Mario Draghi: Stable euro, strong Europe

Speech by Mr Mario Draghi, President of the European Central Bank, at the Wirtschaftstag 2013, Berlin, 25 June 2013.

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Ladies and Gentlemen,

It is a great pleasure to speak to you today. And I am grateful for the invitation from the Wirtschaftsrat, an institution grounded on the principles of the Soziale Marktwirtschaft in the tradition of Ludwig Erhard.

In a speech here in Berlin just 18 months ago, I quoted Erhard's famous dictum: "Die soziale Marktwirtschaft ist ohne eine konsequente Politik der Preisstabilität nicht denkbar".

So I am happy to accept our host's invitation to reflect on the importance of a stable euro and a strong Europe.

All policy-makers can and should contribute to preserving the stability of our common currency and to building a stronger and more prosperous Europe. I would like to emphasise my personal commitment to this goal.

I am confident that through our joint efforts to complete the institutional architecture of economic and monetary union (EMU), we can serve this collective mission.

The European Central Bank (ECB) has an unambiguous mandate against which our performance can be measured: medium-term price stability, understood as an average annual inflation rate of just below 2%.

The ECB's task and track record

With this objective, we are continuing for 17 countries what the Deutsche Bundesbank achieved for Germany. Our history is younger, but it is with some pride that I say that the ECB has accomplished this objective for almost 15 years. And it is with emphasis that I say that we are committed to taking the exact same objective into the future.

The euro's track record demonstrates the ECB's success in attaining this objective. According to our projections, by the end of 2014, the average annual inflation rate since the start of the euro will decline to 1.97%.

This inflation record over such a long period is well below those recorded in any larger country now part of the euro area in the half-century preceding the euro and also compares very well in an international context. The ECB's track record is therefore remarkable.

Our commitment to taking the exact same objective forward is reflected in inflation expectations. They confirm that the currency is stable. Survey- and market-based measures of inflation expectations are firmly anchored at levels consistent with our definition of price stability.

In the spirit of Ludwig Erhard, the ECB is making its contribution to the social market economy.

The ECB's response and instruments

Having the same objective does not necessarily mean using the same instruments. The ECB has inherited its objective from the Bundesbank, but it is operating in a new and different environment.

Today's economic and monetary union is larger and more diverse than a single country, such as Germany. It is highly integrated but still at times fragmented. And it comprises a very large number of policy-makers on fiscal, structural and other economic matters.

All policy-makers have to recognise that we belong to EMU together and that policies as well as policy inaction create spillovers for other members. This is an enormous responsibility for governments and other economic policy-makers.

For the ECB to operate in this environment, and to be responsible and effective in accomplishing its objective, we have to use a wide range of instruments. Some instruments are standard, some non-standard, but all are based on the ECB Statutes. The use of these instruments has been essential in safeguarding our objective during the financial and sovereign debt crisis.

In the run-up to the crisis, inappropriate fiscal, structural and other economic policies fostered an excessive build-up of risk in the financial sector and created vulnerabilities on a global scale.

When the crisis erupted, these vulnerabilities placed a heavy burden on central banks. In particular, the threat of a financial meltdown jeopardised their capability to counteract downside risks to price stability.

The ECB acted on that threat according to our unambiguous mandate to deliver price stability.

We have reduced our main policy rates to historical lows. This contributed to stabilising investment and consumption decisions in the euro area. Our actions prevented a steeper fall in aggregate demand and ensured the conditions for stable prices in the euro area.

In a bank-based economy like the euro area, monetary policy works through banks, and banks lend to each other, based on mutual trust. In the crisis, that trust got lost, and the banks no longer lent to each other. Facing the threat of a euro-area wide funding crisis, they turned to the central bank.

We, the central bank, provided liquidity to banks because we have to work through them. They are our counterparts – and we had to act. There was no guarantee that the liquidity provided would all end up in the real economy but because we acted, we avoided an even larger credit crunch and a collapse of parts of the banking system.

We designed our instruments so as to provide long-term credit to banks and give them reassurance that they could satisfy their liquidity needs over an extended period. This gave banks a clear funding perspective and put them in a position to provide credit lines to the real economy, in line with their business assessment of credit risks.

ECB policy responses over the past 12 months

By mid-2012, the crisis took a new turn. We saw the risk of a complete collapse of all credit markets. Risks to fiscal sustainability and growing market distrust in some euro area countries started to spill over into their respective banking sectors. Close links between sovereigns and banks threatened the stability of the entire banking sector in some countries.

While impairments to the transmission of monetary policy eased in some countries, they became entrenched and more acute in others. Fractures in transmission – a new phenomenon since the start of EMU – appeared along national borders.

Investors suddenly lost confidence that the euro area could survive in its current composition. In fact, the prospect that claims on certain governments and private companies in certain countries could not be discharged in euros had become a possibility.

International investors started divesting securities issued by governments of non-core economies and of private institutions domiciled in those countries.

Germany became the destination of “safe-haven” flows. Capital, deposits and central bank liquidity were leaving the periphery and concentrating in the core. Market interest rates in Germany fell as bond prices were driven upwards, and at some point, German bond market rates were lower than ECB refinancing rates!

