Mario Draghi: Europe and the euro – a family affair

Keynote speech by Mr Mario Draghi, President of the European Central Bank, at the conference "Europe and the euro – a family affair", organised by the Bundesverband der Deutschen Industrie and Bundesvereinigung der Deutschen Arbeitgeberverbände, Berlin, 16 September 2013.

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Ladies and gentlemen,

Thank you for inviting me to speak to you today. It is a great pleasure to be part of an event that brings together entrepreneurs and family businesses from across the euro area.

Such a gathering reflects many of the reasons why Europe established a single currency in the first place – to deepen the integration of our economies by making it easier for firms and households to exchange across national borders; to encourage the small- and medium-sized enterprises that are so important for growth and job creation; and to give citizens across Europe an impetus to work together.

Reading the resolution that you plan to adopt at this conference, I am very encouraged by the determination that you show to take the euro area forward – and I naturally support your central objectives of promoting sustainable growth.

Today, I would like to share with you some thoughts on how to achieve sustainable growth in the euro area from an ECB perspective. There are two main components.

The first component is stabilising the euro area, as without a stable foundation there can be no growth. The second component is strengthening the euro area – by ensuring sustainable economic policies in all member countries, by increasing the competitiveness of our economies and by completing the institutional architecture of economic and monetary union (EMU).

My main message is that we have made significant progress on the first step, stabilising the euro area. But there is still work to do to transform this achievement into higher growth and employment. Strengthening the euro area through sustainable policies, higher competitiveness and stronger common institutions is therefore our priority for today.

Stabilising the euro area

Let me begin by reviewing the measures that have been taken to stabilise the euro area.

Last year, the euro area faced difficult circumstances. Fears about extreme events were leading to severe tensions in financial markets. Borrowing costs for some governments had risen to very high levels. And market sources of financing for banks in some countries were drying up: for example, between April and July 36 billion euro of Spanish bank bonds matured, but no more than half a billion euro could be newly issued during that period.

These market events were starting to harm the real economy. Corporates in stressed countries were struggling to issue debt, and bank loans were becoming prohibitively expensive.

But today, the situation is improving. Borrowing costs for most governments have returned to more sustainable levels. Funding for banks in countries under stress has improved significantly, even if this has not yet been fully reflected in the cost of credit. And measures of systemic risks have dropped to pre-2011 levels.

Why has this happened?

The role of governments

The first reason is that governments are addressing their fiscal policy challenges. Thanks to their consolidation efforts so far, the primary fiscal deficit for the euro area has fallen from 3.5% of GDP in 2009 to around 0.5% in 2012. This is projected to turn into a primary surplus from 2014 onwards.

This improvement in public finances has helped send a signal to investors that government debt levels will stabilise and then fall in the future. This has been crucial in reassuring markets about debt sustainability. But the average public debt level in the euro area is still very high, at around 95% of GDP. This means that consolidation efforts need to be maintained in the years to come.

The role of the ECB

The second reason for the improvement in markets is actions by the ECB, notably through the announcement of Outright Monetary Transactions (OMT).

Our measures have countered investors' fears about the future of the euro area that emerged last year. As such, they have helped restore the normal functioning of markets, and removed the uncertainty that was paralysing the economies of some countries.

The impact of the OMT announcement has naturally been largest in countries where the uncertainty was greatest. But its effects have been felt across the euro area.

Capital has started flowing back from the core to the periphery, unwinding some of the distortions in interest rates we saw last year. In Germany, for example, long-term interest rates have risen significantly, despite the ECB cutting rates in that time. Target2 balances have fallen by around 30% from their peak.

More generally, the risk of an extreme event in the euro area has fallen – and therefore the risk of an adverse impact on price stability.

This threat to euro area price stability was the reason we had to act. We had to preserve our mandate. But I am encouraged that throughout this period, inflation expectations remained firmly anchored. This shows that markets and citizens trust the ECB to maintain price stability.

Strengthening the euro area

This improved situation in financial markets, however, has not yet translated into a broad-based economic recovery. Let me turn therefore from stabilising the euro area to the measures that are needed to strengthen it.

It is welcome news that the euro area recorded 0.3% GDP growth in the second quarter, after six straight quarters of negative growth. But the recovery is only in its infancy. The economy remains fragile. And unemployment is still far too high. Given the overall subdued outlook for inflation extending into the medium term, the ECB's Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time.

So what can we do collectively to raise growth and employment? As I mentioned, in my view there are three key elements: sustainable policies, higher competitiveness and a more complete EMU.

The first element is sustainable policies because this is a prerequisite for the others. Only if there are sound fiscal and macroeconomic policies in all countries can firms prosper and compete effectively. And only if all countries can maintain a sustainable position can there be closer euro area integration. EMU was not set up for some members to be permanent creditors and others to be permanent debtors.

Why competitiveness matters

With this basis in place, the second element is to improve competitiveness. This can be broadly defined as the ability of firms to remain profitable in an open market economy, and to sustain or expand market share.

