Mario Draghi: Introductory statement at the Italian Parliament

Introductory statement by Mr Mario Draghi, President of the European Central Bank, at the Italian Parliament, Rome, 26 March 2015.

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It is an honour to be invited here to the Italian Parliament for the first time as President of the European Central Bank.

The economic situation and the short-term outlook for the euro area are currently brighter than for several years. Various factors are helping to boost confidence that the weak and uneven recovery experienced up to now will gain strength and stability and that inflation of a sustainable kind will return to the objective specified in the ECB's mandate: a level below, but close to, 2%.

There are three main factors that support these expectations of a pick-up: the positive effects of the fall in energy prices; our expansionary monetary policy, which has helped to reduce the fragmentation of the financial system and ensure that our low interest rates reach households and businesses; and the structural reforms carried out in various euro area countries, albeit at different speeds and intensity, which are now starting to have effects.

It is the second and third points – monetary policy and structural policies – that I would like to focus on in my introductory remarks this afternoon. Both policies support economic activity, both are essential, although in different ways.

Monetary policy provides cyclical support to growth, which means that it helps the economy get back to its full potential. But it cannot raise that potential because this depends on the structure of the economy and, to be precise, on structural reforms.

Similarly, monetary policy can achieve its price stability objective across the entire euro area, but only structural reforms can create real, lasting convergence in terms of productivity at national level. And because we need both in a monetary union, we need our institutional arrangements in both areas to be equally effective.

1. The role of monetary policy in the euro area

You will remember that not so long ago, at the end of 2011 and 2012, we were facing a much less favourable environment than today. The banks had hardly begun the necessary deleveraging after the financial crisis. We were experiencing a sovereign debt crisis of confidence, which in turn resulted in a severe fragmentation of the euro area financial system across national borders. And this was compounded by unfounded fears about the reversibility of the euro, which pushed national risk premia even higher.

In Italy, the yield on 10-year government bonds exceeded 7% at the end of 2011, compared with under 2% in Germany. The spread between Italian and German bonds soared again to levels similar to those in July 2012. Protection against a hypothetical default by the Italian government was trading in mid-2012 at three to four times higher than it was in mid-2011.

The level of the public debt of a country influences the state of health of its banks through two main channels.

On the one hand, the budgetary position is seen as the ultimate guarantor of the solvency of a bank: if it fails the state budget is seen as the guarantor of last resort. The higher the public debt, the more fragile this guarantee, the more the banks have to pay to finance themselves and the more capital they need to have.

On the other hand, banks hold general government debt securities in their books. When the credibility of the debt of a country is called into question, as happened in 2011 and 2012 for various reasons, the securities lose value, the sovereign guarantee is weakened exactly when the banks have to post significant losses because of the fall in value of the securities. Credit then collapses. It is not the case that low-debt countries have higher credit ratings.

In Italy, the cost of borrowing for firms stood in July 2012 at 4.1%, compared with 3.1% on average in the euro area, and 2.9% in Germany. The transmission mechanism of the common monetary policy was no longer uniform in the individual countries.

In reality these numbers underestimate the seriousness of the credit crisis that hit Italy from mid-2011 until a few months ago.

In this environment, the ability of the ECB to deliver price stability for the euro area as a whole was severely challenged. Monetary policy had to respond in a comprehensive way, commensurate with the multi-dimensional nature of the risk and simultaneously based on several channels running in parallel. By and large, we have made significant progress.

First of all, for monetary policy to be effective again across the euro area we needed to remove those unwarranted fears about the 'reversibility' of the euro. We did this in two ways. With the Outright Monetary Transactions (OMTs), i.e. the commitment to purchase government securities on the secondary market if situations were to occur in which the credibility of the euro was called into question. Together with our other non-standard measures, the OMTs have been decisive in reducing financial fragmentation.

Secondly, and of equal importance, there has been the project of establishing a banking union – based on its single mechanisms of supervision, resolution and deposit guarantees. This has contributed to boosting confidence in the sustainability of the euro area by demonstrating that governments and parliaments were willing to take corrective measures to complete monetary union.

When governments entrusted us with setting up the Single Supervisory Mechanism (SSM), we proceeded to execute a comprehensive assessment of the balance sheets of around 120 large euro area banks. This prompted many of them to take pre-emptive action to strengthen their balance sheets, including via asset sales and capital raising. This in turn resulted in a more efficient transmission of monetary policy across the euro area.

