Mario Draghi: The policy and the role of the European Central Bank during the crisis in the euro area

Speech by Mr Mario Draghi, President of the European Central Bank, at the Katholische Akademie in Bayern, Munich, 27 February 2013.

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Excellencies,

Ladies and Gentlemen,

I am delighted to be here in Munich at the Catholic Academy and thank you for this kind invitation. As befits this setting, I would like to begin my remarks by noting the momentous nature of the current period for the Catholic Church, on the eve of the last day of the pontificate of Benedict XVI.

Pope Benedict, a great son of Bavaria, used his eight years at the helm of the Church to address a variety of pressing concerns of the modern world. Among them was an emphasis on ethical concerns in the economic relationships of our globalised world.

Those concerns have become more relevant than ever during the economic and financial crisis that now extends into its fifth year.

The crisis has dented people's confidence in the capacity of markets to generate prosperity for all. It has strained Europe's social model. Alongside the accumulation of staggering wealth by some, there is widespread economic hardship. Entire countries have been suffering from the consequences of misguided past actions – but also from market forces that are sometimes beyond their control.

In a sense, the "social question" of the 19th century, which inspired the Catholic Social Doctrine, has re-emerged – but today it transcends national borders: what is the right framework for reconciling free enterprise and individual profit motives with concerns for the common good and solidarity with the weak?

In recent decades, this question seemed to be approached from a purely economic perspective. The invisible hand of the market, if only left unconstrained, would eventually generate better outcomes for all. The rational actions of *"homo oeconomicus"* were seen as divorced from ethical concerns about compassion, charity and decency. It seemed forgotten that Adam Smith, the philosophical father of market economics, saw his "Wealth of Nations" as inextricably linked to his "Theory of Moral Sentiments".

Thankfully not everywhere. At the Jesuit school in Italy where I was educated, we had a fundamental guiding principle: our striving for excellence had to be paired with integrity and a moral message – an ultimate sense of purpose in the service of social justice and fairness.

I have previously noted that "without ethics, there cannot be a genuine development". We cannot have an economic model that allows excesses to go uncorrected, which relies exclusively on self-regulation of markets and in which individuals believe that "anything goes".[1] Ultimately, we must be guided by a higher moral standard and a profound belief in creating an economic order that serves every person.

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1 M. Draghi "Non c'è vero sviluppo senza etica" – Articolo per "*L'Osservatore Romano" del 9 luglio 2009: "La crisi attuale conferma la necessità di un rapporto fra etica ed economia, mostra la fragilità di un modello prono a eccessi che ne hanno determinato il fallimento. Un modello in cui gli operatori considerano lecita ogni mossa, in cui si crede ciecamente nella capacità del mercato di autoregolamentarsi, in cui divengono comuni gravi malversazioni, in cui i regolatori dei mercati sono deboli o prede dei regolati, in cui i compensi degli alti dirigenti d'impresa sono ai più eticamente intollerabili, non può essere un modello per la crescita del mondo.*"

Here I find myself in the company of Marx. Not Karl, but Reinhard. Cardinal Reinhard Marx has rightly insisted that *"the economy is not an end in itself, but is in the service of all mankind."*

And caring for the welfare of our neighbours is not only an ethical principle of the Christian faith: it also makes eminent economic sense. No-one knows this better than the successful entrepreneurs of Bavaria. Interdependence is not just a catchword. The economic health of the countries around you affects us here and now.

So these are the challenges facing European policy-makers today: how do we recreate confidence in the capacity of our economies to grow and generate prosperity so that they can ultimately serve the people? How do we shape our economic model so that it reconciles individual freedom and social justice? And how, as the European Union, do we strike the right balance between the responsibilities of individual countries and those of the Union as a whole?

How the ECB plays its part

Let me begin by focusing on the role of the European Central Bank (ECB).

We have been given a special responsibility by the people of the euro area to ensure price stability. Price stability is the foundation of a functioning economy. It is also the basis for a just and fair society. It is a common good for all Europeans.

As Walter Eucken, the philosophical father of ordoliberalism, noted, *"all efforts to establish a liberal order are futile unless a certain monetary stability is guaranteed. Monetary policy therefore has a primary importance for the liberal order."*[2]

Price stability ensures that the market mechanism works properly, which is the best way we know to create growth, jobs and prosperity for all. It preserves the purchasing power of our money and the value of our savings.

