Mario Draghi: Building the bridge to a stable European economy

Speech by Mr Mario Draghi, President of the European Central Bank, at the annual event "Day of the German Industries", organised by the Federation of German Industries, Berlin, 25 September 2012.

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Ladies and gentlemen,

It is a privilege to be invited to address the *Bundesverband der Deutschen Industrie* this afternoon.

The BDI in many ways mirrors the strengths of the German economy. It simultaneously represents global multinationals and family-owned small businesses. It is this combination of small, medium and large firms that gives German industry its uniqueness and resilience. And this has been rewarded in recent years through strong growth and high employment.

The euro area as a whole has been facing challenging times. Financial markets are fragmented. Economic growth has been broadly flat for the first half of 2012. Growth also remains highly uneven, with some parts of the euro area economy expanding at a solid pace, while others are still in a phase of adjustment.

But my central message to you today is that, provided that all policy-makers persevere with the necessary reforms, we have a number of reasons to be positive about where the euro area is heading. We are seeing signs of improved sentiment in financial markets and we expect the economy to return to growth next year. At the same time, considerable progress is being made on all fronts to strengthen the foundations of the euro area.

Above all, the Member States of the euro area are undertaking determined measures to address the root causes of our current challenges. Individually, governments are implementing the fiscal and structural reforms essential for growth. Collectively, they are reforming the governance of the euro area so as to guarantee sound policies for the future.

We at the European Central Bank (ECB) are continuing to maintain price stability, which is the foundation of growth and job creation. We have introduced new measures to ensure price stability by removing unfounded fears about the euro area. These measures are supporting financial market sentiment while deeper reforms are implemented across the euro area.

However, our measures can only build a bridge towards a more stable future. It must be completed with decisive measures by governments to address fundamental challenges and complete the euro area's institutional architecture. They are currently making progress in this direction. The key challenge going forward is to ensure that the immediate upturn strengthens rather than weakens this commitment.

Actions by the Member States to strengthen the euro area's foundations

Let me begin with the actions being taken by the Member States to strengthen the euro area's foundations.

Across the euro area, strong budgetary consolidation is taking place. The International Monetary Fund (IMF) forecasts that the euro area's primary budgetary position will be almost in balance this year. This means that, apart from debt service, all other expenditures are covered by current revenues.

This is quite an achievement in an international context: Japan, for example, will have a 9% of GDP primary deficit this year, the U.S. 6% and U.K. more than 5%. And the euro area is not only performing well on average: each individual country will have a primary budget deficit lower than these three countries. It is those countries most in need that are making the largest adjustments.

Important improvements are also taking place in competitiveness. For example, the countries under full EU-IMF programmes have seen unit labour costs improve by around 10% since 2008, relative to the euro area average. This has translated into current account deficits that are on average more than five percentage points of GDP lower than they were then. And this is not only due to lower imports, but also rising exports induced by higher competitiveness.

At the same time, the Member States are taking significant steps to improve euro area governance. Governance of fiscal policies has been decisively strengthened with the fiscal compact. This agreement is a powerful tool for keeping fiscal policies in balance and reducing debt to sustainable levels.

Governance of financial policies is also now being given proper attention. The European Commission has recently proposed a single supervisor for euro area banks. Single supervision is particularly important in a single currency area where countries are more immediately affected by instability originating from other member countries. Such single supervision should ultimately lead to a more stable financial system.

Taken together, these actions show that clear progress is being made towards addressing the fundamental causes of our current challenges. Deficits *are* being reduced. Rebalancing *is* happening. And governance *is being* reformed.

Actions by the ECB to ensure price stability

Let me turn to the ECB's recent actions. We have played a role in improving overall confidence by removing unfounded fears about the euro area that were affecting our ability to ensure price stability – notably through our recent announcement of Outright Monetary Transactions, or OMTs. Let me briefly explain the rationale for this decision.

The euro area has experienced a very severe fragmentation in its financial markets. In recent months, we have seen highly divergent borrowing costs for the real economy in different parts of the euro area. In our analysis, these differences were larger than justified by individual credit risk. They reflected, to a considerable extent, unfounded fears about the future of the euro area.