But further monetary policy action was called for. In June we adopted longer-term refinancing operations (TLTROs) to maintain bank lending to the economy.

In September, as we had by then exhausted our margin to reduce interest rates, we moved to asset purchases as a means to ease financial conditions and thereby provide further support to the economy. We announced the programme for purchasing asset-backed securities and covered bonds.

And in January, the Governing Council decided on additional stimulus when we announced that we would also purchase public sector securities. This provides a key contribution to a full pick-up in economic activity and to keeping inflation from remaining too low for too long. The decision was based on two considerations.

First, the basis of the initial pick-up was still looking too weak to ensure that inflation would return to a level close to, but below, 2%.

Second, the expansionary potential of the monetary policy interventions between June and October was still uncertain, because their effects depend on the decisions of the banks to make use of the Eurosystem loans, while the size of the private sector asset purchase programme may be fairly limited. The total take-up of loans under the two TLTROs came to €212.4 billion, in the lower range of possible forecasts. Thus the stimulus was reinforced and should become more predictable and controllable in quantity terms.

On 9 March we started these purchases of sovereign bonds and we continued to buy ABS and covered bonds. All in all, we are counting on making the €60 billion of purchases foreseen for March even though we didn't start until 9 March.[1]

At this juncture there are no signs of a scarcity of securities and market liquidity remains ample.

We intend to pursue these purchases at least until the end of September 2016 and in any case until we see an inflation path that is sustainably approaching our objective.

This assessment will be made by looking at the trends and not at the individual numbers that could result from temporary phenomena.

Early evidence shows that these measures, in combination, have been effective. Bank lending rates to firms started to decline in the second half of last year, and gradually showed less dispersion across countries. Lower interest rates in markets are now being transmitted along the entire chain of financial intermediation. The contraction of credit seems to be reversing. And the lower cost of finance – both of debt and equity – means that investment projects which were previously unprofitable become attractive.

GDP growth projections by ECB staff were raised from December to March, by 0.5 percentage point for 2015, and 0.4 percentage point for 2016. Inflation is projected to be zero for the euro area as a whole in 2015, largely because of the fall in oil prices, but projections for subsequent years have been raised to 1.5% in 2016 and 1.8% in 2017.

This underpins the optimism that monetary policy is contributing to deliver a more robust cyclical upturn, and that the Governing Council of the ECB will fulfil its mandate.

2. From monetary policy to structural policies

We know that, by itself, monetary policy cannot create lasting growth of a structural kind. And it cannot create even growth because it is not the right tool to correct divergences between countries that emanate from low growth potential and high structural unemployment.

At the same time, we cannot expect those divergences to be addressed through means such as permanent transfers from economically stronger countries. The euro area was not created to be a union with permanent creditors and debtors. It is an area where each country, by exploiting its comparative advantages and the opportunities afforded by the Single Market, and by converging to the highest standards in terms of competitiveness and income, must be able to stand on its own two feet.

And this is where structural reforms come in.

They are essential to raise potential growth, which provides the basis for lasting prosperity. They are also essential to make economies more resilient to economic shocks, and help them diverge less when a crisis hits. And both these effects are today more important than in the past as we face a large stock of outstanding debt and an ageing population.

Yet, in several euro area countries, potential growth has been gradually waning, even well before the introduction of the euro. In Italy, potential growth declined from an average estimated at around 2.5% in the early 1990s, to 1.5% by 1999. The decline continued afterwards, and is now estimated by the IMF and other institutions to be close to zero.

So how can we reverse this trend?

Raising potential growth is principally about lifting the labour supply (the amount of hours people work in the economy) and productivity (how much people produce per hour worked).

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[1] See my introductory remarks at the Economic and Monetary Affairs Committee of the European Parliament, Brussels, 23 March 2015, http://www.ecb.europa.eu/press/key/date/2015/html/sp150323_1.en.html.

Given our ageing population, however, we can only expect limited gains on the labour side. We therefore have to focus our efforts on making our economies more productive.

For most countries in Europe, and for Italy in particular, productivity growth rates have been very modest. Between 2000 and 2013 productivity[2] in the euro area grew cumulatively by 9.5%, by barely 1.3% in Italy and by 26.1% in the US. Total factor productivity[3], which assesses the efficiency of the use of inputs to productive processes, has only grown by 1.1% in the euro area. In Italy it has fallen by 7.7% and in the US it has risen by 10.5%.

