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, before the Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 9 October 2012.

* * *

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure to be back here in Parliament and in front of your Committee for our regular exchange of views.

- As you know, the European Central Bank (ECB) has recently taken important decisions to address severe distortions in government bond markets. The ECB stands ready to undertake, under appropriate conditions, what we have called outright monetary transactions (OMTs). These provide a fully effective backstop to avoid destructive scenarios that might threaten price stability in the euro area.
- Our OMT announcements have helped to support financial market confidence. The ECB's actions can help to build a bridge. But the bridge must have a clear destination.
- Reaching that destination involves three processes: first, full implementation of fiscal consolidation and structural reforms to enhance competitiveness; second, full implementation of financial sector reform; and third, completion of a genuine economic and monetary union. The establishment of a Single Supervisory Mechanism (SSM) is a key step in these processes.

Today, I will review economic and monetary developments since July. I will then explain in some detail the rationale and modalities of the OMTs. I will end by sharing my views on one of the four building blocks of a genuine economic and monetary union, namely the financial market union.

1. Economic and monetary developments

Let me start with the economy. Since our last meeting, the ECB has left its key interest rates unchanged: the main refinancing rate stands at 0.75%; and the deposit rate at 0%; the marginal lending facility at 1.50%;.

Economic activity contracted in the second quarter of 2012. Looking ahead, we expect weak economic activity in the near term and only a very gradual recovery after that. The risks to this outlook are on the downside, mainly related to the tensions in several euro area financial markets.

Average inflation in the euro area stood at 2.7% in September, reflecting indirect taxes and high energy prices. It should decline to below 2% in the course of 2013. Underlying price pressures should remain moderate given modest economic growth and well-anchored long-term inflation expectations. Risks to the outlook for price developments are broadly balanced.

Our monetary analysis paints a picture consistent with price stability. In particular, the underlying pace of monetary expansion remains subdued. Loan dynamics are also subdued as a result of weak demand for credit but also restrictions on the supply of credit in some euro area countries.

2. Outright monetary transactions (OMTs)

Let me now explain the decision announced by the ECB's Governing Council in September on outright monetary transactions.

The impact on financial and monetary conditions of past reductions in key ECB interest rates differed considerably within the euro area. For example, in some countries, following cuts in key ECB interest rates, the rates charged by the banking system for credit to the real economy have declined only a little, if at all. In other countries, ECB rate cuts have been fully passed through.

One reason for this difference is that the cost of bank credit to firms is inevitably linked to the cost of market funding for the banks themselves. If there are fears about potential destructive scenarios, the cost of funding for banks can be affected asymmetrically across the euro area. This means that two firms that are otherwise identical and have the same creditworthiness have benefited to a different extent from past cuts in key ECB interest rates, merely because they are located in different countries.

It is that distortion in financing costs that hinders the smooth functioning of credit markets and the transmission of monetary policy. It is that distortion which keeps some countries in what I have previously described as a "bad equilibrium". And it is that distortion which falls clearly within our mandate to address.

To counter the impairment of monetary policy transmission and to preserve the singleness of the ECB's monetary policy, the Governing Council decided to undertake outright monetary transactions.

OMT interventions in government bond markets provide a fully effective backstop to avoid destructive scenarios that might threaten price stability in the euro area. The aim is to ensure that the ECB's monetary policy stance is transmitted more evenly to the real economy across euro area.

The ECB will conduct OMTs if and as long as countries comply with strict and effective conditions attached to an appropriate programme via the European Financial Stability Facility and the European Stability Mechanism.

Conditionality preserves the primacy of our price stability mandate and ensures that OMTs will not compensate for a lack of fiscal consolidation. Conditionality in particular preserves the incentives for governments to continue with economic and fiscal adjustments. And only if conditionality is fulfilled will the OMTs be successful in moving an economy towards what we might call a "good equilibrium".

OMTs are ex-ante unlimited but, as I have just explained, they are not unconditional. Exit from OMTs would take place once their objectives have been achieved or when there is a failure to comply with a programme. OMTs would not take place while a given programme is under review and they would resume after the review period once programme compliance has been assured.

Consistent with the Treaty prohibition of monetary financing, the ECB will only conduct transactions on secondary markets, buying from investors and not from governments. Purchases will focus in particular on government bonds with remaining maturities of between one and three years. This is in line with the traditional focus of central bank monetary operations.

The ECB will accept the same treatment as private or other creditors with respect to bonds purchased in the context of OMTs. And the ECB will be fully transparent on its OMTs. We will report weekly on total portfolio holdings, and monthly on the average duration of our holdings and the breakdown by country.

