

Mario Draghi: Building stability and sustained prosperity in Europe

Speech by Mr Mario Draghi, President of the European Central Bank, at the event entitled “The future of Europe in the global economy”, hosted by the City of London Corporation, London, 23 May 2013.

* * *

Ladies and Gentlemen,

Introduction

Let me begin by thanking you, Lord Mayor, for this kind invitation.

I have always been deeply impressed by the sense of commitment that motivates distinguished City of London professionals such as yourself to take on the demanding role of your office.

No doubt this sense of responsibility to the community has been instrumental in delivering the longevity and stability of the City of London Corporation. This institution has played an important role in developing the Square Mile into the premier financial centre of the world.

I cannot say which of the two sets of arguments is stronger, the economic or the political ones, but what I can say is that Europe needs a more European UK as much as the UK needs a more British Europe. To limit myself to matters that are close to my own professional capacity, let me note a few reminders of the depth of the interconnection:

More than twice as many euros are traded in the UK’s foreign exchange market as in all the countries of the euro area combined and more than in the US.

All major euro area banks have important branches in the City of London – and UK banks are leading players in financial markets of the euro area.

Around 40% of the deposits placed with euro area banks from outside the euro area come from the UK.

At the same time, an equally large share, i.e. 40%, of all loans granted by euro area banks to non-euro area residents goes to UK borrowers.

In fact, 40% seems to be a key figure when looking at the UK’s linkages with the euro area: it is also approximately the share of the euro in all the foreign currency-denominated loans as well as deposits in the UK.

Finally, the euro area is the UK’s largest export market. It may not come as a surprise to you by now that no less than 40% of all the goods and services exported by UK businesses are delivered to euro area countries. In 2012 this amounted to 240 billion euros, or just short of 200 billion pounds.

With such deep interconnections, the UK and the euro area share a common interest: stability in the functioning of our economic system and particularly of our financial markets.

As a long-established financial powerhouse, London is no stranger to crisis. “Lombard Street”, the classic work of Walter Bagehot on the London money market recounts multiple instances of panic gripping this market.¹

Bagehot’s book also made a series of recommendations for how the Bank of England should react to such bouts of market instability. Today, these recommendations are commonly

¹ W. Bagehot (1873), *Lombard Street: A Description of the Money Market*, Wiley, New York, 1999, originally published by Henry S. King and Co., London, 1873.

regarded as having set out the principles by which central banks should conduct lender of last resort operations.

Of course the world has changed since Bagehot was writing in the second half of the 19th century. And the crisis that we are facing today is much more multi-faceted than an isolated panic in a specific market segment. This means that the policy response must also be multi-faceted – and it must involve a wide array of institutions.

We as central banks have acted as crisis managers. Our response was immediate and forceful. When called on to act, central banks have been able to draw on a wide and powerful toolkit to steer the economy in difficult times.

In my remarks this evening I would like to share with you a euro area perspective on the challenges of the crisis and how we can build an economy that will ensure stability and sustained prosperity for the people of Europe. I will discuss the monetary policy of the European Central Bank (ECB), the actions of national governments as well as initiatives at the level of the European Union as whole.

The ECB's role in addressing the crisis

Let me first look at the ECB's approach to the crisis. The success of the ECB's monetary policy is based on two pillars: respect of the European Treaty (Treaty on the Functioning of the European Union) and a realistic assessment of the financial and institutional framework through which the effects of our monetary policy are propagated to the real economy.

Article 127(1) of the Treaty assigns to the ECB the responsibility for maintaining price stability. This has been defined by the Governing Council as a rate of inflation that is positive and close to but below 2% in the medium term. This clearly stated objective and the ECB's compliance with it have firmly anchored inflation expectations, which since 1999 have been on average 1.91% and thereby protecting the purchasing power of the citizens of the euro area. It is precisely this high credibility in reaching its primary objective that has allowed the ECB to tailor its response to the crisis in the most suitable way.