And it has profound social implications. Stable prices support the weakest members of our societies – including pensioners and the unemployed – who depend on fixed incomes to live. In that sense, a stability-oriented monetary policy is a key component of the Social Market Economy.

I do not say this based on theory: the history of this country has taught us that inflation undermines not only economic wealth but also political stability. The deep-seated fear of inflation is therefore more than understandable. Your own national experience is at once a powerful reminder and steadfast obligation for the central bank.

The challenges of the crisis

But preserving price stability today requires different actions than it did in the past. We have required new tools to ensure that our monetary policy decisions are able to reach firms and households.

This is because the crisis has severely fragmented the euro area's financial system. It has disrupted the way our interest rate changes are passed on by banks to the wider economy. As a result, our low interest rates have simply not been getting through to people in some parts of the euro area.

This may sound like a technical matter. But the transmission of interest rates is fundamental. The euro area is a bank-based economy. Around three quarters of firms' financing comes

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[2] Walter Eucken, (1952) "Grundsätze der Wirtschaftspolitik", p. 265: "Alle Bemühungen, eine Wettbewerbsordnung zu verwirklichen, sind umsonst, solange eine gewisse Stabilität des Geldwertes nicht gesichert ist. Die Währungspolitik besitzt daher für die Wettbewerbsordnung ein Primat."

from banks. So if banks in some countries will not lend at reasonable interest rates, the consequences are dire.

Perfectly healthy companies would be forced to close. Credit for new investment would not be available. Not because business models are flawed or because investment projects are too risky, but because firms happen to be located in the wrong place.

Worse still, in the first half of last year fragmentation in the euro area had become so serious that some investors were questioning the future of our currency. Fears of a potential break-up were sending capital fleeing from the periphery to the core. For some in the financial markets, the most fundamental notion of confidence in a currency – that a euro is a euro regardless of where you are – was no longer a given.

But a currency whose integrity is in doubt cannot be a stable currency.

So we had to decide: do we passively let events take their course and accept severe risks for price stability? Or do we assume the responsibility, within our mandate, to defend the stability of our currency and our monetary union?

Those were difficult and existential decisions. They required deep reflection, a proper assessment of risks in the short and long term, and a clear-headed judgement of possible alternatives. They also required the courage to face the inevitable criticism and engage with those who disagreed.

But we chose to act – because we judged this to be right and necessary to safeguard price stability.

Defending the transmission of monetary policy

First, we acted to remove blockages that were stopping banks from passing on our low interest rates to borrowers.

We allowed banks to take as much liquidity as they needed from our operations. We allowed a wider set of collateral that banks could use to access this liquidity. And we extended the maturity of our operations, going up to 3 years.

Second, we acted to remove the unfounded fears about the future of the euro area that were undermining the stability of our currency.

We launched a new measure called Outright Monetary Transactions (OMTs) to provide a fully effective backstop in the sovereign bond market.

We focused on this market because it has a "knock-on" effect on other markets. Fears in the sovereign bond market were seeping into the banking system. They were paralysing the economy, and ultimately threatening price stability. By putting in place a credible backstop, we were able to remove those fears at the source.

Those fears were unjustified by economic fundamentals. They were the result of market failure: a situation where investors seem to act rationally, but collectively they create destructive outcomes. Countries that were fundamentally adjusting were being driven to the wall by panic. And the result would have been unnecessary hardship and suffering.

Much has been written about this measure, especially in this country, and some fundamental questions have been raised:

- Is the ECB still independent?
- And will the ECB stay focused on fighting inflation?

The answer to both these questions is a categorical "yes".

First, we always protect our independence.

We take all our monetary policy decisions in full independence. And we have designed the OMTs so that these decisions could never be dominated by fiscal policies. This is why a pre-condition for access to the OMTs is a strong economic adjustment programme. It ensures that we would only ever intervene in situations where fiscal discipline is firmly ensured.

Second, we keep a permanent watch on inflation.

