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, 25 April 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 regular exchange of views.

Accolgo con soddisfazione l'esito delle riunioni di primavera di aumentare le risorse del Fondo monetario internazionale (FMI) di 430 miliardi di dollari. L'area dell'euro ha fatto la sua parte accrescendo le proprie protezioni e impegnandosi a fornire al FMI un importo aggiuntivo di 150 miliardi di euro. Sono lieto che ora altri azionisti del Fondo si siano offerti di prestare il proprio contributo per incrementarne le risorse.

Il est maintenant d'une importance cruciale que le Mécanisme de Stabilité européen soit entièrement opérationnel. La BCE peut fournir son soutien à cet égard. Naturellement, même avec un pare-feu important en place, les pays de la zone euro doivent continuer à mettre en œuvre les ajustements budgétaires et structurels qui s'imposent.

Wie üblich, werde ich zuerst auf die aktuelle wirtschaftliche Lage im Eurogebiet eingehen. Danach werde ich mich den Themen zuwenden, die Sie vorgeschlagen haben: Bewertung der Sondermaßnahmen der EZB und Bewertung der wirtschaftlichen Ungleichgewichte in der Währungsunion.

Economic and monetary developments

Let me first focus on economic and monetary developments in the euro area since our previous meeting on 19 December last year.

Available indicators for the first quarter of 2012 broadly confirm a stabilisation in economic activity at a low level. Latest developments in survey data are mixed, highlighting prevailing uncertainty. Looking ahead, growth should be supported by foreign demand, the very low short-term interest rates as well as our non-standard measures. At the same time, downside risks relate in particular to a renewed intensification of tensions in euro area sovereign debt markets and their potential spillover to the real economy. Further increases in commodity prices may also hamper economic activity.

Euro area annual ***inflation*** was 2.7% in March, unchanged from the previous three months. Inflation is likely to stay above 2% in the course of this year, because of recent increases in energy prices and indirect taxes. The Governing Council continues to expect annual inflation rates to fall below 2% in early 2013.

Looking forward, in an environment of modest growth in the euro area and well-anchored inflation expectations, underlying price pressures should remain modest. Risks to the outlook for price developments are broadly balanced. Upside risks could stem from higher than expected oil prices and further indirect tax increases; downside risks could arise from weaker than expected economic activity.

Let me stress that the Governing Council will pay particular attention to any signs of pass-through from higher energy prices to wages, profits and general price-setting. It is essential that medium-term inflation expectations for the euro area economy continue to be firmly anchored in line with the Governing Council's aim of maintaining inflation rates below, but close to, 2% over the medium term.

The ***monetary analysis***, in particular the subdued pace of underlying money growth, confirms the prospect of price developments remaining in line with price stability over the policy-relevant horizon. Money and credit data up to February point to a stabilisation of financial conditions. At the same time, the demand for credit remains weak in the light of still subdued economic activity and the continuing process of balance sheet adjustment in non-financial sectors.

I consider it of crucial importance that banks strengthen their resilience further, including by retaining earnings and by retaining bonus payments. The soundness of banks' balance sheets will be a key factor in facilitating both an appropriate provision of credit to the economy and the normalisation of their funding channels.

The effectiveness of the ECB's recent non-standard measures

I would now like to turn to the effectiveness of the latest Eurosystem ***non-standard monetary policy measures***, in particular the long-term refinancing operations (LTROs).

Let me first of all be clear about why we implemented the three-year LTROs.

As you will remember, the second half of 2011 was marked by an intensification of stress in sovereign debt markets and an environment of high uncertainty. This increasingly hampered the access of euro area banks to market-based funding. If no action had been taken, this could have resulted in severe strains on bank lending to firms and households and a generalised selling of assets.

The LTROs contributed to alleviate these very difficult funding conditions. Banks could satisfy their additional liquidity needs, which is reflected by a net liquidity injection of around €520 billion, taking into account the shifting of liquidity out of other operations. Moreover, banks have benefited from more certainty about their medium-term funding due to the longer maturity of the new operations.

I understand that you are particularly interested in the transmission of the LTROs to the real economy. This is indeed a crucial point: ensuring that the ECB's monetary policy continues to be transmitted effectively to the real economy was a key motivation of the Governing Council decision. It is encouraging to observe that a very large number of small banks have participated in the two LTROs. Small banks are best placed to refinance the real economy, in particular small- and medium-sized firms which are the biggest generator of employment in the economy.

