Mario Draghi: Speech by the President at SZ Finance Day 2015

Speech by Mr Mario Draghi, President of the European Central Bank, at SZ (Süddeutsche Zeitung) Finance Day 2015, Frankfurt am Main, 16 March 2015.

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Summary

Europe needs to accelerate on its way to economic and institutional convergence. Due to falling oil prices, accommodative monetary policy and successful structural reforms, we can be optimistic about the economic outlook. The nascent recovery should be used as a window of opportunity to go ahead with reforms that make the euro area less fragile and vulnerable to shocks. Economic convergence should be reached through structural reforms that lead to an alignment of productivity levels. On the institutional side, we need to move from a system of rules and guidelines for national economic policy making to a system of further sovereignty sharing within common institutions. As part of this process, we need to strengthen the democratic accountability of Europe towards its citizens.

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Ladies and gentlemen,

It is a pleasure to be here this evening and to be able to address this conference.

We are meeting against the backdrop of a steadily recovering economic situation in the euro area. Most indicators suggest a sustained recovery is taking hold. Confidence among firms and consumers is rising. Growth forecasts have been revised upwards. And bank lending is improving on both the demand and supply sides.

These improvements reflect the coming together of several external and internal factors.

First, the terms of trade gains for firms and households arising from falling oil prices. Second, the monetary policy measures taken by the ECB since the middle of last year, which have led to a significant easing of financing conditions and protected the euro area from second round effects from this oil price drop, thus amplifying its benefits. And third, the successful structural reforms that have been implemented in several countries in recent years, which are now starting to produce results.

These effects look set to persist for some time, meaning we can rightly be optimistic about the outlook. But this does not mean we should rest on our laurels. On the contrary, a nascent recovery provides us with a window of opportunity – with the conditions to press ahead with the reforms that will make the euro area less fragile and vulnerable to shocks.

These vulnerabilities will not disappear just because the cycle is turning. They stem from the fact that our union remains incomplete along two dimensions. Neither our economies nor our institutions have converged enough. This is why whenever there is a serious shock in any part of the euro area, questions about the sustainability of the union still arise.

So the current upturn in economic conditions, which the ECB has helped to generate, must be used. It provides a favourable environment to address once-and-for-all these sources of fragility at the root – and in doing so to ensure that the cyclical recovery turns into a structural one.

To achieve this, we need now to press ahead with two streams of policy. First, we need to move from *integration to convergence* through structural reforms. And second, we need to move from *rules to institutions* through governance reforms.

1. From integration to convergence

In the euro area structural reforms are not a policy choice. They are a necessity that follows from the special way in which our monetary union is constructed. Let me explain why.

Monetary union automatically creates economic *integration* as financial and trade connections deepen. But integration does not automatically lead to economic *convergence*, by which I mean the gradual alignment of productivity levels.

This does not necessarily matter if the monetary union is of a sort where fiscal transfers are foreseen. Then, growth can cluster in certain regions, and the cohesion of the union can be maintained by transfers from those richer regions to the poorer ones. In the US, for example, a $1 decrease in per capita income in a state/region is associated with a roughly 20–40 cent net transfer from the federal government to its residents, with the bulk of the adjustment occurring through the tax system.

But lack of convergence does matter if fiscal transfers are not foreseen. In this case, cohesion depends on *every* state producing enough growth to support its citizens' welfare. Otherwise, citizens in poorer regions will start to question whether they might be better off outside the union. And that creates self-fulfilling fragmentation, which has repercussions across the union from which all countries ultimately suffer.

The euro area falls squarely into this second category of monetary unions. It was not created to have permanent creditors and debtors. It was created with the expectation that countries would be able to stand on their own two feet, without continuous help from others. Therefore, there has to be convergence for the union to be sustainable – every economy needs to be able to meet the highest standards in terms of competitiveness, employment and growth.

This imperative has always been understood in principle in the euro area. But it has not always been followed through in practice, as we see with the divergence in the euro area today.

This creates an uncertain half-way position. We have now integrated too much to even entertain reversing the process – our economies are far too intertwined. But we have not yet converged enough to dispel doubts about the cohesion of our union and guarantee its long-term stability.

So there is only one answer: we have to make our economies more convergent than they are today. And it is in this context that structural reforms are so important.

Only with those reforms can we create the conditions where every country can allocate resources efficiently, exploit comparative advantages and grow. And I do not say this from theory, but from our own experience.

We have already seen in the euro area that convergence cannot be sustained if it is not structurally anchored. We had rapid convergence in nominal GDP levels before the crisis, but driven by demand and without an underlying alignment in productivity levels. When the cycle turned, those nominal gains largely reversed.

Moreover, we are seeing now how convergence can gradually restart when the right structural policies are in place. Those countries that undertook reforms in recent years are starting to see the positive effects come through.

For example, the OECD estimates that the 2012 labour market reform – and in particular the decentralisation of wage bargaining – was responsible for a 3.2% decline in labour costs in the business sector up to the second quarter of 2013, a period where Spain was also able to gain large export market shares. In Portugal, well targeted and efficient active labour market policies have been able to explain about one-third of the employment recovery.

And the fact we now have an extremely accommodative monetary policy is not a disincentive for countries to continue with these reforms. For example, Italy has introduced a major labour market reform since the ECB announced its most recent measures. In fact, monetary policy creates an *incentive* for reform.

Any country that does structural reforms today will see the benefits materialise faster, as those reforms will strengthen the impact of monetary policy in their economy, in particular where there is pent-up investment demand. And this in turn will make further structural reforms easier, as in a stronger economy the short-term costs of reform are lower – for instance because transitions between jobs are faster and there is less risk of hysteresis effects.

