Mario Draghi: Strengthening financial resilience

Speech by Mr Mario Draghi, President of the European Central Bank, at the 2013 International Monetary Conference, Shanghai, China, 3 June 2013.

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Ladies and Gentlemen,

Introduction

It is a great pleasure to speak to you at this year's International Monetary Conference.

Let me start by congratulating the organisers for devising a programme that precisely pinpoints the key challenges that policy-makers must address on the path towards a more resilient financial sector.

The financial sector constitutes the main link between monetary policy and the real economy. So the challenges associated with financial stress and the prospects for financial reform are close to the heart of every central banker.

The economic situation in the euro area remains challenging but there are a few signs of a possible stabilisation, and our baseline scenario continues to be one of a very gradual recovery starting in the latter part of this year.

The drivers of such a gradual recovery are the highly accommodative monetary policy and export growth, caused by growing foreign demand. There is an adjustment happening across the board, with fiscal deficits and external deficits declining. The price of energy is declining as well and finally there are a number of important wealth effects that can support consumption and investment. These effects come from the rebound of financial markets that is benefitting virtually all economic agents, including corporations, banks and households.

Nevertheless, vulnerabilities remain, and I would like to take this opportunity to share my thoughts on the appropriate policy response to remaining financial and economic vulnerabilities from a euro area perspective. In doing so, I will focus on the banking system, which accounts for around two thirds of financial intermediation in the euro area.

When analysing the capacity and willingness of euro area banks to lend, it is useful to distinguish three factors: their funding situation; their capital position; and their attitude towards risk.

Each of these factors may, at times, require targeted policy intervention to overcome obstacles to bank lending. But the *types* of policy intervention and the *domains* of policy responsibility fundamentally differ across these three factors.

In this context, let me outline what I believe are the three major lessons of the crisis.

First, the crisis has reconfirmed both the scope and the limits of what central banks can do to support the economy.

Central banks play a pivotal role in stabilising funding conditions at times of acute market turmoil. But they cannot compensate for weaknesses in banks' capital positions. And they cannot substitute for reforms to boost the growth potential of economies.

Second, in the euro area, the crisis has demonstrated the capacity and unwavering commitment of the European Central Bank (ECB) to support the economy in its pursuit of price stability.

We have adopted monetary policy measures that are unprecedented in scale and scope. In doing so, we have benefitted from the array of different perspectives on the Governing

Council. These different perspectives collectively shape the single monetary policy for all euro area countries and form a durable basis for our united institutional decisions.

Third, the crisis has shown the need to adjust our monetary policy toolkit to a new reality. A very important new tool have been the two 3-year LTROs (long-term refinancing operations) that helped avoid a massive euro area wide credit crunch in early 2012. But the most salient feature of this new reality is financial fragmentation across euro area countries.

In response, the ECB has adopted Outright Monetary Transactions (OMTs). This policy initiative was *necessary* to counteract the threats to price stability; it has been *effective* in mitigating fragmentation and especially in fulfilling our mandate of *maintaining price stability*.

Let me explain in a little more detail.

Improving banks' funding situation

As the crisis has demonstrated forcefully, a sudden retreat of market liquidity can severely rattle financial markets.

Unable to refinance their illiquid assets, banks are forced either to explore alternative sources of funding or to engage in large-scale fire sales to shrink that part of their assets that remains tradable, although at falling prices.

To avoid socially costly fire sales and in common with most other central banks, the ECB compensated for the shortfall in private finance by providing solvent banks with additional central bank liquidity against adequate collateral.

In doing so, the Governing Council followed three avenues.

First, we provided these banks with ample access to central bank liquidity – both by reducing our main policy rate and by expanding the collateral pool against which we would lend to euro area banks.

Second, we provided reassurance to market participants that ample access to central bank liquidity would persist over the relevant planning horizon. Most notably, our two three-year long-term refinancing operations (LTROs) assured banks that their liquidity needs would be met over horizons that stretch beyond the usual maturity of central bank credit. In fact, the LTROs come closer to matching the average maturity of their loan books.

Third, we forcefully confronted financial fragmentation which has weakened the impact of monetary policy in the very parts of the euro area where it is most needed. Fragmentation has created divergent borrowing conditions for firms and households with equal creditworthiness but different country codes.

As our main tool to combat fragmentation, we adopted Outright Monetary Transactions (OMTs). OMTs allow for targeted intervention in euro area sovereign debt markets – provided the country concerned commits itself to strict and effective conditionality under an EU/IMF economic adjustment programme.

A closer look at OMTs

At almost one year from its announcement, the benefits of OMT are visible to everybody:

Spreads in sovereign debt markets have fallen substantially. Since the OMT announcement, spreads on long-term bonds for Spain, Italy and Ireland have fallen by around 250 to 300 basis points and for Portugal by almost 600 basis points.

