Mario Draghi: Monetary policy and structural reforms in the euro area

Speech by Mr Mario Draghi, President of the European Central Bank, at Prometeia40, Bologna, 14 December 2015.

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Summary

The tools we have deployed since June 2014 are producing the intended effects, said Mario Draghi in a speech in Bologna today. Following the recalibration of our instruments decided by the Governing Council earlier this month, the ECB expects inflation to return to its objective without undue delay. The President also said that if the ECB had to intensify the use of its instruments to ensure that it achieves its price stability mandate, it would.

However, while monetary policy can deliver price stability, that alone does not guarantee lasting prosperity. To have a structural recovery we need to raise not just current growth but potential growth as well. The key to this is higher investment. Investment has been held back in the euro area by three things: weak demand dynamics, the still-high private debt overhang and fragile private sector confidence.

The euro area today needs to take additional steps, alongside supporting demand, to address the debt overhang and fragile confidence. Structural reforms are key to this end. It is clear that, in some countries, the large stock of non-performing loans (NPLs) is still preventing a stronger recovery in credit. All this explains why facilitating a work-out of NPLs has to be part of the package of policy actions to restore productive investment. The ongoing work towards a Capital Market Union (CMU) is an opportunity to accelerate progress also on this front. If we are to truly underpin confidence, it is important that, even while dealing with more pressing priorities, we do not lose sight of the need to complete our monetary union.

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After a crisis lasting eight years, the European economy appears at long last to be on a more solid footing. The recovery is now led by domestic demand rather than exports; it has proven to be resilient to the recent slowdown in global trade.

Monetary policy has given a decisive impetus to this. The tools deployed since June 2014, in particular the asset purchase programme of public and private sector securities introduced in September of last year and expanded in January this year, are producing their desired effects. Following the Governing Council's recalibration of our instruments earlier this month, we expect inflation to reach our objective without undue delay.

But we continue to closely observe movements in economic and financial conditions. As I said at the last Council meeting, and again more recently, "there is no doubt that, if we had to intensify the use of our instruments to ensure that we achieve our price stability mandate, we would".

But the shocks that have hit our economy since 2008 were not merely of a cyclical nature. They were also structural.

In this context, while monetary policy can secure price stability, that alone cannot bring lasting prosperity for our economies. It is essential, therefore, to intervene on both the supply and demand sides and to act consistently on all fronts to consolidate the turning of the cycle, and at the same time create the conditions for a sound and lasting recovery. What I would like to discuss today is the way in which different policies can help achieve this result, by acting not sequentially but simultaneously in their respective spheres of responsibility.

The role of monetary policy

One characteristic of this crisis was the fall in the potential growth rate in the euro area, which is the pace at which the economy can grow on a stable basis without overheating, and so without generating inflation. It is estimated that this rate is now around 1% in the euro area, compared with around 2% in the United States, where the crisis was in fact accompanied by a decline in the potential growth rate as well. This means that even with a strong cyclical recovery growth will be fairly low. To ensure a structural recovery, we must boost not just short-term cyclical growth, but also long-term potential growth.

In determining potential growth, the role of investment is crucial. It increases at once today's demand and tomorrow's supply. In the euro area, however, the recovery has thus far mainly concerned consumption and only to a lesser degree involved investment, which is still 15% lower than its pre-crisis levels. This weakness is, moreover, common to other advanced economies as well.

In the euro area, investment is being held back primarily by three factors: weak demand, the debt overhang, which was building up already in the period preceding the crisis, and the private sector's shaky confidence in the growth prospects of our economies.

At the same time, as in a virtuous circle, an increase in investment, by strengthening demand, supports the recovery, lessens the debt burden and boosts confidence. To this end, monetary policy can play a vital role in speeding up the return of output to its potential level if the output gap is wide and inflation below the objective. This is what the ECB is doing with the measures implemented since the middle of last year, in a context of prolonged low inflation.

We have cut the official rates down to negative levels, approved a credit easing packages – most notably with the targeted longer-term refinancing operations – and expanded our purchase programme of public and private sector securities. Since June 2014 banks' lending rates to firms have fallen steeply, by about 80 basis points for the euro area as a whole and with decreases of up to 100–140 basis points in the countries most badly hit by the crisis. So the transmission of our monetary policy has been powerful: in June 2014, to have a similar effect on banks' lending rates, we would have had to lower monetary policy rates by 100 basis points, something which at that time was clearly not possible. These measures, according to Eurosystem staff estimates, will help to increase growth in the euro area by about 1% overall between 2015 and 2017.

