilities in emerging markets. We welcome a deal on an orderly exit of the United Kingdom from the European Union.

Headline inflation in the euro area has lately been hovering around 1.0% and stood at 0.8% in September, lower than in the first months of this year, when it was around 1.5%. This largely reflects the decline in the annual rate of change in energy prices. Measures of underlying inflation remain generally muted. While labour cost pressures have strengthened and broadened amid tightening labour markets, their pass-through to inflation is taking longer than previously anticipated. Looking ahead, underlying inflation is expected to increase over the medium term, supported by our monetary policy measures, the ongoing economic expansion and robust wage growth. The latest ECB staff projections foresee annual euro area headline inflation of 1.2% in 2019, 1.0% in 2020 and 1.5% in 2021.

Latest monetary policy decisions

Confronted with a more protracted weakness of the euro area economy, the persistence of prominent downside risks, and muted inflationary pressures, resulting in a continued shortfall

of medium-term inflation with respect to its aim, the ECB's Governing Council decided in September on a package of monetary policy measures to support the convergence of inflation towards its medium-term inflation aim. This package includes the following elements:

- The interest rate on the deposit facility was reduced by 10 basis points, to -0.50%. The Governing Council expects the key ECB interest rates to remain at their present or lower levels until it has seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within its projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics.
- Net asset purchases will be restarted under the asset purchase programme (APP) at a monthly pace of €20 billion as from 1 November. The Governing Council expects these purchases to run for as long as necessary to reinforce the accommodative impact of its policy rates, and to end shortly before it starts raising the key ECB interest rates.
- Reinvestment of the principal payments from maturing securities purchased under the APP will continue, in full, for an extended period of time past the date when the Governing Council starts raising the key ECB interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.
- The modalities of the new series of quarterly targeted longer-term refinancing operations (TLTRO III) were changed to preserve favourable bank lending conditions, ensure the smooth transmission of monetary policy and further support the accommodative stance of monetary policy. The interest rate for TLTRO III can now be as low as the average interest rate on the deposit facility and the maturity of the operations was extended from two to three years.
- Finally, the Governing Council decided to introduce a two-tier system for reserve remuneration in which part of banks' holdings of excess liquidity will be exempt from the negative deposit facility rate, so as to support the bank-based transmission of monetary policy.

This comprehensive package of monetary policy decisions provides substantial monetary stimulus to ensure that financial conditions remain very favourable and support the euro area expansion, the ongoing build-up of domestic price pressures and, thus, the sustained convergence of inflation to the Governing Council's medium-term inflation aim. The Governing Council continues to stand ready to adjust all of its instruments, as appropriate, to

ensure that inflation moves towards its aim in a sustained manner, in line with its commitment to symmetry.

The effectiveness of monetary policy can and should be enhanced by other policies. On the fiscal side, the mildly expansionary euro area fiscal stance is currently providing some support to economic activity. In view of the weakening economic outlook and the continued prominence of downside risks, governments with fiscal space that are facing a slowdown should act in an effective and timely manner. At the same time, governments in countries with high public debt should pursue prudent policies and deliver on their structural balance targets. This will create the conditions for automatic stabilisers to operate freely. All countries should reinforce their efforts to achieve a more growth-friendly composition of public finances. The implementation of structural policies in euro area countries needs to be substantially stepped up. The transparent and consistent implementation of the EU's fiscal and economic governance framework, over time and across countries, also remains essential.

Euro area banking sector developments

The resilience of the euro area banking sector remained solid and was supported by both microprudential and macroprudential actions, such as the increase of countercyclical capital buffers by national authorities in a number of countries. The aggregate Common Equity Tier 1 ratio of significant institutions at the end of the second quarter of 2019 stood at 14.3%, unchanged from the end of 2018. At the same time, vulnerabilities related to liquidity and funding risks, including those related to US dollar activities, have abated amid lower funding costs and broader access to bank bond markets. Non-performing loan ratios improved further to 3.6% over the first half of 2019, from 3.8% at the end of 2018. However, banks' profitability in the euro area remains low due to both structural and cyclical factors, with some weakening since the beginning of the year on account of slower economic growth.

