Mario Draghi: The role of monetary policy in addressing the crisis in the euro area

Speech by Mr Mario Draghi, President of the European Central Bank, at the "Room for discussion" of the Study Association SEFA and the Faculty of Economics and Business, Amsterdam,15 April 2013.

* * *

Introduction

There was a time, not too long ago, when central banking was considered to be a rather boring and unexciting occupation. In the era of the "Great Moderation", mostly seen as the period between the mid-1980s and the beginning of the global financial crisis, inflation was tamed and macroeconomic volatility was contained. Some thought that monetary policy could effectively be placed on auto-pilot. I can confidently say that this time has passed.

The ECB's monetary policy in the crisis

The global financial crisis has put an end to that period in a way that has been very abrupt and certainly lasting for quite some time to come. In this country, the outbreak of a financial crisis brings back memories that go quite far into history. In 1763, exactly 250 years ago, Amsterdam was the centre of a deep financial crisis. Highly leveraged investors were faced with a situation of falling asset prices. The rolling over of existing obligations became very difficult and the liquidity crisis became severe. Investors could not refinance themselves other than through fire sales of distressed assets. Amsterdam bank houses went bankrupt and merchants suffered significant losses.[1]

The 1763 crisis has some important resemblances with today's crisis. In the first stage of today's crisis, liquidity was at the epicentre. Money markets seized up and several market participants found themselves unable to roll-over funding positions. Concerns regarding bank solvency rapidly surfaced and the crisis then morphed into a banking crisis. Finally, at the beginning of 2010 the latest turn: several euro area countries' debt and deficit levels were found to be unsustainable. It was a sovereign debt crisis.

But differently from the crisis in 1763, the determined actions of central banks prevented the destructive downward spiral of abrupt deleveraging, fire sales and ultimately deflation. The ECB, and indeed all major central banks, reduced its policy rates to unprecedented lows. In addition, the ECB has implemented various non-standard measures to restore monetary policy transmission, also with a view to supporting credit flows to the real economy. This is a necessary pre-condition for fulfilling our ultimate objective of lasting price stability.

Our liquidity support gives banks unlimited access to central bank money at a fixed price against adequate collateral. To make it fully flexible and facilitate banks in their attempt to liquefy their assets at times of stress, we expanded the set of eligible assets that can be used as collateral.

Furthermore, in order to give banks sufficient reassurance that access to liquidity will not be a problem over a relevant planning horizon we have extended the maturity of our lending. The longest maturity of our long-term refinancing operations (LTROs) has been raised from the standard 3 months before the crisis to 6 months after the post-Lehman cataclysm, to one year by mid-2009, and to three years at the end of 2011.

---

[1] See I. Schnabel and H.S. Shin (2004), "Liquidity and Contagion: The Crisis of 1763", Journal of the European Economic Association, vol. 2(6), pages 929–968, December.

More recently, we have announced the Outright Monetary Transactions (OMTs), in order to eliminate the pricing of un-warranted tail risks in the bond markets. OMTs entail interventions in government bonds with a remaining maturity of up to three years. OMTs have a number of characteristics: they require the government concerned to accept a programme involving support by the European Stability Mechanism that entails strong and effective conditionality. Such conditionality is important in particular to preserve monetary policy independence. Interventions would be ex ante unlimited, which is essential to ensure their effectiveness. All interventions would be sterilised so as to ensure that there is no impact from these measures on the overall monetary policy stance. There would be transparency as the stock of securities acquired under the OMT programme would be published regularly, together with the average duration.

Like previous non-standard liquidity operations, OMT cope with extraordinary risk premia that markets require when self-fulfilling expectations of catastrophic events prevail. In 2008, the dominant fear had originated from the collapse of the payment system following the Lehman bankruptcy. In the first half of 2012, the prevailing fear had been caused by unfounded doubts about the continued existence of the euro.

There is another parallel between our early liquidity operations with banks and OMTs. In providing liquidity to our banking counterparties, we cannot and do not want to subsidise banks that are failing. Our liquidity support is not and should not be equity support. Likewise, in pricing out break-up risk in sovereign debt securities, we cannot and do not want to subsidise governments.

