Mario Draghi: Memorial lecture in honour of Tommaso Padoa-Schioppa

Keynote speech by Mr Mario Draghi, President of the European Central Bank, at the inaugural event to honour the late Mr Tommaso Padoa-Schioppa, London, 9 July 2014.

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Summary

The governance of structural reforms deserves as much attention as enforcing fiscal rules and should be done at the euro area level, ECB President Mario Draghi said in a speech in London on Wednesday.

Structural reforms need strong domestic ownership since they reach deeply into societal arrangements. But at the same time, the example of the International Monetary Fund shows that there is a convincing case to be made for a supranational body that makes it easier to frame national debates on reform. This can shift the debate from whether to how to implement reforms, Mr Draghi argues.

The outcome of structural reforms – a higher level of productivity and competitiveness – is not merely in a country's own interest, but in the interest of the monetary union as a whole.

In the euro area, there is therefore a case for establishing rules on structural reform at the EU-level. While a lack of reform can threaten cohesion of the union, the recovery shows us how decisive reform can strengthen it.

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Ladies and gentlemen,

The belief that there are interests of the people that cannot be safeguarded by purely national authorities, and that require the establishment of supra-national institutions, was a constant motivation through the life and work of Tommaso Padoa-Schioppa.

It is also this belief that motivated the involvement of Tommaso in your work to develop global accounting standards. More than 100 countries speak the same accounting language today, whereas a decade ago, no major economy used the International Financial Reporting Standards (IFRS). I trust that the momentum will be kept, and in particular that European policy-makers will progress swiftly in the adoption of IFRS 9.

But where Tommaso Padoa-Schioppa's deep-rooted convictions found their most pronounced expression was in his constant support for European integration and his seminal contribution to the creation of the euro.

At the end of a recent press conference, I said that the crisis would not have been as severe if we had had more, not less, integration in Europe; and that our future lies with more integration, not the renationalisation of our economies. I suspect Tommaso would have agreed.

Sovereignty as a positive concept

Sovereignty in the European Union is not only a normative concept linked to the rights of states. It is also a *positive* concept. A sovereign that cannot effectively deliver the expectations of its citizens is only sovereign in name. Genuine sovereignty exists only if policy-making is effective.

This notion of the efficacy of public powers is reflected in the principle of subsidiarity embedded in the EU Treaties – or what is known as the federalist principle in the United States – the logic of which was elegantly captured by John Locke in the 1680s:

"For all power given with trust for attaining an end, (…) whenever that end is manifestly neglected (…) that power must devolve in the hands of those that gave it, who may place it anew where they shall think best for their safety and security".

European integration has, in effect, been a process of progressively applying this principle: governments have pooled sovereignty every time it has proved necessary so that they could continue to deliver on their duties towards their people.

At the start of the process, the objective was to prevent continental war. Two world wars had demonstrated the inability of European governments, acting alone, to provide physical security for their citizens. Thus, they established common institutions, such as the Coal and Steel Authority, that could guarantee peace more effectively.

In parallel, and quite independent of policy actions, economic integration has also progressed, in a more gradual but also more continuous process. Such integration results indeed at least as much from technological developments and improvements in transportation and communication as it does from policy choices. It is, in large parts, inescapable. But because it creates far-reaching interdependencies, it has required governments to respond. They have had to proactively choose to pool sovereignty to regain control of their economies.

With the establishment of the Single Market, in particular, the pace and reach of integration accelerated markedly. This was of course its purpose – and it remains the most significant and successful achievement of the European Union. But a free market does not only assume the freedom to take part. It also assumes the means to protect that freedom, by which I refer to the protection of property rights, the enforcement of contracts, the conditions of fair competition and the avoidance of moral hazard. Economic integration therefore required integration of some economic policies.

The euro itself emerged in fact as a corollary of the Single Market. It was conceived, as early as the late 1950s, as a response to the costs associated with exchange rate frictions within a single market, which at the beginning was only for agricultural products.

Already in 1944, in an influential study commissioned by the League of Nations, the great economist Ragnar Nurkse had warned convincingly of the economic losses resulting from currency volatility. Tommaso himself later argued in his "inconsistent quartet" that free trade, free capital movement, fixed exchange rates and independent monetary policies were ultimately incompatible.

And the euro itself has had consequences. Some of these were identified early, in particular with respect to fiscal governance. Some were fully acknowledged only later, such as the pervasive effects of macroeconomic imbalances.

But in both cases, the crisis showed that the cohesion of the Union in fact relied on the behaviour of *each* of its members. This is why I believe that the case for community-level governance does not apply only to fiscal policy, or to the banking union, but also to structural reforms, as I will endeavour to explain.

Fiscal policies within a monetary union

The case for fiscal governance at the community level is well understood, and stems from the negative externalities that unsound public finances in a Member State can generate for its neighbours. The crisis not only validated this concern; it reinforced it, by showing that externalities could be even more pervasive than initially thought.

