Mario Draghi: The euro, monetary policy and reforms

Speech by Mr Mario Draghi, President of the European Central Bank, on receiving an honorary degree in political science, LUISS (Libera Università Internazionale degli Studi Sociali) "Guido Carli" University, Rome, 6 May 2013.

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My first grateful and fond mention goes to Guido Carli. My gratitude goes to the university that bears his name, to its Rector, Professor Massimo Egidi, to its Senatus Academicus, which has honoured me with this title, and to Professor Messori for his kind words, as well as to the entire academic body of this university.

The origins of the crisis in the euro area

Until a few years ago monetary policy was considered a textbook discipline, almost a mechanical skill involving the implementation of computational applications by conscientious experts. In the period known as the Great Moderation, from the middle of the 1980s to the beginning of the global financial crisis, inflation had been brought under control. Macroeconomic volatility was contained and this was a source of great pride for all central bankers. Some foresaw a future of genteel and honourable oblivion for monetary policy. This is no longer the case. The experience of the first five years following the crisis shows that all central banks have adjusted their monetary policies along hitherto unexplored lines: some have been abandoned and no new paradigm has yet been formulated, the wish is to put an end to the emergency and return to normality where the rules are based on a well-established discipline of long standing, but it is not known with any certainty what reality will emerge in the long term. Furthermore, although the precise shape of monetary policy has always been influenced by the respective institutional and historical context – consider the varying "mandates" of the central banks – the various forms that the crisis took in different parts of the world reinforced this correspondence between the specific institutional and financial contexts and the monetary policies pursued in them.

In the euro area, the extraordinary success of the single currency concealed for years the risks that were building up. The governments of the Member States considered themselves free from previous constraints: with the exception of Germany and a few other countries, they delayed structural reforms that could have redressed the competitiveness of obsolete economic structures to meet the challenges of relentless globalisation; they undermined the limits introduced in the Stability and Growth Pact, jeopardising their own credibility as partners in a Monetary Union.

In the years preceding the crisis, this Union began to divide countries with positive trade balances and sound budgets from those with growing budget deficits and external deficits financed by private credit flows increasingly sourced from the first group of countries and not used for investments to increase competitiveness, but rather to finance unproductive spending, or property bubbles. No one ever imagined that the Monetary Union could become a union divided between permanent creditors and permanent debtors, where the former would perpetually lend money and credibility to the latter.

A profound change in the governance of the Union became necessary, with new rules whereby the solidarity clamoured for had as its counterpart the transfer of national powers. But this too was delayed and its urgency was downplayed in the face of the requirements of a purported national sovereignty which was in reality weakened by globalisation and growing levels of public debt.

The global financial crisis, which swiftly and dramatically increased market perceptions of risk, rudely awakened all the actors from this long, complacent amnesia.

The external deficits, budget deficits and levels of public debt of the countries in the second group fast became unsustainable once they were no longer financed externally and in particular by the rest of the Union, the inadequate governance of which was then laid bare.

This brief scrutiny of the origins of the crisis in the euro area shows how the response of economic policy cannot be other than composite: in it, monetary policy plays an important but by no means exclusive role.

The crisis and the ECB's monetary policy

The epicentre of the crisis in the initial phase was liquidity, an economic measure that had been neglected by the theory for many years since a lack thereof seemed so unlikely. The day after Lehman Brothers collapsed, the money markets stopped functioning. The liquidity required by banks to refinance their maturing assets suddenly became extremely scarce.

Generally speaking, banks borrow at short-term or very short-term from savers with a strong preference for the immediate availability of funds, or for "liquidity". If savers suddenly refuse to roll over their deposits with the banks, the banks then attempt to discontinue the credit that they supply to the economy. If this is not possible owing to long maturities, banks seek to liquidate first of all those assets in their portfolio that are traded on the market at known and verifiable exchange prices, in an effort to avoid insolvency. But a sudden financial retreat by many financial institutions simultaneously cannot occur without generalised financial suffering, and without banks incurring substantial capital losses.

Asset prices fall rapidly and bank capital declines. The interbank markets dry up. The economy loses an indispensable mechanism for generating income and allocating resources, namely the intermediation of savings.

In a second phase beginning in 2011, the lack of credit to the more vulnerable sovereign issuers became the centre point of the crisis. The euro area governments responded with actions that, while individually effective, revealed the political unsustainability of a Union in which the countries that pay and the countries that receive are always the same. Sovereign debt in the euro area is no longer risk-free: it depends on the sovereign and the quality of its policies. This process, beneficial in and of itself, revolutionised the risk structure on which the functioning of the European financial markets was based for so many years. In addition, without a single Union government and economic policy, it led to an abnormal increase in risk premia, which reached systemic proportions. Premia were no longer based on the creditworthiness of borrowers, which was admittedly shaky for reasons already mentioned, but rather could only be explained by the manifestation of expectations regarding the end of the euro.