Placing the ECB's monetary policy in the broader context of central bank non-standard measures

Let me briefly digress to put our monetary policy and its impact on borrowing conditions in the context of unconventional monetary policies deployed by central banks more generally.

To begin with, the remuneration that investors demand on a long-dated security should be at least as large as the expected return from a strategy of rolling over short-term instruments and the risk premia that investors demand over and above the return from the rolling over strategy. Premia, in turn, are a composite object. They compensate investors for different risks attached to term investments:

- The *term risk premium* for holding on to an asset for a specific period of time;
- The *liquidity risk premium* as the compensation for the possibility of incurring losses when selling the asset back to the market before maturity and at short notice; and
- *Credit risk premia* of various types as compensation for the possibility of not receiving at maturity repayment for the principal because, for instance, borrowers may renege on their contractual obligations.

At the risk of oversimplifying, one can distinguish the main types of unconventional measures depending on which component in this decomposition they are aiming to address.

Forward guidance about the intended path of the central bank's monetary policy rate in the future mainly aims to manage expectations regarding the future evolution of the short-term interest rates. It thus addresses the expectations component I was referring to before. Changes in the level of the current policy rate always have an intrinsic signalling content with respect to possible changes for short-term rates in the future. But during crisis times, when short-term nominal rates are at zero or close to zero, they cannot be adjusted further down. The central bank may then engage in active communication reassuring markets that the future path of policy rates would not deviate from the current low level for a certain period or until certain observable conditions are verified.

Large-scale asset purchases, or quantitative easing, instead, mainly aim to compress the term premium.[2] This type of policy intervention works through reducing the supply of securities with long duration and increasing the supply of reserves or liquidity. With less term risk to hold in the aggregate, the market should require a lower premium to hold that risk.

The ECB's non-standard measures I mentioned earlier are geared towards addressing primarily two types of premia: the liquidity risk and the redenomination risk. The ECB's liquidity operations, such as the 3-year Long-Term Refinancing Operations (LTROs), are intended to relieve banks of liquidity and funding stress. They, therefore mainly aim to reduce liquidity risk in the money market.

Central banks have adopted different approaches as regards their non-standard measures. For instance, the Fed, the Bank of England and the Bank of Japan all engage in Large-Scale Asset Purchases. The Fed also uses forward guidance.

When viewed, however, from the perspective of the framework I just described, most non-standard measures employed by the major central banks around the globe seem remarkably similar. They aim to implement the desired monetary policy stance, in conditions in which the stance may not be smoothly and homogeneously transmitted to the economy, or where a further easing of the stance through standard policy rate adjustments is hindered by the lower bound constraint. The unifying overall goal is to improve the effectiveness of monetary policy, in ways that can support the attainment of the monetary policy objectives.

Yet, the varying emphasis on instruments and the approaches used by central banks around the globe are tailor-made to the particular challenges of their economies. The particular challenge of the ECB is to operate in a multi-country environment: one monetary policy for 17 countries that constitute our currency union.

Unlike economies with a single fiscal authority or with a fully-fledged federal structure, the euro area comprises multiple sovereign states. The debt of each of these states has different liquidity and risk characteristics. In such a set-up there is no uncontroversial way to define the term structure of the risk-free rate. As a matter of fact, this means that there is no univocal measure of the term premium for the euro area as a whole.

At the same time, during the crisis, normal heterogeneity has turned into detrimental fragmentation: a landscape with natural diverse scenery has turned into a dangerous surface with jagged cliffs and stumbling blocks. Liquidity risk, which was a widespread concern for banks throughout the euro area at the start of the crisis, has become more concentrated as the crisis has progressed. Fault lines between banking sectors with structural funding surpluses and banking sectors still suffering from a precarious access to credit run across national borders.

The banking sector and the financial market of the euro area has become fragmented. This is harmful as the euro area is a bank-based economy. Around three quarters of firms' financing comes from banks. So if banks in some countries will not lend at reasonable interest rates, the consequences for the euro area economy are severe.

