

Monetary policy challenges for Europe: banking on the recovery

Despite the challenges, the banking industry in the euro area is well-positioned to foster sustainable growth, states Yves Mersch

Introduction

The recovery underway in the euro area is spreading by sector and geography and is gathering momentum. Confirmation of a broadly balanced risk outlook is within realistic reach. The extraordinary monetary policy measures introduced since 2014 are bearing fruit. The financial sector has an important role to play in supporting this recovery and ensuring continued resilient growth in the future. My intention is to give a brief overview of the recovery, before making a few remarks about financial institutions that are relevant to the current situation.

Economic recovery

The first quarter of this year marked the 16th consecutive quarter of real growth in the euro area. In fact, GDP grew by 0.5% in the first quarter. This translates to annualised growth of 1.8%, according to Eurostat – much higher than the 0.7% annualised growth recorded in the United States in the same quarter.

Moreover, the latest survey data support expectations of robust growth throughout the first half of 2017. The PMI composite output index – which is strongly correlated with growth in the euro area – registered its highest quarterly average in nearly six years during the first three months of 2017, while the forward-looking components of the survey data point to continued growth in future quarters. Meanwhile, economic sentiment in the euro area is at a six-year high and unemployment is at an eight-year low.

Five million jobs have been created since 2013. This proves that the combination of consolidation and reform measures has worked where it was pursued credibly.

The economic recovery is also broad-based. The dispersion of growth rates across both countries and sectors is at its lowest level in two decades, reflecting a convergence of growth rates at higher levels. This is good news for economic growth going forward because recoveries tend to be stronger and more resilient when they are broad-based. These developments have, of course, been supported by our monetary policy measures, which have led to a sharp

easing of financing conditions and a convergence of funding costs across countries. The remaining spreads are clearly related to credit risks – which fall outside our mandate.

The monetary policy measures taken since mid-2014 have supported price stability in particular by buoying domestic demand, which is now the mainstay of the ongoing recovery. This marks a departure from the past when euro area growth was far more reliant on external demand. While world trade has weakened considerably and last year grew at the slowest pace since the financial crisis, growth in the euro area has accelerated.

Looking at the domestic recovery in more detail, consumption expenditure is a key source of support for growth. Rising employment and growth in real disposable income are translating into increased spending rather than in-

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creased saving, reflecting households' confidence in future economic prospects. This contributes to a positive feedback loop between consumption, employment and income, further bolstering the recovery. But wage dynamics still lag behind due to the remaining slack. Higher incomes are mostly the result of job creation rather than salary or wage increases.

Investment is also gradually picking up given the favourable financing conditions, the need to modernise capital stock after years of subdued investment and the strengthening of corporate profitability. Improvements in business confidence and in the production outlook, as reflected in recent business sentiment surveys, should result in higher investment spending. However, public investment is below trend in some surplus countries.

Also on a positive note, the risk assessment of the growth outlook is more and more balanced.

Although we still face some risks, in particular regarding the external outlook, political uncertainties and fragilities have consistently evolved in a positive fashion in Europe since the beginning of the year.

Available data also point to an improving external environment. Global economic activity indicators suggest robust growth at the start of 2017, which should further support business investment in the euro area as export demand picks up. One could say we have left behind an environment of elevated uncertainty in a Knightian sense and progressed to one of calculable risks.

But in the euro area the balance of risk for inflation is not where the balance of risk to growth lies.

In terms of the labour market, the unemployment rate continues to decline despite growth in the euro area labour force. Meanwhile, survey data suggest further improvements in labour demand during the first quarter of this year.

While the level of economic slack remains elevated, which subdues underlying inflation, growth rates are above potential so the output gap will continue to close over the policy horizon. This should support wage growth and return inflation towards a level that is close to, but below, 2% over the medium term. Indeed, there are also timid signs of early pipeline pressure stemming from industrial producer prices.

Against this background, market expectations regarding deflationary risks and further policy rate cuts by the ECB have faded and focus is beginning to shift towards a normalisation of policy in the future.

Indeed, as the Governing Council has recalled recently, if the euro area economy recovers and inflation proceeds further on its path towards the ECB's inflation aim in a sustained manner, a discussion on policy normalisation becomes warranted in the future. Any such discussion should, of course, take place in a structured, orderly and appropriately prudent manner and the Governing Council is convinced of the need to continue an accommodative monetary policy stance without deviation from the announced measures under implementation to be expected.

But we could examine the interaction of our different policy measures and their functioning in a new environment of balanced prospects as opposed to the environment of deflationary risks that prevailed when they were first introduced.

As has been stated, our forward guidance needs to be aligned with an evolving assessment to underpin both the consistency and credibility of our communication.

Prospects for the banking system

In this context, it is imperative that the banking sector is well-positioned to foster sustainable growth in the coming years as the exceptional levels of monetary policy support will be adjusted in line with the progress towards our

policy objective. A well-functioning, profitable and resilient financial sector is vital for the long-term economic prospects of the euro area. Allow me, then, to make three remarks on this topic.

My first remark relates to bank profitability. As I have just discussed, the ECB's unconventional monetary policy measures have been successful in fulfilling their intended purpose.

But that is not to say that they did not have any side effects. They have drawn criticism for their negative effects on financial sector profitability. I believe such criticism is somewhat unbalanced. In the absence of the recovery generated by these unconventional measures, unemployment would have been higher, credit growth lower and a greater proportion of loans would have been non-performing. All of these things would have weighed on banking sector profitability.

