Mario Draghi: Interview with *Frankfurter Allgemeine Zeitung*

Interview with Mr Mario Draghi, President of the European Central Bank, in *the Frankfurter Allgemeine Zeitung*, conducted by Messrs Holger Steltzner and Stefan Ruhkamp, published 24 February 2012.

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For two years, Europe's politicians have been promising to save the euro, whatever the cost. But the problems have kept on growing. Do you believe the second aid programme for Greece will be successful?

Yes, I do. But the work has only just begun. With the adoption of this comprehensive financial package, we are sending a clear signal: Europe is helping Greece, and important international institutions, such as the IMF, are assisting as well.

What is different this time?

Of course the ball is now in Greece's court. The country has started to take action: for example, to cut the minimum wage. Above all, however, political debate in Greece has changed. The Greek people and Greece's politicians now have a completely different attitude towards their country's responsibilities. The key to controlling risks lies with the implementation of the programme, which has to be flawless. The upcoming elections will be very important. It is essential that the new government supports the programme, just as the old one has. Since everything depends on the implementation of the programme, monitoring is very important. And that is being taken care of.

Is that also what the "escrow" account is for, which has been set up for Greek debt servicing?

In organising such a large financial aid programme, we need effective assurances to minimise the risk as much as possible. That is why there is such an account for the first time.

The haircut requested of Greece's private creditors has been raised again. Do you expect voluntary agreement?

Yes, all parties involved have signalled their agreement.

Then there is no need for clauses to enable a binding haircut for all creditors, the so-called Collective Action Clauses?

No, they may need them to achieve a sufficient level of participation among creditors.

That doesn't sound quite so "voluntary" any more. Won't it then come to what the ratings agencies call a default? Will the ECB then accept Greek bonds as collateral?

It is not a rating default yet. But, of course, that could happen, if Greece introduces the clauses by law. Then we will have to stand by our principles. The alternative is: we could ignore it and continue to accept bonds as collateral, which we don't intend to do.

Or you obtain collateral from the other Member States.

That is the solution it boils down to. Via the EFSF, additional safeguards to the value of €35 billion are to be provided for a transitional period, so that the Eurosystem could then accept Greek bonds as collateral, even if they were to be downgraded to "selective default". We are not the IMF of Europe. Our primary task is to ensure price stability in the euro area as a whole, irrespective of what is happening in an individual country such as Greece.

By removing the Greek bonds held by the central banks from the debt restructuring, the ECB has gained a privileged position as creditor. How is that justified?

The bonds were bought for monetary policy reasons. There is therefore a public interest. But even more important is the fact that, in the end, it is taxpayers' money. It is our duty to protect the taxpayers' assets. Moreover, we are not there to contribute to government financing by dispensing with claims.

But the ECB has always said that the purchases were part of its monetary policy. If it was an independent decision, why shouldn't the central banks bear the losses, which they would take over, without hesitation, if the financing of a bank proved to be unprofitable? What is the difference between losses on government bonds and losses from a bank failure?

Look at the United States and the United Kingdom. In both cases, the central banks have bought up large amounts of securities and the State has secured it with guarantees.

But for the markets, this means that the risk for private creditors has become greater. They have to count on the fact that, if the worst comes to the worst, the central bank will be serviced first. How great is the damage for the European government bond market?

Not very great, because the amount of our bond purchases, compared with the entire market, is small. For that reason, we do not see any effect on risk premia either. Moreover, Greece is a special and unique case of private sector involvement.

The call for Greece's creditors to accept a haircut makes it clear that there is no such thing as a risk-free investment any more. Is that a problem?

That issue was processed by the markets a long time ago. The decisions of autumn 2010 (at the Deauville summit) put an end to all public debtors borrowing at the same conditions, irrespective of their creditworthiness.

Does the disappointment that there is no absolute security any more actually, in the end, have a stabilising effect on the financial system?

Of course there is an excess of risk aversion and fluctuations, and that may cause great difficulties for monetary policy. But in the long run, the different perception of risks makes the system more stable. And what's more, it forces governments to keep their finances under control. Before the introduction of the euro, corrective signals came from exchange rates. After this corrective mechanism ceased to exist, some governments thought they could do and allow what they wanted, without having to pay. Now market prices are being corrected and that is a good thing. However, we must of course be careful that the markets do not overdo it and send false signals. Markets can be stabilising up to a point, but destabilising beyond it.

How can you tell whether a market price is right or wrong?

One indication is extremely high volatility. Strong fluctuations can shake confidence so badly that nobody dares to lend out money any more. Interbank lending then becomes virtually impossible and the banks can no longer issue any bonds either, even when these – like covered bonds – are well secured. In such a situation one knows that something is wrong.

And then the central bank must intervene?

If the operation of monetary policy is no longer certain because of the distrust, if monetary policy is no longer reaching the economy which negatively affects credit, overall demand and ultimately price stability. Yes, then the central bank must act and work out a strategy for dealing with the disruptions. Of course it depends on the reason for the risk aversion. If it is because of a lack of liquidity, or even just the assumption that the counterparty might be short of funds, then the central bank could help. But if banks have a capital shortfall, then it is not the task of the central bank.

Many Germans are concerned about the majority composition of the ECB Governing Council, which in numerical terms is dominated by central bankers from fiscally weak countries. They fear inflation. What would you say to these people?