The fiscal soundness of a government is obviously first and foremost in the interest of its own country. Countries with excessively stretched public finances can lose the ability to use fiscal policy as a counter-cyclical stabilisation tool. Indeed, this ability relies on the government being able to access markets under favourable conditions at the time when it needs to, at the trough of the cycle. As we have seen during the crisis, this cannot be taken for granted when doubts arise about the sustainability of the debt.

This would be problematic anywhere but it is more so in a monetary union, as the common monetary policy can only aim at price stability for the euro area as a whole. It cannot cater specifically for asymmetric shocks. In the absence of a federal budget, like we see in the United States, the soundness of government credit everywhere is of paramount importance to counteract regional slumps.

If some governments retain the ability to stabilise their economies but others do not, then it becomes more plausible that economic divergence will occur. This is one channel through which the cohesion of the Union can be affected. This ability depends on keeping debt low and budget deficits close to zero when output grows at potential, not on having more flexibility in the existing rules.

Keeping one's own house in order also has a further benefit: it helps mitigate the effects of contagion. As we have seen during the crisis, those governments that had more robust fiscal positions were much less affected by contagion – at the extreme they even benefited from safe-haven status.

This protection, however, is not absolute, because it relies on the ability of markets to discriminate between sound and unsound debtors. Yet bubbles and panic happen. A bubble is a situation where markets ignore fundamentals, even if debtors are unsound. For too long, markets failed to raise funding costs for countries with unsustainable policies. And a panic is a situation where markets also ignore fundamentals, but this time to the detriment of sound debtors.

In fact, the main channel of contagion within a monetary union is not direct exposures between one country and another. It is the fact that if a precedent set in one country is seen to be replicable elsewhere, it can affect the conditions of market access for all. Put differently, the main channel of financial contagion is not the asset side of balance sheets, but the liability side.

We perhaps saw this effect most clearly with the fragmentation of the banking sector three years ago. Fears that one country could leave the euro resulted not just in that country being cut off financially, but in fragmentation everywhere.

This fragmentation created considerable damage. The renationalisation of finance hindered the homogenous transmission of monetary policy across borders. And it resulted in a divergence of financial conditions across the euro area. This initiated an economic divergence process, which, in turn, could have challenged the sustainability of the euro area.

The ECB therefore had to act and we did – through the creation of the Outright Monetary Transactions (OMT) programme – to nip in the bud unwarranted fears of a euro area break-up, and prevent an adverse equilibrium from becoming entrenched through prophecies that were as much false as they were self-fulfilling. It was necessary to protect the monetary transmission process. And it was necessary to protect price stability, which is essential for the cohesion of the Union.

The threats to price stability today do not come from unfounded fears of a break-up of the euro, but from the consequences of changes in other factors, such as energy and food prices, relative price adjustment in stressed countries, exchange rate behaviour, weak demand and high unemployment. Nonetheless, those threats are real and to cope with them the Governing Council is determined to keep the monetary policy stance accommodative for an extended period of time.

Moreover, the Governing Council is unanimous in its commitment to also using unconventional instruments within its mandate, should it become necessary to further address risks of too prolonged a period of low inflation. We are strongly determined to safeguard the firm anchoring of inflation expectations over the medium to long term.

The lesson I draw from the fragmentation we have experienced is that the cohesion of the Union is in the fundamental interest of all of its members. If it is called into question, as we have experienced first-hand, the consequences cannot be anticipated with total certainty, but they are detrimental to all.

It is therefore of considerable relevance and importance that Europe has already made extensive progress in strengthening its rules, for example through the fiscal compact. What is essential now is that these rules are enforced. To unwind the consolidation that has been achieved, and in doing so to divest the rules of credibility, would be self-defeating for all countries, for three reasons.

First, the high level of indebtedness in almost all euro area countries implies a higher vulnerability to market pressure and contagion, if the euro area faces further economic or financial shocks. The higher the level of debt, the greater the probability of falling into a bad equilibrium, where high rates lead to defaults.

Second, if fiscal rules are applied by national governments to achieve not only stability but also sustainable growth, they do not in my view clash with national ownership of the budget. Fiscal rules should be viewed in the national debate as promoting growth-friendly fiscal consolidation and not simply as a painful accounting exercise.

Third, respecting the rules matters because it is a prerequisite for any other form of integration. It is only by demonstrating a willingness to fulfil their commitments that Member States can achieve the degree of mutual trust that is a pre-requisite of integration in other areas. Indeed, any pooling of sovereignty requires a great amount of mutual confidence, in particular in the fiscal area, which is traditionally seen as a prerogative of national parliaments.

Structural policies within a monetary union

This same reasoning that I am applying to the fiscal framework can, to a large extent, be extended to other areas of economic policy. In particular, I think there is a case for some form of common governance over structural reforms. This is because the outcome of structural reforms – a continuously high level of productivity and competitiveness – is not merely in a country's own interest. It is in the interest of the Union as a whole.

The Single Market and the single currency were conceived as a sort of "Ricardian" union, meaning a union in which each country, each sector and each firm can exploit its comparative advantages. I do not think there is any disagreement that the Single Market was a success.

