Mario Draghi: The path to recovery and the ECB's role

Speech by Mr Mario Draghi, President of the European Central Bank, at the Symposium on Financial Stability and the Role of Central Banks, organised by the Deutsche Bundesbank, Frankfurt am Main, 27 February 2014.

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Summary

The euro area has made considerable progress on its reform agenda, says ECB President Mario Draghi. Speaking at a conference organised by Germany's Bundesbank in Frankfurt he emphasises that euro area governments have improved their fiscal positions despite recessionary headwinds and stressed euro area countries have become more competitive. "In parallel, the architecture of EMU has been strengthened in ways that many would have considered inconceivable two years ago", says Mr Draghi. The move towards a banking union is crucial not only for the functioning of the financial system, but also for the conduct of monetary policy.

Since the beginning of the crisis the ECB's Governing Council has taken decisive steps to engineer a monetary policy stance that is commensurate with the subdued medium-term inflation outlook. But standard monetary policy in the form of rate cuts was not enough to ensure an appropriate monetary policy stance, because unwarranted fears of euro break-up impaired the monetary transmission, he says. Against this background the ECB announced Outright Monetary Transactions (OMT). Like all the ECB's monetary policy measures, OMT served, says Mr Draghi, to ensure compliance with the bank's price stability mandate.

"And it builds on an established monetary policy doctrine that has gained prominence not least through its successful adherence by the Bundesbank for several decades", Mr Draghi says. "Namely that the central bank should be endowed with a clear price stability mandate and, within this mandate, should be allowed – in fact obliged – to use its instruments in full independence to deliver price stability."

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Ladies and Gentlemen,

It is a great pleasure to speak to you tonight.

When I last spoke at an event organised by the Bundesbank, in March 2012, the euro area stood at a crossroads. One direction pointed to continued malaise, with various vulnerabilities threatening to undo the benefits of economic, financial and even monetary integration. The other direction pointed to gradual repair, with ambitious reform efforts removing the key obstacles to economic stability and growth.

The euro area has chosen the latter path. And today, we are seeing first signs that this decision is paying off. At the same time, challenges remain and continued reform efforts are needed to ensure that the recovery proves sustainable.

Against this background, let me first elaborate on what I think are the key milestones achieved so far and then address what are the key challenges for the ECB in the coming months.

What have we achieved so far?

The euro area reform agenda has consisted of two pillars. One is to restore fiscal sustainability and economic competitiveness at country level. The other is to fix structural shortcomings in the euro area architecture that had allowed imbalances to build up in the first place.

On both counts, the euro area has made considerable progress.

Despite strong recessionary headwinds, euro area governments have markedly improved their fiscal positions. Average government deficit ratios fell by more than a quarter over the last two years and, excluding interest payments, were approaching balance at the end of 2013.

Simultaneously, most of the stressed euro area countries have made remarkable progress in gaining competitiveness. Over the past five years, the cumulative unit labour cost differential vis-à-vis the euro area have fallen by more than 20 percentage points in Ireland, around 15 percentage points in Greece and Spain, and almost 10 percentage points in Portugal. This was accompanied by substantial improvements in the export dynamics of these countries.

Overall, we see the euro area's economic recovery gradually taking hold, albeit at a slow and uneven pace.

In parallel, the architecture of Economic and Monetary Union (EMU) has been strengthened in ways that many would have considered inconceivable two years ago.

Perhaps most important for monetary policy, and certainly most topical for this conference, are the concrete and ambitious steps towards a banking union.

By establishing the Single Supervisory Mechanism (SSM), European policy-makers have demonstrated a firm commitment to a stringent and uniform application of common supervisory standards. As a crucial counterpart, policy-makers are in the process of establishing the Single Resolution Mechanism, which should enable quick and efficient resolution of ailing banks without permanent recourse to taxpayer funds.

Together, these new institutions will fundamentally strengthen transparency, stability and incentive-compatibility in the financial sector.