We understand and take very seriously people's concerns about possible inflationary threats. But it is a fallacy to make a mechanical connection between the creation of central bank liquidity and a rise in the money supply. The liquidity we provide to banks is used in the markets where banks lend to each other. It does not automatically increase credit or money in the economy – and so does not automatically lead to price pressure in the economy.

Indeed, money growth is currently well below an inflationary level. Credit provision to the private sector is overall weak, and contracting in large parts of the euro area. And inflation expectations are firmly anchored. So risks of inflation down the road are firmly in check.

The euro area dimension to our actions

It is also important to understand that our measures are designed not only to help the people in countries under stress. In fact, in line with our mandate, they serve the citizens of the whole euro area.

Many of the financial developments that concern people in this country – such as meagre returns on their savings or large imbalances in the Target-2 payment system – are really only the mirror image of fragmentation in the rest of the euro area.

As money flows out of stressed countries and into safe-haven countries like Germany, it pushes up interest rates in the stressed countries, and pushes down interest rates here. These flows cause Target-2 imbalances to increase.

What has not been sufficiently acknowledged, however, is that these imbalances would only affect German taxpayers in the event of a break-up of the euro area. This means that actions by the ECB that protect the euro area against such outcomes – like the OMTs – *also* reduce hypothetical risks for German taxpayers.

And this is exactly what we have seen. Since the announcement of the OMTs, the Bundesbank's Target-2 exposure has decreased by more than 100 billion euros.

In sum, the ECB has acted, and will continue to act, to fulfil its mandate. We are committed to preserving the integrity of our currency, in the interests of all people of the euro area.

We do not act to help banks. We do not act to help governments. We act to help maintain the flow of credit to real firms and households. We act to preserve price stability.

Incidentally, while some in this country are wondering whether the ECB does "too much", elsewhere in the euro area I am asked why the ECB does not "do more". I just returned from the Spanish Parliament in Madrid – and the concerns expressed there are very different from what I hear in Germany. People worry that a stagnating economy will lead to the emergence of a "lost generation", where young people have no jobs, and even worse, no hope.

But our answer – both to those who want us to do less and to those who want us to do more – is the same: we will preserve price stability. This is our mandate.

How governments play their part

It is important to stress that the ECB's mandate only extends so far. There are clear limits to what monetary policy can and should aim to achieve.

We cannot repair unsound budgets. We cannot clean up struggling banks. We cannot solve deep-rooted problems in the structure of Europe's economies.

Our monetary union was deliberately constructed so that these policies would be the preserve of elected governments in each Member State. Sharing a common currency would only be sustainable if each country assumed its own responsibility.

This reflects the subsidiarity principle embedded in our European Treaties. And in that sense, it also echoes a central tenet of Catholic Social Doctrine. As Pope Pius XI wrote in 1931, *"It is a fundamental principle that one should not withdraw from individuals and commit to the community what they can accomplish by their own enterprise and industry."*[3]

Individuals have to do what they can to help themselves before they seek help from the community. The same is true for the countries in the euro area.

Fortunately, this is what we are seeing across Europe today.

Governments have already done a lot to tackle the imbalances that accumulated in previous years.

Progress in implementing economic reforms has been extraordinary. Deficits are being reduced. Current account imbalances are being unwound. Wide-ranging structural reforms are underway.

Particularly impressive is the scale of the adjustment that has taken place in countries receiving financial assistance.

In many countries these efforts have largely removed the underlying drivers of the sovereign debt crisis. But while sovereign debt markets have improved, bank lending is still very fragmented across the euro area. Credit in some countries is still difficult to obtain. The benefits of the painful actions undertaken so far have not yet materialised.

And this means that economic adjustment is coming at a heavy social cost. Economists often speak about "inevitable adjustment costs", which to some sounds cold, heartless and lacking compassion. But we are fully aware of the human dimension that lies behind it.

Euro area GDP is currently lower than it was in 2008. Almost 19 million people are unemployed – more than the population of the Netherlands.

Unemployment is a tragedy. It squanders the vitality of our workers. It prevents people from playing a full and meaningful part in society. It induces a sense of hopelessness, which drains the inspiration from our young.

Reform as the path to growth and fairness

Reducing unemployment is therefore a pressing challenge.

