Mario Draghi: Keynote speech at the Eurofi Financial Forum

Keynote speech by Mr Mario Draghi, President of the European Central Bank, at the Eurofi Financial Forum, Milan, 11 September 2014.

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Summary

We are facing a set of conditions – low growth and low inflation, high debt and high unemployment – that can only be addressed by concerted action on both the demand and supply sides of the economy. This requires that all actors – both at national and European levels – play their parts in line with their respective mandate as laid down in the EU Treaties.

No monetary or fiscal stimulus can be successful if not accompanied by the right structural policies – policies that foster potential growth and instil confidence.

Investment has been one of the great casualties of the crisis. From peak to trough business investment in the euro area decreased by around 20% since 2008, against 15% in the 1992 recession. We will not see a sustainable recovery unless this changes.

A decisive rise in investment is essential to bring inflation where we would want to see it, to kick-start the economy and to bring down unemployment.

There are two key areas where national and European level government action can help revive investment. First, the regulatory environment should be made more favourable to economic growth. Second, companies need to have access to more diversified sources of financing: the launch of a capital markets union could contribute to achieving this. It is an idea that the ECB fully supports.

The development of the market for simple and transparent Asset Backed Securities deserves particular support. Member States should consider the provision of public guarantees to support lending to small and medium sized enterprises.

There also needs to be a consistent and credible application of the Stability and Growth Pact across time and across countries. Within the existing framework, countries should explore how to support productive investment.

In monetary policy, we have deployed a number of non-standard tools to ensure our very accommodative monetary policy stance is transmitted to the real economy. Last week, the Governing Council decided to start the purchase of certain high-quality asset-backed securities and covered bonds in October. Senior tranches of such ABS have proven to be high quality assets.

Alongside our Targeted Longer Term Refinancing Operations, we expect these measures will enhance the functioning of monetary policy transmission, provide further accommodation now that we are at the lower bound, and have a sizeable impact on our balance sheet.

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Ladies and gentlemen,

It is a pleasure to be here tonight with you in Milan.

In a recent speech in Jackson Hole, I spoke about the need for a policy mix involving monetary, fiscal and structural policies to jump-start the economic recovery in the euro area. We are currently facing a set of conditions – low growth and low inflation, high debt and high unemployment – that can only be addressed by concerted action on both the demand and supply sides of the economy. This requires all actors – both at national and European level – to play their parts in line with their respective mandates as laid down in the EU Treaties.

No monetary stimulus, indeed no fiscal stimulus, can be successful unless accompanied by the right structural policies – policies that foster potential growth and instil confidence.

I would like to illustrate this argument by focusing on investment, which will also be discussed at the informal ECOFIN this weekend. Investment has been one of the great casualties of this crisis.

The downturn in business investment in the euro area since 2008 has been much more severe than in earlier business cycles. From peak to trough, business investment decreased by around 20%, against 15% in the 1992 recession. The level of business investment in the euro area has only slightly improved since 2008, whereas in the US it is above its pre-crisis level.

We will not see a sustainable recovery unless this changes. A decisive rise in investment is essential to bring inflation closer to where we would want to see it, to stimulate the economy, and to bring down unemployment. So what can we policy-makers do to revive investment? My main message today is that only if structural, fiscal and monetary policies go hand in hand will the euro area see investment return. Let me focus in particular on the decisive contribution which structural policies can make.

A policy mix to revive investment

I see two key areas where government action both at national and European level should help to revive business investment. First, the regulatory environment should be made more favourable to economic growth. Second, companies need to have access to more diversified sources of financing: the launch of a capital markets union could contribute to achieving this and, at the same time, help overcome the remaining fragmentation of financial markets. Let me briefly elaborate on each of these points.

Improving the regulatory environment

Business activity would greatly benefit from an improvement in the regulatory environment, in particular as regards product and labour markets. The differences between Member States are quite striking in respect of wage differentiation (across workers and between sectors), employment adjustment rigidities, barriers to entry in product markets and the ease of opening and running businesses. For example, in some Member States contractual disputes between firms take on average little more than a year to resolve, while in other countries they take more than three years. Start-ups in the latter countries have to deal with more red tape than their counterparts elsewhere. Another telling example relates to the regulated professions whose number varies considerably across euro area Member States [from 45 in Estonia, 170 in Italy, 219 in France to 304 in Slovakia, according to European Commission figures]. Such barriers to entry limit competition and employment, creating undue rents for a select few to the detriment of customers. These are just a few examples.

In many cases, these obstacles sap entrepreneurial spirits, especially of young, innovative firms that create most of the new jobs and that are highly sensitive to changes in investment opportunities. These examples show how converging towards best practice in the euro area would mean radical improvements in the business environment. Spain provides an encouraging example in this regard. Among the large euro area countries, investment in Spain is projected to rebound strongly over the coming two years, notably due to the combination of business-friendly reforms and lower personal and corporate taxes. More recently, other countries have also committed to improve the business environment. A forceful and swift implementation of the necessary reforms is now key in order to reap the benefits as quickly as possible.

