Mario Draghi: The monetary policy of the European Central Bank and its transmission in the euro area

Speech by Mr Mario Draghi, President of the European Central Bank, at the opening of the academic year 2012–2013, Università Bocconi, Milan, 15 November 2012.

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Financial markets and the disruption caused to the transmission of monetary policy

The year that is about to end will be remembered not only for the effects the European sovereign debt crisis has had on the euro and for the significant weakening of the European economy, but also for the responses to these challenges by the ECB, national governments and the European Union.

The artificial calm in the markets prior to the crisis had, in Europe, for a long time allowed misguided economic policies or simply encouraged inaction in countries that had profound need for fiscal consolidation and structural reforms. The outbreak of the crisis substantially increased risk aversion: the weaknesses of these countries were exposed; in an environment of already weak growth, investors turned away, sovereign spreads started to rise.

Soon, the solvency of the governments of these countries was questioned, and with it the solvency of the financial institutions located there. Within the euro area, less and less money circulated between banks in different countries. Doubts about the future of the euro area in its current form encouraged a speculative movement which lead to further increases in sovereign spreads. All the governments of the weaker countries responded with fiscal consolidation policies, initially hesitant, then more vigorous. But economic activity continued to weaken and spreads continued to grow.

It was a situation which has brought into focus the nature of the “ideal” fiscal consolidation – one which reduces the deficit and the debt with the least negative consequences for a country’s GDP.

The prevailing evidence indicates that it should be concentrated on reductions in current spending and not on tax increases. Even those who do not share this approach agree, however, that it is essential that the process be perceived as credible, irreversible and structural so that it can affect sovereign spreads, and that price stability conditions as well as conditions on financial markets are such that they do not interfere with fiscal consolidation.

In response, the ECB lowered its benchmark interest rates. Under normal circumstances, such reductions would have been transmitted in a relatively uniform way to households and firms across the euro area. But that’s not what we found.

In some countries, the rate cuts were fully passed on. In others, the interest rates charged on bank loans to the real economy declined only little, if at all. And in a others still, some lending rates have actually risen.

Why this divergence? The concept of “monetary policy transmission” is fundamental to the activities of a central bank, i.e. the process by which changes in the benchmark rate of interest of a central bank are transmitted through the financial system to the real economy.

In a system that is working properly, there is a stable relationship between changes in the central bank’s rates and the cost of bank loans for households and firms. Central banks can thus influence the overall economic situation and maintain price stability.

But the financial system of the euro area has witnessed a severe fragmentation of the single financial market. The costs of bank financing differed greatly in different countries. Many banks, and in some countries the entire banking system, have in fact had no access to the euro area interbank market. Increases in interest rates on government securities have exacerbated the funding costs of domestic banks and severely limited their access to markets.

This has made difficult the transmission of impulses coming from an accommodative monetary policy through adjustments in interest rates on loans to households and firms by banks. Interest rates do not have to be identical across the euro area, but it is unacceptable if significant differences arise because of the fragmentation of capital markets or the perception of a break-up of the euro area. In an economy like that of the euro area, where about three-quarters of corporate finance comes from the banking sector, the impact on the real economy, investment and employment are serious. The fragmentation of the single financial market has led to a fragmentation of the single monetary policy.

For this reason, the countries most exposed to the crisis of confidence were not able to take advantage, except to a limited extent, of the low rates of interest: they had entered a vicious circle.

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

The outlook for the euro area economy as a whole was increasingly fragile. There were potentially negative consequences for Europe’s single market, as access to finance was increasingly influenced by location rather than creditworthiness and the quality of the project.

The disruption of the monetary policy transmission has profound implications. It threatens the single monetary policy and the ECB’s ability to ensure price stability in both directions. This was why we acted.

Restoring the proper transmission of monetary policy

To decide what type of action was appropriate, we had to make two key assessments. First, we had to diagnose precisely why the transmission was disrupted. And second, we had to identify the most effective policy tool to repair those disruptions, while remaining within our mandate to preserve price stability.