Although we see a decrease in fragmentation on the funding side, our very accommodative monetary policy stance is only partly passed on to the financing conditions faced by firms and households in some euro area countries. Companies headquartered in stressed countries face worse borrowing conditions than equally risky competitors in non-stressed countries. And, within the same stressed economy, Small and Medium-sized Enterprises (SMEs) suffer relatively more than large companies that have easier access to capital

[2] This is a stylised account of the intended aim of the various policies. In the empirical literature there is evidence, for instance, that a sizeable part of the effect of LSAPs on long-term rates comes from affecting expectations regarding future short-term rates (see M. Bauer and G. Rudebusch (2012), The Signalling Channel for Federal Reserve Bond Purchases, Federal Reserve Bank of San Francisco, Working Paper 2011-21).

markets and are less dependent on the banking system. This is especially disconcerting given that SMEs account for about three quarters of euro area employment.

Our non-standard monetary policy measures have, therefore, the task of removing these stumbling blocks to ensure that our single monetary policy in fact reaches all parts of the euro area. This is crucial for fulfilling our mandate.

Beneath the surface: the root causes of the crisis in the euro area

Within the limits of our mandate we have acted with determination. Our balance sheet has expanded substantially, to almost three times its pre-crisis size. While it has shrunk since its peak, the expansion is comparable to the increase in the balance sheet of the Fed during the crisis.[3]

Tail risks have been largely removed from the pricing of euro area assets. Financial fragmentation has been receding: banks in stressed countries have seen the deposits placed with them by euro area residents increasing by about 130 billion euro since August 2012, TARGET2 balances of the National Central Banks in these countries have declined by more than 200 billion euro or about 20% since their peak and also banks' dependence on ECB liquidity intermediation is waning to some extent.

Nevertheless, problems in the euro area economic landscape still loom large. This understandably triggers calls for more action to be taken by the authorities that shoulder the responsibility to navigate the economy through these troubled waters.

To address these calls, one needs to take a sober look at the root causes of this crisis.

Most of the stressed euro area economies – and certainly the ones that are finding it most difficult and painful to adjust – have suffered from a chronic loss of competitiveness while being members of the monetary union. The erosion of their competitiveness has meant that these economies started running large current account deficits and some of them have accumulated large external debt positions.

In some cases the expanding external debt was driven by increasing public sector indebtedness. Imprudent fiscal policies were masking the private sector's lack of competitiveness in an effort to shield and even improve living standards.

In other countries it was the banking sector's leverage that increased fast. This in turn reflected a strong increase in lending to domestic firms and households. In these cases the lack of competitiveness was triggering a shift of the economies towards domestic consumption and activities shielded from international competition, such as the housing sector.

On top of that, banking supervision and regulation did not always mitigate the destabilising tendencies. There were cases when banks were not induced to develop sufficient capital and loss buffers in good times.

The way out is to restore competitiveness. And the way to do this in the context of a monetary union is to pursue with determination an ambitious structural reform agenda. Such an agenda comprises a number of national measures to make sure that the functioning of product and labour markets is fully compatible with participation in monetary union. One specific aspect is to fight vested interests that hamper competition, structural weaknesses of productivity and to allow, where needed, the nominal adjustments to play out.

---

[3] Based on a comparison of central banks' simplified balance sheets as defined in the article entitled "Recent developments in the balance sheets of the Eurosystem, the Federal Reserve System and the Bank of Japan", ECB Monthly Bulletin October 2009, pp. 81–94.

And such an agenda also comprises a number of European measures to fully complete the Single Market especially in the area of services and to allow for higher labour mobility within the euro area.

Since the crisis started considerable progress has been made in making structural reforms in euro area countries, particularly those under an EU/IMF programme. And the painful measures taken are starting to bear fruit.

In Greece, Ireland and Portugal current account balances have improved by more than 7 percentage points (relative to GDP) between 2008 and 2012. In Spain the current account has improved even more substantially.