The fall in rates has been accompanied by a recovery in lending to businesses. Last May, before the credit easing measures were announced, lending was declining at an annual rate of about 3% in the area as a whole. Since July, that trend has been halted; in the euro area on average, lending is growing once again, albeit at modest rates. At the height of the crisis, in 2012, small firms reported that access to credit was their principal problem, immediately after the need to find customers. Since April this year, however, access to credit has been one of the least significant of the factors holding back business activity for small and medium-sized enterprises, according to our surveys. Lending terms and conditions have begun to converge rapidly towards those enjoyed by large-scale borrowers.

Our measures have therefore proved to be effective in two ways: they have reduced the divergence in lending conditions among euro area countries and they have compressed the dispersion between different categories of borrowers.

All of this has helped not just to consolidate the recovery but also to make it more flexible. The weakening of foreign demand from the emerging countries has been offset by increased demand within the euro area, especially from the economies of the "non-core" countries. By supporting the budding recovery, our monetary policy measures have thus made it possible to mitigate the negative effects of the weakening of the emerging countries' economies on the euro area's main exporting countries.

It is important that the positive effects of our measures have also reached small firms because this means that they have been felt by a large audience and not just by specific economic and social groups, as is sometimes claimed. We must not forget that small and medium-sized enterprises make up 99% of the total number of firms in Europe and, more importantly, provide jobs for two-thirds of all those in employment.

Why were our monetary policy measures effective?

One of the reasons that lending rates to firms were high in the past is that, given the weakness of economic conditions, banks particularly feared the risk of enterprises becoming insolvent, and for this reason raised their risk premia. However, these higher rates also caused the demand for credit from healthy firms to fall, thus worsening the conditions of the economy and justifying, *ex post*, the higher risk premia. And so a vicious circle was created.

By reducing borrowing costs for new loans, our measures, especially the targeted longer-term refinancing operations, have encouraged banks to resume lending. The increased competition in credit markets has in turn compressed rates, driving lending and improving the macroeconomic picture. We have thus succeeded in breaking the vicious circle.

The public and private sector purchase programme has also fuelled competition in credit markets by driving down the yields on sovereign bonds and thus reducing their appeal with respect to loans, ensuring that a growing volume of banking activity is directed towards the real economy. In addition to the direct impact of targeted longer-term refinancing operations, analyses conducted by the ECB show that the asset purchase programme has had an indirect effect on credit supply conditions, by also improving the macroeconomic outlook and further reducing risk premia.

And these measures have not damaged the banks. Far from it. Although they may sometimes have led to a contraction in interest income, our measures have also led to capital gains in banks' assets, and higher volumes and quality of credit. Considering all of these effects, the staff of the ECB estimate that the impact of our measures on the profitability of the banking sector has been essentially nil for the euro area as a whole.

The role of other policies

The effectiveness of our monetary policy shows that the ECB has all the appropriate tools to achieve our price stability objective and thus to support demand. And within our mandate we are unconstrained in our choice of instruments and the way we deploy them. We can always bring inflation to our objective; we must, and we will.

But monetary policy cannot and must not be the only instrument. On the one hand, the risks of a very accommodative monetary policy over an extended period must be addressed with the most appropriate macroprudential instruments. On the other hand, it is clear that there are other economic policy instruments which could improve the effectiveness of monetary policy in closing the output gap. In the past, the limited space for the deployment of fiscal policy has increased the burden on monetary policy; today, the two policies seem to be more coherent in this regard.

So monetary policy benefits if other policy areas play their part in their spheres of responsibility. At the same time, insofar as monetary policy succeeds in supporting the cyclical recovery, this facilitates the introduction of structural policies which could encounter greater resistance in a weak macroeconomic climate.

None of this is controversial. The G20 finance ministers and central bank governors clearly stated it in the communiqué issued after the meeting in Ankara in September: "*Monetary policies will continue to support economic activity consistent with central banks' mandates, but monetary policy alone cannot lead to balanced growth*". For the euro area this means that additional steps need to be taken, alongside supporting demand, to address the other two factors holding back investment: the debt overhang and fragile confidence.