The countries most affected are those where the economic policies of the past tended to be inappropriate, where the response of governments at the start of the crisis was half-hearted and hesitant. It is up to the governments of those countries to make a major effort to regain credibility.

The responses of all these governments have been remarkable for its intensity and speed, and yet interest rates continued to rise. There was a fear factor in the market valuations that governments alone did not seem able to dispel.

A situation of systemic instability was occurring; it was undermining the euro area and dashing hopes for the positive effects of the reforms undertaken to restore the transmission of monetary policy. It was necessary to allay the unfounded fears about the future of the euro area. It was necessary to create a credible support mechanism capable of averting destructive scenarios, and the exercise of that support falling within the mandate of the ECB.

The OMTs have been designed for this purpose, to restore the transmission of monetary policy.

The OMTs provide for interventions in the markets for government securities, with no ex ante limits, but not in an uncontrolled or unconditional way. These interventions relate to bonds with a residual maturity of up to three years. It is a clear signal to investors that their fears about the future of the euro area are unfounded.

But we have not forgotten the origin of the problems of the sovereign debt market in Europe. One of the requirements for conducting OMTs is that the countries concerned must have negotiated with other governments in the euro area a programme under the European

Stability Mechanism (ESM) which imposes strict, effective and credible conditions over an extended period of time. In this way, governments are obliged to continue the necessary reforms, even in a scenario where the ECB intervenes. The participation of the International Monetary Fund (IMF), with its experience in monitoring adjustment programmes, is an additional safeguard.

The consequences of the ECB's actions

First, OMTs will not lead to disguised financing of governments. We have specifically designed our interventions to avoid this. They will take place solely on secondary markets, where bonds that have already been issued are traded. If interventions take place, they will involve buying government debt from investors, not from governments. All this is fully consistent with the Treaty's prohibition on monetary financing. Moreover, they will focus on shorter maturities and leave room for market discipline on longer maturities.

Second, OMTs will not compromise the independence of the ECB. The ECB will continue to take all decisions related to OMTs in full independence. It will decide whether to intervene based on its own assessment of monetary policy transmission and with the aim of safeguarding price stability. The fact that governments have to comply with conditionality will actually protect our independence. The ECB will not be forced to step in because of a lack of policy implementation.

Third, OMTs will not create excessive risks for euro area taxpayers. Such risks would only materialise if a country were to run unsound policies. This is explicitly prevented by the ESM programme. And we have been very clear that each time a programme starts being reviewed, we will routinely suspend operations and resume them only if the review has been concluded positively. This will ensure that the ECB intervenes only in countries where the economy and public finances are on a sustainable path.

Finally, OMTs will not lead to inflation. We have designed our operations so that their effects on monetary conditions will be neutral. For every euro we inject, we will withdraw a euro. In our assessment, the greater risk to price stability currently is associated with the possibility of falling prices in some euro area countries. In this sense, OMTs are not in contradiction to our mandate: in fact, they are essential for ensuring we can continue to preserve price stability.

Moreover, we have no evidence that the announcement of the OMT programme has affected inflation expectations. They continue to be firmly anchored. This is testament to our track record on price stability over the last decade and our credible commitment to preserving it. We have all the necessary tools at our disposal to maintain it and to withdraw any excess liquidity in case of upward risks to price stability.

Since the announcement of the possibility to undertake OMTs, there have been several signs of greater tranquillity in financial markets: the significant decline of sovereign spreads, the resumption of capital flows by money market funds in the United States, which had stopped for about a year, some issues of corporate and sovereign bonds from countries that had lost access to the market for almost three years, such as Ireland and Portugal, the completion of the financing plans of the Italian and Spanish treasuries, the fact that the share of Italian public debt held by non-residents has increased, and lastly a stabilisation of TARGET2 balances, which are the true measure of the economic and financial imbalances in the euro area. Finally, it is yesterday's news that recourse to the ECB by banks in some large countries that were in difficult funding conditions has declined for the second consecutive month. It is important to understand that financial stability in the euro area is in everyone's interest, but primarily in the interest of creditor nations which have greater exposures.

