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Bank restructuring and the economic recovery

Speech by Mario Draghi, President of the ECB, at the presentation ceremony of the Schumpeter Award, Oesterreichische Nationalbank, 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.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, President of the ECB, Brussels, 3 March 2014

Madame Chair,

Honourable Members,

This is my last hearing in ECON before the end of this legislature. I would like to first of all thank you, Sharon, for the way you have guided this committee throughout a challenging period.

Let me also thank all of you for the frank and fruitful exchanges we have had in the last two-and-a-half years. It has been an invaluable experience for me. In these difficult crisis times, discharging accountability in front of an assembly with a true European perspective has been helpful for the public acceptance of our actions. Moreover, the hearings have always been a welcome occasion to discuss the state of Economic and Monetary Union between two genuinely European institutions and to debate about what is the right way forward. I am very much looking forward to continuing this approach with the new ECON committee from July onwards.

I would like to take the opportunity of this last hearing to take stock of the monetary policy that the ECB has conducted over the last five years and to review what has been achieved in the euro area over the course of these years. Let me then also offer our assessment of the challenges that lie ahead and that will await the new Parliament and the new Commission.

Before I start to go into detail in these three areas, let me however remind you that the next meeting of the ECB Governing Council takes place on Thursday. In view of the so-called purdah period, you will understand that I will not be able to give detailed answers on our monetary policy stance today.

Five years of monetary policy – the ECB has delivered

In the last five years, the ECB has continued to take the necessary measures with a view to maintaining price stability in the euro area.

Let me turn back to the first hearing of this Parliament's term which took place with my predecessor in September 2009. At the time, the economy was just bottoming out in the aftermath of the great contraction which had ensued after Lehman's failure. We were witnessing negative inflation rates. In this environment, the outlook was seen to be broadly in line with price stability. Inflation was projected to increase toward levels close to 2%. The key ECB interest rates were kept on hold at the very low level to which they had been brought in several stages since the autumn of the preceding year. Some phasing-out of non-standard measures was announced.

However, in May 2010, sovereign debt markets froze in various euro area Member States. Financial fragmentation took a new and unfamiliar form, with financial conditions and the transmission of our monetary policy varying to a great extent across Member States. We responded by introducing the Securities Markets Programme, focused on purchases of government bonds.

Initially, while the economic impact of the sovereign debt crisis was limited and largely confined to vulnerable economies, the rapid global recovery put upside pressure on energy prices. This drove up inflation also in the euro area. We decided to raise interest rates in early 2011 given upside risks to

the medium term inflation outlook stemming from energy prices and from ample monetary liquidity.

However, the sovereign debt crisis deepened and the euro area entered a second recession. The inflationary pressures that had emerged before receded. Therefore, we lowered interest rates in a series of steps. Stress in sovereign debt markets quickly undermined the wholesale funding conditions of banks based in those Member States. To forestall a credit crunch, we introduced refinancing operations with maturities of up to three years, in a context of full liquidity allotment at a fixed rate.

As the mutual exposures of banks and their sovereigns fed an adverse, self-reinforcing confidence crisis, investors started to fear that public and private liabilities issued in certain Member States would not be redeemed in our common currency. A significant redenomination risk arose.

As you know, the integrity of the euro area is an absolute precondition for us to be able to deliver on the mandate prescribed by the Treaty and in particular to ensure a smooth transmission of our monetary policy. In order to preserve this integrity, we thus announced our readiness to conduct Outright Monetary Transactions with the specific purpose of removing compensation for that risk from the financial pricing of securities. This announcement reversed the destabilising capital flows that redenomination fears had encouraged in spring 2012.

While financial markets had been on a steady course toward normalisation for some months, in late spring and summer of 2013 the euro area money market – not unlike elsewhere in the global financial system – became subject to external shocks. We noted a sustained increase in expected interest rates. This was unwarranted in view of our underlying macroeconomic conditions, and was not in line with the Governing Council's policy intentions. In July last year we therefore clarified the orientation of monetary policy going forward: we offered forward guidance on the future path of policy conditional on the evolving outlook for price stability.

All our measures, standard and non-standard, have been taken to serve our primary objective of maintaining price stability. And they have delivered: since June 2009 (i.e. the start of this legislature) the average inflation rate in the euro area has been 1.8%. In exceptional circumstances, our measures were exceptional. But our commitment to our primary objective has not changed, and our strategy has remained the guide of our action. Our credible commitment to these core elements is reflected in medium to longer-term inflation expectations remaining firmly anchored in line with the Governing Council's aim of keeping inflation rates below, but close to, 2% over the medium term.

Five years of economic and governance reforms – the euro area is more stable and resilient

The last five years have not only seen effective *monetary* policy-making in the euro area – we should also remind ourselves that much has been achieved in the field of *economic* policy-making.