3. Financial market union

Let me now turn to the other topic you have chosen for today's exchange of views, namely the financial market union.

The ECB welcomes the European Commission's proposal for a Single Supervisory Mechanism, which is very much in line with the statement of the euro area summit of 29 June 2012. We are looking forward to working closely with the European Parliament in this field. I am confident that the excellent cooperation we have established so far will continue with matters of financial supervision.

Let me here focus on three issues that are key to setting the stage for the new supervisory framework in the euro area: first, the principle of separation between monetary policy and financial supervision; second, the possible participation of non-euro area Member States in the SSM; and third, the accountability framework.

On the first issue of the separation of monetary and supervisory functions, we are not entering uncharted territory. Many central banks around the world – including a large majority of the national central banks in the Eurosystem – combine monetary and supervisory functions.

Proper arrangements to prevent monetary policy being inappropriately affected by the supervisory role have been devised in several countries. I am confident that we can establish suitable arrangements in the euro area, drawing in part on their experiences.

The Commission's proposal provides a solid basis for achieving that goal. By having the Supervisory Board carry out all regular supervisory activities performed directly by the ECB, we will go a long way towards avoiding possible conflicts of interest between the two functions. In addition, we are examining internal procedures that would separate the relevant work-streams supporting the two functions.

The second key issue for the supervisory framework is the possibility of non-euro area Member States participating in the SSM. Let us first take a step back and remind ourselves that the key reason why we are building the financial market union is because of what is happening in the euro area. We are building it to break the vicious circle between sovereigns and banks, the manifestations of which are much more acute and disruptive in a monetary union. That is why we need the SSM in the single currency area.

At the same time, it is clear that we have to create the financial market union while sustaining – and even strengthening – the single market. Both the single currency and the single market are key pillars of growth and prosperity in Europe. Both should be maintained – indeed, both should be enhanced.

The ECB welcomes the possibility of involvement of non-euro area Member States in the SSM. The participation of additional Member States would provide an even stronger boost to the completion of the single market.

That being said, for an entity such as the ECB, whose key legal powers and key decision-making fora are limited to the euro area, imposing obligations on – and granting corresponding rights to – non-euro area Member States raises a number of legal issues. Our legal services – together with those of the Commission and the European Council – are examining closely the possible modalities of participation of non-euro area Member States within the legal constraints of our Statute.

The third key issue for the supervisory framework is one that I suspect is particularly close to your hearts: how the ECB will be accountable for its supervisory actions to the citizens of Europe and their elected representatives. While the independence of the supervisory function is important, so is its accountability. They are, after all, two sides of the same coin.

Given the nature of the tasks of supervision and the need for operational cooperation with other authorities – notably where fiscal costs are concerned – separate and robust mechanisms of accountability have to be in place to legitimise the high degree of independence. The Commission proposal foresees, in particular, that the SSM will be accountable to the European Parliament and the European Council.

Questions have been raised about the timeline for when we should begin our supervisory tasks. Irrespective of the precise schedule for the performance of supervisory tasks, I believe that it is very important that the Council Regulation enters into force as envisaged on 1 January 2013. This would allow us to start the preparatory work as swiftly as possible.

I have discussed the main aspects of the SSM. But the financial market union would be incomplete without commensurate progress towards a common resolution regime. The lack of such a regime has increased the cost of bank failures for taxpayers. It has also complicated the handling of bank failures, especially in cross-border cases. A common resolution regime – with an independent European resolution authority at its centre – is crucial for managing crises in a way that is as orderly, effective and efficient as possible.

4. Concluding remarks

Let me conclude my remarks. The euro area is making good progress towards achieving stable and sound foundations. I trust that in October and subsequently in December, the Heads of State or Government will reaffirm their commitment to the irreversibility of the euro by agreeing on a long-term vision for our economic and monetary union.

That process has not yet had a fully visible impact on the everyday life of citizens in the countries suffering most from the crisis. I am well aware of the hardship that the current situation entails for many people, especially those whose job is lost or at risk.

The adjustment process towards sustainable public finances and a competitive economy can be painful in the short term, both politically and economically. Yet, the reforms are necessary corrections which will bring countries back on the path of sustainable growth. And they also contribute to improve social justice, by fostering tax compliance and limiting rent-seeking by vested interests.

I am confident that the euro area and its currently weaker members will emerge from the crisis with stronger and better functioning economies – and that this will be to the benefit of all Europe's citizens.

Thank you very much.