Mario Draghi: Interview with Lithuanian business daily *Verslo Zinios*

Interview by Mr Mario Draghi, President of the European Central Bank, with *Verslo Zinios*, conducted by Mr Dalius Simenas on 25 September 2014.

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The saying that "When America sneezes, Europe catches a cold" was absolutely true in the aftermath of the dramatic collapse of Lehman Brothers in the autumn of 2008. We are now seeing signs of a recovery in the United States and the United Kingdom, but are still not seeing any in the euro area. Does this worry you? What is missing?

I am not sure I can agree with the last part. The euro area has, in fact, been recovering since the second quarter of 2013, when the economy returned to growth after six quarters of recession. It is true, however, that the recovery seems to have lost momentum recently: the flat GDP reading in the second quarter of 2014 was disappointing. According to the preliminary information received over the summer, economic conditions have been somewhat weaker than expected. Overall, however, we expect modest growth in the second half of the year and continue to expect euro area domestic demand to be supported by various factors. These include our accommodative monetary policy stance, favourable financing conditions and structural reforms, which should sustain private consumption and investment. At the same time, unacceptably high unemployment and continued weak credit growth are likely to curb the strength of the recovery. There are clear risks in sight: in particular, heightened geopolitical tensions could dampen business and consumer confidence. Furthermore, the risk of insufficient structural reforms could weigh on the business environment.

How can this uncomfortable cocktail of high unemployment (11.5% this July) and ultra-low inflation in the euro area (0.3% in August, i.e. far below the ECB's target of below, but close to, 2%) be overcome? How, if at all, can Europe avoid a stagnation scenario such as that faced by the Japanese economy for decades?

We do not see Japanese-style deflation in the euro area, as a number of factors differ distinctly from Japan in the 1990s. Firstly, we, the ECB, took decisive action at a very early stage in the crisis, and have continued to do so. Most recently, against the backdrop of a persistently weak inflation outlook, slowing growth momentum and subdued monetary and credit dynamics, we decided in early September to adopt a number of additional monetary policy initiatives which will complete and complement the measures already announced in June. On the basis of our current information, we expect inflation to remain at low levels, before gradually increasing during 2015 and 2016.

Furthermore, while inflation expectations have declined, particularly at shorter maturities, our measures will underpin the firm anchoring of inflation expectations in line with our aim of maintaining inflation rates below, but close to, 2%.

Additionally, our Comprehensive Assessment and stress tests have been rigorous and thorough; this means that banks' balance sheet problems are being dealt with and that the necessary transparency will be provided on the health of European banks. This is in contrast to the pronounced balance sheet problems of Japan in the 1990s.

Finally, a number of euro area countries have implemented structural reforms to increase their competitiveness. Clearly, these efforts now need to gain momentum to achieve higher sustainable growth and employment in the euro area. In this context, it is also essential that governments conduct fiscal adjustment that is growth-friendly.

Economists and politicians in Lithuania sometimes voice concerns that the economic benefits of being part of the euro area are offset by the rising costs of having the euro, e.g. with the implementation of the Single Supervisory Mechanism, contributions by Member States to the European Stability Mechanism, etc. What would your response

be to these concerns? Why does Lithuania need to be part of the euro area despite those costs?

Joining the euro area is not a free lunch: it entails significant obligations, but many benefits at the same time. The obligations are stated very clearly in the Treaty and in EU regulations. In this respect, compared with those countries that joined in the first wave of entry, Lithuania has the advantage of joining a stronger euro area. The euro area has painfully recognised the flaws in its original design and taken major steps to repair them. There are tougher rules for fiscal policies, stronger oversight of macroeconomic imbalances, a lender of last resort for sovereigns in the form of the European Stability Mechanism, and there will soon be a sounder and more integrated banking sector thanks to the creation of the Single Supervisory Mechanism. The euro area has gone through its difficult initial learning phase, and new members will reap the benefits, which certainly outweigh the costs associated with the existence of these institutions.

Joining a stronger euro area will increase the long-term prosperity of its members and their resilience to adverse shocks. But there are also other concrete benefits stemming from trade and foreign direct investment, which will be bolstered, especially given Lithuania's strong trade ties with its two Baltic neighbours in the euro area, Estonia and Latvia. Moreover, Lithuania will be an equal partner at the Governing Council table and will fully participate in deciding monetary policy for the whole monetary union.

Do you share the view that being a member of the euro area is an additional safeguard for countries such as the Baltic states or Finland against the spillover effects of geopolitical tensions in Europe (or even an insurance policy against Russian aggression), such as those that we have recently witnessed in Ukraine? Does the euro make us safer and, if so, how?

While we currently consider geopolitical developments as a downside risk to growth, I will refrain from commenting on the political aspects of these tensions, as these issues fall outside the mandate of the ECB.

As regards the economic effects, the recent crisis concerning Ukraine and the consequent imposition of sanctions on and by Russia has so far had limited spillover effects on the euro area economy, either via trade or financial links. However, the Baltic states and Finland are more likely to feel any negative effects than other euro area economies owing to the strong trade ties they have with their eastern neighbours. But on the economic risks, I would like to add that the European "family" provides safety nets to partly offset the negative effects of geopolitical tensions related to Russia and Ukraine. For instance, the European Commission announced support measures to protect food producers affected by Russia's food embargo. The euro area is a large market that can help Lithuanian producers to make up for losses from the Russian market. Finally, euro area countries can use the emergency liquidity lines provided in euro by their national central banks, which in turn would receive euro liquidity from the Eurosystem, in the event of significant turbulences in the financial sector.

Why is lending to the real economy in the euro area sluggish? What else needs to be done in addition to the mix of different measures that the ECB is applying, such as low interest rates (or negative interest rates for bank deposits at the ECB) and the planned asset-backed securities programme?

It is true that credit dynamics remain weak. At the same time, recent trends show some positive changes. Among other things, in our own bank lending survey, banks have been reporting an increase in loan demand for all loan categories for two successive quarters, as well as an easing in credit standards for loans to enterprises. However, we should not forget that credit standards overall remain rather tight from a historical perspective.

As mentioned before, it was exactly against the backdrop of weak credit dynamics contributing to a subdued inflation outlook that we decided in early September to adopt a number of additional monetary policy measures, specifically designed to support the extension of credit to the real economy. As they work through the economy, these measures will help inflation rates return to below, but close to, 2%.

What else is needed: well, it is now in the hands of governments to act decisively on further structural reforms that will ensure higher sustainable growth and employment in the euro area. Also, on the fiscal policy side, governments should not unravel the progress made in fiscal consolidation, but use any leeway to make fiscal policies more growth-friendly.

As regards monetary policy, we remain fully determined to counter risks to the medium-term outlook for inflation. As I said in the European Parliament last Monday, we stand ready to use additional unconventional instruments within our mandate, and alter the size or composition of our unconventional interventions should it become necessary to further address risks of a too prolonged period of low inflation.