Mario Draghi: The euro area economy – current prospects and challenges ahead

Speech by Mr Mario Draghi, President of the European Central Bank, at the Economic Club of New York, New York, 10 October 2013.

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Ladies and Gentlemen,

I am delighted to be here with you today and I would like to take this opportunity to talk about what is happening in Europe right now.

As you know, the euro area as a whole is undergoing a process of fundamental reform. The overarching objective is to lay the foundation for recovery and more jobs, foster financial stability and fiscal sustainability and enhance international competitiveness for the benefit of all parts of the economy and wider society.

Reform will be a lengthy process but while it is far from complete, perhaps for the first time we are seeing signs of significant progress.

National policy-makers in Europe are able to focus a little less on short-term difficulties and a little more on their longer-term responsibilities to strengthen the resilience of their domestic economies while developing their growth potential.

And the monetary policy that we at the European Central Bank (ECB) are implementing will accompany the reform process by maintaining the degree of accommodation that is most appropriate, given our economic outlook and the risks that surround it.

The economic situation and outlook

So let me start with an overview of the current situation and outlook for the euro area economy.

Recent data releases support our baseline outlook of a nascent economic recovery over the coming months. Following six quarters of negative output growth, euro area real GDP rose by 0.3% in the second quarter of this year.

Although more recent data has pointed to a fairly slow start in the third quarter, survey-based confidence indicators give some comfort that the turning point in economic activity that we saw earlier in the year is not reversed.

Taken together, incoming information has confirmed the growth outlook from the September ECB staff projections. While these projections still see real GDP shrinking by 0.4% this year, a positive growth rate of 1% is expected for 2014.

But the pace of recovery is going to be subdued and uneven across countries for as long as it is meaningful for us to look into the future. The unemployment rate, currently standing at 12.1%, remains unacceptably high, and the risks around the outlook continue to be tilted to the downside.

In keeping with the broad-based weakness in aggregate demand, underlying price pressures remain subdued as well. Annual euro area headline inflation is projected to reach 1.5% this year, before declining to 1.3% in 2014.

These levels are historically very moderate, and remain in the lower part of the range of values that the ECB's Governing Council has identified as consistent with the ECB's quantitative definition of price stability.

That said, inflation expectations continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. And the risks to the outlook for price developments are expected to be broadly balanced.

Finally, monetary and, in particular, credit dynamics remain weak. The annual growth rate of loans to the private sector has remained well in negative territory; and the pace of contraction has actually accelerated over recent period.

Certainly, weak loan dynamics can largely be explained by the current stage of the business cycle but we have to be attentive to alleviate structural and supply-side factor that may hamper credit provision. The significant improvement in the funding situation of banks since the summer of 2012 has partly offset supply-side restrictions. But it will be some time before the more permissive funding conditions faced by many banks will be turned into an active spur for credit creation.

The strategy of euro area policy-makers

Against this background, how should policy-makers respond to the still fragile macroeconomic recovery?

In my view, we need a three-pronged strategy:

First, monetary policy has to remain consistently supportive of the baseline outlook and mitigate the risks that surround it. Our price stability mandate is sufficiently precise to keep us concentrated on that mission.

But preserving monetary accommodation is a necessary but not sufficient condition for the recovery to take hold.

A second essential ingredient is that countries continue the adjustment of their domestic policies in a way that removes structural impediments to their economic potential and fosters long-term fiscal sustainability.

Monetary accommodation can accompany and facilitate such regime shift in economic policy. But we know it can never replace it.

Third and equally important, Europe has to continue the reform process in its banking sector.

Sound finance is part and parcel of a dynamic economy and banks remain a major conduit of finance in the euro area. Hence, we must establish conditions that align incentives of individual financial institutions with those of society.

Let me explain the measures that European policy-makers are taking in each of these areas: monetary policy; fiscal and structural adjustment; and banking reform.

Monetary policy

Let me start with monetary policy.

As you know, the Treaty clearly prioritises price stability as the ECB's primary objective. Within this disciplining framework, we tailor our policy response to the challenges at hand.