There is no doubt that these improvements would not have been sustainable, nor would they be so in the future without an extraordinary, persistent and, above all, structural consolidation of public budgets and structural reforms in all euro area countries.

Completing economic and monetary union

It is worth looking back to remind ourselves of the difficulties that the process of European integration has encountered in the past, and overcome.

Tommaso Padoa-Schioppa's tenure at the Banca d'Italia and at the European Commission was punctuated by realignments in the exchange rate mechanism of the European Monetary System. He famously pointed out the key problem of the "inconsistent quartet" – fixed exchange rates, free trade, capital mobility and national monetary policies.

The single currency was identified as the solution.

Today, we see that this solution was incomplete. The crisis has exposed the need to complete economic and monetary union.

In my joint work with the Presidents of the European Council, the European Commission and the Eurogroup, we have identified four pillars on which to build a stable and prosperous Europe: a banking union with a single supervisor; a fiscal union that can effectively prevent and correct unsustainable budgets; an economic union that can guarantee sufficient competitiveness to sustain high employment; and a political union that can deeply engage euro area citizens.

Progress is under way in all these directions. Of course, it is not straightforward to implement such an ambitious vision. But I am confident that Europe will once again emerge stronger from its present difficulties.

Tommaso was convinced that "a strong currency requires a strong economy and a strong policy, not only a central bank that is strong and authoritative". I share his conviction.

The ECB's response to the crisis has a clearly defined relationship with the process of European integration.

With our non-standard policy measures, we have preserved the functioning of the monetary policy transmission mechanism and thus been able to maintain a steady course for the objective of price stability inscribed in our mandate. Potentially disastrous outcomes to the crisis have been thwarted; valuable, though not infinite, time has been gained.

But the ECB cannot replace the actions of national governments with respect to either economic policy effectiveness or democratic legitimacy. Ultimately, it is up to governments to dispel once and for all the persistent uncertainties that markets perceive and citizens fear.

The ultimate goal is political union, a stable and integrated Europe with a common destiny. This will take a long time and the path will be an uncertain one. But in the meantime, it would be wrong not to act.

A great deal has been achieved already. Governments have implemented corrective actions for public finances. The fiscal compact envisages the principle of balanced budgets in national legislations. The ESM provides for the possibility of financial assistance for countries in difficulty to keep the crisis from spreading. And the ECB's non-standard policy measures will be complemented by banking union, a single supervisory mechanism for European banks.

It is essential that all parties involved in Europe's large and complex path of reforms stick to their commitments. We have to proceed along this path with calm pragmatism, asking ourselves what the minimum requirements for completing Economic and Monetary Union are. They are all within our reach, including fiscal reform and structural policies to support competitiveness and growth.

Along the way, we must remain guided by the principle that no country is justified in pursuing policies that harm other members of the community to which it belongs. The construction of an institutional architecture for Europe based on this foundation is not only a response to a need for responsibility. Without the sharing of national sovereignty at European level, the very sovereignty of individual states is in danger.

This is the first lesson of the crisis for us Europeans. It is not only a matter of economics and finance. We can, together with Zygmunt Bauman, extend it to much broader areas.

He wrote: “The European house is not to the detriment of national cultures, but provides a sort of roof covering local traditions, values and differences. And the paradox is that each country is much more at risk of losing its specific identity if it is exposed without protection, that is, without this European shield, to the global forces which are violently and blatantly supranational, which disregard local issues and specificities”.

Let me finish with an anecdote about Tommaso, to whom we are dedicating this professorship today. As you know, in recent months I have repeatedly stressed the irreversibility of the euro. This was precisely the sentiment of one of Tommaso’s most noted quips. Speaking in 2004 about the “EMU”, an abbreviation for Economic and Monetary Union, he remarked that it was also the name of an Australian bird rather like an ostrich. And he added: “Neither of them can go backwards”.

Thank you for your attention.