Mario Draghi: The euro, monetary policy and the design of a fiscal compact

Speech by Mr Mario Draghi, President of the European Central Bank, at the Ludwig Erhard Lecture, Berlin, 15 December 2011.

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Ladies and Gentlemen,

I am honoured to have received the invitation from Professor Hans Tietmeyer to deliver this year's Ludwig Erhard lecture.

When I was working at the Italian Treasury in the 1990s, Professor Tietmeyer and I had many opportunities to work together. I vividly remember many of our exchanges over the course of the two decades since the Maastricht Treaty. And I am very grateful that he remains in close contact with the European Central Bank (ECB) as adviser to our audit committee.

Ludwig Erhard's legacy in shaping Germany's post-war recovery stretches far beyond his own country and far beyond his own times. His conception of the social market economy was visionary. And he even held cherished views about central bankers, stressing the importance of price stability: "Die soziale Marktwirtschaft ist ohne eine konsequente Politik der Preisstabilität nicht denkbar." I think we cannot formulate this idea any better today.

Ludwig Erhard also helped to enshrine the principle of central bank independence. When in the early 1950s the independence of the German central bank system was not yet settled, he as minister of the economy argued that the government should not issue instructions to the central bank. You all know that the statutes of the ECB inherited this important principle and that central bank independence and the credible pursuit of price stability go hand in hand.

Current circumstances remain demanding, with economic, financial and fiscal issues deeply intertwined with challenges at the political level in many countries and in the supra-national European sphere.

Last week two sets of important decisions have been taken, which are going to be the focus of my remarks today. First, I will elaborate on the motivation for the monetary policy measures that the ECB announced last Thursday and what we expect from them. Second, I would also like to share with you some views on last week's European Council summit's decisions, which brought some very important new elements to our economic and monetary union.

Monetary policy decisions for the euro area

To explain our recent monetary policy measures, let me recall the particular role of banks in the euro area economy. The flow of credit to firms and households in the euro area works largely through banks. During recent years, about three quarters of firms' external financing have come from that source.

This means that any impairment in the bank lending channel will have stronger consequences in the euro area than in other economies where firms' external financing comes largely from corporate bond markets.

Banks in the euro area have recently come under pressure both as regards their capital bases and their funding conditions.

The plan to strengthen their capital bases is an attempt to reinforce their standing in financial markets, but this is not an easy process. There are essentially three options for banks to pursue to raise their capital ratios as demanded by the European Banking Authority: they can raise their capital levels, sell assets or reduce their provision of credit to the real economy.

The first option is much better than the second, and the second option is much better than the third. But raising capital levels is expensive in a depressed market and faces resistance from shareholders. Selling assets is less preferable and curtailing credit to the real economy is even worse. Therefore, public authorities ought to cushion the impact on the real economy and banks should consider restraining dividends and ad hoc compensation to strengthen buffers.

Banks are also facing problems in raising longer-term funding in financial markets. The resulting shortening of their funding leads in turn to maturity mismatches on balance sheets of the kind that caused the financial crisis. At the same time, shortages of collateral are beginning to emerge in some segments of the financial system especially for the small and medium sized banks.

In addition to identifying these particular strains in the banking sector, our regular economic and monetary analysis has indicated that the intensified financial market tensions continue to dampen economic activity in the euro area and the outlook remains subject to high uncertainty and substantial downside risks. In such an environment, cost, wage and price pressures in the euro area should remain modest over the policy-relevant horizon. At the same time, the underlying pace of monetary expansion remains subdued.

In these conditions, and faithful to our mandate to maintain price stability over the medium term, the ECB's Governing Council has taken a number of far-reaching decisions.

The Council decided to reduce its key interest rates by another 25 basis points to 1%. In normal financial market conditions, a policy rate reduction is a potent instrument of inflation control and demand support. The rate cut works its way through a long chain of downward adjustments in financial returns. At the end of the process, the yield on large spectrum of securities declines and promotes broad-based policy accommodation.

In the present conditions, this process turns out to be hampered, so that the impact of a rate cut by itself is weakened. Banks limit their lending to other banks and potentially to the broader economy, and they hold on to precautionary balances of cash as self-insurance.

Therefore, the Governing Council last week decided on three other measures, each of which provides additional support in order to bring the necessary monetary policy impulse to the real economy.

The current package should be felt tangibly in the financial sector and the real economy over the coming weeks and months. Of course, it comes against strong headwinds generated by deleveraging.

We established very long-term refinancing operations with a maturity of three years. This duration is a novelty in ECB monetary policy operations.

The extension of central bank credit provision to very long maturities is meant to give banks a longer horizon in their liquidity planning. It helps them to avoid rebalancing the maturities of their assets and liabilities through a downscaling of longer-term lending. Incidentally, we want to make it absolutely clear that in the present conditions where systemic risk is seriously hampering the functioning of the economy, we see no stigma attached to the use of central banking credit provisions: our facilities are there to be used.

Banks will be able to refinance term lending with the Eurosystem and thus preserve their long-term exposures to the real economy. After the first year, banks will have the option to terminate the operation. So they can flexibly adapt to changing liquidity conditions and a normalising market environment.