In response to the events of the past six years, we've taken swift and resolute action. We cut the main policy rates to record lows. We provided funding support to euro area banks over long time horizons. And we counteracted and removed unwarranted fears of a breakup of the euro area.

In July this year, we again expanded our toolkit to protect the nascent recovery from the risk that it could be choked off prematurely by an unwelcome restriction in monetary conditions.

To that effect, the ECB's Governing Council adopted explicit communication on how it expects its key interest rates to evolve in the future. In particular, we have communicated our

expectation that the key interest rates will remain at present or lower levels for an extended period of time.

This expectation is based on our assessment that the subdued inflation outlook extends into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.

What was the rationale for adopting "forward guidance"?

In June and July, we observed substantial volatility in money market rates. The pricing of term interbank credit in the money market – the first stage of the transmission of monetary policy to the broader economy – had become increasingly divorced from euro area fundamentals.

Markets tended to overreact to news that was either not directly relevant to the euro area macroeconomic outlook or simply confirmed our baseline scenario.

Against this background, our forward guidance aimed at better aligning money market conditions with our policy intentions.

In interpreting our forward guidance, there are three essential elements.

First, it acknowledges the scope for further cuts in our key interest rates. In other words, the adoption of forward guidance does not imply that we've reached the effective lower bound.

Indeed, the opposite is the case: the Governing Council has unanimously agreed to incorporate an easing bias into our forward guidance that explicitly provides for the possibility of further rate reductions, should the volatility in money market conditions return to the levels observed in the early summer.

Second, our forward guidance is specifically tailored to the ECB's mandate and monetary policy strategy: the path of the policy rates remains conditional on the outlook for inflation; and it will be reviewed over time against the analytical framework underlying the ECB's monetary policy strategy.

This means that we assess whether the medium-term outlook for inflation remains subdued against two types of metrics. On the one hand, economic indicators pointing to persistent slack in the real economy. On the other hand, monetary indicators pointing to persistent subdued dynamics in money and credit.

The third element of our forward guidance is that, by confirming our policy framework, it refocuses attention on what matters most for our monetary policy, namely the medium-term inflation outlook in the euro area. On our side, it induces the sort of prudent language in communicating about the economy and the type of balanced and steady response to economic news that is needed in the exceptional circumstances in which we currently have to steer our monetary policy course.

The observed decline in market uncertainty about future short-term rates indicates that our forward guidance has helped to anchor market expectations.

Going forward, we will carefully assess developments in money markets and liquidity conditions. We have to ensure that interest rate expectations remain firmly anchored around a path that does not add to downside risks to the recovery.

Thus, our monetary policy stance will continue to be geared towards maintaining the degree of accommodation warranted by the outlook for price stability and promoting stable money market conditions. It thereby provides support to a gradual recovery in economic activity.

Fiscal consolidation and competitiveness

But preserving monetary policy accommodation is not sufficient in itself for the recovery to take hold and become self-sustaining.

This leads me to the second element of the policy response: repairing the fiscal and structural problems that hold back individual euro area economies.

A painful lesson from the last few years is that we all underestimated the destructive potential that myopic national policies could exert on the euro area's collective body, and on the world economy as a whole.

It is time to remove the institutional shortcomings that allowed imbalances to build up in the national economies and escalate into systemic threats in the first place.

In the euro area, two such shortcomings were particularly consequential.

First, the EU fiscal rules were weakly enforced and, as such, incapable of promoting prudent fiscal policies in times of favourable economic conditions. Second, there was no mechanism to prevent and correct macroeconomic imbalances within the EU.

This resulted in an incentive vacuum.

Rather than exploiting the advantages of monetary union for a modernisation of domestic economies, several countries simply delayed necessary adjustments.

And the elimination of exchange rate fluctuations and the levelling-off of spreads in sovereign borrowing costs that preceded the downturn deactivated the market forces that previously had disciplined macroeconomic policies at the country level.

European policy-makers are addressing these issues.

Due to a recent strengthening of the EU fiscal rules, Member States now face stronger incentives to adopt sound budgetary policies.

Moreover, a new "Macroeconomic Imbalances Procedure" has been established at EU level. It requires governments to adopt competitiveness-enhancing policies and tackle potential sources of financial instability in their domestic economies.

