Mario Draghi: Financial stability and growth – the role of the euro

Speech by Mr Mario Draghi, Governor of the Bank of Italy, at the "Europe and the Euro" Conference, NBER-Bocconi University, Milan, 17 October 2008.

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To anticipate the thrust of my discussion today, I will concentrate essentially on two themes:

1. First, the euro has proved to be an invaluable asset for our economies. The benefits of the European single currency are crystal clear at the current juncture, while we are facing the most dramatic financial crisis of the last several decades. The common currency has been an essential element of stability. The advantages, however, are not confined to this role: the euro has also been a catalyst for fundamental and positive changes in the real economy, some of which are already very visible.
2. Second, much remains to be done to fully reap the benefits of the single currency. And in my opinion, what is left to be done goes very much in the direction of more – rather than less – integration of our economies. There are measures that may be taken to achieve this goal in many areas and, foremost, in the field of regulation.

1. The euro and the financial crisis

To start with, it is quite easy for me to speak of the benefits of the euro in relation with the current crisis. There are several aspects I should like to consider.

A first theme relates to the emergency responses to the crisis.

As it has been emphasized, in academic publications and in the press, the current turmoil presents both similarities and differences with respect to earlier financial crises, in particular the crisis that led to the Great Depression in the 1930s. As in the past the crisis is marked by a loss of confidence by investors and the public towards key financial institutions and markets. Often in the past, the response of policymakers was marked by uncoordinated actions, and in some case, very serious mistakes, in the provision of liquidity, in the management of exchange rates and trade policies, in the insufficient scale of the interventions needed to support banks. Exchange rate volatility and associated beggar-thy-neighbor policies were an important step along the road leading to the Great Depression.

Today the situation is clearly different, and we do have some tangible advantages in dealing with the crisis.

First, the existence of a common currency in Europe ruled out the possibility of destabilizing movements of intra euro area exchange rates in response to the financial shocks, which would have greatly complicated the response to the crisis.

Second, the existence of EMU, by supplying a common currency, a common liquidity policy across Europe, a forum in which the issue of coordinating economic policies can be more effectively discussed and solved, is also crucial.

In the immediate aftermath of the crisis, the ECB was quick and flexible to respond to the challenge posed by the drying-up of market liquidity. The Eurosystem's operational framework has proved adequate to allow rapid and far-reaching decisions and a timely management of the initial stages of the crisis, and flexible enough to deal with the evolving situation, smoothly incorporating any required amendments. We have increased the amount of liquidity provided, lengthened the maturity of operations, set up a facility to offer liquidity in dollars in agreement with the Fed. In the last weeks, we stepped up our effort to normalize the dislocated money market, by deciding some further, and more profound, changes to the operational system. We have narrowed the corridor of monetary policy, shifted to a fixed rate tender with full allotment and enlarged the collateral that can be used by participants.

We do not have a counterfactual, but I would argue that some of the pre-EMU national systems would have been put to a hard test by the recent events. The existence of a common liquidity policy proved effective in avoiding that uncoordinated national initiatives open the way to cross-border arbitrage and to undesired spillovers that could have further amplified the turbulence.

More generally, in the presence of a systemic crisis and with closely integrated financial markets, the appropriate policy response needed to be coordinated, not only across European borders, but also beyond the euro area. The unprecedented policy move decided jointly by the main central banks of the world on 8 October is a case in point. Coordination on such a scale may have been very hard in the old days.

Finally, the worsening of the turmoil since the beginning of September posed new challenges to policy makers of the euro area, calling for prompt action. At first, the severity of the crisis induced some national governments to take autonomous steps to restore confidence, but this proved insufficient, signaling very strongly the need for a coordinated action at the European level. The agreement of October 12 on a concerted European plan of action setting the guidelines for interventions aimed at restoring confidence in financial markets has been a fundamental step in the management of this crisis, not only at the European level, but also globally. Our ten year experience in sharing a single currency and monetary policy proved to be a solid foundation for a common and timely response to the emergency, providing strong support for a coordinated action of governments and central banks.

A second theme relates to how we should act to limit the credit crunch. In the current situation the possibility that the tightening of credit conditions and the cyclical downturn reinforce each other in a vicious spiral represents the main risk for the global economy. In this respect, restoring the smooth functioning of the interbank markets globally and within the euro area is a precondition to ensure the stability of credit flows to households and firms, thereby minimizing the real impact of the financial turmoil. The policies adopted so far, including the changes in the operational framework I just mentioned, the lowering of monetary policy interest rates, the efforts of governments to recapitalize distressed institutions have been all essential to avoid a major financial disruption. However, while some progress is visible, their effect on interbank interest rates has so far been limited and slow to build up. Liquidity and counterparty risks continue to be major drivers in money markets, which remain impaired with abnormally high spreads between secured and unsecured lending.

In the weeks ahead, an additional support can come from the implementation at the national levels of the decisions agreed at the European level, including the recapitalization of banks and the possibility to make available, for an interim period and on appropriate commercial terms, governments' guarantee, insurance, or other similar arrangements of new bank senior debt issuance. While some degree of flexibility to adapt to local conditions must be preserved, it is also of the utmost importance that the actual implementation of the new measures proceeds in a coordinated manner, so as to avoid creating any segmentation in markets or uneven conditions for financial institutions across Europe.

At the same time, we cannot rule out that further and even bolder steps may be needed in the near future to quickly restore confidence, including actions to strengthen interbank markets.