Competitiveness can be measured in a number of ways, but its essence is a comparison of relative costs and relative productivity. Within the euro area, as countries share an exchange rate, a key measure of competitiveness is the relative cost in particular of labour compared with relative productivity – in other words, unit labour costs.

In the first decade of monetary union a focus on unit labour costs and their implications for competitiveness was largely missing. This was based on the false presumption that current accounts did not matter in a single currency area. As a result, competitiveness imbalances emerged. We saw wages and productivity diverging in several euro area countries. For some of them a significant competitiveness gap and large current account deficits emerged.

Why does this matter?

It is not only because persistent current account deficits create vulnerabilities, such as a dependence on external financing and an over-indebted banking sector. It is because, since 2008, countries that are more competitive have on average seen higher business margins, lower public debt levels, higher growth, and higher employment.

This correlation suggests that closing the competitiveness gap is a key component of improving the current economic situation.

Closing the competitiveness gap

One way to regain competitiveness quickly is to address the numerator in unit labour costs – nominal wages. Another, longer-term approach is to increase the denominator – to achieve higher productivity. In my view, in the euro area today we need both.

On the first count, there are already some encouraging signs of rebalancing in the euro area in terms of cost competitiveness. Thanks in part to the structural reforms introduced in several countries, relative costs are adjusting where they had become misaligned in the past.

For example, Spanish export volumes grew by more than 20% since 2009. Over time, rising mark-ups should allow Spanish firms to expand capacity and increase hiring.

But let me be clear here that I do not see competitiveness as a race between euro area countries with winners and losers. That is why the longer-term challenge of raising productivity is also key. While cost adjustments increase competitiveness only relatively, productivity gains, by increasing trend growth, can be absolute and benefit all countries.

So how do we raise productivity?

In my view the key issue is the connection between three “I’s”: innovation, investment and incentives. As innovation and investment mostly take place within the private sector, most interesting from a policy perspective are incentives – namely, the role that government can play in encouraging these other factors.

Take investment as an example. Total investment in the euro area is currently 17% lower than in 2007, while in Germany and France, it is still 2% and 6% below 2007 levels, respectively. Certainly, this derives in part from macroeconomic uncertainty, and in some countries from spare capacity. But there is also a strong microeconomic dimension linked to incentives.

In many jurisdictions, some regulations deter private investment and hinder cross-border projects. This makes a strong case for fully completing the Single Market.

More generally, firms’ incentive to invest is linked to their optimism in the business environment. This is affected by issues such as the burden of administrative procedures, or the speed and quality of the judicial system. These are areas where governments, through reforms, are in a position to make a difference.

Measuring progress in these areas is not straightforward, but in one indicator that measures the overall business environment, the euro area is currently ranked 26th in the world. This suggests that several countries could make improvements.

But it is notable that in this same indicator Germany has risen from 6th to 4th place in the last year, while achieving full employment. This underscores once again that competitiveness creates jobs.

The need to strengthen the institutional architecture of EMU

Let me turn to the third key element in our collective efforts to strengthen the euro area – and that is to build a stronger architecture for EMU. There are several areas in which we can make progress, as we outlined in last year's "Four Presidents' Report". For now, I see the priorities as banking union and economic union.

Banking union serves a range of aims, but in the current circumstances restarting lending to the real economy is the key priority. One barrier to bank lending at present is lack of transparency over bank balance sheets. Having a single European supervisor will help address this, as we plan to conduct a comprehensive balance sheet assessment of banks we directly supervise.

Another barrier to bank lending is low investor confidence, which is in part created by different rules for banks across jurisdictions and a lack of comparability. The future European supervisor will also help here, not least by leading to harmonised treatment across the banks it supervises – for example, of loan classification, forbearance and provisioning.

Beyond that, banking union should help speed up the repair of banks – that is if, as I hope, we end up with a strong single resolution mechanism. We need a mechanism that allows non-viable banks to be wound down without financial stability risks, as we see in the US. This tends to support a quicker recovery from banking crises and more stable credit provision to firms and households.

Economic union is also intended to help the real economy, as it aims to help countries reorient their economic policies to benefit more from sharing a single currency. We need to ensure that countries can maintain sustainable growth and high levels of employment without developing internal and external imbalances. This is a prerequisite for the stability of the euro area as a whole.

One way to achieve this would be to develop better ways of measuring economic performance – for example, more structural indicators of competitiveness. Another possibility would be to encourage structural reforms that make economies function more efficiently, and in a way that is more inclusive and benefits all groups in society. Here an idea currently being contemplated is so-called "reform contracts". Such concepts are still at a relatively early stage, and I look forward to them being developed further in the next few months.

Conclusion

Let me now conclude.

As I have explained, the euro area has taken important steps to restore stability. But we now need to build on those foundations to create higher growth and employment.

The good news is that we understand the challenges we face: to strengthen EMU; to ensure sustainable policies; to improve competitiveness. And to meet these challenges, we can look to several countries for examples.

But the key is to persevere on the path of reform – and to take inspiration from others that are succeeding. Within the euro area, we all benefit from each other's prosperity. I hope that the range of businesses from across the euro area here today will join me in spreading this message.

Thank you for your attention.