Risk premia and non-standard measures

But what are risk premia?

The compensation required on a long-term financial contract must be at least equal to what could be obtained with a short-term contract that is continuously renewed until the end of the term. Long-term investors require a return that, at the very least, establishes financial equivalence between the two strategies. But, in general, equivalence is not enough. Creditors expect additional compensation for the risks they take on relating to not being paid back promptly. These risks are varied and the markets attach a price – or risk premium – to each one. The pure risk relating to postponing the availability of capital for a period of time is compensated by a term risk premium. The risk that a creditor is forced to liquidate a long-term financial investment before maturity in difficult market circumstances is compensated by a liquidity risk premium. Finally, the risk that the borrower does not meet his/her repayment obligations at the end of the contractually-agreed term is compensated by a credit risk premium.

In a period of deep financial crisis, the increase in all risk premia is, as I mentioned, out of proportion because market participants are no longer willing or able to bear them.

The non-standard measures adopted by the central banks in the larger countries in the five years since the start of the financial crisis can be identified according to the type of risk premia they were intended to tackle.

For example, the large-scale purchasing of assets, or quantitative easing, carried out by the Federal Reserve System affects the term risk premium. The main aim of quantitative easing is to reabsorb the quantity of term risk held in the economy as a whole and thereby compress its price – the corresponding risk premium.

The ECB initially adopted non-standard measures primarily aimed at cutting the financial premium linked to liquidity risk. At the dawn of the crisis, shortly after the collapse of Lehman Brothers in 2008, the liquidity risk in the interbank market shook to its foundations the very structure of the payment system. This catastrophic risk led to an exceptional reassessment of the liquidity risk premium on credit between transactors. In this context, the ECB took the place of the interbank market, which had cut off its supply of short-term and very short-term credit to banks. The ECB subsequently changed its own instrument for providing banks with liquidity, adopting a system whereby it supplied unlimited credit at a fixed interest rate – known as the fixed rate full allotment policy. In this way, the ECB allowed banks to refinance their assets using its own credit, rather than through asset fire sales in the market. A situation in which sound and solvent banks became insolvent was thus avoided.

In order to reassure banks that access to central bank liquidity would indeed be extended in line with their refinancing needs in the medium term, we extended the maturity of our credit lending from the standard three months pre-crisis, to six months after the collapse of Lehman Brothers, to one year by mid-2009 and, finally, to three years at the end of 2011.

From the second half of 2011, we witnessed the emergence of a new source of stress, which has been defined as the risk of "redenomination", resulting from the potential exit of a country from the euro or even from the potential collapse of the single currency. A particular form of credit risk premium was associated with these possibilities, which was unrelated to the assessment of a borrower's solvency but which, in fact, came about owing to unfounded concerns regarding a systemic breakdown in the euro area. The ECB therefore launched the OMTs (Outright Monetary Transactions), a monetary policy instrument aimed at eliminating the financial risk premium caused by this specific systemic risk.

OMTs allow the ECB to buy sovereign bonds with a remaining maturity of up to three years in the secondary market, where necessary in order to remove the risk of "redenomination" (i.e. the risk related to concerns about the end of the euro) from the financial markets. The bond-issuing governments which request the activation of OMTs agree, in conjunction with the European authorities and, if possible, with the International Monetary Fund, on a recovery programme to address macroeconomic and structural weaknesses. This is a necessary, but not sufficient, condition as the ECB has full discretion to decide on the start, continuation or suspension of OMTs. Furthermore, the excess liquidity created by these purchases will be reabsorbed by the ECB.

The conditionality associated with the programme to which governments and the European authorities agree is a crucial element in being able to preserve monetary policy independence. It is important in providing the ECB with adequate assurance that interventions supporting sovereign debt bond prices do not mutate into financial subsidies for unsustainable national policies in the medium term.

By way of drawing a parallel between OMTs and our standard liquidity operations: as the credit provided to banking counterparties cannot be, and must not be, interpreted as an injection of capital into failing banks; in the same vein, under OMTs, in compressing the premium for the risk of "redenomination", the ECB cannot and does not intend to provide financial support to governments which reinstate solvency conditions which have not already been approved ex ante.

In both cases, the ECB's non-standard measures were triggered by the need to restore the functioning of monetary policy transmission channels, first by reducing liquidity premia and then by reducing the redenomination risk premium.

