Mario Draghi: Bank restructuring and the economic recovery

Speech by Mr Mario Draghi, President of the European Central Bank, at the presentation ceremony of the Schumpeter Award, Central Bank of the Republic of Austria, Vienna, 13 March 2014.

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Summary

On accepting the Schumpeter Award in Vienna, ECB President Mario Draghi said 2014 and 2015 were set to be a period of recovery after two years of stabilisation and a return of confidence in the euro area. But the recovery "remains conditional on our pursuing the very policies that have brought about the return of confidence," including growth-friendly fiscal consolidation, structural reforms and a committed monetary policy.

In his speech, Mr Draghi drew a parallel between the policies applied in the euro area with the ideas of economist Joseph Schumpeter, who spoke of "creative destruction" driving innovation and productivity growth. By cleaning up and repairing banks' balance sheets, the ECB's comprehensive assessment helps create the necessary conditions for resources again to flow to the productive economy. "By encouraging creative destruction in the banking sector, we can facilitate creative destruction in the wider economy and support the recovery."

Deleveraging in the financial system was necessary, since too much debt has been built up in the run up to the crisis, but the question is what form this deleveraging should take, and at what speed it should be allowed, or encouraged, to take place. What we want to achieve, Mr Draghi said, is a "good" form of bank deleveraging, where equity is built up, where deposits rise and where balance sheet reduction takes the form of swift asset clean-up, rather than a slow scaling back of the loan book while rolling over bad loans.

The ECB's monetary policy is helping this process. As the recovery proceeds and inflation gradually increases towards levels closer to 2%, the ECB's forward guidance, firmly reiterated by the Governing Council in its last meeting, creates a de facto loosening of policy stance, and real interest rates are set to fall over the projection horizon. At the same time, the real interest rate spread between the euro area and the rest of the world will probably fall, thus putting downward pressure on the exchange rate, everything else being equal. The strengthening of the effective euro exchange over the past one and a half years has certainly had a significant impact on our low rate of inflation, and, given current levels of inflation, is therefore becoming increasingly relevant in our assessment of price stability.

The risk of deflation, which would make deleveraging harder, is quite limited. But the longer inflation remains low, the higher the probability of such risks emerging. That is why the ECB has been preparing additional non-standard monetary policy measures to guard against such a contingency and why it stands ready to take further decisive action if needed, Mr Draghi said.

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Ladies and Gentlemen,

Let me start by expressing how grateful I am, but also how humbled I feel, to speak before you today as the recipient of the *Schumpeter* Preis.

It would be tempting to see the honour that you are bestowing upon me today as a reward for a job well done. I prefer, however, to regard it as encouragement and inspiration to continue to pursue our task with the determination and single-mindedness that we have shown over the past few years.

After five years of crisis and uncertainty, 2012 and 2013 have been years of stabilisation for the euro area. They have seen a return of confidence in the prospects of our union.

2014 and 2015 will be a period of recovery. But that recovery remains conditional. It remains conditional on our pursuing the very policies that have brought about the return of confidence: growth-friendly fiscal consolidation; structural reforms aimed at enhancing investment and productivity; a committed monetary policy guarding against all threats to the integrity of our money – in particular, the risk of both too high and, currently more relevant, too low inflation.

But the recovery is also conditional on another set of policies, to which it is appropriate that I devote my remarks tonight, because those policies draw significantly on the teachings and ideas of Joseph Schumpeter. I refer here to the actions being undertaken to "reboot" the financial system, in particular the so-called comprehensive assessment, the current health check of the euro area banking system, which precedes the start of the Single Supervisory Mechanism (SSM) in November this year.

The rationale for what we are doing actually connects two of Schumpeter's most important and better known insights. First, it acknowledges the importance of a well-functioning financial sector for the efficient allocation of capital and credit. And second, it contributes to the Schumpeterian notion of "creative destruction" which drives innovation and productivity growth.

