Mario Draghi: Interview in *Il Sole 24 Ore*

Interview with Mr Mario Draghi, President of the European Central Bank, in *Il Sole 24 Ore*, conducted by Mr Alessandro Merli and Mr Roberto Napoletano, published on 31 October 2015.

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President Draghi, in Malta last week, you stressed the downside risks for both growth and inflation and, in particular, the developments in emerging markets. Also, the most recent data for the United States show that there is a sharp brake on growth. Can you quantify the risks to growth in the euro area?

The conditions in the economies of the rest of the world have undoubtedly proved weaker compared with a few months ago, in particular in the emerging economies, with the exception of India. Global growth forecasts have been revised downwards. This slowdown is probably not temporary. To illustrate the importance of emerging markets, it is recalled that they are worth 60% of gross world product and that, since 2000, they have accounted for three-quarters of world growth. Half of euro area exports go to these markets. The risks are therefore certainly on the downside for both inflation and growth, also because of the potential slowdown in the United States, the causes of which we need to understand fully. The crisis led to a sharp drop in incomes. It is up to us to push them up again. This requires the necessary structural reforms to be carried out in order to increase labour force participation rates and boost productivity. There are still at least 20 million unemployed people in the euro area – many of whom are young – who need to be brought back into the labour market. This represents enormous potential.

In Malta, you said you were "less sanguine" about the inflation outlook. Based on the most recent data, the inflation path now starts from a lower point than what was expected as recently as September, as we will see from your December macroeconomic projections. How realistic is it at this stage to speak of inflation reaching 1.7% by the end of 2017?

I would make a distinction between the forecasts for the next period and those for the medium to long term. As far as the next few months are concerned, the most relevant factor will be the price of energy. We expect inflation to remain close to zero, and maybe even to turn negative, at least until the start of 2016. After that, the effect of the sharp decline in oil prices that we have seen between the end of 2014 and the end of this year will disappear from the one-year ahead annual price index. This will lead to a purely mechanical increase in annual inflation.

What will happen in the medium term?

From mid-2016 to the end of 2017, also due to the delayed effect of the depreciation in the exchange rate, we expect inflation to increase gradually. But what is important to note today is that, even in September's forecasts, we had already lowered our inflation expectations for 2017 compared with those we forecast in March, when we had just started purchasing €60 billion of public sector securities a month.

It will therefore take longer than was foreseen in March to return to price stability. The good news about medium-term inflation expectations is that, after falling in September, these have now returned to a level above 1.7%, which is not far from our inflation objective. However, these figures should be viewed with caution, because these expectations have always showed a degree of volatility.

You have always said that this outcome depends on the full implementation of your monetary policy and you have added on a number of occasions that there is flexibility

in your asset purchase programme in terms of its size, composition and duration. You have also said that the next meeting on 3 December 2015 is when you will "re-examine" these aspects. The financial markets read this date as being decision time for the ECB. Is this interpretation correct? Have you started to consider the relative merits of these three types of action, which could have different effects? Do you envisage using them simultaneously?

If we are convinced that our medium-term inflation target is at risk, we will take the necessary actions. In the meantime we are assessing whether the change in the underlying scenario is temporary or less so. Moreover, after the meeting in Malta, we asked all the relevant committees and ECB staff to prepare analyses of the relative effectiveness of the different options for the December meeting. We will decide on this basis. We will see whether a further stimulus is necessary. This is an open question. The programmes that we have put together are all characterised by their capacity to be used with the necessary flexibility.

However, for the first time you mentioned a cut in the ECB's bank deposit rate and you said that "things have changed" since you had stated that –0.20% was the minimum lower bound. Can you explain what has changed?

The circumstances informing the decision to reduce the bank deposit rate to its current level actually consisted of a macroeconomic framework that has since changed. The price of oil and the exchange rate have changed. I would say that the global economic situation has changed. The interest rate on deposits could be one of the instruments that we use again. Now we have one more year of experience in this area: we have seen that the money markets adapted in a completely calm and smooth way to the new interest rate that we set a year ago; other countries have lowered their rate to much more negative levels than ours. The lower bound of the interest rate on deposits is a technical constraint and, as such, may be changed in line with circumstances. The main test of a central bank's credibility is – as I have said before – the ability to achieve its objectives; it has nothing to do with the instruments.

