Mario Draghi: The European Central Bank – rebuilding trust, restoring prosperity and re-establishing price stability

Speech by Mr Mario Draghi, President of the European Central Bank, to mark the opening of the academic year at the Università Cattolica del Sacro Cuore, Milan, 5 November 2015.

* * *

The adult lives of the students gathered here today have been marked by crisis: a global financial crisis of a magnitude that many, more fortunate, generations have never had to experience; a European economic crisis that has lasted too long, and from which we are only gradually emerging; and a series of critical situations that has significantly tested the solidity of European Monetary Union.

Everyone has paid a very high price, but particularly younger generations. The crisis has laid bare the imbalances that built up in the preceding years, which were certainly due to serious errors in the economic policies of member states, but also to shortcomings in Europe’s institutional architecture. Those shortcomings in turn contributed to making the policy response to the crisis slow and cumbersome. The price paid has been the unacceptable number of unemployed, of whom many, too many, are young people.

Today I will try to explain what the ECB, the central bank of the euro area, in fulfilling its mandate, has done and is doing to rebuild trust, restore prosperity and re-establish price stability.

The mandate of the ECB

What is our mandate? Central banks have different mandates, depending on the jurisdiction and institutional framework in which they operate. Ours is not like that of the United States or of Japan, for example. Broadly speaking, central banks exist to preserve the integrity of money.

This function of central banks comes from historical experience, which shows that sound money is crucial to economic prosperity and social stability. In the words of John Kenneth Galbraith: “When money is bad, people want it to be better. When it is good, they think of other things”. We want sound money precisely so that people *can* think of other things and do other things: work, save, invest, innovate.

If today we only rarely ask ourselves if money is “good” or “bad”, it is because for most of our lives it has generally been stable. The youngest amongst you have not suffered first-hand from the damage caused by the inflationary episodes of the 1970s. Few of us have felt the consequences of deflation, as in the 1930s. That is a sign that, in recent times, central banks have largely succeeded in delivering their mandates.

The mandate entrusted to the ECB is to safeguard price stability in the euro area – i.e. ensuring the value of money over time. Specifically, our objective is an annual rate of inflation below, but close to, 2% over the medium term. Note that this definition of price stability is symmetric: inflation should be neither too high for too long, nor too low for too long. History teaches us that deflation, although relatively less common, can have consequences just as destabilising as excessive inflation; above all for young people, who are generally net debtors, the consequences can be particularly distressing.

But to ensure price stability, a currency must be sound in other respects, too. In particular, it must be a reliable unit of account – i.e. its value must be the same across the jurisdiction of the central bank and across whatever forms money takes.

The money people use every day, however, is not only that created by the central bank. In a fractional reserve banking system, as is the case in the euro area and other modern

economies, the bulk of the money stock takes the form of bank deposits. Money is the liability of the banking system as a whole, and it circulates electronically.

For money to be "single", then, the payments system has to work smoothly across the jurisdiction – that is actually one of our statutory tasks – and the banking system that creates money has to be sound. It is above all for this reason that we attach great importance to high-quality banking supervision, a task that has been entrusted to the ECB since November last year. And it is for the same reason that we act as lender of last resort to solvent banks in the event of a liquidity crisis.

These functions are not designed to protect individual banks *per se*. They aim to ensure confidence in deposits and their continuous fungibility with banknotes and other forms of money across the Union. Moreover, as monetary policy impulses are transmitted in part through bank lending channels, sound banks are a prerequisite for ensuring price stability. If only for that reason, countering fragmentation in the banking system falls without doubt within our mandate.

The ECB's mandate, in its broadest sense, is based on a consensus rooted in society. Politicians receive their mandates from elections which reflect the preferences of the electorate. The ECB's mandate, by contrast, is inscribed in a document with a constitutional status: the Treaty. A constitution rests on those shared values deeply felt by citizens; that is why constitutions are not, nor should be, subject to periodic scrutiny by voters.

To fulfil our mandate, we enjoy a large measure of independence in how we formulate our monetary policy. But that freedom has precise limits.

We cannot use instruments prohibited by the Treaty to achieve our objectives. For example, we are prohibited from engaging in monetary financing of governments. Neither are we at liberty to redefine those objectives: abandoning the pursuit of our mandate, for instance, is simply not an option. And neither can we engage in behaviour that would *de facto* redefine the provisions of the Treaty, such as a country's membership, or not, of the euro area. In other words, our mandate is defined by the Treaty.