For example, a loan to a family in Germany for a house purchase with a five- to-ten-year maturity had an interest rate of 3%; the rate for a comparable borrower in Spain was 7.5%. At the same time, the average firm in Germany paid around 3% for a new loan over five years, while the average firm in Italy paid above 5.5%.

In these circumstances, monetary policy cannot work properly. This is because a key channel through which the ECB ensures price stability is through the cost of credit, in particular bank credit. Bank credit accounts for about 70% of external financing of euro area firms, and that ratio is even higher for smaller enterprises.

But if we are unable to influence borrowing costs in some parts of the euro area, this channel is disrupted. Firms and households have less access to financing, economic growth stalls and these regions are faced with a risk of deflation. In other words, our ability to ensure price stability for the whole euro area is compromised.

The ECB's Governing Council therefore faced a choice: to accept this situation and allow the singleness of its monetary policy to be undermined; or to take actions within its mandate to restore the normal transmission of monetary policy across all parts of the euro area. We decided in favour of the latter.

Our actions aim to repair monetary policy transmission through providing a credible backstop in government bond markets that removes unfounded fears and tail risks from the euro area. Insofar as this supports investor confidence, it will help stabilise conditions in other markets, such as those for corporate and bank bonds. This ultimately feeds into more even borrowing costs for the real economy across the euro area.

Early signs suggest a positive effect. Since the beginning of this month, euro area banks issued about 27 billion euros of new debt – the most since March of this year. Some of these banks had not been able to access the market for almost six months previously. Non-financial corporations have also issued around 43 billion euros of new bonds, the highest figure for five of the last six months.

It is too early to tell the full impact of our measures on borrowing conditions for firms and households. It will take time for the effects of our actions to feed through systematically.

But the fact that we have seen positive signs so quickly is revealing. It shows that investors are fundamentally confident in the overall trajectory of the euro area. They are ready to re-invest at the first signs of stabilisation. This underscores my central message today: the euro area is making progress – and investors are recognising that progress.

The benefits of stability for the euro area as a whole

I have described how the measures taken by both the Member States and the ECB are beginning to improve confidence. This will ultimately lead to greater overall stability. The benefits of this do not accrue only to countries in difficulty. They accrue to the euro area as a whole.

This is particularly true for an open and outward-looking country like Germany. German industry is a sector deeply embedded in the wider European economy. The stability of the euro area is key to its sustained prosperity. For this reason, ECB actions to maintain price stability for the whole euro area are directly in its interests.

As has long been recognised in this country, low inflation and stable exchange rates ensure a level playing field on which German firms can prosper. They can compete based on their sophistication and innovativeness, without unfair distortions. At the same time, being part of a large and stable currency area provides a buffer against external shocks. This will only become more essential in an ever globalising world.

These factors have led to real economic benefits for Germany. Its intra-euro area trade increased from around 25% of GDP in 1999 to almost 40% of GDP in 2010, while its extra-euro area trade increase by more than 20 percentage points in the same period. Almost 65% of foreign direct investment in Germany now comes from the euro area – and more than one and a half million jobs depend on that investment.

In other words, a stable euro area supports a strong German economy. And a stable euro area is the objective of the all the measures that I have just described.

Moreover, measures that support investor confidence also support the proper functioning of the financial system. For instance, TARGET2 data suggests that balances have now fallen slightly from their peak in August. This highlights the fact that if investors are confident that adverse scenarios will not materialise, they will be more prepared to make cross-border loans. This supports demand across the euro area and the smooth functioning of the Single Market.

I understand that some observers in this country have concerns about the medium-term implications of this policy. So let me be clear: we always have a medium-term orientation. We are steadfastly committed to our mandate to maintain price stability. And the measures we have announced fully support this commitment.

First of all, our actions are for the sole purpose of ensuring the proper transmission of monetary policy. They do not aim to finance governments, and nor would they if they were activated. Our operations would only take place in the secondary market, which ensures that money would pass to investors holding sovereign bonds, not to governments.

Moreover, we have been explicit that our measures can be only successful if they are accompanied by reforms from governments that address deep-rooted issues. The Governing Council has made a strong commitment to such reforms a pre-requisite to be considered for our operations. This ensures that governments will continue to take essential measures.

