

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, before the Hearing at the Committee on Economic and Monetary Affairs of the European Parliament, Brussels, 23 February 2019.

* * *

Introduction

Madam Chair,

Honourable members of the Economic and Monetary Affairs Committee,

Ladies and gentlemen,

I would like to start by congratulating all of you on your election, and you, Madam Chair, on your recent appointment as Chair of this Committee.

It is a pleasure to appear before this Committee in this new legislative term and before my term as ECB President comes to an end.

The legitimacy of the ECB's independence, as enshrined in the EU Treaties, crucially relies on our accountability. And the Treaties have conferred this Parliament with a central role in holding the ECB accountable.

Hearings before this Committee play an essential role here. In my time as President, I have found them to be extremely beneficial.

When I appeared before the ECON Committee for the first time, in December 2011, the euro area was rife with financial instability; it was falling into a second recession, which eventually led to sustained disinflation and, at times, heightened risks of outright deflation.¹ The euro area has come a long way since the crisis, in part thanks to the support provided by the ECB's monetary policy. The unemployment rate in the euro area was 7.5% in July this year, the lowest level since July 2008.

Over the past years, the ECB has repeatedly and clearly shown its readiness and determination to fulfil the primary objective of achieving price stability, as laid down in the Treaties. This readiness and determination has been critical in addressing the economic crisis and the downside risks to our objective.

It was with this same determination that, two weeks ago, the ECB's Governing Council decided to act in response to the continued shortfall of inflation with respect to its aim.

I am happy to be able to discuss these decisions with you today. I will first review the main developments in the euro area economy since my last appearance before this Committee. I will then present the monetary policy decisions that were taken by the Governing Council in the light of the economic outlook. As requested by this Committee, I will conclude by drawing some lessons from the past eight years that could be relevant when discussing the policy responses to the challenges that lie ahead of us.

The euro area economic outlook

Since my last hearing before this Committee earlier in the year, euro area growth momentum has slowed markedly, more than we had previously anticipated. Real GDP growth is now

projected to be 1.1% in 2019, down by 0.6 percentage points from the December 2018 staff projections, and 1.2% in 2020, down by 0.5 percentage points from the December projections.

This slowdown is mainly due to the weakness of international trade in an environment of persistent uncertainties related to protectionist policies and geopolitical factors. These factors are increasingly weighing on economic sentiment and, in particular, on the manufacturing sector, which is more trade-oriented and exposed to foreign influences.

Of course, countries which have a relatively large manufacturing sector are more vulnerable to any turn in the global economic cycle. Germany, for example, accounts for 28% of euro area GDP, but for as much as 39% of euro area manufacturing value added. Accordingly, Germany is today one of the euro area members most affected by the slowdown.

While the euro area services sector continues to be resilient, we should not be complacent about its capacity to remain robust to negative spillovers. The longer the weakness in manufacturing persists, the greater the risks that other sectors of the economy will be affected by the slowdown.

Looking ahead, recent data and forward-looking indicators – such as new export orders in manufacturing – do not show convincing signs of a rebound in growth in the near future and the balance of risks to the growth outlook remains tilted to the downside.

In the context of this more protracted weakness of the euro area economy, both realised and projected inflation have been persistently below levels that are in line with the ECB Governing Council's medium-term aim.

Headline inflation remains well below 2%, while inflation excluding the more volatile food and energy components has been hovering around 1% for an extended period of time. Underlying inflation remains muted, as the weaker economic outlook may imply a delay in the pass-through of wages to prices. In particular, firms are absorbing increases in labour costs in their profit margins rather than passing them on to customers. Meanwhile, indicators of inflation expectations stand at low levels. Although the likelihood of deflation remains limited, market expectations of inflation over the medium term are settling around values that are not consistent with our inflation aim.

Since my last hearing here, we have revised down the inflation outlook over the entire projection horizon, first in the March 2019 staff projections and then again in September, reflecting weaker economic activity and lower energy prices. Inflation is currently expected to average 1.2% in 2019, 1.0% in 2020 and 1.5% in 2021, which is well below the Governing Council's medium-term aim of below, but close to, 2%.

The ECB's response to the current outlook

So when the Governing Council met two weeks ago, it was confronted with a more rapid and extended slowdown than previously anticipated, persistent and prominent downside risks to the growth outlook, and a further delay in the convergence of inflation towards our aim. A strong monetary policy response was therefore essential.