In short, by "cleaning up" and repairing bank balance sheets, we are creating the conditions necessary for resources to flow once more to the firms that use them most productively. And in this sense, by encouraging creative destruction in the banking sector, we can facilitate creative destruction in the wider economy and support the recovery.

Deleveraging and the real economy

Let me begin by outlining the challenge facing policy-makers in repairing the banking sector.

Looking back, there is no doubt that the business models and liability structure of euro area banks had to evolve. Before the crisis, numerous banks funded their activities with too much debt and not enough equity; and that debt involved wholesale financing that was too high relative to deposits.

This model was only able to develop because of the perception of an implicit state guarantee for bank debt – a perception that is perhaps the most pervasive component of the link between sovereign and bank risks. The deterioration of sovereign credit, on one side, and the clarification of the rules regarding bail-in of bank debt, on the other, have both contributed to putting an end to a funding model that was neither desirable nor sustainable. As a result, the euro area banking system has begun a secular process of restructuring and deleveraging.

From a policy perspective, the question presented to us is not whether we can avoid this deleveraging. It is universally accepted that too much debt had been built up in the run up to the crisis, by governments, non-financial firms, households and banks, and that we now have to work through the effect of the subsequent debt overhang.

The correct question, in my view, is what *form* this deleveraging should take, and at what *speed* it should be allowed, or encouraged, to take place.

Clearly, we do not want any excessively rapid deleveraging that involves disorderly fire sales of assets. This is why two years ago, in the context of a bank funding squeeze, the ECB implemented longer-term refinancing operations. Borrowing from Schumpeter's terminology, it would have been "destructive destruction".

At the same time, we do not want any excessively prolonged deleveraging, where banks reduce their loan book by curtailing new lending, while hoping that the underperforming assets they hold recover in value.

Put bluntly, this would create “zombie” banks that do not lend, and the longer this persists, the longer credit conditions will interfere with the process of creative destruction described by Schumpeter. The “churn” process between firms entering and exiting the market that is a crucial driver of productivity would be disrupted.

There is some evidence that such credit misallocation is already occurring in the euro area, and it is creating an undesirable, even if only temporary, distortion to the detriment of small firms. Unlike large firms, small and medium-sized enterprises (SMEs) cannot easily replace bank funding with capital market financing. Banks perform a key role in reducing information asymmetries with respect to the creditworthiness of smaller borrowers.

If small, innovative firms cannot access finance, it has an important impact on employment and investment. Studies from the United States show that the bulk of net new job creation comes from young firms. At the same time, young firms have been shown to be much more sensitive to changes in investment opportunities than older firms, meaning that fewer start-ups would probably lead to lower trend productivity growth.

Achieving a “good deleveraging”: the comprehensive assessment

What we want to achieve is a “good” form of bank deleveraging, where equity is built up, either through retained earnings or through outright issuance, where deposits rise and where balance sheet reduction takes the form of an asset carve-out, rather than of credit attrition.

Our comprehensive assessment of bank balance sheets is, in my view, creating the setting and incentives for achieving this. The assessment will shed light on bank assets, ensure that problematic assets are fully recognised and prompt timely corrective action in the form of bank restructuring and capital replenishment.

Frontloading banking sector repairs in this way should in turn facilitate the Schumpeterian process of creative destruction in the economy at large – and not only by helping credit flow to younger firms, but also by facilitating debt resolution for older ones.

Firms that no longer have a viable business model should go into insolvency. But there also appear to be corporates in the euro area that cannot invest in new growth opportunities because of an excessive level of debt. Well-capitalised banks are better able to end or restructure loans to firms with bad credit standing. This in turn ought to facilitate the process of selection of the firms that deserve to survive because they can thrive.

Of course, credit conditions are not the only obstacle to innovation, and it is important to emphasise the role of structural and tax reforms in creating a business climate that is conducive to investment and job creation. Cleaning-up banks is not a sufficient condition for a return to sustained growth – but it is a necessary condition.