Euro area citizens can be certain that we remain alert to any risk to price stability. We have always delivered price stability in the past – indeed, the average rate of inflation in Germany since the launch of the euro has been the lowest since the 1950s. And we will continue to deliver price stability in the future.

The credibility of our commitment is clear. Indicators of inflation expectations show that citizens and financial markets expect inflation to remain low in line with our mandate. We take very seriously the trust that citizens put in us to meet their expectations. We will not let them down.

Building a bridge to the long term

I have discussed the actions that the ECB has taken to ensure price stability and the positive early impact they are having. Of course the current improvement in sentiment does not mean that everything is solved. The ECB's actions can only build a bridge to the future. The project must be completed through decisive actions by governments – both individually and collectively – to address the underlying causes of our current challenges.

This requires further efforts by governments to restore fiscal sustainability across the euro area. It requires deep structural reforms to achieve long-term competitiveness and growth. Governments must remain firmly committed to their current reform efforts, and not seek to relax them as economic conditions start to improve.

To secure long-term stability also requires a second level of actions. For citizens and investors to fully regain confidence in the euro area, they need to be convinced that its design flaws have been permanently fixed. A concerted effort from governments to complete our economic and monetary union is therefore essential.

This does not require a choice between extreme options. Some observers have argued that long-term stability requires a return to the original Maastricht framework. Others have suggested that we need a full federation, a United States of Europe. In my view, neither approach is necessary.

We can ensure future stability by elevating to the European level *only* those policies that are essential for our union to function effectively. I have been asked to work on identifying these policies under the lead of the President of the European Council and together with the Presidents of the Commission and the Eurogroup. In our view, a stable and prosperous union must be built on four pillars.

The first pillar is a *financial union* that can maintain a stable and integrated financial market. This implies a single supervisor to control risk-taking by banks and reduce regulatory capture – and a single resolution system to ensure that banks can fail without dragging down their sovereigns.

As regards the Commission proposal for a single supervisor that I mentioned earlier, I am confident that governments will find agreement on the appropriate perimeter of supervisory responsibilities, as well as issues related to democratic accountability. For our part, we will guarantee the firm separation of monetary policy from supervisory tasks. We will also ensure close cooperation with national supervisors who have the competence and resources to implement supervision.

The second pillar is a *fiscal union* that can effectively prevent and correct unsustainable budgets. The consequences of misguided fiscal policies in a monetary union are too severe to remain self-policed. So a stable EMU would ultimately require the establishment of true budgetary oversight at the European level.

The third pillar is an *economic union* that can guarantee the highest standards for competitiveness. Countries must be able to generate growth and high employment without excessive imbalances. This implies that there must be minimum standards for key economic policies and incentives for continued structural reform.

The fourth pillar is a *political union* that can engage euro area citizens more deeply and make the other pillars legitimate. This is essential to ensure that where sovereignty in selected policy fields is pooled, democratic participation is deepened in parallel.

A firm commitment from governments to complete economic and monetary union is the best complement to the ECB's actions.

It ensures that, by supporting immediate confidence, we will build the bridge to a more stable and prosperous euro area. And it sends a clear signal to investors that the euro area has a vision for a sustainable future.

Conclusion

Let me draw to a close.

In exceptional times, regaining stability sometimes requires exceptional measures. We cannot always look to the past for answers. We may need to take new steps to achieve longstanding goals.

That is the situation we have been facing.

For the Member States, new steps have been needed to restore competitiveness. A sustained commitment to reform efforts is required and a rethinking of the institutional architecture of the euro area.

For the ECB, new steps have been needed to maintain price stability in the face of fragmented financial markets. These new steps are not a departure from our mandate. Indeed, they are the only way to ensure that we continue to fulfil our mandate.

All the measures I have described today are fundamentally about ensuring stability. In the current circumstances, the greatest risk to stability is not action, but *inaction*. This is why the ECB has acted.

The euro supports the strong industrial sector on which Germany depends. It supports openness, growth and prosperity. And ultimately, it supports peace and stability.

This is why the euro is irreversible.

Thank you for your attention.