

Mario Draghi: Interview with *Neue Zürcher Zeitung*

Interview with Mr Mario Draghi, President of the European Central Bank, and *Neue Zürcher Zeitung*, published on 23 January 2014.

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Mr Draghi, the founder of the World Economic Forum, Klaus Schwab, said last week that this year's Davos meeting should not only focus on the debt crisis. Is the crisis over, or are the political and economic decision-makers simply tired of the crisis?

We see some encouraging signs but the recovery in the euro area is still weak and uneven. All in all, the risks are still on the downside. So I would be cautious about becoming overly optimistic.

But the mood has brightened considerably.

Yes, the economy in the monetary union is growing again, but the growth is not uniform and the unemployment rate, at over 12%, is still very high. Another positive sign is that this recovery, which was originally driven by exports, is now gradually, slowly, spreading to domestic demand. We are now at a stage like that of the US a year and a half ago. The survey data are strong, but we don't yet have a continuous stream of strong hard data. That's a familiar pattern in economic recoveries after a deep crisis.

What must happen so that euro area finds its way back to sustainable growth?

Countries should not unravel their budget consolidation efforts, but the consolidation should become more growth-friendly than what we have seen so far. In other words: less current expenditure and lower taxes and more expenditure on infrastructure and on human capital. All this should be accompanied by the implementation of structural reforms. Only structural reforms will bring Europe back onto a sustainable growth path.

And what contribution can the ECB make to more growth?

The ECB contribution is to maintain price stability. Sustainable growth is possible only with stable prices. We have plenty of instruments to ensure price stability. Some of them we have already used, such as forward guidance. And we have shown that we can, if necessary, react quickly. Last November, for example, we did not wait. We saw that the inflation path was lower and we acted and, as a result of it, the credibility of our forward guidance became stronger. What we do not see, frankly, is deflation. Inflation expectations are firmly anchored in the medium term.

Why are low prices a risk if inflation expectations are so well anchored? And why can the ECB live better with an inflation rate of just under 2% than with one of 0.5%?

There are several reasons for this. First, we have learnt from Japan's experience in 1990s that it is much more difficult to operate monetary policy when inflation goes close to zero. Moreover, due to measuring errors, during periods of very low inflation you may think that inflation is still in positive territory, whereas in fact it might be below zero. Finally, for countries that want to adjust their external imbalances it is much more difficult to become competitive again if you have very low inflation compared to near to 2% inflation. If there is no inflation, they have to lower the levels of their nominal wages and prices. That is why most central banks target inflation of just under 2%.

But disinflation is unavoidable particularly for countries that want to become competitive again.

Indeed. Disinflation currently has two causes. It is in part necessary because some countries need to regain their price competitiveness. Another aspect of disinflation, however, can be attributed to the very different and fragmented financing conditions in the euro area.

Are you more concerned about deflation than inflation?

Actually, I would say neither. The risks of deflation or inflation are limited at this point in time.

But wouldn't inflationary pressures rapidly increase in the case of a strong economic recovery?

Not necessarily. In the US, for example, and certainly in the euro area the recovery after the crisis has not been accompanied by inflationary pressures; unemployment is too high for that and production capacities are underutilised.

The financial markets have clearly calmed down since your famous speech in London in summer 2012, in which you promised to do whatever it takes to preserve the euro. Would you say that your words back then have prevented the euro area from breaking apart?

The stress in the markets since then has indeed decreased dramatically. My words certainly had a calming effect. But the effect has lasted so long only because, shortly before that, the European governments had agreed on banking union. The trust this indicated in the monetary union has helped the effect last until today.

But you received a lot of criticism shortly afterwards, particularly in Germany, when you announced the OMT programme, under which the ECB can theoretically purchase unlimited euro area government bonds under certain conditions. It was said that, in doing so, you would be carrying out monetary financing, which is prohibited.

OMTs were not designed to finance government budget deficits, but, in support of our mandate of maintaining price stability, to remove the risk of a break-up of the euro area. We took a lot of precautions when designing OMT that demonstrate that the programme has nothing to do with monetary financing. For example, we would only buy on the secondary market; only buy bonds with short maturities and not necessarily keep the bonds until maturity. But the most important thing is that OMTs are bound by strict conditionality. This conditionality makes sure that countries put their own houses in order as far as budget financing is concerned. A country that is supported by OMT would have to have a reform programme, agreed by the Eurogroup. If a country no longer stuck to the requirements of the programme, OMT purchases would automatically be stopped.

How come you were unable to convince the German public of this? Even Germany's Federal Constitutional Court is dealing with OMTs.

One of the fears in Germany was that this would in the end cause inflation. But this has not been the case up until now, and I get the impression that, as a result, we have been able to allay the concerns of German people somewhat regarding OMTs. Indeed, the risks for Germany have decreased since the announcement of the programme.