There is a second incentive for frontloading bank restructuring and balance sheet adjustment, which has to do more directly with monetary policy. Banks that need to recapitalise typically do not pass the low level of our policy rates through to their lending rates. This has shown up for some time in the dispersion of bank lending rates across the euro area, and in the muted reaction, especially in the stressed countries, of lending rates to our successive steps of monetary easing.

As bank balance sheet deleveraging progresses, one should expect to see – and we are in fact starting to witness – an improved transmission of our currently loose monetary policy stance, in particular as deposit rates converge to lower levels. And we expect the effect of this improved transmission to become gradually more visible throughout the current year.

The role of monetary policy

In this context, last Thursday the Governing Council firmly reiterated its forward guidance to keep key ECB interest rates at present or lower levels for an extended period of time. The intention to maintain an accommodative policy stance for as long as necessary is based on an overall subdued outlook for inflation extending into the medium term. This accommodative stance supports the deleveraging process through various balance sheet channels.

But our forward guidance also has a further effect. As the on-going recovery proceeds in line with our projections, the significant slack in the economy will begin to be absorbed, and inflation will gradually increase towards levels closer to 2%. Our forward guidance therefore creates a de facto loosening of policy stance, as real interest rates are set to fall over the projection horizon. This is recognised, for example, in lower forward real interest rates embedded in the term structure of nominal interest rates and inflation swaps.

How does this help? While the process of repairing the banking sector should improve the credit supply, falling real interest rates should support demand for credit by encouraging higher business investment, thus fostering a virtuous circle of higher spending, growth and inflation. At the same time, the real interest rate spread between the euro area and the rest of the world will probably fall, thus putting downward pressure on the exchange rate, everything else being equal. The strengthening of the effective euro exchange over the past one and a half years has certainly had a significant impact on our low rate of inflation and, given current levels of inflation, is therefore becoming increasingly relevant in our assessment of price stability.

At present, risks of deflation, which would of course make the deleveraging process harder, are quite limited. In fact, inflation excluding energy and food started to increase slightly from 0.7% in December to 0.8% in January and to 1.0% in February. And medium to long-term inflation expectations remain anchored to our objective of an inflation rate of close to, but below 2%. But the longer inflation remains low, the higher the probability of such risks emerging. That is why the ECB has been preparing additional non-standard monetary policy measures to guard against such a contingency and why it stands ready to take further decisive action if needed. Any material risk of inflation expectations becoming unanchored will be countered with additional monetary policy measures.

In other words, the ECB’s accommodative monetary policy stance and its strong symmetric commitment to price stability will help the deleveraging process. At the same time, the healing of the banking sector will accelerate the transmission of our policy stance and firm its grip on the economy. Together, they will support the on-going recovery.

Conclusion

Ladies and gentlemen,

I can summarise what I said tonight in a few words: the comprehensive assessment of bank balance sheets, which we initiated last year, is a bank-level supervisory exercise ahead of the start of the operations of the Single Supervisory Mechanism. But it also has significant macroeconomic consequences and, as such, forms an integral part of the strategy for the recovery of the euro area.

In fact, just the prospect of the comprehensive assessment has already caused banks to raise new capital and to shed non-core or non-profitable exposures. This is very welcome: corrective action does not need to wait until the end of our comprehensive assessment. It is to everybody’s benefit that it takes place pre-emptively.

In this way, I believe that we are already starting to witness some of the positive effects of frontloading bank balance sheet adjustment. I expect that we will see those effects gradually strengthen over the year, including in the form of a better transmission of our monetary policy impulse. In turn, I expect the necessary process of creative destruction to gain pace.

I think we can now say of the euro area economy what Galileo said of the earth: eppur si muove – and yet, it moves!

The job is by no means complete. But as evidence accumulates that we are on the right track, I am hopeful that, eventually, we will have deserved the prize that you have generously awarded to me tonight.