Mario Draghi: Strengthening the foundations of the euro area and maintaining price stability

Speech by Mr Mario Draghi, President of the European Central Bank, at the Wirtschaftstag 2012 "Kapitalismus in der Krise? Die Zukunft der Marktwirtschaft" der Volksbanken Raiffeisenbanken, organised by Genossenschaftsverband e.V., Frankfurt am Main, 7 November 2012.

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Sehr geehrte Damen und Herren,

Es ist mir eine große Freude, heute hier bei Ihnen zu sein.

I am very pleased to have the opportunity to speak to you today. Small- and medium-sized enterprises – and the banks that finance them – are the backbone of the German economy. Your continued success is vitally important – not only for Germany, but also as a key driver of growth and employment in the euro area as a whole.

For this reason, you are a very important constituency for the European Central Bank (ECB). We pay close attention to your experiences and your views of the future. For example, through surveys that we conduct twice a year, we are able to gather valuable information on the access to finance of smaller companies in the euro area.

The most recent survey was released only last Friday and relates to the period from April to September 2012. It contains information from about 7,000 small and medium-size firms throughout the euro area, of which around 1,000 are from Germany.

The findings are encouraging for firms in Germany. Banks remain willing to provide them with loans. But the situation for SMEs in the euro area overall is more difficult. Many are reporting a deteriorating financing situation. The availability of bank loans for SMEs across countries has become increasingly divergent.

These developments reflect the fact that the economic and financial situation in the euro area remains challenging. I would like to use my address today to discuss that situation and to share with you the ECB's views. I will focus on two themes in particular.

My first theme will be the important steps being taken by governments to put the euro area on the path back to stability. Individually, they are addressing their deep-rooted economic challenges. Collectively, they are working to strengthen the foundations of the euro area.

My second theme will be the measures taken by the ECB to maintain price stability and to remove unfounded fears about the euro area. These measures are essential to ensure that our low interest rates are passed through to the real economy.

The current economic situation

Let me begin with the current situation in the euro area.

Unemployment is deplorably high. Overall economic activity is weak and it is expected to remain weak in the near term. And the growth of money and credit are subdued.

In this context, inflation is well contained. We expect it to fall below 2% next year.

Germany has so far been largely insulated from some of the difficulties elsewhere in the euro area. But the latest data suggest that these developments are now starting to affect the German economy. This is also evident in the KfW-ifo-Mittelstandsbarometer.

Germany is an open and integrated economy, so it is not surprising that a slowdown in the rest of the euro area has an impact here. Intra-euro area trade amounts to around 40% of

German GDP. And around 65% of foreign direct investment in Germany comes from other euro area countries.

But it is less often noted how problems in the wider euro area affect the ***financial situation*** in Germany. It is the weak euro area economy that is keeping interest rates here at very low levels. And it is the crisis of confidence in some euro area countries that is causing safe-haven flows of money into Germany, depressing interest rates even further.

This highlights the fact that countries in a single currency area are connected like communicating vessels. A change in one vessel creates an equal change in all the others.

As interest rates rise in countries in difficulty, they fall in strong countries like Germany. As TARGET2 liabilities increase in some countries due to capital outflows, TARGET2 claims increase in Germany due to capital inflows.

Financial developments in Germany are the mirror-image of financial developments in the rest of the euro area. And this means that measures to ensure the stability of the euro area as a whole will also be to the benefit of Germany.

So let me now turn to the actions being taken by governments to achieve that goal of stability.

Actions by governments to restore stability

Across the whole euro area, governments are making determined efforts to reverse economic imbalances. They are implementing reforms to redress the misguided policies of the past and to create sustainable long-term growth. It is a difficult road and there is still a long way to go. But the early signs are encouraging.

Fiscal consolidation is progressing well in most countries. The International Monetary Fund (IMF) forecasts that the euro area's primary budget will be almost in balance this year. By comparison, Japan will have a primary deficit of 9% of GDP, the United States 6.5% and the UK more than 5%.

We are also seeing some noteworthy improvements in competitiveness. Price competitiveness has improved significantly in several euro area countries. And current account deficits are falling.

For example, the countries under full EU-IMF programmes have seen their unit labour costs improve by more than 10% since 2008, relative to the euro area average. Their current accounts have improved by around 8% of GDP since then.

Governments have also taken measures to strengthen the rules and institutions that guide economic policies in the euro area. This is important to ensure that the positive developments do not simply reverse when economic conditions improve and markets stabilise.

One notable example is the new fiscal compact, which will provide a strong tool for keeping budgets close to balance in the future. Governments have also set up a new framework to prevent and correct unsustainable developments in the private sector.

In short, some hard work has been done in the euro area to unwind imbalances and to reinforce governance. But there is still a lot more hard work to do. Maintaining the current momentum of reform is essential for putting the euro area on the path back to stability.

Fragmentation in monetary policy transmission

Let me now turn to the measures being taken by the ECB.

The confidence crisis and the process of adjustment across the euro area has weighed on short-term growth and dampened inflationary pressures. To maintain price stability, the ECB has lowered its interest rates to historically low levels.

But before August this year, our low interest rates were not reaching companies and households evenly across the euro area. In some countries, interest rate reductions were being fully passed on. In others, lending rates barely declined. And in a few countries, they had actually risen.

This divergence happened because banks in some countries had found it increasingly expensive to obtain funding from market sources. They therefore could not pass on the lower interest rates to their customers.