The financial stability environment remains challenging, as the global economic outlook has deteriorated. There are mild signs of overstretched valuations in the euro area in some riskier segments of the financial markets, as well as in real estate markets, with marked differences across regions. In addition, the non-bank financial sector has continued to take on risk.

In this environment, it is particularly important to ensure that the financial sector maintains its resilience and has sufficient buffers in place that can be used in times of stress. These buffers would mitigate procyclicality and avoid excessive deleveraging if risks were to materialise.

Deepening the Economic and Monetary Union

While the euro area is now more robust than before the crisis, Economic and Monetary Union (EMU) needs to be strengthened, first and foremost by implementing what has already been agreed and finishing the common projects we have started: completing the banking union, strengthening the operational capacity of the European Stability Mechanism in full compliance with EU law, and making true the ambitious design of the capital markets union. We should also rekindle trust in our economic and fiscal framework by making it more effective in ensuring sound policymaking at the national level. At the European level, these actions are further supported by the envisaged budgetary instrument for convergence and competitiveness. However, like existing federations, the euro area will also need a central fiscal instrument to act countercyclically over time. A stable and resilient euro area economy that contributes to global economic growth and financial stability needs a more complete EMU.

The global policy agenda

The international environment continues to pose considerable risks, with the further escalation of trade tensions and rising geopolitical risks. Multilateral cooperation is needed to reduce trade frictions and mitigate risks of major disruptions to global economic activity and financial stability. Preserving openness is crucial if the global economy is to thrive and secure its growth potential.

We must remain committed to implementing the agreed post-crisis regulatory reforms and evaluating their effects to ensure they are working as intended. It will be essential that we do not backtrack on the progress made during the crisis in strengthening the regulatory and supervisory framework, and that a level playing field is preserved.

While progress has been made towards more resilient market-based finance worldwide, it is important to continue monitoring emerging risks and vulnerabilities in the financial system and to address them if necessary. In view of the potentially systemic nature of these risks, macroprudential frameworks also need to be extended beyond banking to ensure that authorities have the appropriate tools to act in a timely manner when needed.

While the first line of defence for national and international stability is to have sound domestic policies in place, the Global Financial Safety Net (GFSN) strongly supports global financial stability. The ECB sees a need for the GFSN to be further strengthened with a strong, quota-based and adequately resourced IMF at its centre, particularly in the face of escalating risks and high uncertainty. Recognising that an increase in IMF quotas is not possible at this time, the ECB would strongly welcome a substantial increase in the New Arrangements to Borrow as a second-best outcome towards ensuring that the Fund has adequate resources.

The IMF's surveillance is a very valuable external check on national as well as regional policies. As regards financial surveillance and the forthcoming Financial Sector Assessment Program Review, the ECB would welcome an agreement for holding a regular euro area review at the same frequency as for jurisdictions with systemically important financial systems in the future.

An important institutional factor for monetary and financial stability worldwide is central bank independence, combined with full accountability vis-à-vis the people and their elected representatives. Currently, central bank independence is being challenged in a number of large advanced and emerging market economies. It is therefore important to recall that a central bank's credibility and, ultimately, the successful fulfilment of its mandate hinge on its ability to choose the appropriate policies independently.

Innovations in payment systems

Finally, as regards innovations in payment systems, depending on their design, stablecoins may help overcome current shortcomings, especially in cross-border payments. At the same time, stablecoins can affect the conduct and transmission of monetary policy and may have implications for the functioning of the international monetary system. Global stablecoin arrangements now under discussion could impact the safety and efficiency of market infrastructures and payments or pose risks to financial stability. Stablecoin arrangements also raise challenges related to anti-money laundering and terrorist financing, consumer protection, data privacy and other issues. They must therefore be appropriately designed and operated in accordance with public policy objectives and they must comply with the relevant regulatory, oversight and prudential standards under the "same business, same risk, same rules" principle before they go live. Central banks should scale up ongoing efforts to foster the efficiency and inclusiveness of payment and financial services, in particular by improving cross-border payments and reviewing and updating the international call for action on financial inclusion, as well as by strengthening cooperation. Furthermore, they should continue to assess the pros and cons of issuing central bank digital currencies.