In a primarily bank-based financial system like the euro area's, these features are crucial, not only for the functioning of the financial system per se, but also for the conduct of monetary policy.

This is because, with an impaired bank lending channel, monetary policy may lose its handle on the real economy and ultimately inflation. At the same time, given the persistent downside risks to price stability, monetary accommodation was a necessary ingredient in the crisis response.

How has monetary policy contributed?

Accordingly, since I last spoke at this venue, the ECB's Governing Council has taken further decisive steps to engineer a monetary policy stance that is commensurate with the subdued medium-term inflation outlook.

These steps included a sequence of further rate cuts, accompanied since July 2013 by explicit communication that we expect the key ECB interest rates to remain at current or lower levels for an extended period of time.

But standard monetary policy in the form of rate cuts and the accompanying communication were not enough to ensure an appropriate monetary policy stance.

In fact, given unwarranted fears of a euro area break-up, monetary policy transmission became severely impaired – to the extent that the financial market dislocations jeopardised our ability to deliver on our price stability mandate.

It was against this background that we announced the Outright Monetary Transactions (OMTs). Like all our monetary policy measures, it has served to ensure compliance with our price stability mandate as provided for in the Treaty.

And it builds on an established monetary policy doctrine that has gained prominence not least because it has been successfully pursued by the Bundesbank for several decades. Namely that the central bank should be endowed with a clear price stability mandate and, within this mandate, should be allowed – in fact obliged – to use its instruments in full independence to deliver price stability.

Combining a clear mandate with strong independence in pursuing that mandate is particularly important when conducting a single monetary policy in EMU, which consists of 18 countries with heterogeneous economic structures and institutional landscapes.

On the one hand, it allows us to flexibly tailor our policy measures to the specific monetary policy challenges that may arise in this multi-country context – most notably to tackle the financial fragmentation that has hampered monetary policy transmission during the crisis. On the other hand, it establishes a stable anchor for inflation expectations through our price stability objective.

This approach of "constrained discretion" is what made the track record of the Bundesbank and then the ECB so successful. And this approach is further validated by the strong progress towards restoring the singleness of the euro area's monetary policy observed since the announcement of the OMTs.

Since summer 2012, Target balances have shrunk by about a third. Spreads on long-term sovereign bonds vis-à-vis Germany have fallen by around 350 to 450 basis points for Spain, Italy and Ireland, and by more than 600 basis points for Portugal. Spreads in corporate debt markets have fallen by more than 150 basis points for some important market segments, and thus have made it easier for firms to raise funds in the market.

What challenges are yet to be tackled?

Despite these achievements, several challenges remain. Let me focus on three challenges for the ECB.

One of them relates to a prolonged period of low inflation. Since the review of the ECB's monetary policy strategy, which took place in 2003 under the auspices of Otmar Issing, the ECB has aimed at inflation rates below, but close to, 2% over the medium term.

To be sure, current HICP inflation, which stood at 0.8% in January, can clearly not be considered close to 2%. Is this a reason for concern?

With the average euro area inflation rate standing at 0.8%, we are clearly not in deflation, which is defined as a self-reinforcing fall in prices that is broad-based across items and across countries.

Moreover, inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%.

What we are experiencing now is a prolonged period of low inflation, which will be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on.

Of course, inflation remaining low for a prolonged period of time is a risk in itself. It implies that there is only a small safety margin away from zero. And it makes structural adjustment efforts more difficult.

Hence, it is important to carefully assess the causes of low inflation. In recent times, energy price developments in particular put downward pressure on headline inflation, a phenomenon that has contributed to weaker inflation at the global level. Moreover, low inflation partly reflects internal rebalancing efforts by way of which several countries, especially those in economic adjustment programmes, have aimed at improving their competitiveness.

However, the low inflation outlook is also driven by continued weakness in demand. At this point in time, we do not have evidence of consumers postponing expenditure plans, which is something one would observe in a deflationary environment. But any setbacks in the absorption of economic slack may give rise to further negative developments.