Diverging financing conditions in the euro area

Throughout the two phases of the crisis – the banking crisis and the sovereign debt crisis – our approach to liquidity provision was elastic, with adjustments made in response to demand for support from banks more severely affected by market pressures. At first, this demand was widespread across large parts of the euro area. In 2008 and 2009, those banks more exposed to sectors and activities under stress were ostracised by the market, no matter where they were based. Then, in the second phase of the crisis, the obstacles to liquidity provision became linked to territory. The banking sector and financial market in the euro area gradually fragmented along national borders. These borders separate banking sectors which, irrespective of the intrinsic quality of their intermediaries, are considered robust, because the country in which they are based is able to cope with a banking crisis, from those considered to be fragile, where the markets consider this capacity to be lacking. These borders thus separate countries that are competitive and have sound balance sheets from those characterised by fragile balance sheets and a lack of capacity for growth.

The measures decided on by the ECB (fixed rate full allotment, LTROs, OMTs, assessment and quality of collateral, guidance on the duration of fixed rate full allotment) helped to overcome, to a large extent, this fragmentation that characterised the funding of the banking system until mid-2012. The dispersion in the growth rate of bank deposits has now returned to 2007 levels.

Progress on the lending front has been much slower. In the first group of countries, we are generally seeing normal or accommodative financing conditions for firms and households. In the second group, we are seeing a persistent tightening of credit, possibly decreasing in intensity in some countries, with retail bank loan rates that are much higher than those applied by banks located in the first group of countries and more stringent collateral requirements for loans.

The ECB's recently published "Survey on the access to finance of SMEs in the euro area"[1] provides a clear picture of the difficulties this sector, so crucial for the euro area economy, finds itself in. Among the principal causes for concern cited by the SMEs interviewed, access to credit was second only to the difficulties encountered in finding customers for their products. The obstacles to obtaining credit (linked to the refusal to grant credit) persist, and represent one of the main factors of heterogeneity between countries in the euro area, though they are not confined to those countries under stress. In fact, in addition to SMEs in Greece, Ireland and Spain, a large number of SMEs operating in The Netherlands are encountering significant obstacles (around 45% of the firms surveyed). These figures reflect the considerable heterogeneity in borrowing conditions, as also shown by the most recent bank lending survey.

This fragmentation is all the more troublesome in an economy such as that of the euro area, in which financial intermediation is bank-based for at least three-quarters of firms' financing. And it penalises all the more those enterprises, often of a small or medium size, which depend more heavily on the banking system. This is particularly serious considering that this sector employs around two-thirds of workers in the euro area.[2]

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1 http://www.ecb.int/pub/pdf/other/accesstofinancesmallmediumsizedenterprises201304en.pdf

2 Eurostat defines SMEs as enterprises with fewer than 250 employees.

Banks are not lending for a number of reasons: lack of funding, investment alternatives, lack of capital, risk aversion. The ECB has done a great deal on the first two fronts, providing liquidity and reducing the redenomination risk premium on government bonds. We cannot subsidise governments by buying their bonds, and we cannot subsidise bank shareholders by removing the need for them to strengthen their balance sheets by means of necessary recapitalisation measures. We can do little directly to reduce the risk aversion which is holding back bank lending. In other financial systems, a large share of credit is transmitted to the economy via capital markets; financial assets are traded on the basis of known, verifiable prices and are often subject to ratings. A central bank that wished to try to reduce the risk premia on such assets would not face great operational obstacles. In the euro area, the capital market is much smaller, and a central bank that wished to intervene would have to purchase from the banking system the loans the latter had made to the economy, for which there is only a very limited market. This would be a very complex undertaking, even without taking into account the institutional context which would necessarily involve intervention in 17 countries.

But the ECB has taken a number of measures on this front too. Banks have for some time been able to use credit claims as collateral when obtaining funding from the ECB. And we should not underestimate the effectiveness of traditional monetary policy when general conditions change. As mentioned, the Governing Council of the ECB cut interest rates to 0.5% at its last meeting, bringing them to a historic low after eight months in which they had been unchanged at 0.75%. This is because macroeconomic weakness is now also affecting parts of the euro area in which the transmission of monetary policy had never been an issue, and also because we are seeing some signs that fragmentation is receding with regard to lending in some of the euro area countries experiencing stress.

In this regard, national measures can also be effective, as already put into practice in some countries, with the involvement of governments, public banks and development agencies. The ECB has launched initiatives with the EIB and the European Commission with the aim of reducing the fragmentation of lending in the euro area.

