Mario Draghi: How domestic economic strength can prevail over global weakness

Keynote speech by Mr Mario Draghi, President of the European Central Bank, at the Deutsche Börse Group New Year's reception 2016, Eschborn, 25 January 2016.

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Thank you, Mr Faber, for your very kind introduction. And let me start by echoing what you said about the critical importance of financial market infrastructures. As we move towards a Capital Markets Union in Europe, strong market infrastructures are essential. In that context, I welcome the fact that Deutsche Börse will be participating in our new TARGET2-Securities system, which will help reduce financial fragmentation and make Europe a better place to invest in.

The euro area has started the New Year facing two opposing forces: a strengthening domestic economy and a weakening global one.

At home, the recovery is proceeding, with consumption as the main driver. That is being supported by our accommodative monetary policy, falling energy prices and a neutral fiscal policy. Employment is rising, up by over 2 million people compared with the trough in 2013.

But in the world economy there is more uncertainty. Developments in China and other emerging markets have led to a slowdown in global demand and financial market uncertainty. Forecasts for global growth are being cut.

The key question for policymakers in the euro area in 2016 will be which of these forces gains the upper hand. Our number one challenge, as a union, is to make sure that domestic strength prevails over global weakness.

Our ability to influence the world economy is limited. But we *can* affect what happens in the euro area. We can take the measures necessary to strengthen our economies and make them more resilient to global shocks. For that, all policymakers need to play their part.

The key element is confidence. Confidence in growth, confidence in stability, and confidence in the future of the euro area. Only by building confidence can we turn the ongoing cyclical recovery into a robust, structural recovery.

The role of the ECB

The ECB has a central role to play in supporting confidence. We do that by fulfilling our price stability mandate: an inflation rate of below, but close, to 2%.

To that end we launched last year our asset purchase programme, or APP, to put inflation on a path back towards 2%. And last December we decided to recalibrate the APP to secure that path.

That decision was taken because of new downside risks which threatened the outlook for price stability. Those risks were largely linked to external factors, and ones which might not be temporary. With inflation already low for some time, we saw a danger that a continued period of low inflation – even if oil-driven – might destabilise inflation expectations and become persistent.

That risk was heightened by the fact that "core" inflation, which strips out energy and food, was also low. Core inflation is not our objective, but it tends to lead headline inflation over the medium-term.

All this called for a monetary policy response. And we chose to respond by recalibrating the APP because we have ample evidence that it works.

I've described that evidence in detail elsewhere[1], but let me give you just one example. Since the middle of 2014, when we launched our credit easing package, bank lending rates have fallen by 80 basis points for the euro area, and by between 100 and 140 basis points in the countries hit hardest by the crisis. To put that in perspective, to have a similar impact on lending rates with conventional policy would've required a one-off rate cut of *100 basis points*.

What this shows is that, even when rates are at zero, we can achieve the effect of a sizeable rate cut through unconventional measures. Overall, it's clear that the impact of the APP on confidence, credit and the economy has been substantial.

Some may wonder why we go to such lengths to meet our price stability objective. Isn't it good for people if inflation is low and things are cheaper?

Certainly, in the short run, a fall in inflation helps consumers. But if inflation stays too low for too long it actually harms them. And that's particularly the case in a post-debt crisis environment like the one we face in the euro area today.

Very low inflation complicates the adjustment process within countries, leading to higher unemployment. It delays the rebalancing process across countries, hindering those that lost competitiveness prior to the crisis from regaining it. And if low inflation is unexpected, it raises real debt burdens making it harder for the economy to grow out of debt.

For example, if euro area inflation were to undershoot our baseline by just 1 percentage point each year for the next five years, it would increase the private debt ratio by around 6 percentage points. That might not sound like a big figure. But, over five years, it's equivalent to €700 billion in extra debt for firms and households at a time when we should be aiming to reduce debt.

More fundamentally, meeting our objective is about credibility. If a central bank sets an objective, it can't just move the goalposts when it misses it. Confidence comes from every party fulfilling its mandate. And that's what the ECB will do, as the Treaty demands of us.

Questions about the ECB's policy

So the ECB is playing – and will continue to play – its part in supporting confidence, price stability and a robust recovery. But I know that our policies are not uncontroversial. The low interest rate environment and our unconventional measures are seen by some as a cause for concern. I would not be surprised if that is the case for many of you here.

