Mario Draghi: Opening statement at Deutscher Bundestag

Speech by Mr Mario Draghi, President of the European Central Bank, at the discussion on ECB policies with Members of Parliament, Berlin, 24 October 2012.

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Dear President Lammert,

Honourable Committee Chairs,

Honourable Members of the Bundestag,

I am deeply honoured to be here today.

As President of the European Central Bank (ECB), it is a privilege for me to come to the heart of German democracy to present our policy responses to the challenges facing the euro area economy.

I know that central bank actions are often a topic of debate among politicians, the media and the general public in Germany. So I would like to thank President Lammert and all Committee Chairs most warmly for this kind invitation – and the opportunity it gives me to participate in that discussion.

It is rare for the ECB President to speak in a national parliament. The ECB is accountable to the European Parliament, where we have scheduled hearings every three months and occasional hearings on topical matters. We take these duties of accountability to the citizens of Europe and their elected representatives very seriously.

But I am here today not only to explain the ECB's policies. I am also here to listen. I am here to listen to your views on the ECB, on the euro area economy and on the longer-term vision for Europe.

To lay the ground for our discussion, I would like to explain our view of the current situation and the rationale for our recent monetary policy decisions. I will focus in particular on the Outright Monetary Transactions (OMTs) that we formally announced in September.

Financial markets and the disruptions of monetary policy transmission

Let me begin with the challenges facing the euro area. We expect the economy to remain weak in the near term, also reflecting the adjustment that many countries are undergoing in order to lay the foundations for sustainable future prosperity. For next year, we expect a very gradual recovery. Euro area unemployment remains deplorably high.

In this environment, the ECB has responded by lowering its key interest rates. In normal times, such reductions would be passed on relatively evenly to firms and households across the euro area. But this is not what we have seen.

In some countries, the reductions were fully passed on. In others, the rates charged on bank loans to the real economy declined only a little, if at all. And in a few countries, some lending rates have actually risen.

Why did this divergence happen? Let me explain this in detail because it is so important for understanding our policies. A fundamental concept in central banking is what is known as "monetary policy transmission". This is the way that changes in a central bank's main interest rate are passed via the financial system to the real economy.

In a well-functioning financial system, there is a stable relationship between changes to central bank rates and the cost of bank loans to firms and households. This allows central banks to influence overall economic conditions and maintain price stability.

But the euro area financial system has become increasingly disturbed. There has been a severe fragmentation in the single financial market. Bank funding costs have diverged significantly across countries. The euro area interbank market has been effectively closed to a large number of banks and some countries' entire banking systems. Interest rates on government bonds in some countries have risen steeply, hurting the funding costs of domestic banks and limiting their access to funding markets.

This has been a key factor why banks have passed on interest rates very differently to firms and households across the euro area. Interest rates do not have to be identical across the euro area, but it is unacceptable if major differences arise from broken capital markets or the perception of a euro area break-up. The fragmentation of the single financial market has led to a fragmentation of the single monetary policy. And in an economy like the euro area where about three quarters of firms' financing comes from banks, this has very severe consequences for the real economy, investment and employment.

It meant that countries in economic difficulties could not benefit from our low interest rates and return to health. Instead, they were experiencing a vicious circle.

Economic growth was falling. Public finances were deteriorating. Banks and governments were being forced to pay even higher interest rates. And credit and economic growth were falling further, leading to rising unemployment and reduced consumption and investment. A number of economies could have seen risks of deflation.

All of this meant that the outlook for the euro area economy as a whole was increasingly fragile. There were potentially negative consequences for Europe's single market, as access to finance was increasingly influenced by location rather than creditworthiness and the quality of the project.

The disruption of the monetary policy transmission is something deeply profound. It threatens the single monetary policy and the ECB's ability to ensure price stability. This was why the ECB decided that action was essential.

Restoring the proper transmission of monetary policy

So let me now turn directly to our recent policy announcements. To decide what type of action was appropriate, we had to make two key assessments. First, we had to diagnose precisely why the transmission was disrupted. And second, we had to identify the most effective policy tool to repair those disruptions, while remaining within our mandate to preserve price stability.

In our analysis, a main cause of disruptions in the transmission was unfounded fears about the future of the euro area. Some investors had become excessively influenced by imagined scenarios of disaster. They were therefore charging interest rates to countries they perceived to be most vulnerable that went beyond levels warranted by economic fundamentals and justifiable risk premia.