In recent years, when pursuing the objectives in our mandate, we have been confronted with extremely demanding challenges which have called for unprecedented monetary policy measures in terms of nature, scale and number. We have had to ward off risks that were corroding the integrity of money both over time – price stability – and across space – within the euro area – especially when doubts arose about some countries' membership of the area.

In each instance we have responded in full compliance with our mandate, within the limits set by the Treaty. To illustrate this point, I would like to consider two recent examples: the launch of the ECB's asset purchase programme (APP) in September last year and the Eurosystem's provision of emergency liquidity assistance (ELA) to Greek banks in recent months.

The asset purchase programme

In the early phase of the crisis, inflation on the whole remained well anchored to our objective. Having recovered after the effects of the Lehman Brothers shock, consumer price inflation averaged 1.6% from September 2008 until the end of 2011. Afterwards, against a backdrop of persistent macroeconomic weakness, inflation began a prolonged downward drift, consistently undershooting our staff projections.

From the start of 2014, it became increasingly clear that without our comprehensive response, medium-term price stability was at risk.

Initially, we judged the main barrier to higher inflation to be impairments in the monetary transmission process that were preventing our policy from gaining traction in the economy. To remove those impairments, our policy response – launched in the summer of last year –

focused above all on supporting bank lending to the real economy with longer-term refinancing operations.

Unlike the long-term operations we launched in 2009 and again between the end of 2011 and early 2012, these targeted refinancing operations are, for the most part, conditional. In other words, any bank, starting in March this year, can have a long-term loan from the ECB at a very advantageous rate only if its lending to businesses and households increases at a higher pace than in the recent past. The banks have, to date borrowed an amount totalling just under €400 billion. This has been critical in stimulating the pick-up in bank lending that we are currently witnessing.

Later in 2014, however, the inflation outlook worsened due to the steep fall in oil prices. Very low oil-driven inflation is not necessarily problematic for the central bank if that inflation is perceived as being temporary and if, as a consequence, inflation expectations remain unchanged. But what we saw was that inflation expectations were tending, at all horizons, to become dis-anchored from our price stability objective and increasingly affected by the low level of current inflation.

This called for monetary policy to shift up a gear, for two reasons. First, when policy interest rates are at zero – as was the case by that time – falling inflation expectations imply a rise in real interest rates, which amounts to a tightening of our monetary policy stance. If left unaddressed, that could have started a further fall in inflation expectations and a sharper tightening of the monetary stance.

Second, though oil price movements can permanently affect the price *level*, they should not exert a longer-term influence on the inflation *rate*. So the fact that we were seeing longer-term inflation expectations responding to low oil prices was a source of concern. It suggested, perhaps, that people believed the central bank's scope of action to achieve its objective was in some way constrained, and hence where inflation would settle was uncertain.

It was in that context that we launched our asset purchase programme in September last year, and expanded it in January this year to include public sector securities. The transition from a monetary policy based on adjusting short-term interest rates to one carried out through asset purchases constituted, in reality, a natural evolution. But it nonetheless helped dispel some misunderstandings about the meaning and boundaries of the ECB's mandate, and confirmed the Governing Council's independence of judgement and of decision-making from the political views within Member States.

Recently, the European Court of Justice has confirmed that the ECB can deploy any available instrument, unless explicitly ruled out by the Statute, to ensure price stability. If risks to price stability arise, we have to use all the tools that are legally available to us. Indeed, the clearest demonstration of the determination of the Governing Council to act when necessary was provided precisely by the decision, taken by the majority of the Council members, to proceed with the asset purchase programme.

Today, like before, we are not constrained in our capacity to intervene; we have many instruments at our disposal. We are confronting a situation in which price dynamics are very weak and the macroeconomic picture remains uncertain. That is why the Governing Council is committed to re-examining the degree of monetary policy accommodation at its next meeting in December. The programme so far has without doubt been effective. But we must assess whether, with the weakening of the economy, the current stance is still sufficient to counter the headwinds which could obstruct a return to medium-term price stability.

Should we believe this not to be the case, we will examine how it can be enhanced to achieve our policy objective.

Emergency liquidity assistance for Greek banks

In its decisions the ECB is bound both by the Statute and by the other provisions of the Treaty. The choices of the Governing Council concerning Greece were another example of strict adherence to the letter and spirit of both.