And in defining the appropriate response, we must take into account the structure of our credit markets, where the role of the banks is more important than it is in the UK or in the US: in fact in the euro area about two thirds of financial intermediation go through the banking system as opposed to about one third in the UK and one fifth in the US.²

Before the crisis, banks were all interconnected and, by and large, could fund themselves everywhere in the euro area. Changes in interest rates were equally transmitted through banks to all parts of the euro area economy.

But a key feature of this crisis has been the fragmentation of financial markets along national borders. Businesses based in stressed countries now face worse borrowing conditions than equally risky competitors in non-stressed countries.

We have responded to this situation by deploying measures that are part of a central bank's toolkit but go beyond adjustments to policy rates. These measures have evolved as the crisis itself has morphed. And while they were targeted at specific immediate challenges, the overriding aim has been consistently to achieve our medium-term price stability objective.

Let me give two examples. In late 2011 and early 2012 we launched two 3-year long term refinancing operations (LTROs). Our LTROs gave banks sufficient reassurance that access to liquidity will not be a problem over a relevant planning horizon. Without these operations, banks would have defaulted on their maturing obligations or would have discontinued and withdrawn existing credit lines to companies.

² This refers to outstanding debt of the non-financial corporate sector.

The LTROs, therefore, helped to avoid a major credit crunch.

Similarly, my second example, the Outright Monetary Transactions (OMTs) have been designed with a view to combatting fragmentation while preserving the credibility of the ECB's monetary policy objective. The OMTs are aimed at eliminating "redenomination risk" – the unwarranted perception of a risk of euro breakup. OMT interventions in government debt markets are tied, however, to an effective macroeconomic adjustment programme. This prevents them from becoming a subsidy for unsustainable national policies. It therefore safeguards the monetary policy nature of the interventions and bolsters the independence of the ECB in pursuing its medium term objective.

Through countering fragmentation OMTs aim to preserve the singleness of monetary policy and to ensure the proper transmission of our monetary policy stance to the real economy throughout the euro area. This falls clearly and squarely within our mandate.

Some critics have argued that because of our determined policy action, the shoring up of bank capital and the consolidation of fiscal positions have been delayed. My answer is simple. Our measures gave breathing space from markets driven by panic, which were forcing the economy into a position where inappropriately high interest rates would make default a self-fulfilling prophecy. Adjustment would have been impossible. Instead of better capitalised banks and stronger fiscal positions we would have been left with financial and economic meltdown.

Today we are seeing some encouraging signs of tangible improvements in financial conditions. Spreads in sovereign and corporate debt markets have narrowed considerably. Banks in stressed countries have seen the deposits placed with them by euro area non-banks increasing by about 200 billion euro since August 2012. TARGET2 balances – the large intra-central bank positions that had accumulated due to the malfunctioning of financial markets – of the national central banks in these countries have declined by about 250 billion euros or 25% since their peak. Recourse to borrowing from the Eurosystem has also abated.

We have, therefore, started observing convincing signs that fragmentation on the funding side for banks has decreased greatly. And although bank lending to businesses and households remains anaemic, we are now seeing some signs of slight improvement on the lending side as well, as our regular surveillance of bank lending conditions and access to finance shows.

These improvements are in no small part due to the fact that unwarranted tail risks of a systemic collapse of the monetary union that were being priced-in by markets have now been largely removed.

We can, therefore, safely say that our Economic and Monetary Union (EMU) is a more stable union today than it was a year ago.

And the markets are fully confident that the euro is a strong and stable currency. To give you an example, the volume of international trade invoices denominated in euro is second only to those denominated in US dollars.

The responsibility of national governments

However, economic conditions in the euro area remain challenging. Real GDP contracted again in the first quarter of 2013. Output has therefore declined for six consecutive quarters. Labour market conditions remain weak.

To maintain and expand the productive capacity of our societies, national governments need to improve the structural functioning of their respective economies. Let me outline some examples.