Productivity can be raised through the emergence of new firms using more efficient technologies and by the reallocation of resources among already existing firms. The benefits of technological progress often appear over the longer term because the efficient use of a new technology often takes a long time to learn, while the reallocation of resources can lift productivity over a shorter time horizon, given that it implies a shifting of resources within already active firms.

If we want to raise productivity quickly, the key factor is reallocation. Firm-level analyses in the euro area suggest that there is much scope for improvement here.[4] Within individual countries there are a few highly productive firms and many which have low productivity. It is essential to act so that those high-productivity firms can grow, so that they can benefit from an adequate flow of capital them and so that the people have the skills needed to be able to work there. To achieve each of those three goals – growth, finance, skills – we need structural changes.

3. Structural reforms and reallocation

With reference to the first objective, the “up-or-out” dynamic of young, expanding firms has been shown in many studies to be central to productivity growth. To facilitate that process the regulatory and legislative environment at the national level needs to be supportive. This is not always the case in the euro area. This is why reforms to complete the Single Market and improve the business environment are so important.

In some countries firms are hindered from growing by regulations and by unfavourable tax treatment that is triggered at certain thresholds. In Italy there is very high concentration of micro firms whose productivity is significantly below the average; regulations that encourage them to stay small contribute to this.

The length of judicial proceedings for bankruptcy crucially affect how quickly capital can be released for new investment projects. Italy has the slowest civil proceedings in Europe. Judgments of first instance in civil and commercial cases take 1.5 years in Italy, compared with eight months in Spain and only six months in Germany.[5] Recent studies suggest that halving the length of these proceedings would increase the average firm size by 8–12%.[6]

Above all, it is crucial to improve the environment for firms in Italy. It’s necessary to ensure clear and predictable rules, effective judicial protection, respect for contracts. The efficiency of public administration, a well-functioning labour market and the promotion of competition are essential. In recent years various initiatives in these areas have been taken. It’s good to continue along this path.

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2 Real value added per hour worked, total economy (sources OECD and EU KLEMS).

3 Total factor productivity, total economy.

4 CompNet Task Force (2014), “Micro-based evidence of EU Competitiveness: The CompNet Database”, ECB Working Paper Series No 1634.

5 EU Justice Scoreboard 2015, European Commission, 2015, http://ec.europa.eu/justice/effective-justice/scoreboard/index_en.htm.

6 Giacomelli, S., and C., Menon (2012), “Firm size and judicial efficiency: evidence from the neighbour’s Court”, Banca d’Italia Working Papers, No 898, January 2012.

Ensuring that capital can flow to the most productive firms also requires a healthy banking sector that can expand credit. This in turn means that any bad loans that have been made in the past need to appear without delay on the balance sheets of the intermediaries and that steps need to be taken quickly to resolve the problem. That process has already begun with the ECB's comprehensive assessment. The ECB looks favourably on new initiatives to help Italian banks reduce the weight of impaired items on their balance sheets; they will free up resources and above all be of benefit to firms.

Finally, perhaps the most important thing is to equip people with the right skills to be able to find jobs in the firms of the future.[7] Italy, like the rest of the Europe, is engaged in a global economy in which technological progress tends to favour skilled over unskilled labour, raising its relative productivity and demand. So skills have to evolve everywhere.

In the euro area today skills and employment are already strongly linked. In 2013 more than 19% of workers[8] with low education levels were unemployed, compared with only 7% of highly educated workers. This is why education and training need to be as much a part of the reform agenda as cleaning up banks and reducing red tape.

Improving skills also has another dimension. Reallocating resources creates both winners and losers. It can create insecurity in particular for those who might have to change jobs, or more generally raise uncertainty about the future. I fully realise that our perspective on these issues cannot be based purely on grounds of efficiency; we also have to think about equity. Both are necessary. They have to be reconciled.

Improving skills provides a way to do this because, on the one hand, it increases economic efficiency, it creates new job opportunities, and on the other hand it makes the economy more equitable by allowing as many people as possible to seize those opportunities.

Education, training and retraining have to go hand in hand with flexibility.