Strengthening the financing side

A second area of key relevance for investment and also of direct interest to the Eurofi community here tonight is the need to diversify sources of financing and to overcome financial fragmentation. Until now, banks have been the main source of lending to companies. The crisis has shown the drawbacks of over-reliance on a bank-centred lending model. So we also need to develop reliable sources of non-bank lending, such as equity and bond markets, securitisation, lending from insurance companies and asset managers, venture capital and crowdfunding.

This is why the ECB fully supports the intention of the incoming President of the European Commission to create a capital markets union. Such a step would be a natural development of the Single Market and would benefit all EU Member States.

We believe that one area that deserves particular attention is the development of a well-functioning market for simple, transparent and real asset-backed securities (ABS). This would allow banks to still originate loans – notably to small and medium-sized enterprises (SMEs) – while preserving their balance sheet capacity. In order to achieve a well-functioning ABS market, it is important that the regulatory treatment of securitisation is proportional to the risk of ABS. In this respect, the ECB welcomes efforts to have a differentiated regulatory treatment of simple, transparent ABS built on real assets. Moreover, the provision of public guarantees should be considered to support lending to SMEs, as other countries do, such as the US.

A further integration of corporate bond and equities markets is also essential to overcome the present fragmentation in the euro area and to ensure more robust cross-border lending and investment flows. To achieve this, we will have to streamline differences between countries, for instance, in the legal protection of borrowers' and lenders' rights as well as in national taxation and insolvency procedures.

To sum up, structural policies are more multifaceted than they are often perceived to be in the political debate and can have a very significant impact on investment in a variety of ways.

Growth-friendly fiscal policy

Yet this is not the only area where governments can make a difference. They have at their disposal a second policy lever of direct relevance for investment, namely fiscal policy. Companies will only invest *in* the future when there is confidence and certainty *about* the future, about the medium-term fiscal path, and ultimately about taxes. We need a consistent and credible application of the Stability and Growth Pact across time and across countries. Within the existing framework, governments can find space to support productive investment, and achieve a more growth-friendly composition of fiscal policies by lowering the tax burden and reducing unproductive current expenditures. In parallel, it may be useful to have a discussion on the overall fiscal stance of the euro area with the view to raising public investment where there is fiscal space to do so. In this regard, there is also a complementary role to play at European level in supporting the rebound in private investment. I therefore welcome the €300 billion package announced by the incoming Commission President two months ago.

The role of monetary policy

Let me finally say a few words on the contribution of monetary policy. 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. Now we have reached the lower bound. To ensure that this very accommodative monetary policy stance is transmitted to the real economy across the euro area in an equal manner, we have also deployed a number of non-standard tools. Increasingly our focus here has shifted towards the financing of small and medium-sized enterprises, which heavily rely on bank financing and in many cases are struggling to retain access to credit. These companies may be small, but when they face a funding problem, it is a big problem for all of us, given that they employ around three-quarters of the euro area's workforce.

In June, we decided to launch a series of targeted longer-term refinancing operations – TLTROs – to ensure that banks have sufficient liquidity to lend to the real economy. The TLTROs have been designed to encourage banks to increase their lending to the non-financial corporate sector.

In addition, we have also taken measures to underpin specific market segments that play a key role in the financing of the economy. Last week, the Governing Council decided to start buying high-quality asset-backed securities and covered bonds in October. We will purchase both existing and newly issued ABS, which are simple, transparent and real in the sense that the underlying assets consist of loans to the euro area non-financial private sector.

Let me respond to the concerns recently expressed about the risks posed to the integrity of our balance sheet. It is worth recalling that senior tranches of ABS have proven to be high-quality assets. According to the Association of Financial Markets in Europe, only 0.12% of European residential mortgage-backed securities (RMBS) outstanding in mid-2007 have defaulted since then – compared with 22.05% for US RMBS. Default rates for consumer finance ABS and SME collateralised loan obligations have also remained low, well below 1%, throughout the worst financial and economic crisis we have experienced.

As regards covered bonds, credit quality is ensured by a double recourse (on the underlying assets and on the issuer), which is in fact comparable with the double protection that exists in our standard repo operations.

Overall, the decisions announced last week were taken with a view to underpinning the firm anchoring of medium to long-term inflation expectations, in line with our aim of maintaining inflation rates below, but close to, 2%. We expect the two purchase programmes to effectively complement the TLTROs in enhancing the functioning of the monetary policy transmission and in providing further monetary accommodation given that we have now reached the lower bound. The newly decided measures, together with the TLTROs, will have a sizeable impact on our balance sheet, which is expected to move towards the dimensions it used to have at the beginning of 2012, and the Governing Council stands ready to take further action if needed, in compliance with its mandate to maintain price stability.

Conclusion

Ladies and gentlemen, it is time for me to conclude.

My bottom line is also my starting line. Investment is rightly said to be today's demand and tomorrow's supply. Yet investment in Europe is falling short. If we don't manage to get investment going again, we will weaken the economy in the short run and undermine its prospects in the long run.

Our efforts should therefore be focused on jump-starting investment. However, and this was really the crux of my argument, we will only manage to stimulate investment if structural, fiscal and monetary policies mutually reinforce each other.