2. From rules to institutions

Still, what adds fragility to our union is the fact that, despite the crucial importance of structural reforms, they remain almost entirely a national responsibility. From the moment countries enter monetary union there is no way to guarantee that they will stay fit enough to thrive within it. In my view this has to change.

Because the cohesion of the euro area depends on all countries prospering, what happens within each one is not just a national interest, it is a collective interest. Every member of the euro area has a vital interest in ensuring that its partners are meeting the membership requirements – and not just at the point of entry, but continuously.

Indeed, it is sometimes asked what differentiates the euro area from a fixed exchange rate regime, and the answer is precisely this point. In a fixed exchange rate regime issues of economic integration are dealt with as foreign affairs. In a monetary union, they are domestic issues for all. And it follows from this that we need a higher degree of institutional convergence in the structural domain as well.

So what does this mean in practice?

Up to now, we have employed two different methods of economic governance in the EU.

In some areas, we have given European institutions executive power. This includes the ECB for monetary policy, the SSM (within the ECB) for financial policy, and the Commission for competition policy. In other areas, executive power has remained at the national level, with policies being aligned through a system of rules enforced by the Commission. This is the case for fiscal and economic policies.

There are of course good reasons why those different methods have been applied. But if we reflect honestly, which would we say has been most successful?

I think few would deny that where European institutions have been invested with executive power, they have used it well. Competition policy has been effective with both large companies and large countries. Monetary policy has achieved a high degree of policy credibility. And for the SSM it is perhaps too early to judge, though I am certain we would not have had such a rigorous clean-up of our banking sector without it.

If we look at the rules-based approach, however, it is difficult to reach such a positive conclusion. The fiscal rules have repeatedly been broken and trust between countries has been strained. And for economic policies we have tried to introduce a new rules-based approach – the Macroeconomic Imbalances Procedure – but it has so far not gained much traction in national decision-making processes.

The discrepancy between these two methods does not arise because of any inherent difference in the quality of European and national authorities. It arises because of the inherent difference between rules and institutions in a monetary union. And there are two reasons why I think, going forward, an institution-based approach would work better for the governance of structural reforms.

First, institutions facilitate both more credible and more flexible policymaking.

Rules can only really be credible if they are applied with very little discretion. Otherwise as soon as they actually bind, countries will find reasons not to follow them. But having no discretion is also not optimal, as circumstances will always arise that the rules did not foresee. There is thus an inevitable trade-off between credibility and flexibility.

Indeed, this is why we often end up in a difficult balancing act in Europe – trying at once to be flexible with the rules in the short-term to reflect circumstances, but rigid with the rules over the medium-term to build credibility. And ultimately we run the risk that this creates inconsistency between countries, which in turn weakens trust.

By contrast, for European institutions the trade-offs are less. Their policies are credible because they are bound by a mandate. But at the same time they can use discretion over how they meet that mandate, allowing flexibility to respond to events. This "constrained discretion" describes exactly the ECB's response to unprecedented low inflation: we did not have discretion over *whether* to meet our mandate, but we exercised it over *how* to do so.

I recognise that for structural reforms the analogy with monetary policy is not perfect. Preferences are not as aligned across countries and it would not be possible to have such a complete delegation of powers.

But I am confident that a European institution could help on two fronts. Making it easier to agree on the *aims* of structural reforms by aligning best practice. And making it easier to *implement* them by using European law to bypass vested interests.

It is clear, however, that the more European governance extends into areas such as economic policies, the more we need strong democratic participation and accountability at the European level. There are fundamental distributional questions at stake with structural reforms that cannot simply be delegated to technocratic bodies.

And this is where the second reason for an institutional approach comes in – institutions with executive power create clearer and more direct accountability.

In the euro area both governments and the Commission are in principle accountable for implementing the rules. But in practice it is often the case that governments claim little ownership over this process, diverting responsibility for the outcome to the Commission. Yet at the same time the Commission has limited powers in this domain.

With effective European institutions, however, it is possible to make a more direct link between decisions and responsibility. Precisely because those institutions are invested with defined powers, citizens can hold them accountable against their mandate.

And in fact, strengthening these channels of democratic participation is vital for the euro area today. It is exactly the impression that there is too little accountability in Europe that populist parties often exploit.

In sum, my conclusion is that there must be a quantum leap in institutional convergence. We need to move from a system of rules and guidelines for national economic policy making, to a system of further sovereignty sharing within common institutions. And as part of this process we need to strengthen the democratic accountability of Europe towards its citizens, which would automatically deepen our political union.

Let me however be clear: in the absence of institutions, rules act as a crucial anchor for confidence. So there is no question that the rules can be ignored because institutions would be better. On the contrary, they have to be fully respected so that we can make such a transition in the future. We have to build trust today by showing that what we agree to, we honour. And then we take the next steps forward as credible partners for each other.

Conclusion

Let me conclude.

The euro area has advanced a long way as a monetary union. We began with a single market, a single currency and a single monetary policy. We now have a single supervisor and resolution authority. And soon we will have a single capital market.

But we have not yet advanced far enough to put all questions about our future to bed. We need to remove those lingering doubts that resurface whenever a shock hits. And to do so we have to accelerate both our economic and institutional convergence.

Our monetary policy is helping to make this possible by creating an improving cyclical environment. But it is now up to governments to seize on this opportunity and make those improvements permanent.

Thank you for your attention.