We must not forget the extraordinary progress made on this front by the European Council in bringing together the national supervisory systems in a single European mechanism – the management of which has been assigned to the ECB – and in creating a European mechanism for the resolution of banks. These initiatives will go the furthest in breaking the link between banks and sovereign debt which is behind the current fragmentation.

But we should not forget that growth is currently weaker in some countries than in others, and not just because credit is scarce. It was weaker even before the crisis, notwithstanding often turbulent growth in public spending, because structural weaknesses were not tackled. In the wake of the crisis, the burden of this failure is now being felt by all of us.

Structural reforms for growth and more solidarity in society

The reforms aim to untie the knots that curb competitiveness and suffocate growth. Effective promotion and safeguarding of competition; an adequate degree of flexibility in the labour market that is properly distributed across the generations; the cutting of government red tape that is an obstacle to growth; human capital that is equipped to face the challenges posed by global competition; and a better environment – these are all fronts on which, despite recent progress, much remains to be done, albeit to varying degrees across individual countries.

Fiscal policies must follow a sustainable path, separate and distinct from cyclical fluctuations. Without this prerequisite, lasting growth is not possible. Particularly for countries with structurally high levels of public debt, rather than temporarily high levels as a result of the current crisis, this means not slipping back from the goals already achieved. Let us not forget that, in an institutional context in which the solvency of sovereign states is no longer an established fact and the governance of the Union is still incomplete, when a country's public finances lack credibility its banks are quickly cut off from the rest of the euro financial market in the absence of private sector credit in that country: this is what we are now seeing.

However, to mitigate the inevitable recessionary effects of fiscal consolidation, the composition of such measures must favour the reduction of current public spending and of taxes, particularly in a context such as in Europe where taxation is already high by international standards.

There is no doubt that lasting growth is essential for reducing unemployment, particularly among young people. In some European countries youth unemployment has reached levels that damage people's faith in prospects for a decent life and which risk giving rise to extreme and destructive forms of protest.

Output growth was essential for the success of the European social model. The extraordinary economic growth during the so-called "Golden Age" – namely the thirty years that followed the Second World War – allowed a significant improvement in the material wealth of a large portion of the European population.

At the same time, this wealth strengthened the growth process. At that time the foundations were laid in Europe for modern welfare systems aimed at protecting individuals against the risk that unemployment, illness or old age could lead to a deterioration in their living standards. It is in part thanks to these instruments that the financial crisis and the recession have not had the same devastating social effects as the Great Depression.

Many years ago Rudi Dornbusch said, exaggerating rather, that Europeans were so rich they could afford to pay everybody for not working. This is no longer the case, but we do not wish to lose the solidarity which inspired that model in such very different times. Therefore, today we must adapt that model in line with the changes that demographic dynamics and the new environment of global competition demand. This must be done to reduce youth unemployment, increase consumption and preserve the very essence of welfare.

Another aspect of growth sustainability, in a European context, that I would like to draw your attention to today is that of income distribution.

For almost twenty years there has been a trend towards a higher concentration of family income in Europe to the detriment of the poorest households, as statistics published by Eurostat show.

A more equal share in the fruits of the production of national wealth helps foster a culture of saving and, therefore, of collective involvement. A sense of being an integral part of a country and of having a stake in its economic future strengthens social cohesion and encourages individual economic behaviour that leads, in the aggregate, to economic prosperity for all.

There are a number of tools governments can use to achieve this aim, but first of all social cohesion must be sought by removing the barriers which limit individuals' opportunity to pursue their goals and which allow family background to dictate life choices. In eliminating vested interests in a non-competitive system, structural reforms are more than just a tool for growth creation. By encouraging everyone to be involved in the process of production, they ensure that the drive for a more equal income allocation is not the task of state-led redistribution alone. In this way, reforms aim to harness individual potential to the growth of the economy.

Nevertheless, looking to the not-too-distant future, national virtues – while indispensable for strengthening solidarity among Member States along the way – won't be enough to make Europe a goal all its citizens can consider their own.

It will also be necessary to introduce reforms that further reduce the barriers between individual Member States, in particular to the development of a single European labour market, and that affirm the principle of solidarity, as proposed recently in the "Four Presidents' Report".[3]

To build, with passion and vigour, a shared future in which the conditions for growth are more favourable, in which all citizens feel that their skills are fully valued, in which individual well-being goes hand in hand with collective well-being. We are all working today, each within our own mandate, to achieve that goal.

Thank you for your attention.

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3 Herman Van Rompuy (in collaboration with José Manuel Barroso, Jean-Claude Juncker and Mario Draghi), "Towards a genuine economic and monetary union", 5 December 2012, http://ec.europa.eu/economy_finance/focuson/crisis/documents/131201_en.pdf.