First, competition in product and service markets needs to be enhanced without regard for the vested interests that are fighting to suppress it. This is necessary in its own right – but it is

also important to temper the social consequences of the required adjustment in labour markets.

Second, narrowing the gap between labour compensation and productivity growth, also across countries, is absolutely essential for improving competitiveness in euro area countries.

Third, the structure of labour markets in some countries needs to be reformed to allow nominal adjustments to play out, and to avoid that the weight of more flexible labour market conditions falls disproportionately on young generations.

In particular, reforms are needed to ensure inter-generational fairness by tackling the phenomenon of “insiders versus outsiders”. In some euro area countries, this phenomenon is driving youth unemployment to levels that threaten the very fabric of society.

Since the crisis started, there has been important progress in labour market reforms and fiscal consolidation in euro area countries, particularly those under an EU/IMF programme.

And the painful measures taken are starting to bear fruit. We see this very clearly, for instance, in the impressive improvement in export performance in Ireland, Spain and Portugal and in the recent uptick in industrial production in the latter two countries.

The role of European policies and progress towards a banking union

Let me turn now to my third and final theme. National policies alone are not enough to leave the crisis behind us once and for all. Policies at the European level are also necessary.

For one, European measures to complete the single market, especially in the area of services, are needed. And I know that this is a need that is urgently felt in this country.

However, major progress has been made in defining a vision and a path towards a genuine economic and monetary union.

The banking union is a major element of this effort. A first step towards establishing it has been taken with the decision to create the Single Supervisory Mechanism, and to entrust its responsibility to the ECB.

This first step is important as it will pave the way towards severing the link between banks and their respective sovereigns. It is this link that lies behind the fragmentation in the financial markets of the euro area.

But to sever this link completely, it is also imperative to create a Single Resolution Mechanism. Such a mechanism, much like the FDIC in the US, could give markets certainty about the ranking of creditors and the procedures that would be followed in the case of a bank resolution.

If we are successful in establishing an effective banking union – as I am convinced we will be – the benefits will be large, not only for euro area countries but for all EU members.

A more stable union will be one where financial contagion will have disappeared, where business for the financial centres will vastly increase, where financial market integration will resume.

A stable union, however, is not only about building new rules and procedures but also about applying existing ones. In the past, credibility of European procedures has at times been weakened because they were not followed with sufficient rigour. It is now important that existing and new rules be applied in a steadfast manner.

Conclusion

Let me draw to a close.

Today we need to focus on securing economic stability and prosperity for the people of Europe. With so many young Europeans feeling deprived of the opportunities and the prospects enjoyed by previous generations, the urgency of advancing this vision has never been greater.

After a deep financial and economic crisis, we now see the restart of the European process, building on the agreement of the June 2012 Summit. This process ultimately entails some transfer of national sovereignty in the areas of budget and structural policies. And the efforts made by Germany and France in this regard are particularly encouraging.

Last summer, speaking here in London, I said that “[w]hen people talk about the fragility of the euro, [they] underestimate the amount of political capital that is being invested in [it]”. Since then, even more political capital has been mobilised. The answer to the crisis has not been less Europe but more Europe.

The ECB, as an institution at the frontier of European integration, has played an active role in addressing the crisis. The credibility of the ECB’s steadfast commitment to its primary objective is unshaken in the eyes of both the markets and the people of Europe. And this is because our credentials in preserving price stability have been tested both when risks were on the upside and when markets driven by panic were threatening to send the economy in a downward spiral.

This is a time when the strength of all our institutions is being tested; first, by the financial crisis, then by the recession. The European Union and the European Monetary Union are no exceptions. The choice is between adapting them to the new conditions or do nothing and risk their dissolution. These institutions were created through the efforts of millions of European citizens since the end of World War II. These institutions have lifted Europe from the darkness of its past. They have given Europe peace and prosperity. Today, I am certain that our democracies have the determination and the cohesion to find a common way to strengthen these institutions further so that they will remain for our future generations the same source of peace and prosperity that they have been for us.

Thank you for your attention.