In pursuit of our mandate, we decided on a comprehensive package of measures to ensure that inflation moves towards our aim in a sustained manner.

We lowered the interest rate on the deposit facility from –0.40% to –0.50%. This rate provides an anchor for short-term market interest rates, which serve as the reference for many types of loans and financial instruments. Lowering the deposit facility rate helps to further improve the borrowing conditions of households and businesses. Negative rates also encourage banks to lend to the real economy instead of holding onto liquidity, thus supporting the portfolio rebalancing

channel of the asset purchase programme (APP).

The impact of the cut in the deposit facility rate is reinforced by our strengthened forward guidance on the likely direction of our monetary policy in the future. Specifically, we clarified that we expect our policy rates to stay “*at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2% within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics*”. This enhanced guidance provides a clear signpost for rate expectations by linking our policy to more stringent conditions for the inflation outlook.

The Governing Council’s statement that we want to see inflation rising to a level that is *sufficiently close to, but below, 2%* reasserts what we said after the July monetary policy meeting: that the values of realised and projected inflation seen in recent times are too low and inconsistent with the Governing Council’s medium-term inflation aim. While the new formulation of forward guidance reflects the characteristic forward-looking orientation of the ECB’s monetary policy framework, we have added two safeguards to ensure that policy rate normalisation only begins once inflation is sustainably on course to reach our medium-term aim. The phrase “*robustly converge*” means that the Governing Council wants to be sure that the process of convergence is sufficiently mature and realistic before starting to lift policy rates. The reference to the inflation outlook being “*consistently reflected in underlying inflation dynamics*” means that the path of realised inflation should underpin our inflation outlook.

Our enhanced guidance helps to reduce uncertainty about the expected path of interest rates in the short to medium term and will ensure that financial conditions adjust in line with inflation dynamics. Moreover, by maintaining the easing bias on rates, we indicate that we still have space to cut rates further, if needed.

We also decided to restart net asset purchases at a monthly pace of €20 billion from November onwards. These purchases are expected to run for as long as necessary to reinforce the accommodative impact of our policy rates, and to end shortly before we start raising the key ECB interest rates. In addition, we reiterated our intention to continue reinvesting, in full, the principal payments from maturing securities purchased under the APP for an extended period of time past the date when we start increasing interest rates, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation.

The net purchases and longer reinvestment horizon reinforce the accommodative impact of our other measures, thereby further easing the funding costs for businesses and households in the euro area. In addition, these measures help keep down longer-term interest rates by mitigating the undue tightening that would otherwise mechanically arise from the reduction in the average maturity of our portfolio. Finally, net purchases also signal our commitment to use all instruments in pursuit of our price stability objective, which can have a powerful effect on the formation of inflation expectations.

As a complement to the policy measures I just outlined, we also decided to change the modalities of the new series of targeted longer-term refinancing operations (TLTRO III) that we announced in June. Banks can now obtain this long-term funding at lower rates with a longer maturity. This will also help to ensure that our accommodative policies pass through entirely to the funding costs of households and firms.

Finally, we also announced a two-tier system for reserve remuneration, in which part of banks’ excess reserves will be exempt from our negative rates. The two-tier system is designed to strike a balance between two outcomes: it seeks to preserve the incentives for banks to pass through the stimulus generated by the negative interest rate on their reserves, while mitigating the adverse effects that these negative rates might have on banks’ lending behaviour by affecting their profitability. The euro area needs financial intermediaries to remain engaged and active in

monetary transmission, and the new two-tier system will make sure that the ability of banks to extend loans to their customers at favourable terms remains unimpaired.

The different elements of this comprehensive package will be mutually reinforcing in supporting favourable financing conditions for businesses and households, which will sustain investment and consumption. Greater business and household expenditure, in turn, will support inflation dynamics and make sure that they durably converge to our aim.

Overall, in view of the outlook and uncertainties we are facing, monetary policy needs to remain highly accommodative for a prolonged period of time. The measures we took at our last meeting underscore our determination and readiness to provide the necessary monetary stimulus in pursuit of our price stability objective. We continue to stand ready to adjust all of our instruments if warranted by the inflation outlook.