Governments need to address the structural problems in their economies. They need to enact fundamental reforms that boost the potential of their economies to grow.

We need reforms that make doing business easier. That guarantee that those who owe taxes actually pay taxes. That ensure that public services actually serve the public.

And these reforms should aim not only to create more growth and jobs, but also to make society fairer.

Fairness starts *within* countries.

In one country in the euro area, more than fifty percent of young people cannot currently find jobs. Is it fair that, as a result, this generation has to bear the bulk of the burden in the downturn?

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[3] Pope Pius XI, Quadragesimo Anno, 79.

In another country, an estimated 55 billion euros of tax revenue remains unpaid. Is it fair that, as a result, other people who are taxed on their salaries have to make up the difference?

This is why I say that reforms that make economies work better also make them fairer.

And fairness also matters *between* generations.

Many countries have to think hard about how they can support ageing populations and generous welfare states. The unsustainable option is to keep increasing debt. But this means nothing else than passing the burden onto future generations. There is no real equity through debt.

The sustainable option is to generate the higher growth that is needed to maintain Europe's social model. And this is only possible by walking the path of determined reform.

There is no doubt that this is the hard path. But it is also the courageous path. It is the path that will create jobs; that will support our social model in the future; and that, in the end, will contribute to a fairer society.

For this reason, it is wrong to claim that countries are undertaking reforms only to please the markets or to satisfy the demands of technocrats in Brussels, Frankfurt or Washington. They are doing it for their own benefit. And it is time that this message gets more emphasis.

The place for mutual support

But what if countries cannot succeed on their own?

The ethical imperative when we see others in need is to help. It is to do what we can to limit their hardship.

Should this not also apply within the euro area? Should countries support those in difficulty?

The answer is yes. Catholic Social Doctrine makes absolutely clear that subsidiarity has to be paired with support. But what binds these together is *trust*.

Trust that each will put its own house in order – even if it is politically difficult.

Trust that each will play by the rules – even if this imposes unpopular choices.

Trust that each will constrain its sovereignty – even if this means making a break with the past.

Such trust has to be built through actions, which is a further reason why the process of reform across the euro area is so important. It shows that countries are ready and willing to be full members of the community. And this makes mutual support between them possible.

Certainly, countries in Europe are already doing a lot to help each other. They are providing generous financial assistance on condition that underlying problems are fixed. But in my view, once trust is established, we should go further still.

We should take stronger collective responsibility over national economic and financial policies, to ensure that countries do not get into trouble in the first place. We should make better use of common resources, to encourage reforms and restore the dynamism of our economies.

In other words, we should aim to build a strong and deep economic and political union in Europe, which would be to the benefit of all members of the single currency.

As I said at the beginning of my remarks, today's social question is not just a national one. It transcends borders. And this path – building a stronger union based on mutual trust – is the way to answer that question for Europe.

Conclusion

Let me conclude by returning to the theme of Cardinal Reinhard Marx – that the economy should be in the service of humanity.

Our common currency exists not as an end, but as a means. As Nobel Prize winning economist Amartya Sen has reminded us, our *"instrumental objectives – like the single market and monetary union – should not overshadow our social commitment to the well-being and basic freedoms of the people."*[4]

The euro is a means to foster peace between nations; and a means to further our collective prosperity.

In many ways, we have already achieved this. War among the countries of Europe is unthinkable. We have integrated our nations and our markets. The ECB has overseen the longest period of price stability in post-war history.

But there are also important ways in which we have not succeeded. The terrible economic hardship in some parts of the euro area is testament to this.

So what we cannot afford now is to stay where we are.

Federal President Joachim Gauck recently called upon all of us to have more courage for more Europe: *"What Europe needs now are not doubters but standard-bearers."*[5]

We need to reinvigorate our social models by reforming our economies.

And we need to harness the market mechanism in the service of humanity.

In this way we can safeguard our primary capital, which is the human person in his or her integrity.

Thank you for your attention.

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4 Sen, A. K. (1996), "Social Commitment and Democracy: The Demands of Equity and Financial Conservatism," in P. Barker (ed.), Living as Equals.

5 Joachim Gauck, Speech on the prospects for the European idea, 22 February 2013.