Mario Draghi: Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mr Mario Draghi, President of the European Central Bank, at a hearing before the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 19 December 2011.

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Dear Madam Chair,

Dear Honourable Members,

È per me un estremo piacere partecipare per la prima volta come Presidente della Banca Centrale Europea a questa riunione. Il dialogo monetario trimestrale con l'ECON rappresenta un'opportunità fondamentale e la pietra angolare per un rapporto costruttivo tra le nostre due istituzioni.

Cet échange a lieu quelques semaines seulement après que d'importantes décisions ont été prises à la fois par le Conseil des Gouverneurs de la BCE et par les Chefs d'Etats et de Gouvernements. Dans ce contexte, notre discussion promet d'être particulièrement riche et fructueuse.

Zur Einführung werde ich zunächst auf die aktuellen wirtschaftlichen Entwicklungen im Eurogebiet eingehen. Anschließend werde ich mich den von Ihnen gewünschten Themen zuwenden, nämlich dem Instrumentarium zur Krisenbewältigung einerseits, sowie den Rating-Agenturen andererseits.

I. Economic and monetary developments

Since the last regular hearing in October with former President Trichet, the ECB has taken a number of steps to ensure that it will continue to deliver price stability in the medium term in an environment that remains challenging. These steps relate both to changes in our interest rates and to non-standard measures.

As you know, regarding interest rates, the Governing Council early December decided to lower the key ECB interest rates by 25 basis points, following a 25 basis point decrease on 3 November 2011.

As regards the short-term growth outlook for the euro area, the intensified financial market tensions are continuing to dampen economic activity in the euro area and the outlook remains subject to high uncertainty. Euro area economic activity should recover, albeit very gradually, in the course of 2012, as also projected by Eurosystem staff in early December. Substantial downside risks to this economic outlook nevertheless remain.

With regard to price developments, inflation was 3.0% in November. Inflation is likely to stay above 2% for several months to come, before declining to below 2%, which view is also broadly confirmed in the December staff projections. Given the environment of weaker growth in the euro area and globally, underlying cost, wage and price pressures in the euro area should also remain modest. Risks to the medium-term outlook for price developments remain broadly balanced.

The latest monetary data reflect the heightened uncertainty in financial markets. Looking beyond short-term volatility, the monetary analysis indicates that the underlying pace of monetary expansion remains moderate.

The Governing Council of the ECB is determined to ensure that inflation expectations continue to be firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

Let me now turn to the latest non-standard measures. Such measures should prevent adverse effects on the monetary policy transmission mechanism stemming from the ongoing tensions in parts of the euro area financial markets. They should in particular mitigate the effects of strains in financial markets on the supply of credit to firms and households.

First, several measures have been enacted to ensure that banks maintain access to funding markets.

- We have decided on three-year refinancing operations to support the supply of credit to the euro area economy. These measures address the risk that persistent financial markets tensions could affect the capacity of euro area banks to obtain refinancing over longer horizons.
- Earlier, in October, the Governing Council had already decided to have two more refinancing operations with a maturity of around one year.
- Also, it was announced then that in all refinancing operations until at least the first half of 2012 all liquidity demand by banks would be fully allotted at fixed rate.
- Funding via the covered bonds market was also facilitated by the ECB deciding in October to introduce a new Covered Bond Purchase Programme of €40 billion.
- Funding in US dollar is facilitated by lowering the pricing on the temporary US dollar liquidity swap arrangements.

These measures should ensure that banks continue to have access to stable funding, also at longer maturities, which gives them the opportunity to continue lending to firms and households.

Second, some banks' access to refinancing operations may be restricted by lack of eligible collateral. To overcome this, a temporary expansion of the list of collateral has been decided. Furthermore, the ECB intends to enhance the use of bank loans as collateral in Eurosystem operations. These measures should support bank lending, by increasing the amount of assets on euro area banks' balance sheets that can be used to obtain central bank refinancing.

Third, the Governing Council decided on measures aimed at fostering money market activity. Amongst others, the reserve ratio will be temporarily reduced, from 2% now to 1%. This increases the incentives for market participants to engage in money market transactions. Also, it increases the collateral available to banks, as it reduces their liquidity needs vis-à-vis the Eurosystem and thereby the amount of collateral that needs to be posted.