Four years after the first Member States requested financial assistance, today we can safely say that the worst has been averted. The political will of all actors involved has been strong enough to defend the integrity of the euro area. Many had underestimated this will.

And more than that: Contrary to the bleak picture that some are trying to paint these days, the euro area is – in terms of economic fundamentals and institutional set-up – on a better footing than it was

at the beginning of this Parliament's mandate. It is clearly moving in the right direction – the glass is at least half-full.

To a large extent, this can be attributed to the correction of economic policies at the national level. Imbalances are receding and foundations are being laid for improved competitiveness and stronger growth. This is especially true for programme countries, which have undertaken a remarkable effort to consolidate public balance sheets, repair their financial sectors and reform the structure of their economies.

Beyond national policies, the euro area as a whole has become more resilient. In these turbulent years, when the return to national remedies often looked tempting, the European Parliament with its true European perspective played a crucial role in ensuring truly European solutions. I am aware that the institutional approach that had to be taken at some instances has created some discomfort especially within your house. But overall, let us recognise what has been achieved:

First, the six-pack, the two-pack and the Fiscal Compact have made the governance framework more commensurate to the challenges of a monetary union. This was an important step towards sound public finances in the euro area.

Second, improved financial regulation (as exemplified by CRD IV and by the compromise reached on the BRRD) and the gradual steps towards a true banking union (with a single supervisor, a single resolution mechanism and a harmonised framework for national deposit guarantee schemes) will importantly reduce the risk that a crisis of the magnitude that we have just experienced will materialise again.

Third, in 2010, there had been no arrangements in place to deal with Member States losing market access. This absence had created major uncertainty in markets about the way forward. With the ESM and the two-pack, both a permanent funding instrument and a governance framework have been created. This has been a major step forward and will ensure that in the future, the euro area will be better prepared to respond to such crises.

In historic perspective, five years are a blink of an eye. In less than five years, the euro area has taken a remarkable leap forward that has kept us together. This cannot be highlighted enough in the weeks to come.

The next five years ahead – towards completing the Union

I have no doubt that from July on the next parliament will continue to assume the important role this house has played in the last legislature. The challenges that still lie ahead of us are too important and too complex to indulge in complacency. It is too early to claim "mission accomplished".

People in the euro area are still suffering from the inevitable adjustment process following years of accumulated imbalances. Unemployment remains unacceptably high. Citizens are judging Europe on its capacity to deliver jobs and sustainable growth. The years to come are about creating a more perfect union that caters to these objectives.

Foremost, this means delivering on commitments made in the past. Member States need to keep their promises to correct imbalances and to reform the structure of their economies. Fiscal policies have to be brought in line with the provisions of the Stability and Growth Pact and of the Fiscal Compact. Fiscal consolidation should be designed in a growth friendly manner while structural reforms will boost potential growth.

This concerns all Member States, not just those who looked at some point into the abyss of losing market access. This concerns also the European institutions. They have to ensure that common rules are thoroughly and evenly applied.

Delivering on past commitments also means keeping the promise made by Heads of States or Governments in June 2012 to complete banking union. It means swift transposition of agreed directives into national law and a stringent application of the adopted regulatory framework. It also means that a strong second pillar of banking union, a Single Resolution Mechanism, needs to be agreed before the end of this legislature.

Creating a more perfect union also requires filling the remaining gaps in the architecture of Economic and Monetary Union. A genuine and comprehensive Economic and Monetary Union as outlined in the Four Presidents Report should still remain our long-term objective.

This does not mean pushing integration as far as we can. This is neither economically necessary nor politically realistic. It means aligning economic governance and policies of Member States where appropriate to ensure that positive spillovers are enforced while negative externalities are minimised. Sharing sovereignty in crucial policy areas is certainly one way to accomplish this.

It is not for a central bank to prescribe solutions. This is a political prerogative. But it is my hope both as a central banker and as a European citizen that the upcoming electoral campaign will serve as an opportunity to engage in a debate on solutions for Europe's common way forward.

Thank you for your attention. I am now looking forward to your questions.

The path to recovery and the ECB's role

Speech by Mario Draghi, President of the ECB, at the Symposium on Financial Stability and the Role of Central Banks organised by the Deutsche Bundesbank, Frankfurt am Main, 27 February 2014

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Summary

The euro area has made considerable progress on its reform agenda, says ECB President Mario Draghi. Speaking at a conference organised by Germany's Bundesbank in Frankfurt he emphasises that euro area governments have improved their fiscal positions despite recessionary headwinds and stressed euro area countries have become more competitive. "In parallel, the architecture of EMU has been strengthened in ways that many would have considered inconceivable two years ago", says Mr Draghi. The move towards a banking union is crucial not only for the functioning of the financial system, but also for the conduct of monetary policy.