A final theme relates to the efforts to reshape the rules governing the global financial system, in a more structural and medium term perspective. In this field, it was immediately clear since the beginning of the crisis that the structural response had to be internationally coordinated. This was the task assigned by the G7 to the Financial Stability Forum (FSF). The line followed by the FSF is that financial intermediaries in the future will need to have more capital and less debt, be more transparent and be subject to more effective rules. Several important actions are being undertaken at the international and national level – largely following the FSF's proposals – to reinforce capital requirements and the management of credit and liquidity risk, to improve disclosure policies, valuation practices, accounting standards and the role of rating agencies, and others. Decisive and tangible progress in this area is an essential part of the cure to come out of the emergency. In Europe, I believe we must in particular step up our efforts to quickly overcome existing differences in supervisory practices at the national level, work towards a more harmonized set of rules, make further progress in the cooperation and exchange of information among authorities. Again, I'm confident that the EMU and its institutions will act as a powerful catalyst, helping governments and regulators to redesign the rules for the financial sector, both at the European and at the global level.

2. The euro and the real economy

2.1. Macroeconomic stability

Besides helping in confronting the financial crisis, there is ample evidence that EMU has also favoured greater resilience of the euro area economy to adverse real shocks. One crucial aspect in this respect is the high credibility of monetary policy that the ECB inherited from the best traditions of the constituent currencies.

A clear cut example is provided by the experience with increases in the prices of energy and raw materials. Blanchard and Galì, among others, have shown that the adverse effects of oil price shocks on the economies have become significantly less severe than it used to be in the past. Recent studies at the Bank of Italy show that after the introduction of the euro the impact of oil price increases on inflation in Italy may have been reduced by ten times compared to the seventies. While there have certainly been other structural changes at work (such as a lower intensity of oil in production and consumption and more flexible labour markets), there is little doubt that the higher credibility of central banks has played a crucial role. The case of Germany is illustrative in this respect: the effects of oil price increases on inflation were very limited already 30 years ago, thanks to the very high credibility the Bundesbank enjoyed at the time.

2.2. International trade

One of the reasons for adopting the euro was to facilitate market integration and the completion of the single market, reducing transaction costs connected with the hedging of exchange risks and the variety of currencies used for commercial invoices. The evidence is that expectations have been confirmed in full.

Numerous empirical studies concur that monetary union has had a positive effect on the volume of trade within the euro area, although they disagree as to the extent, which is estimated between 5 and 15 per cent. A positive effect has also been observed on commercial flows outside the area; this supports the theory that the adoption of a common currency, unlike preferential liberalizations, does not have distortionary effects on international trade.

2.3. The trend in productivity

Is there a visible link between the adoption of the euro and productivity trends in the single currency area? This is a fundamental question on which no consensus has formed yet. From the second half of the 1990s, total factor productivity increased much faster in the United States than in the euro area, where instead its growth slowed sharply. The gap widened with the start of monetary union and has begun to narrow only recently: during the period it has averaged about one percentage point a year. The gap reflects diverging trends in the leading

European economies: slower growth in France and Germany and absolute decline in Italy and Spain, although our estimates indicate it has stabilized in Italy in the last two years.

The poor performance of total factor productivity accounts for much of the growth gap in labour productivity in the euro area as a whole. The adjustment of capital intensity has also slowed in the area as a result of heavier reliance on labour in the presence of institutional reforms making employment more flexible.

To be sure, there are important issues concerning the reliability of statistical measurements. For example, some studies have shown that productivity growth in the United States might have been somewhat overestimated due inter alia to the incorrect measurement of gains in the terms of trade and tariff reductions. In Italy, The Bank of Italy showed that the rate of increase in the export deflator was overestimated in the official statistics. This led to a revision of statistics resulting in an increase of more than 0.5 percentage points per year in productivity growth in manufacturing in the period 1996-2005.

But if the correction for statistical error can make Europe's productivity and growth gap vis-à-vis the United States less alarming than it seems on the basis of the original data, they do not annul the gaps. The fact that they have existed for a decade forces us to seek their causes in the structure of our economies.

Answering the question on the effects of the euro on productivity is as difficult as any counterfactual exercise. It requires to estimate what trend in productivity would have been without the single currency.

However, I believe an answer emerges quite clearly from this conference, at least in two mutually consistent analyses. In a presentation tomorrow, Bugamelli, Schivardi and Zizza will explain how the euro has fostered the restructuring of firms and productive systems, especially in sectors and countries that had relied most heavily in the past on currency depreciation in order to recoup price competitiveness in the short term. And Alesina, Ardagna and Galasso show how the same discipline has pushed governments to carry out significant reforms in the markets for products and services. The findings point to a substantial positive contribution of the euro in terms of productivity.

Another case in point is the labor market. Thanks to the reforms of the last ten years, it has been possible to overcome the old image of an immobile European labour market – reflected in high rates of unemployment and a low labour force participation rate – for which the term "Eurosclerosis" was coined. There is empirical evidence of a clear positive association between adoption of the single currency and the increase in employment and decrease in equilibrium unemployment.

Finally, Bank of Italy research shows that the reduction of entry barriers in the past decade, thanks to new, less anti-competitive rules, led to an increase in the share of total employment of the sectors where reforms were introduced. Sharper competition has increased incumbents' productivity and decreased their profit margins, fostered the adoption of ICT and reduced price increases.

3. Conclusions

To conclude, I believe that confronting successfully the challenges posed by the current crisis requires that we continue on the road of greater integration and market openness which has been spurred by the adoption of the euro.

In difficult times our economic paradigms may change dramatically and the temptation to go in isolation to deal with the most pressing problems may be understandable but may prove to be disruptive. The benefits of having had the euro for the last 10 years speak by themselves. We want to come out of this crisis able to continue enjoying these benefits.