Overall, all measures mentioned aim to ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market, thereby avoiding severe limitations to the real economy from a lack of financing possibilities. This also helps ensure that the official interest rates set by the ECB are transmitted in an appropriate way to the economy, and in that way help maintaining price stability in the medium term.

II. Foundations for a stable economic and monetary union

Let me now turn to the outcome of the last European Council.

This Council has really brought about a breakthrough in terms of commitment to sound and transparent fiscal rules. The foundations for a fiscal compact have been laid – a suggestion presented before the plenary of the European Parliament at the ECB hearing on our annual report at the beginning of this month.

It has been agreed that the annual structural deficit should not exceed 0.5% of nominal GDP. Euro area Member States will implement such a rule in their national legal frameworks at a constitutional level. The objective is to avoid excessive deficits before they arise, rather than trying to control them after they have emerged. An automatic correction mechanism is also foreseen in case of deviation. Moreover, the leaders agreed on a numerical benchmark for annual debt reduction to bring down debt levels. Sanctions will also apply automatically to euro area Member States in breach of the 3% reference value for deficits. The European Court of Justice may be asked to verify the implementation of these rules at national level.

The new fiscal compact is an essential signal, showing a clear trajectory for the future evolution of the euro area. It frames expectations of both citizens and financial markets. Enshrining strict rules in primary legislation, making them enforceable by the European Court of Justice: all of this should contribute to making public finances in the euro area credibly robust. The ECB welcomes this outcome.

As regards the euro area crisis management instruments, we welcome the decisions of the Heads of State or Government of the euro area to strengthen the EFSF and the ESM in a number of areas.

First, there is now greater flexibility in the euro area crisis mechanisms to act as backstops, thanks to the decision to accelerate the entry into force of the European Stability Mechanism, ESM, to July 2012 and for the European Financial Stability Facility, EFSF, to remain active in financing programmes that have started until mid-2013.

Second, the clarification that as regards private sector involvement, the euro area will adhere to established IMF practice is also helpful in reassuring investors.

Third, the decision to include an emergency procedure into the voting rules of the ESM[1] is essential for effective decision making procedure, especially in crisis situations.

As regards the EFSF, the Governing Council of the ECB has decided that the ECB will be able to act as agent for the EFSF in its market operations. The ECB – probably supported by a number of National Central Banks – will make its technical infrastructure and know-how available to the EFSF. The technical and legal preparations have started and we hope to complete them in January.

III. Credit rating agencies

The activities of credit rating agencies, notably in relation to sovereigns as well as the EFSF, have lately occupied centre stage in the debate in Europe. Calls for better regulation have become louder. Against this background, the Commission’s recent legislative proposals on Credit Rating Agencies, which the ECB broadly supports, is also discussed by this Committee.

Credit ratings have a direct impact on the market functioning and the wider economy. A sound and robust framework must thus be created. This framework should be geared towards the following objectives: to reduce market volatility; to enhance the quality of rating process; and to restore market confidence.

The two issues that are of particular importance are, first, the assurance of appropriate underlying methodologies and the transparency of ratings; and second, the reduction of hardwiring of ratings in legislation and market practices. Ratings simplify complex risk assessments. But they should only be one of several inputs for investors. In particular, they should be no substitute for financial institutions and other investors to carry out their own assessment. This is the main step towards avoiding mechanistic reliance on external credit ratings.

Let me say a few words on how the ECB itself uses ratings. In practice, for the large majority of marketable securities (such as sovereign bonds) the Eurosystem Credit Assessment

[1] Subject to approval by Finnish Parliament.

Framework mainly uses the ratings issued by eligible credit rating agencies. At the same time, the Eurosystem does not mechanically rely on these assessments, as it is aware of the limitations of methodologies. It reserves the right to reject or limit the use of an asset on the basis of any information on its credit quality that it may consider relevant. The Eurosystem has applied such discretion to temporarily suspend the application of the minimum rating requirement to debt instruments issued or guaranteed by some euro area governments following EU/IMF adjustment programmes.

Thank you for your attention.