Mario Draghi: Remarks at the Annual Reception of the Association of German Banks

Speech by Mr Mario Draghi, President of the European Central Bank, at the Annual Reception of the Association of German Banks, Berlin, 26 March 2012.

* * *

Sehr geehrter Herr Schmitz,

vielen Dank für Ihre freundliche Einführung und vielen Dank für Ihre Einladung nach Berlin. Ich freue mich, heute hier zu sein.

Ladies and Gentlemen,

I would like to take this opportunity to provide you with my assessment of the current situation in the euro area and shed light on recent signs of improvements in the overall outlook. I would particularly like to draw your attention to the effectiveness of the policy measures implemented by the Eurosystem, the EU institutions and national authorities. And to remind you of the measures that we all must continue to pursue over the coming months and years with great diligence in order to continue on this path of stabilisation.

The current economic situation

As this audience knows very well, in November last year, the prospects for the euro area financial sector were very bleak.

Banks were experiencing a period of heightened stress. The inter-bank market was closed except to the strongest institutions in the safest countries, and funding markets were impaired. Unable to raise funds beyond short maturities, many banks were reducing medium-term lending to the real economy.

At the same time came the requirement to increase capital ratios to 9%. This increased the risks of substantial deleveraging, including the risk of banks cutting back on loans, notably those to small and medium-sized enterprises.

We could see the intensity of the deleveraging pressures in bank lending surveys and other data. In the fourth quarter of 2011, there was a significant tightening of credit standards on loans to both companies and households. There was no doubt that the euro area was on the brink of a major credit crunch, with potentially adverse consequences for the economy and employment.

At that time, many observers had little confidence in the capacity of the euro area to reverse the situation.

Yet today, only four months on, the picture looks different. There are signs of stabilisation in both financial markets and overall economic activity – albeit still at low levels.

Conditions in bank funding markets have improved. For example, euro area banks have already issued about 70 billion euro in senior unsecured debt so far this year, which is well above the amount they issued in the whole second half of 2011.

Banks are meeting their new capital requirements. The capital plans submitted to the European Banking Authority (EBA) indicate an intention to exceed the benchmarks by more than 20%. EBA has also confirmed that there will be no stress test this year.

Bank lending is also stabilising. Banks are starting to assess their financial situation more positively and in many cases their willingness to make loans is increasing.

How has the picture changed so clearly in only four months? There are two parts to the answer.

First, the doomsday predictions were always exaggerated. Not because the situation last November was not very serious. But because the willingness of euro area authorities to take the measures necessary to restore stability was greater than many commentators realised.

Second, euro area authorities have proved their commitment to safeguarding financial stability through a number of important policy measures. The Eurosystem, the EU institutions and national authorities have all played a role in constructing a comprehensive and coherent response to the economic, financial and fiscal challenges that we face.

Let me now explain the key elements of this response in more detail.

The policy response of the Eurosystem

The primary explanation for the improvement in sentiment over the last few months has been the measures taken by the Eurosystem – that is, we at the European Central Bank (ECB) and our colleagues at the national central banks of the 17 countries that share the euro.

As you know, since December last year the Eurosystem has launched two long-term refinancing operations – LTROs – with a maturity of three years. While the total liquidity requested by banks in these operations amounted to around 1 trillion euro, the net liquidity injection by the Eurosystem has been around half a trillion euro because the other half has been shifted over from other operations.

Let me be clear about why we implemented the three-year LTROs. It was not to support sovereign debt markets. It was also not to bolster bank profits.

The LTROs were specifically designed to prevent a credit crunch that could compromise the maintenance of price stability in the euro area. With funding markets closed, banks needed liquidity assurance over the medium term to avoid pre-emptive deleveraging and to continue lending.

To understand why these operations were necessary requires a euro area wide perspective. It would be misleading to judge the urgency for action – or the necessary responses – based on the situation in any one country or groups of countries. The Eurosystem acts in the interests of the euro area as a whole with 330 million citizens. This is the perspective that always informs our decisions.