Let me discuss what I see as the three main issues.

The first is the perception that low interest rates unfairly punish savers. Low interest rates of course lead to lower returns on safe assets, such as deposits. But what matters for savers is what their assets can actually buy – i.e. real returns – and how their *overall* portfolios are performing. And it turns out that on this metric, the situation isn't nearly as bad as it's often thought to be.

As our colleagues at the Bundesbank have shown[2], the real return on a typical private portfolio for a German household since 2008 has been around 1.5%. That is lower than the pre-crisis average, to be sure. But it's hardly an "expropriation" of savers. In fact, it's better than in several repeated periods since the early 1990s.

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[1] See speech by Mario Draghi at the European Banking Congress: Monetary Policy: Past, Present and Future, Frankfurt am Main, 20 November 2015 https://www.ecb.europa.eu/press/key/date/2015/html/sp151120.en.html

[2] Bundesbank Monthly Report article: German households' saving and investment behaviour in light of the low-interest-rate environment, October 2015: https://www.bundesbank.de/Redaktion/EN/Downloads/Publications/Monthly_Report_Articles/2015/2015_10_households.pdf?__blob=publicationFile

A related concern is that low interest rates cause people to save more to make up the difference and are therefore self-defeating. But that's also not quite right. The Bundesbank study I just mentioned shows that just 1% of German households are saving more because of low interest rates. For the vast majority – 77% – those rates have not caused them to adjust their savings behaviour.

What low interest rates *are* doing, however, is stimulating the economy and especially the demand for durable goods, like cars. That supports the recovery, boosts incomes and will ultimately lead us back to normalisation more quickly. If, on the other hand, we were to raise rates today, the opposite would happen. It would simply push us back into recession and rates would stay lower for longer.

The second concern about our policy is that it threatens financial stability. Low interest rates, it's said, discourage balance sheet repair and create "zombie banks". It's also claimed that they encourage excessive risk-taking, leading to bubbles. And the longer they last, the worse the risks get.

These are doubtless important issues – but is it really the task of monetary policy to react to them?

After all, as far as policymaking is concerned, what matters for the health of banks is not the level of interest rates, but the quality of supervision. And thanks to the creation of the Single Supervisory Mechanism (SSM) and the comprehensive assessment of banks' balance sheets, banks are actually stronger now than they were a few years ago. Capital ratios for euro area banks have risen from around 8% in 2007 to close to 14% today. In other words, the risks are currently *falling*, not rising.

What's more, though low interest rates can encourage risk-taking, there are no warning signs of serious financial instability. Financial crises are typically associated with strong credit growth and rising leverage in the banking system. What we see at the moment, however, is a nascent credit recovery and *de*leveraging among banks. In fact, coming out of a deep banking crisis, rapid credit growth would really be a "luxury problem"!

That's not to say we don't see pockets of exuberance, for example in some housing markets. But euro area interest rates are set to achieve macroeconomic objectives, not to prick local bubbles. In fact, we've established a whole new macroprudential toolkit since the crisis precisely for that purpose, and if necessary countries should use it. And let me also add that if we did at some point see a generalised overheating in the economy, it's never a problem for central banks to withdraw excess liquidity.

The third concern about our policy is that it takes the pressure off governments to pursue structural reforms. But there are several problems with this argument.

For a start, it doesn't work institutionally. It's not the role of the ECB to use its monetary policy to force governments to reform. That's not our mandate in the Treaty. And frankly, for us to act in that way would be totally illegitimate as unelected central bankers.

It doesn't work empirically either. There's not necessarily any connection between interest rates and reforms. For example, Spain started its labour market reforms when interest rates had already gone down. Italy passed a labour market reform last year in tranquil market conditions. Likewise, France is pursuing the Macron reforms with no market pressure.

And the argument doesn't work logically. Think about the types of reforms that euro area countries really need – reforms to judicial systems, to education, to public administration. Such reforms are difficult and can take a decade to bear fruit. Enacting them takes personal conviction from politicians and a popular mandate for change. Whether interest rates are temporarily higher is immaterial.