Spreads in corporate debt markets have fallen by about 150 to 200 basis points for important market segments, and made it easier for firms to raise funds in the market. This has been the case for highly rated large corporations as well as for other corporations.

Banks have been able to re-access the market, for both funding and for raising capital, and the strong divergence in funding costs across constituencies has receded somewhat.

Deposits have flown back: banks in stressed countries have seen the deposits by the euro area money-holding sector increasing by about 200 billion euros since August 2012.

Another sign of normalisation, and a very important one for German savers, pension funds and insurance companies, has been the increase in German government bond yields, previously suppressed by panic-driven safe-haven flows, which have edged up by around 25 basis points.

And the best summary indicator for fragmentation and related payment flows in the euro area, the level of Target balances, has shown a decline by 285 billion euros, or 25%, since the peak last year. Target balances now roughly stand at levels prevailing before the launch of the two 3-year LTROs in late-2011.

The establishment of OMT has therefore been beneficial to everybody: sovereigns, corporations, banks as well as individuals, and it has benefitted both periphery and core countries.

Therefore, I would like to reflect in more detail on this measure. What is its purpose?

OMTs are aimed at eliminating redenomination risk from the markets – the unwarranted anticipation of euro area breakup.

Redenomination risk undermined our ability to preserve price stability and contravened the singleness of monetary policy.

The possibility that financial claims may be redeemed in a different unit of account than the one in which they were denominated at issuance – that is, the euro – was the prime source of panic that fractured transmission of monetary policy a year ago.

OMTs priced that risk out of market values and act as a deterrent against a resurgence of fundamentally unjustified redenomination fears. But their role is cast within a robust framework in which the ECB can fulfil its primary task of ensuring stable prices in steady financial conditions. And the fiscal authorities can take care of their solvency conditions and concentrate on structural adjustment.

One concern that has been raised with regard to OMTs is that they may discourage reform at the national level.

Quite the opposite is true. OMTs can be applied only if governments accept policy conditionality that leads to reforms. At the same time, it was the requirement of effective conditionality embedded in OMTs discourages governments and parliaments from requesting a programme unless strictly necessary.

They can either reform *without* OMTs and retain economic sovereignty or they can reform *with* OMTs but give up some of their economic sovereignty. Either way, they have to persevere in their reform efforts.

So it is quite misleading to compare OMTs to historical episodes in which governments relied on central bank support to replace fiscal consolidation.

Another concern made against OMT was that conditionality weakens the independence of monetary policy. The reality is that OMT's are not tied to political decisions since the Governing Council retains its full discretion, even after a country has engaged in a programme. In addition, that same conditionality ensures that the governments remain solvent, which in turn protects the freedom of action of monetary policy.

A third argument made against OMTs suggests that they would reintroduce excessive compression of euro area bond yield spreads, as observed prior to the crisis.

This too is inaccurate.

OMTs are designed to keep government bond yields just below 'panic' levels, as previously defined, not to bring them down to levels that would somehow help government solvency.

As we have seen, the mere existence of OMTs keeps government bond yields from rising excessively: the market expects that if yields rose too much, governments would apply for the programme and ECB purchases would bring yields back down. OMTs have therefore had a self-fulfilling downward effect on yields, just as before, in absence of OMT, there was a self-fulfilling upward effect with a potentially catastrophic risk for the euro area.

But this downward effect does not mean that spreads are forced to converge. In fact, ECB intervention under OMTs would not address those parts of sovereign bond yield spreads that are fundamentally justified.

The implication of a high backstop rate is that governments continue to have the incentives to raise their primary balance towards stabilising levels and to engage in structural reform. These are the only two options for them to lower their funding costs well below the backstop level implied by the OMTs.

For governments and parliaments, the ultimate driver of their actions remains employment. It is important to recall that always and especially in the present situation, the need for governments and parliaments to reform does not stem so much from the bond market but from the dramatic conditions in the labour market. Unfortunately, millions of unemployed are a much greater driver to reform that the interest rate to be paid on sovereign debt. And unfortunately, OMTs have almost no effect on the sources of employment creation. Indeed, while OMTs have eliminated one dimension of financial fragmentation (the risk of euro breakup), they only have a muted and indirect effect on the other source of fragmentation – the adverse feedback loop between sovereigns and banks.

A final criticism of OMTs is portraying them as a means of transferring risks from peripheral to core euro area countries via the ECB balance sheet. Quite the opposite has happened: the elimination of catastrophic outcomes strongly benefits core countries.

To see this, recall that the tail risks that OMTs seek to address distort financial prices and quantities in both the core and the periphery. Tail risks generate a glut of liquidity in core banking systems, as monetary assets are relocated by panicking investors from fragile countries to safe-havens.

With OMTs, pressure to reform remains on peripheral countries, while re-establishing confidence in the euro area reduces the flows of money from the periphery to the core countries like Germany.