The ECB acts according to two maxims: that it should ensure price stability and should not provide monetary financing to governments. We operate independently of our nationality. In the early phase of the currency union, the former president of the Bundesbank, Hans Tietmeyer, whose picture hangs on the wall here, once refused to sit at a table on which name cards specifying the participants' respective institutions had been laid out. He said: "Clear them away, we are here in a personal capacity and not as envoys of our institution or country." This is the spirit of the ECB.

Even after the debt forgiveness, Greece's government debt will amount to 120% of annual overall economic output. That is barely sustainable for a country with a sound economy, but much less so for a country in a poor competitive position. What is so terrible about the idea that Greece might give up the euro?

Firstly there is no provision in the treaty for a country to leave or to be excluded from the euro. But even apart from that: do you think that by leaving the euro, printing a new currency and undergoing the subsequent adjustment, Greece could avoid the structural reforms that are necessary?

No, they remain necessary. But it would be easier to find agreement for the adjustment and, above all, the sheer possibility of an exit would improve the basis for the negotiations with Greece. Without this option, the rest of Europe is signalling: whatever you do, whatever happens, we will fund you.

That is not true, because Member States and the IMF would not finance a programme that lacked credibility.

But if the Greeks remain in the euro area, they must reduce their costs and, for example, cut the wage level by at least a third. Will that succeed?

There is no alternative, because even if a country has flexible exchange rates and devalues but make no other changes, it has not gained anything. It depends on the real lowering of wage costs. In the currency union, this occurs when nominal wage costs fall or remain contained, while prices remain stable. Experiences in the 1970s show that this is the more sustainable method to regain competitiveness. Otherwise we get inflation with high social costs over the long term.

If Greece keeps the euro, the adjustment will take many years. During that time, the country will import more than it exports. As this current account deficit will no longer be financed by private lenders, this task will fall to the central bank.

That is correct, there will be deficits for a while. But Greece is making progress. A part of the adjustment in wage costs that is required to restore competitiveness has already been achieved. Some of the agreed structural reforms will only make themselves felt in the long term, but others, such as efforts to make the labour market more flexible, can immediately strengthen confidence.

The funding of such deficits of fiscally weak euro countries are visible in the huge balances of the TARGET payment system. Would the Eurosystem have already collapsed without this rescue system, this bailout?

I cannot see any bailout there. We have a currency union and a payment system which is organised by the ECB as a single platform. And there are payment flows from one country to another. The fact that these balances arise at all is because of the disturbed conditions in the money market, in which banks distrust each other. Rather than lending money to each other, they borrow it from the central bank and deposit it there too.

Does that not entail enormous risks for central banks, at which TARGET claims are mounting up because of the imbalances? For the Bundesbank alone, they amount to almost €500 billion.

There are no risks in a cohesive monetary union. There are certainly grounds to monitor the imbalances, because in a currency union with a well-functioning interbank market, the TARGET claims would not become so large in the first place.

Do you expect the TARGET balances to disappear again one day?

Yes, of course. We have seen in the past that imbalances recede whenever the situation improves.

In December the ECB provided financing of almost €500 billion for the unusually long period of three years. The second operation of this kind, which will be conducted at the end of February, could be of a similar magnitude. Can you understand that these large sums make many people feel uneasy, and lead them to wonder if they will one day have to foot the bill?

It is important to explain things well. That's why the media are so important.

Only we are worried too, unfortunately.

The net inflow from the first three-year tender, at a good €200 billion, was not that high. There is no sign of inflationary tendencies in the euro area, quite the opposite. And if there should be any sign of future inflation, we have the instruments with which to absorb the liquidity again within a short space of time.

But with the longer-term refinancing operations, the ECB also relaxed the collateral framework.

We have made it possible for individual loans to be lent on. This mainly benefits the smaller banks, which do not have the capacity to securitise such credit claims and then use them as collateral with the central bank. This extension involves additional collateral of around €600 billion, which, as a result of the large haircuts, can permit additional lending of €200 billion. In relation to the size of the euro area, that is not such a big sum. In addition, the national central banks bear the risk stemming from these loans.

There were rumours that the ECB asked the banks to borrow a lot of money and then to use it to buy government bonds.

Who said that? I'd like to have a word with that person. No, we made it very clear that the banks take their own decisions. We would prefer it if they would lend the money to companies and households. Incidentally, the impact of the three-year tender was underestimated when I announced it in December, because many people expected the ECB to expand its government bond purchases, the famous "bazooka". Maybe I should have called the tender "Big Bertha" when I announced it, then everyone would have listened.

The ECB is hardly buying any bonds of fiscally weak euro area countries at the moment. Wouldn't this be a good opportunity to put an end to this programme that is so controversial, particularly in Germany?

The markets are still vulnerable, and so we have to be very careful about announcing the end of such an instrument. The Securities Markets Programme has served a purpose since it was introduced.

If the situation were to worsen again, would you be ready to expand the collateral framework again?

That would be for the Governing Council of the ECB to decide, but I personally am not in favour of it. We have done enough. The collateral rules should not be relaxed further. In future, based on the current outlook, it will rather be a question of tightening the requirements again.

You said recently that the ECB's financing measures had prevented a credit crunch in December. What has changed since then?

Banks were tightening their credit conditions. This applied more to countries such as Portugal and Spain and less so to Germany. But following the very weak fourth quarter of 2011, both hard indicators and confidence indicators have gradually improved. The situation varies considerably across the individual euro area countries, but it has stabilised overall.

Have the positive signs increased over the past two weeks?

Yes, I would say so, although uncertainty remains high.

Is there still a risk of a "lost decade" of very low growth, as experienced in Japan?

No. What makes me confident are the reforms that have been started in Europe in the past four or five months.