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, for the Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 17 November 2014.

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Mr Chairman,

Honourable Members of the Economic and Monetary Affairs Committee,

Ladies and Gentlemen,

It is a pleasure for me to be back again in this committee for the last hearing of 2014. This year has once again been a year of profound change for the euro area and for the Union as a whole. It was a year of legislative and institutional progress on many fronts, as 2014 saw the birth of banking union with the agreement of the Single Resolution Mechanism, the start of the Single Supervisory Mechanism and the successful conclusion of the comprehensive assessment of banks' balance sheets. And it was indeed a challenging year for monetary policy, which saw the ECB take a wide range of measures to respond to the risks emanating from an increasingly sobering economic outlook.

You have chosen two topics for today's hearing, the relationship of financial fragmentation and monetary policy as well as the Eurosystem's collateral framework. I will touch on both these issues, but let me first run you through our current assessment of the economic outlook.

Economic and monetary developments

The euro area growth momentum has weakened over the summer months and most recent forecasts have been revised downwards. At the same time, our expectation for a moderate recovery in 2015 and 2016 remains in place. Demand should be supported by a number of factors. Among them are our monetary policy measures and progress made in fiscal consolidation and structural reforms in some countries. At the same time, high unemployment, sizeable unutilised capacity, and the still ongoing and necessary balance sheet adjustments are likely to dampen the recovery.

Risks to the economic outlook continue to be on the downside. In particular, the weakening in the euro area's growth momentum, alongside heightened geopolitical risks, could dampen confidence and, in particular, private investment. In addition, insufficient progress in structural reforms in euro area countries constitutes a key downward risk to the economic outlook.

Inflation in the euro area remains very low. In October, it stood at 0.4%. We expect it to remain at around current low levels over the coming months, before increasing gradually during 2015 and 2016. Looking forward, we closely monitor risks to price developments.

The latest monetary data point to subdued underlying growth in broad money. Its annual growth rate has increased moderately over recent months. It appears that the turning point in credit growth is now behind us, and credit growth rates, while remaining negative, are gradually improving.

Monetary policy and financial fragmentation

Let me turn to financial fragmentation, the first topic you suggested for today's hearing. Fragmentation in various segments of the financial market has been a major obstacle to the smooth conduct and transmission of monetary policy, and ultimately to our ability to deliver on our mandate. Also owing to determined actions the ECB has taken, fragmentation has receded significantly since the height of the financial crisis. Unsecured money market rates are trading again at reasonable spreads over their secured counterparts. Sovereign bond spreads in the euro area decreased significantly from their peaks in 2012. Together, these developments reflect the gradual return of confidence among investors in the euro area.

Yet, we still face a situation where our very accommodative monetary policy stance does not sufficiently reach some final borrowers in the euro area. This is because credit markets in some parts of the euro area are still impaired and show only timid signs of recovery. As a result, credit growth continues to contract and credit conditions – while having eased recently – remain overall tight from a historical perspective. Importantly, costs of bank funding have improved, but are still relatively high in some Member States. Where they are lower, they are not passed on in full to the real economy.

The monetary policy measures decided in June and September this year, the Targeted Longer-term Refinancing Operations and the purchase programmes for asset-backed securities and covered bonds, are designed to overcome these obstacles. They will enhance the transmission of monetary policy, support the provision of credit to the euro area economy and, as a result, provide further monetary policy accommodation. We see early indications that our credit easing package is delivering tangible benefits. Since the beginning of June, forward money market rates have shown steep declines across the maturity spectrum. Now, the forward curve consistently lies below zero over a two-year horizon. EONIA is not expected to exceed 25bps before well into 2018. The 3-month EURIBOR rate, which is an important conduit of monetary policy impulses to lending rates, dropped to all-time lows and now stands close to zero. And the policy decisions, in particular those announced in September, triggered a compression of spreads across other asset classes, including ABS, covered bonds and sovereign bonds. But more time is needed for the full materialisation of the positive effects of the most recent set of measures.

In this context, let me emphasise that we are committed to scale the total magnitude of our measures – lending operations as well as outright purchases – up to a size that can deliver the intended support to inflation and the recovery of the euro area economy. All these measures will have a sizeable impact on our balance sheet, which we expect to move towards its early 2012 dimension. This will ensure that our accommodative monetary policy stance will contribute to a gradual recovery and a return of inflation rates in the medium term to levels closer to our aim of below but close to 2%.

Nonetheless, we need to remain alert to possible downside risks to our outlook for inflation, in particular against the background of a weakening growth momentum and continued subdued monetary and credit dynamics. We therefore need to closely monitor and continuously assess the appropriateness of our monetary policy stance. If necessary to further address risks of too prolonged a period of low inflation, the Governing Council is unanimous in its commitment to using additional unconventional instruments within its mandate. In this context, we have also tasked relevant ECB staff and Eurosystem committees with the timely preparation of further measures to be implemented, if needed. Such measures could include further changes to the size and composition of the Eurosystem balance sheet, if warranted to achieve price stability over the medium term.

Monetary policy alone – however – cannot overcome financial fragmentation in the euro area. Fragmentation across national borders also reflects underlying national imbalances and institutional deficiencies.