So, you see cutting the bank deposit rate as an instrument that can be used at the same time as the amendments to QE?

I would say that it is too early to make that judgement.

In Malta, you also said you had discussed "some other monetary policy instruments". What did you have in mind?

It would be too early at this stage to restrict the menu of instruments that will be assessed by the relevant committees and ECB staff. The existing menu is nevertheless extensive – you only have to look at what has been done in the past three years. However, it is too early to say in any case that "this is the menu" and that "there is nothing to add".

In light of the results achieved, do you think that your move to QE came too late?

I would say that, overall, the Governing Council took steps based on the information available. As regards the policy design, this move towards QE started with a speech at the Sciences Po in Paris in March 2014, continued with one in Amsterdam in April of that year and finished in Jackson Hole in August. In particular, in Amsterdam it was said that a significant worsening of the medium-term outlook for inflation could warrant the purchase of government securities. As these conditions gradually materialised, we worked consistently on this plan.

But were you delayed or not?

On the whole, I would not say that we acted late: we took note of the information which became available and at the same time drew up the conceptual framework that led to these decisions. It should also be taken into account that, in the case of monetary union, the decisions were even more complex, because it was necessary to assess the relative importance of different factors driving the fall in inflation such as the structural readjustments in the countries which were in greater need of restoring their competitiveness, the fall in the price of oil and the strong appreciation of the exchange rate in 2013. I would say in short that what emerges from this experience is that the monetary policy framework which was reactive at the end of 2012 became proactive with the speeches I have mentioned.

You spoke earlier about the global macroeconomic environment which is changing. The Vice Chairman of the Federal Reserve System, Stanley Fisher, said that the Fed today takes much greater account of international factors than it did up until a few years ago. Is this true of the ECB as well? And does the Fed's delay in starting to raise rates influence in some way your decisions, considering that the exchange rate is not a policy target?

As I said, external circumstances, the assumptions underlying our forecasts, are important because they influence inflation expectations, and therefore the profile of the return towards price stability and of the growth rate. They form part of the set of information that we, like the other policy-makers, use to take our decisions. As far as the Fed is concerned, there's no direct link between what we are doing and what they are doing. Both central banks have their mandate defined by the jurisdiction in which they operate, for them it's the United States, for us it's the euro area.

In Lima you said that high-debt countries had to prepare for the day when they suffer from the impact of higher yields. At the same time, these countries suffer but also from the fact that inflation is very low, making debt reduction complicated. Isn't this an even more serious risk? In Europe an increase in yields is not imminent, while too low inflation is making itself felt.

Low inflation has two effects. The first one is negative because it makes debt reduction more difficult. The second one is positive because it lowers interest rates on the debt itself. The path on which fiscal policy has to move is narrow, but it's the only one available: on the one hand ensuring debt sustainability and on the other maintaining growth. If interest rate savings are used for current spending the risk increases that the debt becomes unsustainable when interest rates go up. Ideally, the savings are instead spent on public investments whose rates of return permit repayment of the interest when it rises. Growth is maintained today and future public finances are not destabilised when rates go up.

Obviously it's not simple because, as we know, there aren't many public investments with a high rate of return.

Precisely on the subject of fiscal policy, there's a lot of discussion in Europe at the political level. You are one of the first to use the expression "fiscal compact" in the European debate. Do you think now, looking back, that the degree of budget restrictions in the euro area was too strong after the crisis, in other words that there has been excessive austerity which has held back the recovery in the euro area?

First of all, there are countries which don't have the scope for fiscal expansion according to the rules which we have given ourselves. Secondly, where this is possible, fiscal expansion must be able to take place without harming the sustainability of the debt. The high-debt countries have less scope to do this. But the fiscal space is not a fact of nature, it can be expanded, even a high-debt country can do it. How? By making the structural reforms which push up potential output, the participation rate, productivity, all factors which substantially boost the potential for future tax revenues. Increasing revenues on a permanent basis expands the possibilities for repaying debt tomorrow and at the same time creates the conditions for fiscal expansion today. The structural reforms are not popular because they involve paying a price today for benefits tomorrow, but if the government's commitment is real and the reforms are credible, the benefits are gained more quickly and they include fiscal space.