At the same time, the loss of liquidity and bank funding capacity in the periphery produced a tightening of credit conditions in those economies. Interest rates for bank customers, firms and households were dropping in the core and rising in the periphery.

Eventually, the fragmentation of financial conditions became so severe that we were effectively losing the steering ability of our monetary policy for the euro area as a whole. In this environment, we once again had to act.

As our main instrument, we announced the programme of Outright Monetary Transactions (OMT) in secondary government bond markets. The aim is to eliminate redenomination risk, namely uncertainty about the survival of the euro.

Since OMT was announced almost one year ago, its benefits have been widely acknowledged.

The glut of liquidity in core economies has been partly reabsorbed, as deposits and savings have returned to the periphery.

Interest rates in Germany have increased and they have fallen in the periphery.

Target balances, a powerful summary indicator of fragmentation, have come down by one quarter from their peak last year.

Funding costs in the countries under stress have fallen substantially. Both banks and firms in stressed countries have been able to regain access to market financing, both for funding and raising capital.

Our initiative has therefore been beneficial to all: banks, companies and households – and it has benefited both periphery and core countries.

Let me highlight a few features of OMT that are essential to bear in mind.

First, OMT comes with strict and effective conditionality attached to a programme with the European Stability Mechanism (ESM). The initiative is activated only if a country submits to policy conditionality that leads to policy reforms.

Governments are not presented with a choice between reforms or OMT. OMT comes only with reforms. And reforms need a disciplined process of monitoring and international surveillance for the country concerned. Otherwise, there is no OMT activation.

Second, conditionality enhances the independence and the effectiveness of our monetary policy. The reason is that conditionality is a necessary but not sufficient condition to activate OMT. We would only act if the right conditions for effective use of this monetary policy instrument were in place.

Third, the ECB would not act to compress spreads artificially; on the contrary, we believe that spreads should naturally reflect the underlying fiscal position of the sovereign and the economic prospects of the country. This is also why we emphasised that a sovereign needs to have market access to qualify for OMT.

Fourth, OMT does not entail a transfer of risks from periphery to core countries via the ECB’s balance sheet, over and beyond risks that are inevitable and inherent in the implementation of a single monetary policy for 17 sovereign states.

The OMT announcement has lowered risks for core countries: the risks of a euro area break-up; the risks arising from Target balances in such a scenario; and the risks from market interest rates distorted by safe-haven flows.

Because of OMT, the euro area is a more stable and resilient place to invest in than it was a year ago.

Indeed, I would say that OMT is even more essential now as we see potential changes in the monetary policy stance with associated uncertainty in other jurisdictions of the integrated global economy.

Essential reforms going forward

So where do we stand?

In terms of monetary policy, price stability is assured, and the overall economic outlook still warrants an accommodative stance. We see some signs of stabilisation in sentiment, even though uncertainties remain. And we expect that monetary stimulus and improvements in financial markets will support a recovery later in the year.

The situation has improved; fragmentation has receded; and tentative signs of stabilisation have occurred.

But monetary policy is only a small part of the overall policy agenda for overcoming the crisis and laying the foundations for sustainable growth and renewed employment creation. Governments, social partners and other important economic decision-makers have to live up to their responsibilities, too.

One key issue is structural reform to make euro area economies more business friendly and more competitive in the global economy. There is a host of indicators – from the Global Competitiveness indicators to the Ease of Doing Business indicators – that lay out the reform agenda in no uncertain terms: only a handful of euro area countries rank highly on these indicators. Germany is among them, thanks to the resolute structural reforms implemented in this country ten years ago. These reforms are an inspiration for other countries.

Many European countries have structural problems: it takes longer to get licenses, permits and other administrative authorisations than in other countries; the judicial system is slower; and regulation is more complex. Structural reforms may hurt a few vested interests, but they would clearly strengthen the effectiveness, competitiveness and, yes, also the fairness of our economies.

Another key issue is growth-friendly fiscal consolidation. We have to be mindful that debt-based fiscal spending is no way to growth. Euro area government debt has risen by almost 20 percentage points of GDP in the last 15 years and by over 50 percentage points in the last 30 years. At the same time, growth has fallen, from 3.8% on average in the 1970s to 2.1% in the 1990s and roughly zero now. Debt spending has not avoided the stagnation of economic growth.

But fiscal consolidation can be made much more growth-friendly by cutting unproductive expenditures, by establishing credible and detailed medium-term fiscal plans and by lowering the tax burden where it is harming economic activity and job creation in particular.

The third key issue is ensuring a sound financial system. This is where current efforts to establish a European banking union are crucial. The aim of the banking union is to establish transparency, stability and incentive-compatibility in the euro area financial market.

Conclusion

I have outlined what we at the ECB have been doing – and what needs to be done in other key domains of European economic policy.

The June 2012 summit was so important because in times of great uncertainty it provided a clear vision of what is necessary for a stable and genuine economic and monetary union. Much of it is being implemented. And I am confident that the project for Europe will continue to evolve towards renewed economic strength and social cohesion based on mutual trust, both within and across national borders, and above all stability.

Thank you very much for your attention.