Moreover, while acknowledging that banks face a charge because of the negative rates policy, internal data show that this burden is alleviated by the benefits gained in wholesale funding markets. Between January and March 2017, on average, two thirds of overnight unsecured funding was raised at an average rate of around -46 basis points, essentially through counterparties having no access to the ECB facilities. Similar developments were observed in the secured markets for all collateral types. Overall, banks recoup on average around 25% of the excess liquidity charge in both secured and unsecured funding.

It is worthwhile remembering that we set monetary policy to honour our mandate, not to support financial sector profitability. That being said, I do recognise that the longer unconventional measures remain in place, the greater the impact they will have on financial sector profitability. It is important that they are used only for as long as is necessary to achieve an inflation rate in line with our definition of medium-term price stability.

Moreover, as the Bank for International Settlements has recently found, there seems to be an independent role for nominal interest rates in the transmission process, regardless of the level of real rates. First, monetary policy transmission could be weakened by the headwinds that arise in the aftermath of balance sheet recessions. Second, inherent non-linearities could kick in when interest rates are persistently low and might dampen the interest rates' impact on spending.

But let us also not forget that profitability is weak in many European banking systems for deeper structural reasons that predate the crisis and current monetary policy settings. Europe remains overbanked, insufficient progress has been made on the overhang of non-performing loans since the crisis and there is increasing competition from Fin-Tech companies and non-banks.

In such an environment, what then can be done to bolster bank profitability? First, there remains significant scope for domestic consolidation in some large countries and cross-border consolidation in Europe. The ratio of banking sector assets to GDP in Europe far exceeds that in the United States or here in Japan, and individual European banks are on average much more leveraged. Overbanking results in lower margins, a higher risk of the loans granted eventually turning sour, and banks operating away from the efficiency frontier with a consequently higher cost to income margins. During the crisis we witnessed the fracturing of interbank markets along national lines, and the negative spill-overs between sovereign indebtedness and banking sectors in a number of countries.

There are a number of benefits from a truly European banking system. A more consolidated sector is likely to help overall profitability and boost resilience. Individual banks would be exposed to a more diversified set of risks, and less vulnerable to downturns in individual countries, helping to break the link between banks and sovereigns. At the same time, a Europe-wide banking system is an important step towards completing Economic and Monetary Union. For a single currency area to work effectively, citizens should have faith in money in all its forms, not only in

cash but also in bank deposits held across the whole region. We also need a prudential approach that ensures both a level playing field and that no exemptions from the rules are granted to protect zombie banks.

Which leads me to my second remark. In times of low profitability and increased competition, be it from other banks or from newer start-ups, keeping your customers happy is key to keeping them as your customers. Therefore, it is important to ensure that customers' interactions with banks can be carried out in the manner that most satisfies the customers. As an example, let me discuss briefly the use of cash and the growing shift to newer payment systems.

There is now a large range of non-cash payment options available, such as credit cards, electronic payments, portable wallets and mobile phone payments to name but a few. As more people adapt to new payment options, there is a risk of disrupting banks' business models. This makes it important for banks to remain agile in the face of these changes and to endeavour to meet their customers' wishes.

We currently witness frequent lobbying, overt and covert, to abolish cash. I won't dwell today on the plausibility of the justifications proposed, except to note that such lobbying fails to respect the will of the general population: cash remains popular. Recent research for the ECB finds that 80% of transactions at point of sale are in cash. Even adjusting for the value of transactions, cash still accounts for the majority. Indeed, the demand for cash currently outstrips the growth in nominal GDP.

There are valid privacy reasons for maintaining cash, and it provides the general public with direct access to central bank money. For an independent institution like the ECB, maintaining that link is important, which is why we place great emphasis on ensuring people's continued trust in cash. For this purpose, we have overhauled the security features in the euro's new Europa series.

To date we have released new versions of the lower denominations – up to and including the 50 euro note. Next year we will introduce stronger and more secure versions of the higher denomination banknotes. Given this widespread desire to use cash, banks should facilitate rather than obstruct customers in using their preferred method of payment. Time will tell how the use of cash will evolve once instant payments are introduced in the near future.

At the same time, while cash remains popular, in some countries there is a move towards newer payment methods. There is an important role here for financial institutions to facilitate and foster these newer methods. Permitting and enabling customers to manage their finances in the manner that most appeals to them encourages loyalty.

It is still vitally important that any form of payment offers protection to its users and engenders trust. Such services should have the necessary security and data protection measures in place. Nonetheless, banks should see such developments as a positive opportunity to engage with customers, rather than react with protectionist urges. As in other economic areas, protectionism is rarely welfare enhancing in the long run.

Let me dwell briefly on regulation for my final remark. Adequate regulatory standards are vital to maintain trust between financial institutions and to ensure continued market functioning in the presence of shocks. It also follows that setting global standards is necessary to underpin the global nature of finance. In the long run, no-one – including financial institutions themselves – benefits from a regulatory race to the bottom. Lobbying for particular special interests in regulation can, in the end, be counterproductive if it succeeds in derailing moves to agree international standards.

Conclusion

The recovery in the euro area is gaining more and more traction. The confirmation of a broadly balanced risk outlook for growth is within reach.

The extraordinary monetary policy measures introduced since 2014 are bearing fruit. They have supported price stability in particular by buoying domestic demand, which is now the supporting pillar of the ongoing recovery.

The financial sector has an important role to play in supporting that recovery and ensuring continued resilient growth in the future.

A well-functioning, profitable and resilient financial sector is therefore vital for the long-term economic prospects of the euro area. There are challenges ahead, be they technological, regulatory or political, but the banking industry in the euro area is well-positioned to foster sustainable growth in the coming years. ■

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