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, 17 December 2012.

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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 last exchange of views in 2012.

This year has not been an easy one. It has been a year when the ties that bind the Member States of the euro area have been tested. But it has also been a year in which a longer-term vision for Economic and Monetary Union (EMU) has been formulated. And it is a year in which that vision has begun to be translated into actions, including on vital reforms of European governance.

We end the year on a positive note with the re-launching of that longer-term vision, with the proactive steps taken by governments and European institutions towards a genuine EMU and, most recently, with the unanimous agreement by the ECOFIN to establish a Single Supervisory Mechanism (SSM).

Let me congratulate your Committee for the swift adoption of its position on the SSM and its ambitious European approach. This a clear demonstration that European institutions are determined to act in a timely and decisive way to complete EMU. And it is a clear demonstration that euro area Member States are ready to agree to a substantial sharing of sovereignty when circumstances require.

Recent agreements mark a major qualitative step towards a stable EMU. The establishment of the SSM can be expected to be a key turning point in the resolution of our current challenges.

The SSM will contribute to restoring confidence in the banking sector across the euro area. It will help to revive inter-bank lending and cross-border credit flows, with tangible effects for the real economy. And combined with possible direct recapitalisation of banks by the European Stability Mechanism and an envisaged single resolution mechanism, the SSM will go a long way towards breaking the vicious feedback loops between sovereigns and banks.

I hope that the legislative process can now be concluded swiftly. After the adoption of the relevant legal acts, the European Central Bank (ECB) will launch the preparations so that the SSM can be established within the timeline foreseen by the legislators.

In my introductory remarks today, I will first briefly summarise the economic and monetary situation. I will then address the relationship between monetary policy and financial supervision. And I will close by outlining my views on the priorities for 2013 in implementing the shared longer-term vision for EMU.

1. Economic and monetary developments

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

On non-standard monetary policy measures, the Governing Council decided in December to continue conducting all refinancing operations as fixed rate tender procedures with full allotment, at least until July 2013.

The medium-term outlook for economic activity remains challenging. Economic activity contracted for a second consecutive quarter in the third quarter of 2012, and indicators for the fourth quarter signal further weakness, although some recent survey indicators have stabilised at low levels and financial market sentiment has improved further. Domestic demand is dampened by still weak consumer and investor sentiment and the ongoing balance sheet adjustments in the banking and business sectors, which continue to weigh on investment decisions.

We expect economic weakness to extend into next year with a very gradual recovery in the second half of the year. The recovery is expected to be supported by strengthening global demand, a highly accommodative monetary policy stance and significantly improved confidence in financial markets, all of which should work their way through to spending and investment decisions.

Annual inflation in the euro area has continued to moderate, falling from 2.5% in October to 2.2% in November. Looking ahead, inflation is expected to decline further. This should support real disposable incomes.

Risks to the outlook for price developments are broadly balanced. Inflation expectations for the euro area remain firmly in line with the Governing Council's aim of maintaining annual inflation rates below, but close to, 2%.

Our monetary analysis paints a picture consistent with price stability. Looking at developments over several months, the underlying pace of monetary expansion, when accounting for special factors, remains subdued. Loan dynamics are also subdued and in many parts of the euro area, credit has been contracting. This is the result of balance sheet adjustments by banks and businesses as well as the current economic weakness.

2. Monetary policy and financial supervision

Let me now turn to the first topic chosen for our exchange of views, namely the relationship between monetary policy and financial supervision.

The discussions leading to the recent decision to establish the SSM have raised questions about how monetary policy responsibilities and supervisory responsibilities should be appropriately separated.

In recent years, many central banks have, for good reasons, assumed supervisory roles. Fourteen of the 17 national central banks in the euro area have a role in supervision and so too do several major central banks elsewhere in the world.

Indeed, the global financial crisis has generally led to closer ties between central banks and financial supervision. The Bank of England, for example, will soon assume supervisory responsibilities previously assigned to the Financial Services Authority. In the US, the role of the Fed in financial supervision has been strengthened.

This all suggests that the relationship between monetary policy and financial supervision is particularly important in times of crisis. It is not by chance that historically the first central banks were supervisors of commercial banks.

The ECB will establish clear guiding principles and internal operating practices to ensure effective separation of monetary policy and financial supervision. Let me briefly elaborate.

First, the ECB's involvement in financial supervision has no bearing whatsoever on our primary objective of price stability. It bears neither on the objective itself, which is statutory, nor on its quantified expression of inflation rates below, but close to, 2%.

