Mario Draghi: Interview with the *Financial Times*

Interview with Mr Mario Draghi, President of the European Central Bank, in the *Financial Times*, conducted by Messrs Lionel Barber and Ralph Atkins on 14 December 2011 in Frankfurt, and published on 19 December 2011.

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Financial Times: We are now more than four years into the financial crisis. What lessons would you draw so far? What has gone right and what has gone wrong?

Mario Draghi: We have to distinguish two stages. First was the financial crisis, with its repercussions for the real economy. I think we learnt the lessons that we need a more resilient financial system, a system where we would have less debt and more capital. There has been substantial progress in designing new regulatory policies and some progress in implementing this new design.

The second stage of the crisis is really a combination of, I would say, a challenging political phase, where euro area leaders are reshaping what I called the fiscal "compact," and a situation where banks and countries, face serious funding constraints. These challenging funding conditions are now producing a credit tightening and have certainly increased the downside risks for the euro area economy.

Action is proceeding on two fronts. At last week's European Union summit you saw a first step towards fiscal rules that are not only more binding, but actually are of a different nature. They would be binding ex ante, which is an entirely new quality, and written into the primary legislations of the member states.

The second line of action is a set of meaningful, significant decisions taken by the ECB last week. We cut the main interest rate by 25 basis points. We announced two long-term refinancing operations, which for the first time will last three years. We halved the minimum reserve ratio from 2 per cent to 1 per cent. We broadened collateral eligibility rules. Finally, the ECB governing council agreed that the ECB would act as an agent for the European Financial Stability Facility (EFSF).

Will the three-year refinancing operations give banks an incentive to buy "periphery" eurozone bonds?

Not necessarily. Of course banks also have capital difficulties, and these measures don't necessarily help them on that side. The objective is to ease the funding pressures that banks are experiencing. They will then decide what the best use of these funds is. One aspiration is to have them financing the real economy, especially small and medium sized enterprises (SMEs). What we are observing is that small and medium sized banks are the ones having the biggest funding difficulties, and they are generally the ones who provide most of the financing for the SMEs. And SMEs account for about 70 per cent of employment in the euro area's corporate sector.

Is this Europe's version of "quantitative easing"?

Each jurisdiction has not only its own rules, but also its own vocabulary. We call them non-standard measures. They are certainly unprecedented. But the reliance on the banking channel falls squarely in our mandate, which is geared towards price stability in the medium term and bound by the prohibition of monetary financing [central bank funding of governments].

Coming back to what banks are going to do with this money: we don't know exactly. The important thing was to relax the funding pressures. Banks will decide in total independence what they want to do, depending on what is the best risk / return combination for their businesses. One of the things that they may do is to buy sovereign bonds. But it is just one. And it is obviously not at all an equivalent to the ECB stepping-up bond buying.

Do you expect, in the next six months, another round of bank recapitalisations and, in some cases, nationalisation?

Last week, we had the results of the European Banking Authority (EBA) "stress tests" exercise. But ideally, the sequence ought to have been different: We should have had the EFSF in place first. This would have had certainly a positive impact on sovereign bonds, and therefore a positive impact on the capital positions of the banks with sovereign bonds in their balance sheet. So the ideal sequencing would have been to have the recapitalisation of the banks after EFSF had been in place and had been tested.

In fact, it was done the other way round, so the capital needs identified by the EBA exercise reflect stressed bond market conditions. That may exert pressure on banks to achieve better capital ratios by simply de-leveraging.

De-leveraging means two things; selling assets and/or reducing lending. In the present business cycle conditions, I think the second option is by far the worst. I understand regulators have recommended to their banks that they shouldn't go this way, so let's hope they follow this advice.

Couldn't somebody just say to the EBA, look, just hold off now, this is completely unhelpful?

I think the press statement by EBA somehow hints at that, because they say that there wouldn't be another exercise next year.