Against this background, we will remain alert as to whether any indications on further downside risks to price stability emerge and we stand ready to act.

A second challenge we will be facing in the coming months is to make the Single Supervisory Mechanism really work. As I initially explained, the institutional reforms that have been adopted or are being adopted to establish a banking union constitute important progress.

But to meet the ultimate objective of strengthening financial stability, implementation is key. And implementation is well under way: the Supervisory Board has held its first three meetings; a Framework Regulation has been prepared and is now the subject of a public consultation; and work is progressing on the supervisory model of the SSM with the Supervisory Manual.

One of the first major implementation tests is the comprehensive assessment, the health check of the euro area banking system, which is currently being conducted as a prelude to the SSM becoming operational.

Here, the ECB is making good progress in establishing the new structures and ensuring that the exercise will be fair, transparent and stringent. But many more steps still lie ahead of us.

A final challenge relates to the macro-prudential arm of the SSM. As you know, the SSM Regulation gives the ECB the power to apply stricter macro-prudential measures than the national authorities if it deems them necessary. We can also advise on the calibration of instruments. This goes some way towards insuring against an inaction bias at the national level, thus improving the prospects for a more stable euro area financial system.

We will maintain a clear separation of objectives between the macro-prudential policy framework and monetary policy and a clear hierarchy, with price stability remaining the ECB's overall primary objective.

But we are very much aware that both policies may interact. As mentioned before, financial instability may undermine monetary policy's ability to maintain price stability, both directly by its negative impact on credit provision, growth and inflation and indirectly by impairing the monetary transmission process. Conversely, a protracted low interest rate environment necessary to maintain overall price stability may create incentives to search for yield and lead to local bubbles in a heterogeneous monetary union.

In both cases, macro-prudential policy can be used to address financial stability concerns and facilitate our monetary policy conduct. In the first case, where the financial stability concerns are of a systemic nature affecting the whole euro area, those policies will have to be coordinated. In the second case, national macro-prudential authorities may take actions to reduce the risk of local financial imbalances.

In such a case, macro-prudential measures may exert cross-country spillovers that matter for monetary policy. For example, raising capital requirements in one jurisdiction may dampen lending in the whole euro area, while a tightening of loan-to-value ratios may simply shift lending between respective jurisdictions, leaving the euro area aggregate unchanged. A monetary authority may therefore have a legitimate interest in which macro-prudential measure is used.

Many of these questions are yet to be fully explored and we have to acknowledge that the macro-prudential policy framework is still in its infancy. We are in a learning process. The objectives, transmission mechanisms and effects are still being established, and this is an area where the ESRB's systemic macro-prudential oversight is playing an integral role. Conferences such as today's can provide crucial input here.

Overall, I am optimistic that macro-prudential policies, if properly coordinated at the European level, will strengthen our defences against future financial instability in the euro area, while also addressing some of the side effects that come from a single monetary policy.

Conclusion

Let me conclude. With the three challenges of: (i) ensuring price stability in the face of a prolonged period of low inflation, (ii) setting up the SSM and rebooting the banking system to support credit and growth, and (iii) establishing an effective macro-prudential policy framework to increase resilience in the face of future financial turbulence, the ECB will have its hands full in the coming year. We are committed to doing our job, but do not expect us to do the job of others. It is more important than ever that, in parallel, governments continue to pursue their structural reform agenda.

The return of confidence in the euro area is evidence that the reform efforts will eventually pay off. This is visible from the return of *market* confidence. But, more importantly, it is visible from the return of *political* confidence – as expressed, for example, in Prime Minister Helle Thorning-Schmidt's assessment that joining the euro would be in Denmark's best interest.

Ultimately, the common theme in all our efforts is to further the aims of the European Union. These are to promote peace, its values and the well-being of its peoples. As the recent events in Ukraine demonstrate, these aims remain as attractive and compelling as ever.

Thank you for your attention.