So what does this entail? Let me highlight two points in particular.

First, structural reforms clearly have to be part of the equation. Beyond current demand, investment largely depends on firms' sentiment about the future: at the micro level, how easy it will be for them to do business, and at the macro level, how confident they feel about future growth. If obstacles to entrepreneurship are high, or if there is too much uncertainty about growth prospects, investment will be lower than it could be. That is why structural reforms are important.

By reducing red tape, they cut the costs for firms of starting new projects, thereby raising the effective return on investment. And by encouraging higher labour participation and boosting productivity, reforms raise expectations of demand, giving firms greater confidence to invest today. Investment is, after all, a bet on the future.

So structural reforms are, in fact, essential to comply with that part of the Treaty which espouses the objectives of balanced growth, full employment and social advancement, and the promotion of scientific and technological progress. None of those objectives will be achieved unless firms invest in research and development, and in exploiting new technologies and developing skills at the upper end of the value chain; unless, in other words, the conditions that favour high private investment are re-established.

Moreover, it is worth remembering that reforms that raise potential growth produce permanently higher income not just for the economy as a whole, but also for governments, through higher tax revenues and more sustainable public debt, which opens up fiscal space. And that, in turn, means there is more scope for fiscal policy to support monetary policy in stabilising the economy.

Second, in the area of structural reforms, special attention should be paid to measures that bring about a reduction in the debt overhang. Certainly, a lot has already been achieved in the banking sector with the creation of the Single Supervisory Mechanism, and as part of that, the comprehensive assessment and the ensuing significant recapitalisation of the banking sector. This has also supported the repair of the banking lending channel and the monetary policy transmission mechanism. But it is clear that, in some countries, the large stock of non-performing loans (NPLs) is still preventing a stronger pick-up in lending.

High stocks of NPLs can dampen credit supply for several reasons: they absorb resources and operational capacity; they tie up bank capital in unproductive uses; and they reduce bank profitability, which weighs on banks' capacity to generate capital internally. Such effects on lending tend to be exacerbated for smaller firms, which are more dependent on bank lending.

Moreover, slow resolution of NPLs hampers the necessary process of corporate restructuring during which viable firms reduce their debt and start investing again, and non-viable firms exit from the market. Creating the conditions for a rapid workout of NPLs has to be part of the economic policy actions to restore conditions that favour productive investment.

Each country has its own list of actions needed to speed up this process, and delays on this front are a serious drag on growth. In particular, well-designed insolvency regimes are key in separating viable from non-viable borrowers and in facilitating the valuation of assets to be sold off. An efficient judicial system is also essential. Analysis by ECB staff shows that the pace of deleveraging is faster in countries that have a strong and effective legal apparatus.

From this perspective, the recent reform of insolvency law in Italy is welcome. It is estimated that the average length of bankruptcy procedures will be halved. Foreclosure times are also expected to decrease significantly. This is important because a shorter time to recover collateral brings the market value of non-performing assets closer to a level at which transactions can take place, meaning bank deleveraging can accelerate.

The ongoing work towards a Capital Markets Union (CMU) is an opportunity to accelerate progress on all fronts. A true CMU should aim to harmonise insolvency regimes and improve their overall quality by converging towards international best practices. That should in turn also help expand secondary markets for distressed debt, helping banks get NPLs off their books more easily. And if CMU is successful in developing European markets for SME asset-backed securities, banks will be able to diversify credit risks from lending to SMEs more easily, strengthening credit supply.

Finally, if we are to truly underpin confidence, it is important that, even while dealing with more pressing priorities, we do not lose sight of the need to complete our monetary union. In that context several steps taken by the Commission are steering the process in the right direction. But what is also important for confidence is that those steps form part of a longer-term vision that removes fragility from our union.

In sum, the combination of our monetary policy measures on the demand side, coupled with structural reforms on the supply side, goes a long way towards creating the conditions for a genuinely structural recovery. Monetary policy and structural reforms together support demand, deleveraging and confidence, all of which are key for increasing investment.

But when it comes to actually implementing the reform agenda, in many countries of the euro area hesitation seems to prevail over determination. Certainly, we need to bear in mind that the necessary changes are on such a scale as to be unachievable without major consensus. But we also need to bear in mind that delays in making important structural reforms, which make a country more prosperous and more able to face today’s challenges, may sometimes have political reasons, but never economic ones.