To be fair to EBA, the shape of the exercise was decided at a time when the biggest economic threat seemed to be the banking system's lack of credibility. People feared banks' balance sheets concealed fragilities that in the end would strain the economies. So they started this exercise thinking that, being transparent, and marking-to-market sovereign bonds, would strengthen the credibility of the banking system and reduce risk premia. At the end, it did not work that way because of the sequencing. But I wouldn't say it's EBA's fault.

The big point here though is, at least the world in 2011, has fundamentally changed, if not for the last two years, where a position where equities would be seen as more risky than government bonds is now in reverse….

The big change is that assets which were considered absolutely safe are now viewed as potentially unsafe. We have to ask what can be done to restore confidence. I would say there are at least four answers.

The first lies with national economic policies, because this crisis and this loss of confidence started from budgets that had got completely out of control.

The second answer is that we have to restore fiscal discipline in the euro area, and this is in a sense what last week's EU summit started, with the redesign of the fiscal compact.

However, we are in a situation where premia for these risks are overshot. When you have this high volatility – like we had after Lehman – you have an increase in the counterparty risk. In the worst case, you can have accidents and even if you don't have accidents, you have a much reduced economic activity because people become exceedingly risk averse.

So the third answer to this is to have a firewall in place which is fully equipped and operational. And that was meant to be provided by the EFSF.

The fourth answer is to again ask: why are we in this situation. Part of this had to do with fiscal discipline, but the other part was the lack of growth. Countries have to undergo significant structural reforms that would revamp growth.

And the fifth answer is that the idea of introducing private sector involvement (PSI) in eurozone bail-outs was, in retrospect, a mistake?

The ideal sequencing would have been to first have a firewall in place, then do the recapitalisation of the banks, and only afterwards decide whether you need to have PSI. This would have allowed managing stressed sovereign conditions in an orderly way. This was not done. Neither the EFSF was in place, nor were banks recapitalised, before people started suggesting PSI. It was like letting a bank fail without having a proper mechanism for managing this failure, as it had happened with Lehman.

Now, to be fair again, one has to address another side of this. The lack of fiscal discipline by certain countries was perceived by other countries as a breach of the trust that should underlie the euro. And so PSI was a political answer given with a view to regaining the trust of these countries' citizens.

Coming to the fiscal pact, what is your answer to those who say there is excessive concentration on budgetary rigour at the expense of competitiveness and growth and that actually what is being created is a "stagnation and austerity union"?

The answer is that they are right and wrong at the same time. They are right because there can't be any sustainable economy without growth and competitiveness and job creation. They are wrong if they think that there is a trade-off between the two. There's no trade-off between fiscal austerity, and growth and competitiveness. I would not dispute that fiscal consolidation leads to a contraction in the short run, but then you have to ask yourself: what can you do to mitigate this.

Improvement in budgetary positions should elicit some positive market response, lower spreads and lower cost of credit. But two further conditions have to be satisfied: Implementation at national level of the structural reforms needed to enhance growth and jobs creation. And finally, it is necessary to have the right euro area design, implementing the fiscal compact, so that the confidence is fully restored. Austerity by one single country and nothing else is not enough to regain confidence of the markets – as we are seeing today.

Consolidation must also go hand in hand with structural reforms. Each country has its own path that they should undertake. For some, the situation would not be sustainable even if they were outside the euro and were to devalue their currency. That would give only a temporary respite – and higher inflation, of course.

But that was part of the answer in the early 1990s in Italy – it did have an exchange rate adjustment.

If you take that as an example, remember there was no IMF around, there was no EFSF and gross [government bond] issuance in 1992 was a multiple of the figures that we see today. It's true that Italy moved the exchange rate, but this cuts both ways. It brought a temporary respite to the economy, so that exports could grow, but it also widened sovereign bond spreads because exchange rate risk came on top of sovereign risk. Three or four years down the road Italy still had something like 600 basis point spread with respect to the German bund. Furthermore, the effect of the devaluation would have been only temporary without the structural reforms (abolition of indexation among others) that followed.

But these austerity programmes are very harsh. Don't think that some countries are really in effect in a debtor's prison?

Do you see any alternative?