Some observers have raised questions about these operations. The questions tend to fall into three categories and since they touch on fundamental issues, I would like to spend a moment responding to them.

First, some wonder whether there is really any transmission from the LTROs to the real economy. The argument goes that banks are simply taking cheap liquidity and setting up carry trades or putting the liquidity back into our deposit facility.

The facts show that this is an incomplete view. Over 800 banks participated in the February LTRO, compared with around 500 in December. This number included 460 banks from Germany, most of them – literally hundreds – being smaller banks.

I cannot tell you names of the towns and villages in which these banks are located because often they are the only bank in town and could be easily identified. But I can tell you this: that the money is now closer to small and medium-sized enterprises than it was before.

We cannot say that this money will necessarily go to these smaller enterprises but it is certainly very close to them. We have this in mind because nearly three quarters of corporate employment in the euro area is in the small and medium-sized business sector. The banks I am talking about are ones whose main business is lending to the *Mittelstand* and thereby supporting the real economy.

It is also not accurate to claim that banks are returning the liquidity straight back to the Eurosystem. We know that banks using the deposit facility are not identical to those borrowing from the Eurosystem. This implies that even though the bulk of the liquidity is returned eventually, it is being directed within the banking system as intended.

The second category of question involves concerns that some have expressed that the Eurosystem is exposing itself to excessive risks. Critics point in particular to the differentiated collateral framework adopted by some national central banks to allow banks to participate in the three-year LTROs.

Let me underscore that high haircuts are applied to the additional credit claims so as to ensure risk equivalence between this collateral and the regular framework. Moreover, the main elements of the risk management framework applied are common: the eligibility criteria and risk control measures were approved by the Governing Council, and the Council will monitor the effectiveness of the risk control framework on an ongoing basis. Hence, there is only limited national discretion. I should also emphasise that the Eurosystem has a long experience in the acceptance of credit claims in its collateral framework.

Moreover, the Eurosystem is being very careful to manage any risks that may ensue from our current operations. We employ a conservative risk management framework. On the additional collateral presented so far, the average haircut is 53%. This means that on a nominal value of 100 euro we provide 47 euro of liquidity. This shows you how prudently such collateral is accepted.

If over time the market value or quality of the collateral posted were to decline, counterparties would have to provide additional collateral or return part of the liquidity. This too serves to protect the financial soundness of the Eurosystem as a whole.

The third kind of question comes from some observers who worry that the liquidity created by the LTRO will lead to inflation or asset price distortions.

Here it is important to distinguish between different concepts of liquidity. We would expect an impact on inflation and asset prices only following a sustained and strong increase in money and credit – not following an increase in *central bank* liquidity *per se*. The tentative signs we are seeing of a stabilisation in money and credit growth do not signal increasing inflationary pressures over the medium term.

For example, growth in monetary aggregates remains at low levels, with M3 increasing by 2.5% in January 2012, well below the average growth rate of M3 in monetary union so far, which was 5.9%. The same is true of the counterparts of M3 – loans to the euro area private sector increased by only 1.5% in January, compared with an average of 6.8% since the start of the euro.

Market indicators of inflation expectations overall show no signs of inflation above our medium-term objective. Investors overall assume a break-even inflation rate in five years of around 1.7%. Looking further out at the inflation expectations between five years and ten years also shows that, adjusted for the usual risk premia, market expectations of long-term inflation are fully consistent with our definition of medium-term price stability.

Moreover, the Eurosystem has a range of tools at its disposal to absorb excess liquidity if that is deemed necessary in the future. Available tools include increases in reserve requirements and the conduct of liquidity absorbing operations including not only short-term but also longer-term deposits. Hence, there are tools and the Governing Council can use them as needed. Moreover, our balance sheet has grown and shrunk in the past without creating inflation – for example, this was evident over the course of both 2009 and 2010.

