# Mario Draghi: Introductory remarks at the EP's Economic and Monetary Affairs Committee

Speech by Mr Mario Draghi, President of the European Central Bank, before the European Parliament's Economic and Monetary Affairs Committee, Brussels, 22 September 2014.

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Mr Chairman,

Honourable Members of the Economic and Monetary Affairs Committee,

Ladies and Gentlemen,

This hearing today takes place at a moment of change for the ECB. On 4 November, the ECB will become the banking supervisor for the euro area, including the direct supervision of 120 large banks. This marks the biggest step of European economic integration since the inception of the euro. We are well prepared for this step, but we are also conscious of the important additional responsibility we will be taking on.

Additionally, over the course of the coming months, the majority of the ECB's services will move to the new ECB premises at Frankfurt Ostend, while the SSM staff will remain in the city centre. This will also geographically underline the separation between the ECB's new supervisory function and its other tasks. In this context, I wish to inform you that we have published today our decision on the implementation of separation between the ECB's monetary policy and supervisory functions as required by the SSM Regulation.

I know that on 3 November, on the eve of the start of single supervision, you will have ample opportunity to discuss with the Chair of the Supervisory Board. By then, the results of the Comprehensive Assessment will also be known. Against this background, I will today and in the hearings from now on focus my attention on the traditional tasks of the ECB – and in particular on monetary policy.

## Economic situation

The economic recovery in the euro area is losing momentum. Following some moderate expansion in recent quarters, growth of the euro area real GDP came to a halt in the second quarter of this year. The early information on economic conditions which we received over the summer has been somewhat weaker than expected. While industrial production and manufacturing orders in July gave some reason for optimism, more recent survey indicators have given no indication that the sharp decline registered in August has stopped.

Looking ahead, we continue to expect euro area domestic demand to be supported by various factors. These include our accommodative monetary policy stance, favourable financing conditions, and structural reforms sustaining private consumption and investment. At the same time, unacceptably high unemployment and continued weak credit growth are likely to curb the strength of the recovery. The risks surrounding the expected expansion are clearly on the downside. In particular, heightened geopolitical tensions could dampen business and consumer confidence. Risks of insufficient structural reforms could weigh on the business environment.

From a high of 3.0% toward the end of 2011, inflation in the euro area has been on a downward path for a considerable period of time. In August, inflation was estimated to have reached a low of 0.3% but has been revised later to 0.4%. We expect inflation to remain at low levels over the coming months, before increasing gradually during 2015 and 2016.

Given the prolonged period of low inflation that we have already experienced, we will closely monitor risks to price developments looking forward. We will focus in particular on the possible repercussions of dampened growth dynamics, geopolitical developments, exchange rate developments and the pass-through of our monetary policy measures.

### TLTROs, the September measures, and the transmission mechanism

Before turning to our latest monetary policy decisions, let me stress that the ECB has done a lot over the past three years to safeguard price stability. We successfully fought the confidence crisis in the euro that raised interest rates to abnormal levels. We provided the euro area banking system with unprecedented funding. We have continuously lowered our policy rates.

Yet, against the backdrop of a persistently weak inflation outlook, a slowing growth momentum, and subdued monetary and credit dynamics, we decided in early September to adopt a number of additional monetary policy initiatives which will complete and complement the measures already announced in June.

First, we lowered the key ECB interest rates by 10 basis points to their effective lower bound. The main refinancing rate now stands at 0.05%, and the deposit facility rate at –0.20%.

Second, we announced further measures to enhance the functioning of monetary policy transmission, support lending to the real economy and provide further monetary accommodation given that we have now reached the lower bound. Restoring a functioning transmission, notably in bank lending, is instrumental in ensuring that the monetary policy stimulus that has been introduced reaches the final borrowers and thereby supports real incomes, spending and price formation.

Following this announcement, under our ABS purchase programme (ABSPP) we will soon start purchasing simple and transparent securities with underlying assets consisting of claims against the euro area non-financial private sector. We will also start purchasing covered bonds issued by euro area MFIs under a new covered bond purchase programme (CBPP3).

These measures will effectively complement and strengthen the targeted longer-term refinancing operations (TLTROs) whose first allotment was just conducted a few days ago.

In this respect, let me provide you with some fresh details on the outcome of the first TLTRO operation.

Last Thursday, 255 banks participated in the first TLTRO for an amount of 82.6 billion euros. This is within the range of take-up values we had expected based on banks' revealed behaviour under previous programmes. In December, banks will have another opportunity to borrow funds in the form of their TLTRO initial allowance, which entitles them to borrow a cumulative amount – between the September and the December 2014 tenders – equivalent to up to 7% of their outstanding stock of loans to the non-financial private sector excluding loans to household for house purchase. By design, the September and December operations should be assessed in combination.

As of next year, there will be additional quarterly allotments in which banks will be able to receive additional funding determined by their recent lending performance.

While it is yet too early to assess the impact of the TLTROs on the broader economy, their announcement already had a noticeable positive impact on financial market sentiment.