We are confident that central bank liquidity has come very close to the real economy. Of course, this does not mean that this will *by itself* boost lending to firms and households. First, the central bank cannot interfere with the banks' use of the liquidity since that is their business decision. But we trust that they will use it to refinance the real economy because that is the role of a banking system. Second, the future evolution of credit growth will depend essentially on demand. In the current environment, this is likely to remain subdued. Thus, money and credit growth may stay weak for some time before the overall economic situation improves. The Bank Lending Survey, with some new information about financing conditions will be published at 10 am this morning.

Some of you may worry about the possible inflationary risks arising from these non-standard measures. Let me emphasize that our non-standard measures are not a constraint on setting interest rates in line with what is required to ensure price stability in the medium term. In particular, the interest rate on the 3-year LTROs is not fixed, but linked to the prevailing main policy interest rate. Furthermore, for measuring monetary liquidity, it is not the balance sheet of the Eurosystem that is relevant, but the balance sheet of the banking sector itself. Only the latter shows the interaction with the real economy. And this is captured by monetary data and credit data which, as I have mentioned, are still very subdued. You can rest assured that the Governing Council will use all the instruments at its disposal to counter possible upside risks to price stability should they materialise.

We also hear concerns that the Eurosystem is exposing itself to excessive risks. I would like to underscore that the expansion of our balance sheet is being managed with extreme prudence. We continually review collateral eligibility and our risk control framework. Furthermore, the application of conservative risk control measures, such as haircuts, in all monetary policy operations protects the soundness of the Eurosystem's financial position.

Let me conclude this point by recalling that all non-standard measures are temporary in nature. Moreover, liquidity support cannot substitute for capital or for sound fiscal and structural policies that bring about sustainable growth and stability in the European economy.

Dealing with macroeconomic imbalances in a currency union

Now, I would like to discuss the second topic selected for our exchange of views, namely ***macroeconomic imbalances*** in the euro area.

Of course, divergences of economic developments are a normal feature within a monetary union. Such divergences can also be observed on the other side of the Atlantic. But they should not become of a persistent and structural nature.

Unfortunately, very large imbalances were allowed to accumulate over recent years in several European countries. These imbalances stemmed from different sources: insufficient fiscal discipline, financial excesses, failure to implement structural reforms especially, but not exclusively, in the labour and product markets and significant competitiveness losses. All of this necessitates urgent and resolute adjustment.

Clearly, it cannot be the responsibility of the ECB to address these imbalances. From the perspective of monetary policy, our primary objective is to maintain price stability in the euro area as a whole. For that purpose, the ECB continuously monitors all relevant information from the countries and various business sectors of the euro area. But the monetary policy stance of the ECB has to be focused on the entire euro area. It cannot address divergences among individual euro area countries.

That is the task of governments: they must undertake determined policy actions to address major weaknesses in the fiscal, financial and structural domains. We note that progress is being made in many countries. These measures need to be complemented by growth-enhancing structural reforms to facilitate entrepreneurial activities, the start-up of new firms and job creation. Here, governments should be more ambitious.

At the European level, there has been substantial progress towards reinforcing the economic governance framework. We have seen a strengthening of the fiscal rules of the Stability and Growth Pact and the introduction of the Fiscal Compact, about which we spoke in the Parliament last December. And we are implementing the new focus on correcting macroeconomic imbalances.

The recent crisis has shown that a well-functioning EMU needs not only a strong institutional set-up for monetary policy at the centre, but also one for economic policies.

Ensuring competitiveness of all euro area countries should be seen as a common responsibility. I am sure many of you here in the European Parliament will agree that we need a change in the mindset of how national policy-making is conducted and perceived.

The economic policies of euro area countries are, ultimately, domestic policies for the euro area. Precisely because of spill-over effects, they must be subject to mutual surveillance, and corrected if required in the collective interest of the euro area as a whole. This should apply both to fiscal and macroeconomic policies.

But surveillance alone is not sufficient. Citizens also expect from Europe common answers to the common challenges which all euro area countries are facing. In a context of global competition and ongoing fiscal consolidation, euro area countries should join their forces. Given that they share a single currency, they have even stronger reasons than other countries to work together. This can be in the field of research and development, education or infrastructure, they should strive for cooperation as much as possible.

Let me add that, just like competitiveness, I see financial stability clearly as a common responsibly in a monetary union. During the crisis, we have observed strong negative spill-over effects across euro area countries and between the banking sector and its respective sovereign. National supervisors and Treasuries are also confronted with the well-known problem that during good times, large banks work as European institutions but in bad times fall on national shoulders. Ensuring a well-functioning EMU implies strengthening banking supervision and resolution at European level.

European integration has brought peace and prosperity. While I hesitate to sketch out the long-term end point of the integration process, I am convinced that we need to actively step up our reflections about the longer term vision for Europe as we have done in the past at other defining moments in the history of our union.

Thank you for your attention.