Second, a supervisory board will form the centre of gravity for the conduct of financial supervision. It may encompass a geographical entity that is somewhat wider than the euro area if, as we hope, several countries that are not currently euro area Member States decide to join the SSM.

Third, separation between monetary policy and financial supervision will in particular take the form of independent analysis and prescription for the use of policy tools for each of the two functions. This will rely on strong governance.

We will establish appropriate internal procedures that ensure clear functional separation. Here we will follow international best practice.

While separation of the two functions is essential, it is an established fact that stronger supervision facilitates the conduct of monetary policy. Let me give you just two examples.

First, in the absence of financial stability, standard monetary policy tools – namely, changes in the short-term interest rate – lose some of their potency. Effective supervision that contributes to a stable financial system can only benefit the smooth transmission of monetary policy.

Second, effective financial supervision can counteract excessive leverage and exuberant credit expansions, which can generate inflationary pressure over the longer term. Thus, in mitigating the build-up of macroeconomic imbalances, effective supervision can foster a stable macroeconomic environment with stable prices.

Monetary policy will stay credibly oriented towards price stability. In so doing, it secures the trust of markets and the public in the stable purchasing power of a currency. This stabilises market expectations, lowers volatility and creates an environment for stable financial markets.

We have begun internal reflections on all these issues, together with the national central banks, and we stand ready to launch the formal preparations as soon as the legal framework has been adopted.

3. A genuine economic and monetary union

Let me now turn to the second topic chosen for our exchange of views, namely a genuine economic and monetary union.

In the spring of this year, after three years of severe economic and financial challenges, it became clear that what the euro area needs is a coherent longer-term vision for EMU. At our April hearing, we discussed such a vision, following earlier discussions in this Committee about the Fiscal Compact and Growth Compact. The vision was then laid out in greater detail for the Heads of State or Government.

Since that time, remarkable progress has been made. The June European Council was an important milestone. Institutional changes that were not conceivable less than a year ago have been put on the EU political agenda or are about to be finalised. The SSM is a prime example of such political momentum.

Last week, the European Council set out further steps towards the completion of EMU. The in-depth discussions of structural reforms and the challenges of competitiveness have been particularly important – and they are reflected in the Council's conclusions.

From an ECB perspective, I see two main priorities for 2013. First, we should improve the functioning of economic union. Excessive imbalances within the euro area have destabilised EMU. This must not be allowed to happen again.

It is encouraging that adjustment is now visibly underway. For example, exports of goods and services have increased by 27% in volume in Spain since 2009 – and by 14% for Ireland, 22% for Portugal and 21% for Italy. These four countries are also experiencing gains in relative unit labour costs.

Economic reforms bear fruit, even if, in the short term, the costs to individual citizens can be considerable. But the reforms are the right path. Governments should persevere.

What can be done at the European level to provide even more support for this process? The proposed "reform contracts" between euro area Member States and EU institutions are a promising avenue. Combined with a carefully designed framework of targeted and temporary financial support, they should contribute to fostering structural reforms and thereby strengthening competitiveness.

Ideally, the reform contracts should focus on countries with the largest competitiveness challenges. They should identify the structural bottlenecks to improving competitiveness and target the reforms in a way that will remove those bottlenecks. This would establish a clear link between reforms and restoring competitiveness, which is essential for growth and job creation.

Smooth functioning of product and labour markets is a prerequisite for growth and job creation in EMU. I therefore welcome the announcement that next year the European Commission will undertake a systematic review of product and labour markets. For euro area countries the review should allow to assess whether these markets are fully compatible with participation in EMU. Here, product and labour markets must provide for enhanced adjustment capacity to adapt to a changing global economic environment and ensure sustained high levels of employment.

The second priority for 2013 from the ECB's perspective is the completion of financial union with the establishment of a single resolution mechanism. The aim of resolution is to deal with non-viable banks through measures that include their orderly winding down and closure while preserving financial stability. Such a mechanism will make it possible for banks to fail in an orderly manner.

Improving economic union by restoring competitiveness and the functioning of product and labour markets on the one hand, and setting up a single resolution framework on the other hand are key priorities for 2013.

This Committee has always pushed for ambitious European solutions in the field of financial and economic governance. I am confident that you will again play an instrumental role in moving the agenda forward and adopting the relevant legislative proposals. Thank you for your attention. I am now at your disposal for questions.