Our second measure will allow banks to use loans as collateral with the Eurosystem, thereby unfreezing a large portion of bank assets. It should also provide banks with an incentive to abstain from curtailing credit to the economy and to avoid fire-sales of other assets on their balance sheets.

The goal of these measures is to ensure that households and firms – and especially small and medium-sized enterprises – will receive credit as effectively as possible under the current circumstances. Of course, we have to screen the collateral carefully so as to protect our balance sheet.

The third measure we announced last week is to reduce the required reserves ratio from 2% to 1%. This measure frees up liquidity of the banking sector by about 100 billion euro. Along with other measures, this reduction in the reserve requirements should, too, help revive money market activity and lending.

You will notice that I referred repeatedly to small and medium-sized enterprises. The reason for drawing your attention to these businesses is that they are a significant part of our economy, accounting for about 70% of employment in the euro area and 60% of the turnover of all firms. We believe that the measures introduced last Thursday will provide support for this sector and indirectly also support much-needed investment, growth and employment.

Foundations for a stable economic and monetary union

Let me now shift my attention to last week's European Council summit. For more than 12 years, Europe's economic and monetary union has been haunted by concerns about national budgets. Within a common currency area during normal times, the fiscal policies of individual countries typically face less pressure from financial markets. It was for this reason that at the very beginning of Europe's single currency, the Stability and Growth Pact was established to provide a control mechanism for fiscal policy.

Next year, the euro area as a whole will have a government primary budget deficit close to zero. This compares with primary deficits projected at around 5% of GDP in Japan, the UK and the US.

Yet the implementation of the Stability and Growth Pact has not been good enough. As the Federal Chancellor of Germany recently remarked, the Pact has been broken 60 times over the past 12 years. So we clearly have work to do to prevent this happening again.

The new set of rules for economic and fiscal surveillance known as the six-pack – which was approved by the European Parliament earlier this year – will certainly strengthen the implementation of the rules. But while these changes were being planned, the entire fiscal cohesion and credibility of the euro area was weakened.

We have now begun the process of re-designing Europe's fiscal framework on three fronts.

The first lies with the countries concerned: they have to put their policies back on a sound footing. I believe that they are now on the right track and they are right in implementing budgetary consolidation resolutely. The unavoidable short-term contraction may be mitigated by the return of confidence. But in the medium term, sustainable growth can be achieved only by undertaking deep structural reforms that have been procrastinated for too long.

The second pillar of a response to the crisis consists of a re-design of the fiscal governance in the euro area, what I called the fiscal compact. The fiscal compact is a fundamental restatement of the rules to which national budgetary policies ought to be subject so as to gain credibility beyond doubt.

Last week's summit committed to enshrine these rules in the primary legislation. They will foresee that the annual structural deficit should not exceed 0.5% of nominal GDP. Euro area Member States will implement such a rule in their national legal frameworks at a constitutional level, so that it is possible to avoid excessive deficits before they arise, rather than trying to control them after they have emerged. Prevention is better than cure.

Rules will also foresee an automatic correction mechanism in case of deviation. Moreover, the leaders agreed on a numerical benchmark for annual debt reduction to bring down debt levels. They also agreed to sanctions that will apply automatically to euro area Member States in breach of the 3% reference value for deficits.

The European Court of Justice may be asked to verify the implementation of these rules at national level.

Taken together, I believe that these decisions are capable of making public finances in the euro area credibly robust.

But restoring financial markets' confidence also requires that investors be reassured that government debt will always be repaid and timely serviced. Greece will remain a unique case, and a credible stabilisation mechanism, a firewall, will be in place and can be activated when needed subject to proper conditionality. The leaders unambiguously agreed to assess the adequacy of the firewall by next March. Its objective is to address the threats to financial stability, and especially the risk of contagion between different sovereign debt markets.

The leaders decided to deploy the leveraging of the European Financial Stability Facility (EFSF) at the earliest opportunity. At the same time they agreed that the EFSF's successor, the European Stability Mechanism, should come into force by July 2012.

It is crucial that the EFSF be fully equipped and be made operational as soon as possible. With this goal in mind, last Thursday, the Governing Council decided that the ECB would stand ready to act with its technical infrastructure and know-how as an agent for the EFSF in carrying out its market operations.

Conclusion

Let me conclude. The decisions of the European Council summit, together with the six-pack approved recently by the European Parliament, are a breakthrough for clear fiscal rules in our monetary union.

However, the crisis has not ended yet. It is now important not to lose momentum and to swiftly implement all those decisions that have been taken to put the euro area economy back on course.

The monetary policy measures taken last week by the ECB's Governing Council will support the flow of credit to firms and households in the euro area economy.

Ludwig Erhard faced a situation that was much more difficult than what we face today. Still, he was able to look through the challenging present and to work hard to build a future that he never doubted would be brighter. The European policy makers might well be inspired by his style: "Den Strom der Zeit können wir zwar nicht lenken, aber wir werden unser Schiff sicher steuern."

Thank you very much for your attention.