This meant that monetary policy was unable to support the real economy in these countries. Smaller companies were affected the most, as was clear from our surveys of SMEs. And as companies in the euro area are very dependent on bank loans for financing, some economies were being forced into a damaging cycle.

Economic activity was weakening. Public finances were deteriorating. Banks and governments were being forced to pay even higher interest rates. And credit and economic growth were then falling further, leading to rising unemployment and reduced consumption and investment.

This situation posed serious risks not only for the countries concerned, but for the whole euro area. It was hindering the overall economic recovery. It was even damaging the single market, as healthy companies were being curtailed in financing solely because of their location.

If this situation had been left unaddressed, it could have created a risk of deflation and threatened the ECB's ability to ensure price stability. That is why we decided that action was essential.

Understanding the ECB's response

How did the ECB respond to this situation?

In our analysis, a key reason why our low interest rates were not being passed on was that, earlier this year, some investors had become influenced by imagined scenarios of disaster. They were therefore charging very high interest rates to governments and private borrowers in countries they perceived to be most vulnerable.

These interest rates went beyond levels warranted by economic fundamentals and justifiable risk premia. Interest rates do not have to be identical across the euro area. But it is unacceptable if the reason for large differences is the fragmentation of capital markets caused by fears of a euro area break-up.

It was clear to us that governments could not address these break-up fears alone. The only way to restore market confidence and the proper transmission of our monetary policy was a fully credible backstop against disaster scenarios.

Our new programme of Outright Monetary Transactions provides this backstop by allowing for unlimited interventions in government bond markets. This commitment has generated a lot of debate. But we have to understand how markets work. Our actions have to send a clear signal to markets that their fears about the euro area are baseless.

It is important to stress that "unlimited" does not mean uncontrolled. Most importantly, to qualify for interventions, countries must have agreed a European Stability Mechanism (ESM) programme with strict conditionality and IMF involvement. The ECB will only intervene if the policy conditions under that programme continue to be met.

Conditionality is very important. It ensures that countries continue to reform while the ECB is active. It provides a clear basis for us to terminate our operations if the programme is not complied with in full. And it also protects the ECB's independence, as we will not be forced to substitute for a lack of actions by governments.

Consequences of the ECB's actions

So what can citizens expect will be the consequences of the new programme? Let me emphasise three key points.

First, our actions will not lead to disguised financing of governments.

Interventions will take place solely on the secondary market, where bonds already issued are traded. This is fully consistent with the Treaty's prohibition on monetary financing. And since we will only purchase bonds with a remaining maturity of between one and three years, there will still be ample room for market discipline on governments at longer maturities.

Second, our actions will not lead to inflation.

The weak overall economic situation, combined with slow money growth, means that the risks of inflation are currently very low over the medium term. Our interventions will not change this outlook. In fact, for every euro we inject with our interventions, we will withdraw a euro. So they will not affect monetary conditions.

Furthermore, we see no signs that our announcement has affected inflation expectations. They are firmly anchored because we have always delivered price stability. And citizens can trust that we will continue to do so: price stability remains our mandate and our sole objective.

Third, our actions will not lead to greater risks for taxpayers in Germany.

Taxpayers are protected by the fact that our interventions will take place ***only*** in countries with sound economic and fiscal policies. Their continued commitment to these policies will be ensured by the ESM programme. And the ECB will assess compliance with this programme in full independence.

Moreover, by normalising conditions in financial markets, our actions will help reverse the capital flows into Germany that are creating some distortions here. This should ultimately support the savers, pension funds and insurance companies that depend on interest income. And it should reduce TARGET2 imbalances.

In other words, ECB actions that support market confidence are of benefit not only to countries in difficulty, but also to the euro area as a whole. Our measures ensure the proper transmission of monetary policy, which means neither excessively high interest rates nor excessively low interest rates. The measures enable the ECB to continue to maintain price stability for the benefit of all citizens of the euro area.

The announcement on OMTs has already triggered positive effects. Sentiment in financial markets has improved significantly. Excessive government bond spreads have gone down, a number of banks in stressed countries have been able to regain access to markets and Target2 balances have broadly stabilised.

The way forward

Let me draw to a close.

Actions by the ECB can build confidence in the euro area in the near term. But only actions by governments can secure confidence in the euro area over the longer term. In particular, governments need to work together to establish a stronger institutional structure for the euro area.

This process began in June this year with what has been called the "Four Presidents' Report". That report – of which I am a co-author – identified four key pillars on which a stable and prosperous monetary union should be built. These pillars are financial union, fiscal union, economic union and political union.

In the near term, the most important pillar is financial union. Financial union is essential in a single currency area where cross-border capital flows can lead to credit booms and other imbalances – and where the negative effects of a bust can spread rapidly to other members.

One essential part of financial union is a single banking supervisor. As you know, the European Commission has recently proposed that the new supervisor should be based at the ECB. This is important to ensure consistency across the euro area and to prevent regulatory capture. Day-to-day tasks, however, would remain with national supervisors who have the competence and resources to implement them.

But financial union does not have to imply the pooling of deposit guarantee schemes, an issue that I know is of concern in this country. Organising and funding deposit guarantee schemes can remain a national responsibility, with comparable effectiveness.

In the longer term, all four pillars are equally important. They are the bedrock for the enormous potential of the single currency for Europe's citizens.

Completing economic and monetary union would give citizens greater security against any future crisis. It would create the foundations for sustainable growth and employment. For all citizens of the euro area, it is therefore essential that Europe's leaders stay on course.

Thank you for your attention.