What has been the impact of your monetary policy on Italy, in particular on credit and indirectly on the recovery which is finally arriving?

The impact of the ECB's monetary policy is clearly visible in the cost of bank loans to businesses and households. Since the announcement of the credit expansion measures in June 2014, based on a composite index which measures the cost of loans, the index has gone down by 120 basis points for businesses and by 80 basis points for households. The sovereign spread between Italy and Germany on ten-year securities has fallen from 160 basis points in early June 2014 – not to mention the 600- 700 basis points in 2012 – to around 100 today. The interest rate on two-year Italian securities is near zero; it was above 5%. Even the spread between mortgages of over €1 million and the small-sized ones, up to €250,000, has got smaller. Positive effects can also be seen in lending volumes. Our Bank Lending Survey points to similar trends. On the whole the attitude of Italian banks with regard to lending has changed; lending standard have become easier and continue to improve.

There has been some recovery in Italy. You have hoped to transform this recovery from "cyclical to structural" through reforms. Are there areas for reform in Italy that should be tackled more urgently by the government?

These are political choices, which should be left entirely in the hands of governments. The menu of structural reforms is well known. I have spoken about it in a number of speeches in the past. The choices must be made by the political authorities chosen by the electorate, but I don't believe that there is any disagreement about the necessity of reforms.

On Sunday your presidency of the ECB will reach the four-year mark. This seems a good time to take stock of an extremely eventful time, starting with an interest-rate cut at the first meeting you chaired.

And another at the second!

This was followed by the launch of long-term refinancing operations (LTROs) to finance banks and a whole series of ground-breaking decisions. What have the milestones of the last four years been?

They certainly have been eventful, and marked by profound changes to the structure of monetary policy. In these four years a variety of new instruments have been introduced in a situation which has, in itself, been extraordinary. In addition to cutting interest rates seven times, we were the first major central bank to reduce the deposit rate to zero, subsequently taking it into negative territory, and we introduced the first three-year LTROs. These were followed by the targeted longer-term refinancing operations (TLTROs), the new programmes for the purchase of covered bonds and asset-backed securities and, lastly, the purchase of sovereign bonds in March 2015. This made it possible to avert the biggest threat to monetary union, namely, fragmentation. In August 2012, with the launch of the Outright Monetary Transaction (OMT), for the first time, we tackled the risk of the redenomination of the euro and fragmentation of the entire banking and financial system in the euro area. This decision was endorsed by the European Court of Justice in June this year.

To ward off this danger, it was also necessary to make another structural change, that is, the creation of banking union and the concentration of supervisory powers in the ECB. Creating banking union, setting up the Single Supervisory Mechanism (SSM) and simultaneously conducting a comprehensive assessment of banks was an extraordinary undertaking and I am deeply grateful to all those who contributed to it. Many among them are Italian, and the Banca d'Italia was one of the key players in this process of change. The ECB also played another role – to contribute to the design of monetary union over the long term – which took concrete form in what is known as the Presidents' Report. This was also important. Our decision-making process was made more transparent, too; for the first time, we decided to publish the minutes of our meetings.

I'd like to touch upon your famous speech in London, in which you said that you were ready to do "whatever it takes" to save the euro. The speech had a huge impact on the markets. To assuage my curiosity may I ask whether you expected it to have such an impact, or did you feel it was a sort of last-ditch attempt at a time when the situation was worsening rapidly? Is the risk of a euro area break-up now definitively over?