Looking back, looking forwards: achievements and future direction of Economic and Monetary Union

The conventional and unconventional measures the ECB has taken over the past decade have been successful in addressing the deflationary risks, restoring the functioning of the monetary policy transmission mechanism and providing vital support to the euro area economy.

But the ECB does not operate in a vacuum and other economic policies matter too. Allow me to recall my first appearance before this Committee in 2011. At that time, half of my introductory remarks were about the functioning of Economic and Monetary Union (EMU) and the need for other European policymakers to act.

So I will conclude my final statement to you by highlighting some lessons that have emerged from these eight years, which I hope can help in addressing the challenges ahead.

When comparing the crisis response of the euro area with that of other advanced economies, it is evident that the latter were able to achieve a better macroeconomic policy mix at the time, thanks to more decisive actions in both the fiscal and financial domains.

The Governing Council has reiterated that we are determined to ensure that inflation moves towards our aim in a sustained manner, and that we continue to stand ready to adjust all of our instruments. At the same time, a better policy mix, including fiscal policy, structural reforms and prudential measures, can help achieve this objective faster and with fewer side effects.

We will continue to carefully monitor – as we always have done – the possible side effects of accommodative monetary conditions. It is crucial to remain vigilant and to use the available micro- and macroprudential policy tools as necessary. I will say more on this during the hearing in my capacity as Chair of the European Systemic Risk Board.

The low yield environment needs to be understood in the context of the protracted decline in real yields we have witnessed since the 1980s. And this trend is not unique to the euro area. It largely reflects more structural factors such as a slowdown in productivity growth, which can be reversed through an ambitious structural reforms agenda.

In other words, we need a coherent economic strategy in the euro area that complements and enhances the effectiveness of monetary policy.

This is why there was unanimous consensus in the Governing Council that fiscal policy must make a more decisive contribution. In view of the weakening economic outlook and the continued prominence of downside risks, governments with fiscal space that are facing a slowdown should act in an effective and timely manner. Where fiscal sustainability is ensured, the potential effectiveness of countercyclical fiscal policy is reinforced in the current environment, given that

fiscal multipliers are higher in a low interest rate environment. At the same time, governments in countries with high public debt should pursue prudent policies and deliver on structural balance targets.

Another key difference compared with other advanced monetary unions like the United States is the lack of a central fiscal instrument to act countercyclically at the federal level.

I fully acknowledge the political difficulties in building such an instrument in the euro area. Similar difficulties also exist when discussing the completion of the banking union and the establishment of a genuine capital markets union.

At the same time, we should remain fully committed to the goal of achieving a genuine Economic and Monetary Union. Ignoring the need to fix the remaining institutional weaknesses of EMU would seriously damage what has already been achieved through the commitment and hard work of everyone involved. As I argued in this Committee eight years ago, we need to show “a clear trajectory for the future evolution” of EMU and thus frame the “expectations of both citizens and financial markets”.

Allow me to take a longer-term perspective to draw the last lesson. While the euro area did not have a fiscal policy response comparable with that of other advanced economies, the ECB’s response was fully comparable with that of the other major central banks.

Thanks to its independence, the ECB has been able to adapt its policy response and reaction function. Preserving this key asset will allow the ECB to adapt to future circumstances and ensure the effectiveness of its measures. This is all the more important considering that the desirability and relevance of central bank independence are increasingly being challenged around the world.

As I argued in my introduction, the best way to preserve the ECB’s independence is to ensure a commensurate degree of central bank accountability. During the past eight years, our accountability practices have evolved and intensified in response to the quest for scrutiny that emerged from the crisis.² I have always appreciated the ability of this Parliament to react to citizens’ demands, support, concerns and channel them in a constructive manner during our discussions here. And I would like to personally thank you for this.

I am confident that this Parliament – and this Committee in particular – will continue the good work it has done during my term as ECB President. This, in turn, will further strengthen the effectiveness of the ECB’s actions and citizens’ trust in the EU project.

Thank you for your attention. I am now at your disposal for questions.

¹ See Draghi, M. (2011), “[Hearing at the Committee on Economic and Monetary Affairs of the European Parliament](#)”, Brussels, 19 December.

² See Fraccaroli, N., Giovannini, A. and Jamet, J.-F. (2018), “[The evolution of the ECB’s accountability practices during the crisis](#)”, *Economic Bulletin*, Issue 5, ECB.