Also, we have seen reductions in unit labour costs. Ireland has seen an 18 percentage point improvement relative to the euro area average. In Greece, Portugal and Spain the improvement has been about 10 percentage points. As I have recently stressed to the Euro Area Heads of State and Governments, narrowing the gap between wage and productivity growth is absolutely essential for improving competitiveness in euro area countries.[4]

To conclusively address the root causes of the crisis these efforts need to be maintained and, in some countries, stepped up. In the meantime, however, what I referred to earlier as the symptoms of the crisis also need to be tackled. Fiscal positions need to be maintained on a sustainable path and balance sheet weaknesses in the banking sector need to be repaired.

And let me be clear: undertaking structural reforms, budget consolidation and restoring bank balance sheet health is neither the responsibility nor the mandate of monetary policy. Monetary policy can only avert an abrupt deleveraging that would have been conducted in an environment of panic and fire sales. And this is what we have done in order to avoid deflationary downward spirals that would have prevented us from delivering on our mandate of preserving price stability in the euro area.

Monetary policy can support the reform progress by safeguarding price stability and anchoring inflation expectations. But it cannot substitute for actions that other actors, including the private sector itself, must take.

Completing the euro area's institutional architecture

In addition to the role of misguided or imprudent national policies, the narrative of the crisis that I have just spelled out clearly points to some serious shortcomings in the institutional architecture of the euro area.

To begin with, the only policy sphere where some form of supra-national surveillance was in place was fiscal policy. And even in this domain, the mechanisms that were envisaged to prevent and correct unsustainable fiscal performance by Member States proved to be lacking. No framework was foreseen for monitoring competitiveness and heterogeneity within the euro area and for enforcing corrective action when needed. What's more, in interconnected financial systems an entirely national perspective on bank regulation and supervision turned out to be insufficient. Finally, no crisis management framework had been set up to complement the national shock absorption capacity of euro area countries.

The creation of the EFSF and more recently the ESM has addressed this last shortcoming. And in our joint work with the Presidents of the European Council, the European Commission and the Eurogroup, we have set out a vision and a process for building a genuine Economic and Monetary Union. This is designed to cover the other gaps in the institutional architecture that I previously referred to.

[4] See M. Draghi, "Euro area economic situation and the foundations for growth", slides from the presentation made at the Euro Summit, Brussels, 14 March 2013 (available at http://www.ecb.europa.eu/press/key/date/2013/html/sp130315.en.html).

The genuine Economic and Monetary Union comprises four pillars: a banking union with a single supervisor; a fiscal union that can effectively prevent and correct unsustainable budgets; an economic union that can guarantee sufficient competitiveness to sustain high employment; and a political union that can deeply engage euro area citizens.

Progress is underway in all these directions. As regards the banking union in particular, a first and important step has been made with the decision to create the Single Supervisory Mechanism (SSM), the responsibility for which has been assigned to the ECB in the last Ecofin. I am confident that the SSM's euro area perspective will make a significant contribution to safeguarding financial stability in the monetary union. In this sense, it will also support the conduct of monetary policy, as a stable financial system is a prerequisite for the proper transmission of our policy signals.

But I would like to stress the importance of quickly complementing the SSM with a Single Resolution Mechanism. This is necessary to guarantee timely and impartial decision-making, particularly in the cases where cross-border resolution is required. What's more, a Single Resolution Mechanism is essential to ensure that the SSM's supervisory decisions for resolution can be followed up with action, without reinforcing the vicious link between banks and sovereigns. Finally, a Single Resolution Mechanism will credibly pursue the least-cost resolution strategy from a euro area perspective, also taking into account cross-border spill-overs.

Conclusion

When considering the challenges that euro area economies are still facing, it is important to remember the economic hardship that many of our fellow citizens in parts of the euro area are experiencing, and in particular the massive unemployment, especially among the youth.

But there are also reasons for confidence. Most of the elements needed to address the root causes of the crisis and to build a genuine Economic and Monetary Union have been set in motion. The ECB's monetary policy will continue to make its contribution to this endeavour, in line with its mandate.

The heavy task of implementing the important decisions already taken lies ahead. All parties involved in this comprehensive reform agenda must persevere. And we must all work with conviction and determination towards our shared vision. If we do so, I am confident that restoring stability and ensuring prosperity in the euro area are within our reach.