But it is not enough for the cohesion of the Union that the Single Market and the single currency constitute a positive-sum game, in the sense that their existence raises aggregate welfare. The cohesion of the euro area relies on the fact that it is Pareto-improving: it must be the case that all the countries are better off inside the Union than they would be outside.

And it is obviously not enough that this is true only at the moment when they join. It has to be true continuously.

There are many instances around the world of political unions whose cohesion is maintained because the weaker regions or states benefit from recurrent fiscal transfers from their peers, typically through the operations of a central budget. It is then possible for those weaker regions to maintain recurrent external deficits, while the stronger regions post permanent surpluses. This is the case in the United States, for instance, but it is also true within most individual countries in Europe.

In the euro area, however, while there are cohesion funds for catching-up countries, and private credit flows can finance temporary imbalances, permanent fiscal transfers between Member States are not envisaged. So, in the medium term, each economy has to stand on its own feet. It has to be productive and competitive enough to benefit from the opportunities afforded by the Single Market.

We can do and have done much to reduce imbalances that are generated by factors other than lack of competitiveness and structural weaknesses. External imbalances have been decreasing since the announcement of OMTs. Persisting imbalances, however, could eventually undermine the economic and political cohesion of our Union. And, as I have already discussed, any threat to the cohesion and sustainability of the Union has pervasive effects for all, in the form of contagion, and uncertainty which weighs on investment.

This is where structural reforms play a crucial role – and perhaps an even more important role in the euro area than in other unions. Markets can be opened through EU legislation. But it is only through structural reforms that firms and individuals can be enabled to take full advantage of that openness.

Indeed, the intention of the Single Market was to free individuals and firms, within a market where no distinction would be made on account of nationality or place of establishment. This is why competition policy is enforced at the EU level, so that no firm is *protected* by its nationality.

By the same token, no firm or individual should be *penalised* by its country of residence. Yet, firms face very different operating environments across the euro area, which can prevent them from exploiting the advantages of the market. For example, the World Economic Forum ranks Finland third in the world in terms of global competitiveness, whereas Greece is ranked 91st. The World Bank ranks Ireland 15th in the world in terms of ease of doing business, whereas Malta is ranked 103rd.

The persistence of such differences creates the risk of permanent imbalances. With this in mind, I believe that structural reforms in each country are enough of a common interest to justify that they are made subject to discipline at the community level.

I see two reasons why this approach could be favourable to national governments today.

The first is that, over the past few years, we have seen both the risks associated with insufficient competitiveness in some Member States and the benefit of structural reforms. We have witnessed the accumulation of external imbalances in peripheral economies prior to the crisis, and how that left them vulnerable to "sudden stop" dynamics.

And more recently, we have seen the improvement that has taken place when governments implemented reform. The change in current account positions in stressed countries ranges from an almost 11 percentage point correction of GDP in Spain to a 16 percentage point improvement in GDP in Greece, only part of which is explained by lower imports in the context of a recession.

In fact, the return of market confidence in the euro area results mainly from the acknowledgement that individual governments, in particular in some of the most stressed countries, have taken significant corrective action and will continue to do so where needed. So while lack of reform can threaten the cohesion of the Union, we can already see how decisive reform can strengthen it.

But we are only at the beginning. The final judgment now rests on our being able to show that cohesion also produces growth and jobs.

The second reason why a stronger role for the Union could be beneficial is that, similar to fiscal policies, establishing rules at the level of the Union may in fact help national authorities implement reform.

Structural reforms reach deep enough into societal arrangements and practices that they can only succeed if they are made the object of strong domestic ownership. At the same time, those reforms require substantial political capital. Historical experience, for example of the IMF, makes a convincing case that the discipline imposed by supranational bodies can make it easier to frame the debate on reforms at the national level. In particular, the debate can be framed not in terms of *whether*, but in terms of *how* reform needs to take place.

In other words, I am not convinced by the argument that, in terms of structural reforms, there is an opposition between rules and ownership. On the contrary, they can be mutually reinforcing.

Conclusion

In conclusion, there is a strong case for us to apply the same principles to the governance of structural reforms as we do to fiscal governance. The essential cohesion of the Union depends on it.

With the benefit of hindsight, it would have been useful to establish, alongside the existing convergence criteria, a set of structural criteria that had to be met to enter the euro area, and then respected once inside. But we have to start from where we are. Thus, I would see merits in initiating, as a one-off, a new convergence process within the euro area – one which ensures that all countries are truly in a position to benefit from membership, and that none cause harm to another.

Today, national governments are not able to fully exercise their sovereignty alone, whether sovereignty is defined normatively, à la Jean Bodin, in terms of inalienable rights, such as to declare war and treat the conditions of the peace, to judge in last resort, to raise taxes and to mint money; or whether it is defined positively, à la John Locke, in terms of a fiduciary power to act for certain ends.

Individually, national governments are simply not powerful enough. To serve their purpose, they have to learn to govern together; they have to learn to be sovereign together so as to respond to their citizens' needs. Those needs today are growth and job creation.