In fact, what typically happens when interest rates are high is not long-term reforms, but rather short-term fixes to placate the markets. And that normally means consolidating budgets by raising taxes, which makes the recession worse. That in turn creates an even harder environment for structural reforms as the costs are higher in a depressed economy.

So if we look at these concerns together, we can see a common theme. While each contains a grain of truth, there's another side to the story which isn't receiving the same attention. And this follows a pattern that we've seen throughout the crisis.

In the course of the last few years some commentators were cautioning that our policies would cause runaway inflation. They didn't. Others warned that we were exposing ourselves to heavy losses from expanding our balance sheet and accepting lower-quality collateral. In fact we haven't had a single loss. Then those same authorities claimed that our policies were illegal. The European Court of Justice disagreed. Now they warn us about the side-effects and risks of what we're doing.

But what I never hear them discuss is *the risks of doing nothing*. What would that mean for our price stability mandate, and therefore for growth and jobs, and eventually, for the future of our monetary union? Those are, to my mind, the real risks we have to be concerned about. And the path our monetary policy is taking is, in that sense, the path of risk reduction.

The role of other policymakers

Still, we've always said that monetary policy alone cannot be the solution. To give confidence a solid foundation, we have to help a cyclical recovery turn into a structural recovery. That depends on other policymakers in the euro area playing their part.

There are four key areas where decisive action could build confidence in 2016.

The first is fiscal policy. For a strong recovery, we need fiscal policy to work with, and not against, monetary policy. And after much hard work, we now have a broadly neutral fiscal stance in the euro area. But many countries still need further structural adjustment to boost confidence in their public finances. So the challenge is how to do that with as little damage to growth as possible.

The key to growth-friendly consolidation is the *composition* of adjustment: on the expenditure side, cutting government consumption rather than investment; and on the revenue side, shifting and possibly reducing the tax burden rather than raising it. But what also matters, of course, is that we lift the growth potential of our economies to help grow out of debt. That brings me to the second area where we need action: structural reforms.

Structural reforms are essential to boost employment, especially in countries that are absorbing large numbers of refugees. They're essential to kick-start a recovery in private investment. And they're essential to lift productivity, so that our shrinking workforces can support our ageing societies.

Every country of course has its own challenges. But if I had to pick out one cross-cutting reform agenda item for 2016, it would be this: making it easier to do business in the euro area. That's not necessarily about deregulation, but rather taking practical steps to improve the business environment, such as speeding up judicial procedures, or reducing the time and costs for setting up a business. Such reforms would have a direct positive effect on investment, but unlike some other measures, they would have little negative impact on inflation or employment in the short run.

A third area is dealing with the high levels of public and private debt which are casting a shadow over the recovery. Part of the solution is to have well-designed corporate insolvency regimes that can separate viable from non-viable borrowers and facilitate the valuation of assets to be sold off. But it's also key for confidence that the bank resolution process is absolutely clear.

In particular, we need to make sure that the new bail-in rules are applied evenly across countries and with the minimum scope for national discretions. We also still don't have agreement on a backstop for the Single Resolution Fund. And a European deposit insurance scheme would signal progress in completing banking union.

That brings me to the final area for action: completing our monetary union. The Five Presidents' Report has laid out a long-term vision for Economic and Monetary Union (EMU) and a sequence of steps towards it. Now we need to realise the short-term steps that will lend credibility to that long-term vision – first and foremost, by finishing all three pillars of banking union.

Removing the fragility of EMU, by making progress with both the short-term steps and the long-term vision, would bring about a vital boost to confidence in Europe.

Conclusion

Let me conclude.

The outlook for the global economy in 2016 is uncertain. But our challenge, in the euro area, is to ensure that global headwinds do not blow our domestic recovery off course. For that, all policymakers need to work to build confidence.

The ECB is contributing to securing the cyclical recovery by fulfilling our price stability mandate. And the concerns surrounding our monetary policy do not stand up scrutiny. Time and again, the critics of our decisions have been proved wrong. The ECB has acted independently from the political system and for the sake of the euro area as a whole.

To turn the cyclical recovery into a structural recovery, however, others have to play their part. That entails concerted action on fiscal policies, structural reforms and reducing the debt overhang. Most of all, we need to continue the process to complete our monetary union on all the necessary fronts.