Mario Draghi: Money and monetary institutions after the crisis

Speech by Mr Mario Draghi, President of the European Central Bank, at the Conference on "Money and monetary institutions after the crisis", in memory of Curzio Giannini, Bank of Italy, Rome, 10 December 2013.

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Summary

Central banks should continue to focus primarily on what they can and are mandated to achieve, which is price stability over the medium term.

Delivering on their mandate is the only way for central bankers to maintain public trust. Pursuit of this mandate must be backed indirectly by public preferences, seen from a longer-term perspective.

The actions undertaken by the ECB have not represented a departure from the ECB's mandate but rather the opposite, namely its pursuit by all the means demanded by the situation.

It is now crucial to complete the reform agenda at European and national level. With this agenda there can be no place for withdrawing into nationalism and protectionism.

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Introduction

Ladies and Gentlemen:

I very much appreciate having the opportunity to intervene in this conference, not only because it honours Curzio Giannini, but also because the issues that were close to his heart have turned out to be fundamental questions concerning the role of central banks in the post-crisis environment.

The morning session has touched upon topics of vital importance for central banks. I would summarise them along two main lines. First, should the objectives (though not necessarily the mandate) of central banks be broadened? Second, and related, how can central banks retain and increase public trust and preserve their legitimacy and independence?

Although these are issues that affect all central banks, I will naturally speak from the perspective of the ECB and our specific institutional context.

The objectives of monetary policy

Claudio Borio has presented a thought-provoking paper on the question of whether central banks had too narrow a focus in the decades preceding the global financial crisis. He now asks whether they should widen their horizon, in particular towards addressing financial imbalances.

Claudio first documents that there is a financial cycle of credit booms and busts that overlaps with the more usual business cycle, but which has a longer duration, in particular in the build-up phase. Although not always easy to detect, this cycle is often characterised by the interplay between soaring real estate prices and easy credit, and both are in principle observable.

Second, Claudio argues that monetary policy (possibly in combination with other policies such as macro-prudential policies) can do something to prevent costly booms and busts – although it has less leverage than commonly thought in a balance sheet recession which often characterises the "bust" phase. Hence, by being more aggressive in preventing risks ex ante, the central bank may have an easier life ex post, and avoid being over-burdened with excessive expectations in the bust phase. A distinct advantage of monetary policy as compared with macro-prudential policies is its robustness to regulatory arbitrage and its ability to "get in all the cracks".

Note that Claudio is careful not to argue that central bank *mandates* should be changed. A stronger focus on the financial cycle could be justified based on central banks' traditional mandate of maintaining price stability.

At the ECB, we are definitely sympathetic to these views.[1] The ECB's monetary policy strategy with its medium-term orientation and emphasis on monetary analysis explicitly involves looking beyond short-term price developments and taking into account the medium-term implications of booming asset prices and credit markets for price stability.

Ultimately, however, the answer to the question how actively monetary policy should be used to "lean against the wind" will depend on the answer to two other questions: i) How effective will the new macro-prudential policy framework be in reining in the financial cycle and maintaining financial stability?; and ii) What is the effect of monetary policy on risk taking and financial stability?

Regarding the first question on the effectiveness of macro-prudential policies, let me just say that the experience with those policies as a stabilisation tool is relatively scarce and often confined to emerging market economies. In the euro area, the Spanish experience with dynamic provisioning shows that increasing buffers during the credit boom can increase the resilience of banks; this was visible in the first phase of the financial crisis. However, at the same time it did not prevent the large run-up in credit and real estate prices and its subsequent painful and protracted bust, suggesting that a more intrusive macro-prudential policy may be necessary. I trust that the new macro-prudential tools created under the Capital Requirements Directive IV, combined with the new role of the Single Supervisory Mechanism in macro-prudential decision-making, will help provide that intrusiveness.

Regarding the second question, there is by now considerable research on the effect of monetary policy on risk taking in the financial sector (also by ECB researchers), but the quantitative importance and hence policy relevance of this channel is still unclear and subject to a lot of debate. It is also unclear whether monetary policy can have an influence on financial stability that would be predictable and systematic enough to allow it to be exploited.

There are additional elements to be considered when conducting monetary and macro-prudential policy in a still heterogeneous economy such as the euro area. Dealing with the financial cycle from a purely national perspective can be detrimental to financial integration, but the common monetary policy cannot fully deal with a financial cycle that is not synchronous across countries. In order to manage this trade-off, the responsibility for macro-prudential policies will in future be shared between the centre (the Single Supervisory Mechanism for the euro area and the ESRB for the entire EU) and the Member States (the national macro-prudential authorities).

In sum, there are many uncertainties associated with the ability of both monetary and macro-prudential policies to rein in the financial cycle. As a policy maker, being confronted with a lot of uncertainty is not new. It is, however, important to acknowledge those uncertainties and draw the necessary implications.

First, central banks should continue to focus primarily on what they can and are mandated to achieve, which is price stability over the medium term. As I will mention later, delivering on this mandate is essential to maintain public trust in the long term.