It's clear that at the time, that speech provided information which highlighted the seriousness of the situation. Since then, things have improved overall. The risks of fragmentation and redenomination have diminished considerably, if not disappeared. It should be pointed out that the euro area countries took action as well, launching a series of structural reforms and gaining credibility in fiscal policy. Although much has been achieved, much still remains to be done, also in terms of the future shape of the European Union. We must be able to propose a way forward to the citizens of the European Union and, of the euro area. We have attempted to do this with the Five Presidents' Report. I'm not saying that it has to be followed in its entirety, but it seems to me that this is the perspective that our leaders and our governments should also take, bearing in mind that the horizon is not cloud-free. We need only look at the newspapers to see that.

However, the Greek crisis has led to a breakdown of trust and caused severe damage to the euro area.

I would not say that. Fundamentally, trust has been rebuilt, primarily by the Greek government, which today is in talks with the European institutions in an atmosphere of close collaboration. The bank recapitalisation process will commence shortly, as soon as the aspects of our assessment have been published. Therefore, I do not believe that there is still a background of mistrust. This was certainly another severe test that monetary union has nevertheless been able to face and overcome. It is too early to draw conclusions, but if we compare the current dialogue with the Greek government with how it was five or six months ago, we see an enormous difference.

The ECB's Governing Council stands ready to increase monetary stimulus, should this be necessary. Your critics claim that this reduces the incentive to implement reforms.

I think that this is wrong for a number of reasons. First, if we look at the time frame of the main structural reforms implemented in the euro area over the past five years, it shows that this has no correlation with the level of interest rates on government debt in the countries concerned. Labour market reforms, for example, were implemented in both Spain and Italy when interest rates were already very low, and the same is also true in other cases. Second, the structural reforms cover a very wide range of areas. I do not believe, for example, that reform of the legal system has anything to do with interest rate developments. Third, recent experience shows that also when interest rates are high because a country's fiscal credibility is threatened, this does not increase governments' propensity to carry out reforms.

How do structural reforms correspond to low interest rates?

Structural reforms and low interest rates complement each other: carrying out structural reforms means paying a price now in order to obtain a benefit tomorrow; low interest rates substantially reduce the price that has to be paid today. There is, if anything, a relationship of complementarity. There are also other more specific reasons: low interest rates ensure that investment, the benefits from investment and from employment, materialise more quickly. Structural reforms reduce uncertainty regarding macroeconomic and microeconomic prospects. Therefore, it is the opposite, rather than seeing an increase in moral hazard, I see a relationship of complementarity, of incentive. But it should never get to the point of having to consolidate the government budget when market conditions have become hopeless. Experience over recent years has shown that, in these circumstances, governments often make mistakes in designing economic policies, dramatically hike taxes and reduce public investment, without significantly reducing current spending, and postpone the structural reforms that require social consensus. In this way, they exacerbate the recessionary effects of the high interest rates and slow the fall of the debt-to-GDP ratio.

To conclude, in the euro area the markets do not typically influence the propensity of governments to carry out structural reforms; when this happens, because the governments have delayed the reforms for too long, and owing to the deterioration in the general conditions, the resulting economic policy action does not foster growth.

Can banking union be considered complete without a common deposit guarantee system, which some countries are opposed to?

Banking union should be completed. Agreements have been drawn up both on the composition of a deposit guarantee system and on a Single Resolution Fund. These measures should be implemented, also because, in this way, one of the problems that characterised the crisis – the two-way relationship between banks and sovereign states – would be weakened by these two measures.

Speaking of Greece, you have acknowledged that even with the implementation of the programme, Athens will need debt restructuring. Do you think that this should be done gradually, so as to preserve the incentive for the Greek government to comply with its obligations?

Greek debt is sustainable if, first, the government complies with the obligations under the programme that it has agreed to, taking responsibility for or ownership of the programme. Second, for the debt to be sustainable a certain degree of relief is required; the latter should be such as to remove any doubt as to the future sustainability of the debt itself, once the first condition has been met. What type of "debt relief" to provide and how to calibrate it so that incentives for compliance with the programme are not distorted are decisions for the Member States, namely for those whose balance sheets will be affected by the decision. The ECB has nothing to say in this regard.

The past four years have been extremely stressful for all involved – and for you in particular, I imagine, especially given your level of responsibility. What helped you through the worst times?

The power of convictions, and the certainty or hope that the decisions we take ease hardship for Europeans.