Overcoming these require determined structural reforms on the side of national governments to improve the business environment and setting incentives to invest, with the aim to boost productivity, create new jobs and raise the growth potential of the economy.

Reducing financial fragmentation also requires tackling remaining shortcomings in economic and financial integration. As already mentioned, substantial progress has been made this year. Banking union should now be completed following the finalisation of the

Comprehensive Assessment and the SSM taking on supervisory responsibility. This means in particular completing the SRM, enhancing the borrowing capacity of the Single Resolution Fund and thereby delivering on the commitment to establish a credible backstop.

Moreover, looking forward, a greater integration of financial markets – also referred to as a Capital Markets Union (CMU) – would be warranted to further reduce fragmentation of financial markets, improve funding to SMEs, enhance the transmission of the ECB's monetary policy, and overall benefit economic growth. We look forward to the detailed elements that the Commission will announce in the course of 2015 and I have no doubt that the European Parliament as co-legislator will again play a decisive role in this regard.

The collateral framework of the Eurosystem

Let me now say a few words on the second topic you have chosen, our collateral framework. Since the very beginning, the Eurosystem collateral framework had been designed to achieve two goals at the same time: First to protect the Eurosystem from incurring losses, as it is explicitly required by the Statute of the ECB/ESCB; second to ensure that Eurosystem credit operations can be carried out smoothly by making sufficient collateral available.

The past and recent experience has shown that such a dual set-up of the Eurosystem collateral framework has been indeed very effective. So far, the Eurosystem has never had to recognise a loss stemming from the Eurosystem credit operations. In the few cases where counterparties have defaulted, for instance in the case of a subsidiary of Lehman Brothers, the Eurosystem was able to fully cover its exposure by seizing the posted collateral. At the same time, the collateral framework ensured that banks were able to obtain sufficient amounts of central bank liquidity throughout the crisis. This became most visible in the context of the two Very Long Term Refinancing Operations that the ECB conducted in 2011 and 2012. In these operations banks obtained collateralised central bank liquidity in the order of EUR 524 billion within only 10 weeks.

This basic set-up of the collateral framework has remained the same since the beginning of monetary union; the three constituent parts of the Eurosystem collateral framework, i.e. (i) the counterparty framework, (ii) the basic eligibility criteria for underlying assets and (iii) the risk control measures, have remained largely unchanged. The Eurosystem maintains a broad counterparty framework and its eligibility criteria are still based on the same principles as at the beginning. This shows that the design of the Eurosystem collateral framework is in general very robust.

However, some changes were necessary to guarantee a smooth implementation of monetary policy at times of financial market stress that led to a general reduction in access to market funding. A collateral framework must never act in a pro-cyclical manner: Restricting banks' access to liquidity in a crisis – for instance, by introducing more restrictive criteria for collateral – might pose a risk not to only to the most vulnerable banks, but to the whole financial system. Ultimately, this would increase the risk for the central bank's balance sheet rather than protecting it. Hence, in order to enable that a wide range of the counterparties could continue participating in the refinancing operations, the Eurosystem temporarily relaxed some of the eligibility criteria for underlying assets. This was done on several occasions. For instance, from 2008 to 2011 and again as of 2012, we accepted foreign denominated marketable assets. In 2012 we created the Additional Credit Claims framework. Credit standards have been changed by accepting lower rated assets compared to those accepted at the beginning, notably for ABS that fulfill certain criteria. However, these accommodative measures were coupled with a stronger-scrutinised counterparty framework and with more stringent risk control measures. As a result, the total amount of eligible collateral increased. Thus, an enhanced participation of counterparties in the refinancing operations was enabled, while at the same time the risks for the Eurosystem expanded only moderately.

The Eurosystem collateral framework has been quite complex from the very beginning, not the least because of the variety of national frameworks preceding it. With the onset of the monetary union, the goal was to provide access to Eurosystem credit operations to a broad range of counterparties, in contrast to some other central banks which rely on a few counterparties. Therefore, the collateral framework had to take into account the various national banking systems and financial markets. Some national central banks, for example, accepted credit claims as collateral, while others did not. Some countries had developed covered bond markets, while others only started to set up a respective covered bonds law later, and the same could be said for ABS. For a collateral framework, a common standard had to be found which embraces these national characteristics, while at the same time ensuring that sufficient collateral is available. Several of the measures taken in the crisis have added to this complexity. Therefore a challenge going forward is to make the collateral framework simpler and more transparent, without impacting the ability of counterparties to access our refinancing operations. I am confident that we will achieve this.

Conclusion

Ladies and gentlemen,

2014 has been a year of profound change. But what has been achieved so far is not enough. 2015 needs to be the year when all actors in the euro area, governments and European institutions alike, will deploy a consistent common strategy to bring our economies back on track. Monetary policy alone will not be able to achieve this. This is why there is an urgent need to agree on concrete short-term commitments for structural reforms in the Member States, on a consequent application of the Stability and Growth Pact, on the aggregate fiscal stance for the euro area, on a strategy for investment, and to launch work on a long-term vision to further share sovereignty ensuring the sustainable and smooth functioning of EMU.

On that note, I am looking forward to our discussion.