In other words, we are constantly alert to threats to medium-term price stability. Euro area citizens can be certain that our objective is delivering price stability over the medium term – and that we have all the necessary tools to achieve it. The consistent strong anchoring of inflation expectations confirms that our commitment is credible.

Let me address one final issue, and this concerns the debate in this country about Target2 balances. It is important that this debate is framed correctly – in particular, by distinguishing between symptoms and causes.

Target2 is a payment system that reflects the flow of funds within the euro area. Imbalances within Target2 are a symptom of real and financial imbalances between euro area countries. Restoring normality within Target2 requires not that we address the symptom – the payment system – but that we address the cause: the underlying imbalances.

This is not the task of monetary policy. It is the task of the national authorities and EU institutions that are responsible for fiscal, economic and financial policies.

Important progress has been made in recent months to strengthen the credibility of these policies – and this has been recognised by financial markets.

This is the second explanation for the overall stabilisation we have witnessed since November – and it is something to which I will now turn briefly.

Policy responses at the national and EU level

The signature at the last European Council of the International Treaty, including the fiscal compact, is an important signal of commitment to reducing deficit and debt levels. Enshrining balanced budget rules in national legislation creates a new "first line of defence" against fiscal imbalances. Like the *Schuldenbremse* in this country, this legislation shifts the onus for enforcement away from Brussels and onto national institutions. Prevention is better than cure – and that is the spirit of the compact.

Member States have also taken important steps to strengthen euro area and global firewalls. The entry into force of the European Stability Mechanism has been advanced and the paying-in of capital will be accelerated to reach full lending capacity sooner than originally planned. On top of this, euro area countries have committed to providing an additional 150 billion euro to the IMF.

Seen together, these measures represent a coherent strategy to strengthen euro area economic governance. The focus is not, as some commentators claim, skewed towards fiscal consolidation. Stronger fiscal rules are one – albeit essential – element in a larger package that addresses real and financial imbalances and provides a safety net for countries in financial difficulties.

But stronger governance cannot be effective without individual Member States also fulfilling their responsibilities. Here too we have witnessed a number of positive developments in recent months.

The new governments in Spain and Italy have shown determination to address their twin challenges of fiscal and macroeconomic imbalances. The government of Spain remains committed to bringing its deficit below 3% by 2013 and taking the necessary measures to ensure a rapid and secure transition to this target from the high deficit in 2011.

The latest review missions confirm that the Irish and Portuguese programmes are on track – with authorities in both countries strongly committed to meeting their targets and with a solid track record.

It is important that observers recognise that these reforms at the national level will take time. They are addressing deep-rooted obstacles to competitiveness and growth, and the positive effects may not be visible immediately. But once realised, they will put employment and growth on a new and more sustainable track.

The example of Germany shows the need for patience. The structural reforms passed many years ago did not immediately feed through into higher growth and employment. But now they have, and Germany is reaping the benefits and leading the way in Europe.

With a new governance framework in place and strong commitments from national governments, there are solid grounds for trusting that reforms will be implemented across the euro area as a whole.

Conclusion

Let me conclude. The turnaround we have witnessed since November is the result of every institution of the euro area fulfilling its responsibilities. No single institution can carry the burden of addressing a set of challenges that are simultaneously economic, financial and fiscal. Everyone has played their part.

But let me emphasise that the current stabilisation should not make us pause in our responses to these challenges. Indeed, this is a time for continued action.

The present situation provides a window of opportunity for governments to accelerate efforts to consolidate budgets, to boost employment and to enhance competitiveness – and to do so with confidence.

It also creates a benign environment for banks to strengthen their resilience further – including by retaining earnings and cutting dividends and bonuses.

Decisive policy measures brought about the stabilisation since last November. Now, further decisive policy measures are required to strengthen fiscal positions and competitiveness.

These measures will lay the foundations for future sustainable and balanced growth in the euro area.

Thank you.