Overall, we expect the TLTROs to act as a powerful tool to strengthen the transmission of monetary policy and facilitate new credit flows to the real economy, given the predominantly bank-based financing structure of the euro area economy.

### Impact channels of the additional measures

The additional measures we took in September will empower the credit easing impact of TLTROs in three directions. First, we expect that purchases of simple and transparent ABS will strengthen the direct pass-through effect – i.e. the extent to which the funding cost relief for banks will be passed along to their borrowers – that we can associate with the TLTROs to a measurable extent. This is because the ABS market remains severely impaired – so that the potential for interventions to change market dynamics is high in that particular market – and the link between the spreads at which ABS are traded in the secondary market and the lending rates which banks apply in the primary market of the credits that collateralise these securities is direct and tight.

Second, there will be a portfolio rebalancing channel, as the expansion in liquidity that will result from the combined operations promotes a diversification of investment patterns in the investor community, and thereby an easing of financing conditions more broadly.

Third, we believe the overall monetary policy package underpins our forward guidance and our determination to accomplish an expansionary stance over an extended horizon in keeping with our price stability mandate and our desire to see inflation stabilise around levels below but close to 2% over the medium term.

**Features and risk management of the new programmes**

Is the market for ABS, in particular, sufficiently ample to allow sizeable purchases? Our purchases will include a fairly wide range of simple and transparent ABS collateralised by loans to the real economy. The total stock of eligible securities which is currently outstanding – held in investors' portfolios or retained by the originating banks – is already sizeable. We are confident that it will grow as a result of our presence in the market. Over time, as our purchases contribute to a normalisation in trading conditions, secondary market and issuance activity will expand in those segments that are currently inactive. As the experience of other central banks that have engaged in outright purchases of structured products can demonstrate, market size and purchasing volumes are to a certain extent co-determined and endogenous.

Will the new initiatives magnify the Eurosystem's exposure to risk? Outright purchases will increase the size of the ECB's balance sheet, but the additional risk exposure will be limited. Under the ABS purchase programme we will be purchasing senior and guaranteed mezzanine tranches. Regarding senior securities, we would buy only those assets that are eligible for Eurosystem operations. So, we have ample experience with managing and understanding the risks associated with this asset class. The assets to be purchased would satisfy high standards of transparency and simplicity and are also characterised by low default risk. The large degree of credit enhancement that originators have to build into a structured financial transaction for its senior tranches to attract the high rating that will make it eligible under our programme will function as a further protective layer against losses. As for the guaranteed mezzanine tranches, their intrinsic credit risk would be comparable to that of the guarantor, be it a national or supranational entity.

Covered bonds share important features with ABS, and therefore are an obvious complement to an ABS-centred programme. First, the link that is established on the issuing bank's balance sheet between the covered bond, on the one side, and the loans that back the covered bond, on the other, is reasonably tight. As the prices for covered bonds are bid up, we expect banks to respond to the market incentives by originating more saleable covered securities, and thus more loans to collateralise them. Second, outright interventions in this market will complement ABS purchases by reinforcing the portfolio rebalancing channels of transmission and generating positive spill-overs into other markets and securities. This will further ease funding and credit conditions and will help the transmission of monetary policy.

The Governing Council has emphasised that the combination of measures announced between June and September will have a sizeable impact on the ECB balance sheet, which is expected to move towards the dimensions it used to have at the beginning of 2012.

With the purchase programmes, we are starting a transition from a monetary policy framework predominantly founded on passive provision of central bank credit to a more active and controlled management of our balance sheet.

**Conclusion**

The Governing Council remains fully determined to counter risks to the medium-term outlook for inflation. Therefore, we stand ready to use additional unconventional instruments within our mandate, and alter the size and / or the composition of our unconventional interventions should it become necessary to further address risks of a too prolonged period of low inflation.

Let me add however that the success of our measures critically depends on a number of factors outside of the realm of monetary policy. Courageous structural reforms and improvements in the competitiveness of the corporate sector are key to improving business environment. This would foster the urgently needed investment and create greater demand for credit. Structural reforms thus crucially complement the ECB's accommodative monetary policy stance and further empower the effective transmission of monetary policy. As I have indicated now at several occasions, no monetary – and also no fiscal – stimulus can ever have a meaningful effect without such structural reforms. The crisis will only be over when full confidence returns in the real economy and in particular in the capacity and willingness of firms to take risks, to invest, and to create jobs. This depends on a variety of factors, including our monetary policy but also, and even most importantly, the implementation of structural reforms, upholding the credibility of the fiscal framework, and the strengthening of euro area governance.

Originally, you had also chosen "inflation differentials in the euro area" as one of the topics of today's hearing. I hope you will understand that given the important decisions we took in July and September, I have focused my remarks on our monetary policy measures. Nevertheless, I of course stand ready and would be very interested to further discuss the matter of persistent inflation differentials, especially given their link to the structural reform agenda.

I am now looking forward to our discussion.