The best way to protect citizens today is not to shield them from the risk of losing their job, but to ensure they have the knowledge to be able to find a better job more quickly, and this applies also to those who have been unemployed for a long time and need retraining programmes.

In this context, the monetary policy measures I have already described reinforce the reform process. They stimulate overall demand, creating more jobs, more favourable conditions on the credit market and the possibilities for reallocating resources. In short, monetary policy and structural reforms are complementary.

4. Ensuring economic convergence through institutional convergence

Despite the importance of structural reforms for economic convergence and monetary policy, such reforms remain largely a national responsibility. This adds an element of fragility to our union. There is no way to guarantee that countries will take the measures necessary to ensure their fitness for monetary union. In my view this has to change.

Monetary union creates deep integration between its member countries and, as such, a high degree of mutual vulnerability. We have therefore always applied the principle that if policies in one country can have large effects on others, they have to be governed by common rules or institutions. This is why we have the fiscal framework, for example, as a default in one country would cause damage to all its partners. And I think it is now clear that the principle should also apply to structural policies because a low growth potential creates macroeconomic imbalances between the countries. The vulnerability which derives from this affects the other countries of the euro area.

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[7] See my speech at the inauguration of the New ECB Premises, Frankfurt am Main, 18 March 2015, http://www.ecb.europa.eu/press/key/date/2015/html/sp150318.en.html.

[8] Working age population from 25–64 years of age.

If countries do not have effective structural policies, and so permanently diverge in terms of unemployment and growth, then questions start to be asked about their membership of the Union. And such questions do not affect only them. As we have seen on several occasions over the last few years, they create self-fulfilling fragmentation with repercussions for the other countries in the Union.

Hence, 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 continuously meeting the membership requirements. And this implies that we need a higher degree of institutional convergence in the structural domain than we have seen so far.

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 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 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 rules-based approaches – such as the macroeconomic imbalance procedure – have so far not attracted much ownership from national policy-makers.

So in my view the conclusion from recent experience is clear: if we agree that further institutional convergence is needed in the structural domain, then our long-term goal must be to move from a rules-based system to one based on stronger European institutions.[9]

I must stress however that to make such a step, we first have to respect and follow the rules we have now. If we look at monetary policy as an example, we did not begin by creating a new institution. This would have been impossible. We had a series of rules-based systems – the "snake", the European Monetary System, the Exchange Rate Mechanism – the experience of which led us to create the single currency and the European Central Bank. These various stages were however essential, because they gradually built trust between countries and led to a convergence of views about how best to conduct monetary policy.

So there is no question today that the rules can be ignored because institutions would be better. On the contrary, it is only by following our rules that we can establish the mutual trust on which future institutions can be built. It is essential that the European Parliament makes this process its own and imbues it with democratic legitimacy.

5. Conclusion

The way forward for the euro area that I have described today may seem simple, but it isn't. It requires vision and perseverance. All those involved have to play their part in a sustained economic recovery.

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[9] See my speech at SZ Finance Day 2015, Frankfurt am Main, 16 March 2015, http://www.ecb.europa.eu/press/key/date/2015/html/sp150316.en.html.

But I also recognise that, in the process, we must not lose sight of what economic policy is about. Economic growth is not an end in itself – its purpose is to empower individuals and to raise the sum of human happiness. So we have to ensure that everyone can make a contribution – and that efficiency and equity are reconciled and no one is left behind.

Some believe that the best way to achieve this is to unwind integration – that inequity comes from Europe doing too much. Others believe that we should press ahead with more integration based on more financial solidarity between nations. They think the source of our problems is Europe doing too little.

But retrenching behind national borders would not solve any of the problems we face today – we would still have to work through our demographic challenges, low productivity and high debt. More people would end up unemployed.

Holding out an unrealistic vision of European integration is not the answer either. We are not a Union where some countries permanently pay for others. And to hope for this only distracts us from taking our responsibilities and facing our national challenges.

So the best way to answer the concerns of our citizens is to chart a course ahead that is both ambitious and pragmatic; that involves both acting at the national level where necessary and integrating at the European level where appropriate.

The monetary policy stimulus we are providing, combined with the structural reforms and institutional changes that governments must engineer, are all part of that course. They would go a long way towards creating a more stable Union that produces stronger and more inclusive growth. And I trust that this parliament, as it always has, will play a central role in that process.