Second, we need to continue and further strengthen the financial sector reform agenda and build more resilience in the financial system. While our knowledge to fine-tune the financial

[1] See, for example, Issing (2006) and Trichet (2006).

cycle may be limited, the financial system must be made more robust to shocks by, for example, increasing capital and liquidity buffers. As Don Kohn recently said, *"We may not be able to make better drivers, but we can make cars and roads safer to reduce damage when accidents happen"*.[2] The creation of a banking union and the comprehensive assessment leading up to it are essential steps in improving the governance of the financial sector in the euro area and increasing its resilience.

Trust in central banks

Let me turn now to the question that was perhaps the most fundamental for Curzio, namely how central banks can build trust. Indeed Curzio viewed not only central banks, but also money itself, as an institution backed by public trust. Let me quote from him: *"The mistake that neo- classical theories make is to consider money a commodity. Instead, it is really an institution that is held up by trust: trust in its future purchasing power and trust in the continued convention that payment is complete when money changes hands (even if this is now something of a metaphor)".*

Trust is important not only as an end in itself, but also because it contributes to economic efficiency. This view, which is now shared by many economists and that Curzio expressed in particularly eloquent terms, stipulates that the ultimate objective of institutions such as central banks is to reduce transaction costs. High public trust, by reducing transaction costs, raises economic efficiency and citizens' welfare.

A high degree of trust by citizens is ultimately the most important safeguard of central bank independence in the long term. Legal provisions for central bank independence are important, but not as important as public trust over the long term.[3] With a high degree of trust, central banks will be able to successfully deal with any potential risks for central bank independence stemming from the use of non-standard measures, for example.

Transparency and accountability are also important pillars of central bank independence and the ECB places a high value on them. Together with delivering on the mandate, they also form the cornerstone of public trust in central banks. The ECB enjoys a high degree of independence in the international comparison, which is matched by stringent transparency and accountability requirements. Indeed, we regard accountability as just "the other side of the coin" of central bank independence.

Looking ahead, central banks should get used to receiving closer scrutiny and in my view should not eschew even higher standards of transparency. It is not surprising that the use of new and non-standard tools attracts closer attention and sometimes even criticism.

How do these considerations apply to the unique case of the euro area? The monetary union is an example of what Curzio called a *"consortium regime"* where monetary sovereignty is permanently transferred to a supranational level. As a consequence, price stability is defined for the euro area as a whole. The challenge for the ECB is to maintain public trust in a multinational environment, in particular when there is a significant degree of heterogeneity in economic structures and preferences.

Trust is intimately linked to acting within the mandate. The ECB is operating and shall operate only within this mandate. A key part of the ECB's aim to retain and build trust is to respect this political legitimization by focusing and delivering on its mandate. Of course, price stability is not important just because it is written in the Treaty. It is also beneficial for economic growth and social cohesion, and indeed available surveys indicate that citizens attach a high value to price stability.

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[2] See Kohn (2013).

[3] See, among others, Posen (2010).

During its 15 years of existence, the ECB has consistently delivered on its mandate to maintain price stability, with average HICP inflation standing at 2.0% between 1999 and now. Moreover, long-term inflation expectations suggest that citizens have a high degree of confidence in the ECB's ability and determination to maintain price stability in the future.

In sum, we have here two aspects which are both essential. On the one hand delivering their mandate is the only way for central bankers to maintain public trust; on the other, their pursuit of their mandate must be backed indirectly by public preferences, seen from a longer term perspective.

I would be the first to acknowledge that there can be a tension between these two dimensions in the short run, and that delivering price stability has been more challenging in recent years, in part due to financial fragmentation in the euro area. The ECB has been addressing financial fragmentation in the euro area since its beginning in 2011. This effort has included the provision of liquidity to the banking system in abundant and uniform terms across the whole euro area, against good quality collateral and subject to risk management limits; as well as securities market purchases, the Securities Market Programme and the covered bonds purchase programme, and the Outright Monetary Transactions (OMT) programme.

I would like to emphasise that these efforts do not represent a departure from the ECB's mandate, but rather the opposite – namely, the pursuit of price stability by all the necessary means that the situation has required.

In short, the ECB has preserved price stability and the necessary conditions for sustainable growth, fought redenomination risks and the fragmentation of financial markets. Time has been gained for other actors to contribute their part in crucial policy domains that do not belong to the competence of ECB as defined by its mandate. The European reform agenda has been put on a new footing.

It is now crucial to complete this agenda at the European and national level. In this agenda there is no place for retreating into nationalism and protectionism. We know better than this and should stay focused on the key reform priorities: completing the banking union, implementing growth-friendly fiscal consolidation, and structural reforms in labour and product markets. I have little doubt that all these reforms are beneficial and trust-enhancing, even though some of them may be opposed by vested interests or entail adjustment costs in the short term.

Our common responsibility for the euro area strengthens the case for reform. As I said recently in Berlin, it is never the case that sound economic policies are good for some in the euro area but not for others, even though they are sometimes portrayed in that way.

A great deal of progress has been made, but more needs to come. Let me conclude by again quoting Curzio: "The EMS crisis could have marked the end of EMU. Instead, it sparked efforts to acquire sufficient institutional capital to support confidence in the new European currency" (p. 213). The crisis has identified some weaknesses in our European construction. But I am convinced, like Curzio, that together we will be able to repair these weaknesses and emerge from the crisis with a stronger Europe.

Thank you for your attention.

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