Yet people had the impression that, on many decisions taken by the ECB's Governing Council during the crisis, a small number of northern European countries which are possibly more stability-oriented were outvoted by the rest. Do you not find it problematic if a minority are always outvoted?

It was not like that at all. The three-year financing operations for banks, LTROs, were approved by the overwhelming majority of the Governing Council, including most of the members you are hinting at; OMTs were approved by all members of the Governing Council except one; the various interest rate cuts during the crisis were mostly unanimously supported, or with an overwhelming majority. For the last interest rate cut in November, the difference was not so much about whether to do it, but when. Up until now, there has not been the same minority constantly opposing the rest of the Governing Council and, in my view, there will not be in the future.

You stress again and again that the ECB has many other instruments at its disposal. But it has already done so much – what else could the ECB do as things stand?

We do indeed have many other instruments at our disposal. But it would be confusing to highlight individual instruments now because the use of a given instrument depends on the situation. For example, we would react with completely different means if the money markets were to stall than if there were a setback in the economic situation.

But the ECB has already pumped so much cheap money into the system and it is still not getting through to the markets.

Yes, it is. It is getting through to the markets very well. It is just that it is still the case that too little is getting through to the real economy.

Could negative deposit rates be an instrument that would help here?

I do not want to speculate about individual instruments. Any instrument may be used if the situation demands, including the one you mention.

In several months' time, the ECB will take over supervision of large euro area banks. Will we no longer see banking crises after that?

Since the outbreak of the financial crisis, banking regulation has made huge progress all over the world. In Europe, approximately half a trillion euros of additional capital has flowed into the banking sector in the past three years alone, half of it from private sources. But I would never say that these improvements mean that there will be no more crises. Nobody knows where the next crisis will come from. It is therefore important to make the financial system as a whole even more resilient.

But are there not simply too many banks in Europe?

That is very hard to say. The ECB's asset quality review of the banks that is currently being conducted pursues one goal in particular: we want to shed more light on bank balance sheets and therefore indirectly also on that issue. The markets and investors should know what state Europe's banks are really in. We want full transparency. Only through transparency will investors be ready to provide additional capital for banks.

Yet this means that the ECB's audit of the banks could itself become a systemic risk. If the ECB were to notice very large capital shortfalls or a large number of banks that are not capable of surviving, this would potentially trigger a new banking crisis.

I see it completely differently. If there are problems in Europe's banking sector, they are there, regardless of whether we uncover them or not. In the financial system in general, light is always better than darkness. Only by uncovering weaknesses in the banking sector can measures be taken to correct them, be it through recapitalisation, restructuring or winding up banks. Without transparency, the weaknesses will remain and put a strain on the whole economy. After all, weak banks do not lend. We have learnt the lessons from Japan in the 1990s that a weak banking sector inhibits growth for years.

The consolidation of the banking sector in Europe since the crisis has made less progress than in the United States, so there should be much remaining to be revealed.

If you look solely at the number of banks that have been wound up, that is certainly true. In the United States, more than ten times as many banks have been closed down as in Europe. However, the banking structure and business models in Europe are totally different from those in the United States. We will see what needs to be done in Europe – our assessment of banks will bring this to light. Precisely that is what the whole exercise is about: weak banks should exit from the market. We are taking this very seriously. Should there be any weakness, we will reveal them, and will take appropriate countermeasures.

Are you happy with the resolution mechanism recently adopted by the governments?

It is a first step. We are now getting a common mechanism, a resolution authority and also a joint resolution fund. It will take ten years for that fund to be filled, which is too long, of course. The proposal that has been put forward must be developed further in the next few weeks, but it is a good starting point.

With regard to the forthcoming assessment of banks, do you believe that the governments will be prepared to take action if it becomes necessary to cover banks that have run into financial difficulties?

Yes, they have committed themselves to do so both at the level of heads of state and government and at finance minister level. Moreover, there are clear bail-in provisions in place that will call the banks' creditors to account. We did not have such rules when the crisis erupted. In future, it will no longer be the taxpayer who has to step into the breach in the event of bank failures.

Are you optimistic in this respect? Will the taxpayer really not be called upon to pay the bill in future?

That is not a question of optimism. The new rules afford the taxpayer far better protection. I am confident that the bail-in rules will be complied with and that taxpayers' money will only be used as a last resort.

Is the ECB really the institution that should deal with banking supervision? Aren't you afraid of reputational risks?

Not really. We will keep supervision strictly separate from monetary policy. The supervisors will have to take care of their reputation with respect to banking supervision, while the monetary policy-makers will take care of their credibility with respect to price stability. I actually believe that our monetary policy will become more effective if supervision is carried out well, because healthy banks will ensure that our monetary policy is better transmitted to the real economy.

And what do you expect of Davos? Praise, because you have rescued the euro area, or criticism because you are not doing enough?

Both.