They could leave the eurozone?

But as I said before, this wouldn't help. Leaving the euro area, devaluing your currency, you create a big inflation, and at the end of that road, the country would have to undertake the same reforms that were due to begin with, but in a much weaker position.

But maybe it would be the best thing for the rest of the eurozone?

Well, then you would have a substantial breach of the existing treaty. And when one starts with this you never know how it ends really.

You said earlier that it would have been far better if the EFSF had have been in place. So where are we on creating this firewall – what size of bazooka are we talking about?

One first observation is that the delay in making the EFSF operational has increased the resources necessary to stabilising markets. Why? Because anything that affects credibility has an immediate effect on the markets. A process that is fast, credible and robust needs less resources.

It sounds like you're a bit disappointed then with the outcome of last week's summit then?

Actually no, because there was confirmation of previous figures on the EFSF's resources – and of an additional €200bn that could be provided by the International Monetary Fund. What was also overlooked by many is that the date for a first assessment of the adequacy of resources has been brought forward to March 2012 – in just three months' time, when the leaders ask themselves whether the resources for the firewall will be adequate. In the meantime, the ECB acting as an agent will make the EFSF operational. Important was also the commitment to clearly restrict the PSI to IMF practices, which should reassure the investors.

When do you think the EFSF will be operational?

Our aim is to be ready to provide agency functions in January next year.

But can we assume that the idea floated in October of leveraging the EFSF is not actually going to happen? And that bringing in other sovereign wealth funds, Chinese, all this was overpriced.

No, I think it is premature and probably wrong to proclaim the EFSF dead. Furthermore I think that if one can show its usefulness in its present size, the argument for its enlargement would be much stronger.

What do you say to those who say the solution is to have a very big fire wall and ultimately put the ECB behind it, because that is the only thing which will tame the markets?

People have to accept that we have to and always will act in accordance with our mandate and within our legal foundations.

But if you look at the wording of the treaty, there is nothing that sets a limit on how many government bonds you buy….

We have to act within the Treaty. In general, there must be a system where the citizens will go back to trusting each other and where governments are trusted on fiscal discipline and structural reforms.

Once the firewall is in place with the EFSF, perhaps as soon as the beginning of next year, might you actually stop the SMP (securities market programme)?

We have not discussed a precise scenario for the SMP. As I often said, the SMP is neither eternal nor infinite.

Let's not also forget that the SMP was initiated with the view to reactivating monetary policy transmission channels. So as long as we see that these channels are seriously impaired, then the SMP is justified.

Arguably, the monetary transmission channels are more impaired than ever before, if you look at interest rates in Greece or Italy compared with Germany?

The cost of credit is bound to differ because it's geared to some extent not on our short-term policy rate but on sovereign spreads.

Would the ECB consider putting a limit on yields or spreads, or would that violate the treaty in your view?

Sovereign spreads have mostly to do with the sovereigns and with the nature of the compact between them. It is in this area that progress is ongoing. Monetary policy cannot do everything.

But if the economic situation deteriorated, would you be prepared to embark on "quantitative easing" in the style of the US Federal Reserve or Bank of England, in terms of large-scale government bond purchases to support economic growth?

The important thing is to restore the trust of the people – citizens as well as investors – in our continent. We won't achieve that by destroying the credibility of the ECB. This is really, in a sense, the undertone of all our conversation today.

What will be the effect of the British staying out of Europe's fiscal compact, and is there in your view a risk to the City of London?

The UK certainly has shown a capacity to undertake a fiscal correction of an extraordinary size. My more general reaction to all this is that it's sad. I think the UK needs Europe and Europe needs the UK. There's a lot that can be learnt from both sides.

The UK has taken legal action against the ECB [over the location of financial market clearing houses]…

I can't comment on that.

What are you expectations for global growth next year?

You could have a significant slowdown in several parts of the world. Global growth is decelerating, and uncertainty has risen. At the same time, we have laid a lot of groundwork for a better functioning of economic union in the future and we should draw confidence from that.