So what do the data say? I mentioned already the large decline in overall Target balances, and it is important to add here that this improvement has materialised also for Germany: the Target claim of Germany has fallen from a peak of 760 billion euros in the middle of last year to about 590 billion euros last month. This is a decrease of 170 billion euros or 22%.

This important improvement largely reflects the removal of unwarranted fears of a systemic collapse of monetary union that was previously priced-in by markets. Today, the euro area is therefore a more stable and resilient place to invest in than it was a year ago.

And not a single euro of government bonds has been purchased under the OMT programme.

Strengthening banks' risk absorption capacity

Banks' capital position clearly lies outside the remit of central banks. In fact, it is – first and foremost – the responsibility of shareholders to ensure that their bank is solvent and able to sustain its core business. And if the private sector is unable or unwilling to provide the capital necessary to achieve solvency, it is for the fiscal and regulatory authorities to decide whether and how to act.

Monetary policy cannot substitute for or subsidise either of these policy domains.

But the euro area has achieved significant progress in terms of solvency. Banks have received fresh capital. Problematic legacy assets have been removed from banks' balance sheets, notably in countries under financial assistance programmes

More remains to be done. In particular, two policy initiatives should take precedence.

First, we need to create full transparency about the risks on banks' balance sheets. Such transparency is a pre-condition for the banking sector to return to lasting health. And a healthy banking sector is a pre-condition to revitalising bank lending.

Second, we must align investors' incentives with those of society. This means that market participants that stand to benefit from the upside of risky activities should also bear commensurate losses on the downside.

Europe is making some progress in these areas too.

To strengthen transparency, we are establishing a Single Supervisory Mechanism (SSM), which tasks the ECB with overseeing major parts of the European banking system. By placing this responsibility with an independent institution at European level, the Single Supervisory Mechanism will ultimately allow earlier identification of financial risk.

To strengthen incentives, the institutional architecture is being augmented by rules to facilitate investor participation in dealing with distressed banks. In particular, harmonised rules and procedures for bank recovery and resolution are currently being developed at European level. To ensure a fully consistent and effective application of these rules, their implementation should be placed within the remit of an independent Single Resolution Mechanism.

Before the ECB takes over the SSM, it will conduct together with the national supervisory authorities and with an appropriate involvement of private sector companies, a balance sheet review of those banks that it takes into the SSM. To this end, the national budgets and where needed, the ESM will have to provide adequate backstop.

Mitigating macroeconomic risk

The final determinant of banks' capacity and willingness to lend concerns their attitude towards risk.

Like any central bank, the ECB cannot control microeconomic risk – how banks assess whether a specific potential borrower will fail to repay a loan.

But the ECB is actively contributing to a reduction in macroeconomic risk: by firmly stabilising inflation expectations, it provides a nominal anchor for the economy as a whole. This supports lending and borrowing decisions, and ensures that longer-term investment projects remain profitable.

But it is the responsibility of national governments to eliminate uncertainty about growth and the sustainability of public finances.

Without unravelling the progress already achieved, it will be essential to focus consolidation on the fiscal composition of the budget, reducing those expenditures that make the least contribution to growth and reducing the tax burden on economic activity. To inspire confidence, policy-makers must follow-through with their fiscal reform agenda. In fact, little would be gained from a loosening of fiscal adjustment today if it creates market expectations that additional tightening will become necessary tomorrow.

In the medium term, we need to ensure that the adjustment is based on increasing the productivity of our economies.

Only through steadfast pursuit of such structural reforms can the competitiveness of euro area economies in the global marketplace be restored.

Summary and outlook

Let me summarise.

Strengthening financial resilience requires ambitious policy efforts in various areas. Lending to the real economy can only be expected to resume if accommodative monetary policy is accompanied by swift balance sheet repair and determined fiscal and structural reforms.

Within the euro area, recent progress suggests that decision-makers are ready to tackle the simultaneous tasks of reforming their domestic economies and completing the institutional architecture at the European level.

The ECB will continue to support macroeconomic performance by ensuring price stability in the euro area.

In calibrating our policy response to future challenges, the ECB will remain deeply committed to our monetary policy framework.

That framework is characterised by pursuing unambiguously price stability, firmly preserving our central bank independence and tailoring our policy instruments to the specific challenges at hand, while maintaining fixed our price stability objective.

As such, our framework is inspired by successful experiences of other central banks which have demonstrated the benefits for monetary policy to rely on a sound institutional anchor, and have earned trust and respect based on their clear commitment to price stability. The ECB has the same commitment and has the task to implement its monetary policy not in a single-country but in a multi-country setting.

This different context and the unprecedented threats to financial stability during the crisis have required new instruments to achieve the same objective of medium-term price stability for the whole of the euro area. We have consistently delivered on that commitment ever since the euro was launched. Over these last 13 years, inflation expectations have on average been at 1.9%.

Thank you for your attention.