Reflecting this reform momentum at the European level, governments are tackling imbalances in their domestic economies. They are implementing reforms to reverse the misguided policies of the past and to create sustainable long-term growth.

Progress is steady and the data increasingly show that governments are heading in the right direction.

Euro area countries have cut their fiscal deficit ratios by half since their peak in 2009. Excluding interest payments, euro area Member States on aggregate are expected to run a small surplus by the end of this year.

This is clearly in contrast to other industrial economies, such as the US or Japan, which last year still recorded primary deficits of 6% and 8% of GDP, respectively.

We are also seeing some noteworthy improvements in competitiveness and external positions.

The countries under full EU-IMF programmes have seen their unit labour costs fall by more than 10% since 2008, relative to the euro area average. Their current accounts have improved by around 8% of GDP since then.

In short, there is progress towards more solid economic fundamentals in the euro area.

But maintaining the current momentum of reform is essential for ensuring stability in the euro area.

Bank balance sheets and banking union

Finally, a sustainable recovery requires healthy financial institutions.

We have seen much progress in the banking sector of the euro area. Since the beginning of the financial crisis in 2007 euro area banks have raised around €225 billion of fresh capital and another €275 billion has been injected by governments. All in all, this amounts to more than 5% of euro area GDP. As a result, the average Core Tier 1 ratio of the largest euro area banks currently stands well above 11% and the majority of euro area banks already comply with the minimum capital requirements of the fully implemented Basel III framework.

Furthermore, in countries under financial assistance programmes, problematic legacy assets have been removed from banks' balance sheets to ensure that they will no longer curb banks' lending to profitable businesses.

More progress is on its way in terms of the institutional architecture. Europe's Economic and Monetary Union (EMU) will be complemented by a European banking union.

Last month, the European Parliament cleared the way for the single supervisory mechanism, 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 new supervisory mechanism will allow for more stringent and consistent supervision. This will, ultimately, afford an earlier identification of financial risk – in both individual institutions and the financial sector as a whole.

Looking forward, two objectives need to be addressed: First, we need to create full transparency about the risks on banks' balance sheets. And, second, we need to align investors' incentives with those of society.

A comprehensive balance sheet assessment will be a crucial preparatory step before we begin our new supervisory task in autumn 2014. This will serve to strengthen transparency and to mitigate the risk of the possible emergence of problem banks in the early days of operation of the new supervisory mechanism. This balance sheet assessment, to be conducted by the ECB together with national supervisors and an independent third party, will consist of a supervisory risk assessment and a thorough asset quality review that in turn will be an input for a stress test to be jointly carried out with the European Banking Authority (EBA). The three elements combined will ensure a comprehensive assessment, identifying remaining risks on banks' balance sheets.

To strengthen incentives, the institutional architecture will be augmented by the single resolution mechanism. As a first step to overcoming the existing problems of incentive incompatibility, harmonised rules and procedures for bank recovery and resolution are currently being developed at European level. These harmonised frameworks should be implemented at national level as soon as possible.

But to ensure a fully consistent and effective application of these rules, their implementation should be placed within the remit of an independent authority that reinforces the new supervisory framework at a European level.

To that effect, the EU's institutional architecture should be augmented by a single resolution mechanism that executes bank resolution in a timely and impartial manner and formulates its decisions from a clear, encompassing European perspective.

By enhancing transparency and incentive compatibility, the combination of the single supervisory mechanism and the single resolution mechanism will help Europe return to a situation in which investment decisions will be based on business prospects, not on geographical location.

Conclusions

Let me conclude.

The recovery remains in its infancy. Given the prolonged build-up of macroeconomic imbalances in the past, we have to be prepared for a protracted and anaemic process in the future.

Yet we should also not exaggerate the euro area's challenges. While the unemployment rate has increased more in the euro area than in the US during the crisis, the employment rate in the US has fallen further than in the euro area, which makes the figures difficult to compare.

Moreover, the euro area has a strategy to return to sustainable growth and employment, and that strategy is being executed. What is essential is that all policy-makers in the euro area play their part and stay the course. The rewards that will result from the reform of our economic institutions cannot be overestimated.

Thank you for your attention.