This was apparent a few months ago when, amid a worsening economic and political situation, the government and the Greek banks lost access to market funding and depositors started to withdraw their money from the banks. The banks became completely dependent on emergency liquidity assistance, a form of "lending of last resort", from the Eurosystem. ELA became the sole channel through which Greek banks could continue to function and make payments, and through which deposits could continue to flow to other parts of the euro area. At the peak we were lending €127 billion euro to the Greek banking system, or 71% of the country's GDP.

In keeping with Article 123 of the Treaty which prohibits the ECB from monetary financing, the Governing Council imposed strict limits on the use of government securities as collateral for loans that the Greek banks received from the ECB. Otherwise the government would have obtained refinancing from domestic banks which would have in turn used the government securities to obtain our funding. We nevertheless continued to supply the necessary liquidity so as to ensure the functioning of the Greek banking system and the continuation of lending to businesses and households. This was in line with the principle by which the Eurosystem may lend to banks which are solvent and have sufficient collateral.

The authority competent in this matter, the European supervisor, deemed that the banks were solvent. But clearly their solvency, like the availability of sufficient collateral, depended crucially on the prospects for success of the programme negotiations that were underway: if they failed, the value of the Greek government securities would have fallen, impairing the solvency of the banks and the quality of their collateral, excluding them from financing by the Eurosystem. The Governing Council thus found itself having to judge the prospects of success of these negotiations.

Two extreme options were put forward. The Governing Council could immediately have considered a positive outcome as improbable, it could have objected to further extensions of ELA or even, as some were demanding, asked for the liquidity granted to be reimbursed, thus causing the whole of the Greek banking system to fail.

Or, as some have subsequently argued, the Governing Council could have allowed the supply of liquidity assistance, in unlimited amounts, even in the event of the talks with the Greek government failing.

As you will remember, our decision was controversial, but it was the right one.

We granted ELA for as long as it was deemed that there were conditions favourable for a positive outcome to the negotiations. Its expansion was suspended when it appeared these conditions were no longer confirmed. ELA was then resumed when it was clear that the prospects for a positive solution were restored.

Looking back at these months just past, we can see that it is not only the actual course of events that proved this to be the right decision. We chose the only path compatible with the Statute and the Treaty, the only path that would have preserved the integrity of the currency.

Other possible paths would have infringed the principle whereby the ECB must lend only to solvent banks, and only if the collateral is adequate – and those paths would probably have destroyed the integrity of the currency.

Similarly, the ending of ELA would most likely have started a process that would have resulted in Greece exiting the euro area, thereby negating the irrevocability of the euro envisaged by the Treaty. And this would have happened not as a result of a new decision, reached democratically, by the signatory countries of the Treaty. It would have been a

consequence of the central bank renouncing to apply strictly and in full the provisions of the Treaty.

The ECB's support for Greece is based on its Statute but also on the assumption in the Treaty that the status of each member of the euro area remains inviolate.

Indeed, the same conviction and the same independence from the political process led us in the summer of 2012, when the sovereign debt crisis endangered the integrity of the euro area, to resolutely declare our determination to defend the single currency.

To sum up, the balance we achieved with our interventions during the Greek crisis was fully within our mandate; it respected the political commitment to the single currency contained in the Treaty, but at the same time we implemented that commitment within the limits of our Statute.

Conclusion

The ECB's response to the exceptional challenges posed by the crisis has preserved the integrity of money in the euro area. Monetary stability is however only one necessary condition for the prosperity of the economy. Indeed, so much attention has been paid to our commitment to a sound currency that, to paraphrase Galbraith, little thought has been given to other things. We must now look ahead, and move from stability towards prosperity.

We need a new pact that prevents the re-emergence of the type of challenges we have addressed, and that above all strengthens the constitutional architecture of the euro area. This is not a new conclusion. It was already reached in the summer of 2012, when the European Council mandated the President of the Council, the Commission, the Eurogroup and me, and subsequently the President of the European Parliament, to outline a credible path that completes our monetary union and makes it "more perfect". Since then, we have made various proposals, all of which go in that direction.

I hope that what I have said to you today will convince you of the urgency of this reflection, of the need to turn it without undue delay into an institutional process able to secure concrete results, in line with a clear calendar for action.

This is a long and complex journey which can only be based on the strong determination of the member states.