Clearly, it was not by chance that some countries found themselves in a more difficult situation than others. It was mainly those countries that had implemented inappropriate economic policies in the past. This is also why the first responsibility in this situation is for countries to make determined reforms and convince markets that they are credible.

But many were already doing this, only for interest rates to rise even higher. There was an element of fear in markets' assessments that governments, acting alone, could not remove. Markets were not prepared to wait for the positive effects of reforms to emerge.

In our view, to restore the proper transmission of monetary policy, those unfounded fears about the future of the euro area had to be removed. And the only way to do so was to establish a fully credible backstop against disaster scenarios.

We designed the OMTs exactly to fulfil this role and restore monetary policy transmission in two key ways.

First, it provides for *ex ante* unlimited interventions in government bond markets, focusing on bonds with a remaining maturity of up to three years. A lot of comments have been made about this commitment. But we have to understand how markets work. Interventions are designed to send a clear signal to investors that their fears about the euro area are baseless.

Second, as a pre-requisite for OMTs, countries must have negotiated with the other euro area governments a European Stability Mechanism (ESM) programme with strict and effective conditionality. This ensures that governments continue to correct economic weaknesses while the ECB is active. The involvement of the IMF, with its unparalleled track record in monitoring adjustment programmes would be an additional safeguard.

The consequences of the ECB's actions

So what are the likely consequences of the ECB's actions? Before announcing the OMT programme, we considered very carefully the possible risks – and we designed our operations to minimise them. But I am aware that some observers in this country remain concerned about the potential impact of this policy. I would therefore like to use this opportunity to go through those concerns – one by one – and explain our views.

First, OMTs will not lead to disguised financing of governments. We have specifically designed our interventions to avoid this. They will take place solely on secondary markets, where bonds that have already been issued are traded. If interventions take place, they will involve buying government debt from investors, not from governments. All this is fully consistent with the Treaty's prohibition on monetary financing. Moreover, they will focus on shorter maturities and leave room for market discipline.

Second, OMTs will not compromise the independence of the ECB. The ECB will continue to take all decisions related to OMTs in full independence. It will decide whether to intervene based on its own assessment of monetary policy transmission and with the aim of safeguarding price stability. The fact that governments have to comply with conditionality will actually protect our independence. The ECB will not be forced to step in for a lack of policy implementation.

Third, OMTs will not create excessive risks for euro area taxpayers. Such risks would only materialise if a country were to run unsound policies. This is explicitly prevented by the ESM programme. And we have been very clear that each time a programme starts being reviewed, we will routinely suspend operations and resume them only if the review has been concluded positively. This will ensure that the ECB intervenes only in countries where the economy and public finances are on a sustainable path.

Fourth, OMTs will not lead to inflation. We have designed our operations so that their effect on monetary conditions will be neutral. For every euro we inject, we will withdraw a euro. In our assessment, the greater risk to price stability is currently falling prices in some euro area countries. In this sense, OMTs are not in contradiction to our mandate: in fact, they are essential for ensuring we can continue to achieve it.

Moreover, we see no signs that our announcement has affected inflation expectations. They continue to be firmly anchored. This is testament to our track record on price stability over the last decade and our credible commitment to maintaining price stability. The citizens of the euro area can be confident that we will remain permanently alert to risks to price stability. We have all the necessary tools at our disposal to maintain it and to withdraw any excess liquidity in case of upward risks to price stability.

Conclusion

Let me conclude these opening remarks.

Three elements are essential for understanding the policies of the ECB: immutable focus on price stability; acting within our mandate; and being fully independent.

The ECB's new measures help to ensure price stability across the euro area. They also contribute to improving the economic environment. But completing that task of economic renewal demands continuing action by the governments of the euro area.

It is governments that must set right their public finances. It is governments that must reform their economies. And it is governments that must work together effectively to establish an institutional architecture for the euro area that best serves its citizens.

We are already moving in the right direction. Across the euro area, deficits are being cut. Competitiveness is being improved. Imbalances are closing. And governments are working seriously to complete economic and monetary union.

It is important that Europe's leaders stay on course. In doing so, they will be able to unlock fully the enormous potential of the euro to improve living standards and carry forward the project of European integration.

Thank you for your attention – and I look forward to our discussion.