Since the beginning of the crisis the ECB's Governing Council has taken decisive steps to engineer a monetary policy stance that is commensurate with the subdued medium-term inflation outlook. But standard monetary policy in the form of rate cuts was not enough to ensure an appropriate monetary policy stance, because unwarranted fears of euro break-up impaired the monetary

transmission, he says. Against this background the ECB announced Outright Monetary Transactions (OMT). Like all the ECB's monetary policy measures, OMT served, says Mr Draghi, to ensure compliance with the bank's price stability mandate.

"And it builds on an established monetary policy doctrine that has gained prominence not least through its successful adherence by the Bundesbank for several decades," Mr Draghi says. "Namely that the central bank should be endowed with a clear price stability mandate and, within this mandate, should be allowed – in fact obliged – to use its instruments in full independence to deliver price stability."

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Ladies and Gentlemen,

It is a great pleasure to speak to you tonight.

When I last spoke at an event organised by the Bundesbank, in March 2012, the euro area stood at a crossroads. One direction pointed to continued malaise, with various vulnerabilities threatening to undo the benefits of economic, financial and even monetary integration. The other direction pointed to gradual repair, with ambitious reform efforts removing the key obstacles to economic stability and growth.

The euro area has chosen the latter path. And today, we are seeing first signs that this decision is paying off. At the same time, challenges remain and continued reform efforts are needed to ensure that the recovery proves sustainable.

Against this background, let me first elaborate on what I think are the key milestones achieved so far and then address what are the key challenges for the ECB in the coming months.

What have we achieved so far?

The euro area reform agenda has consisted of two pillars. One is to restore fiscal sustainability and economic competitiveness at country level. The other is to fix structural shortcomings in the euro area architecture that had allowed imbalances to build up in the first place.

On both counts, the euro area has made considerable progress.

Despite strong recessionary headwinds, euro area governments have markedly improved their fiscal positions. Average government deficit ratios fell by more than a quarter over the last two years and, excluding interest payments, were approaching balance at the end of 2013.

Simultaneously, most of the stressed euro area countries have made remarkable progress in gaining competitiveness. Over the past five years, the cumulative unit labour cost differential vis-à-vis the euro area have fallen by more than 20 percentage points in Ireland, around 15 percentage points in Greece and Spain, and almost 10 percentage points in Portugal. This was accompanied by substantial improvements in the export dynamics of these countries.

Overall, we see the euro area's economic recovery gradually taking hold, albeit at a slow and uneven pace.

In parallel, the architecture of Economic and Monetary Union (EMU) has been strengthened in ways that many would have considered inconceivable two years ago.

Perhaps most important for monetary policy, and certainly most topical for this conference, are the concrete and ambitious steps towards a banking union.

By establishing the Single Supervisory Mechanism (SSM), European policy-makers have demonstrated a firm commitment to a stringent and uniform application of common supervisory standards. As a crucial counterpart, policy-makers are in the process of establishing the Single Resolution Mechanism, which should enable quick and efficient resolution of ailing banks without permanent recourse to taxpayer funds.

Together, these new institutions will fundamentally strengthen transparency, stability and incentive-compatibility in the financial sector.

In a primarily bank-based financial system like the euro area's, these features are crucial, not only for the functioning of the financial system per se, but also for the conduct of monetary policy.

This is because, with an impaired bank lending channel, monetary policy may lose its handle on the real economy and ultimately inflation. At the same time, given the persistent downside risks to price stability, monetary accommodation was a necessary ingredient in the crisis response.

How has monetary policy contributed?

Accordingly, since I last spoke at this venue, the ECB's Governing Council has taken further decisive steps to engineer a monetary policy stance that is commensurate with the subdued medium-term inflation outlook.

These steps included a sequence of further rate cuts, accompanied since July 2013 by explicit communication that we expect the key ECB interest rates to remain at current or lower levels for an extended period of time.

But standard monetary policy in the form of rate cuts and the accompanying communication were not enough to ensure an appropriate monetary policy stance.

In fact, given unwarranted fears of a euro area break-up, monetary policy transmission became severely impaired – to the extent that the financial market dislocations jeopardised our ability to deliver on our price stability mandate.

It was against this background that we announced the Outright Monetary Transactions (OMTs). Like all our monetary policy measures, it has served to ensure compliance with our price stability mandate as provided for in the Treaty.

And it builds on an established monetary policy doctrine that has gained prominence not least because it has been successfully pursued by the Bundesbank for several decades. Namely that the central bank should be endowed with a clear price stability mandate and, within this mandate, should be allowed – in fact obliged – to use its instruments in full independence to deliver price stability.

Combining a clear mandate with strong independence in pursuing that mandate is particularly important when conducting a single monetary policy in EMU, which consists of 18 countries with heterogeneous economic structures and institutional landscapes.

On the one hand, it allows us to flexibly tailor our policy measures to the specific monetary policy challenges that may arise in this multi-country context – most notably to tackle the financial fragmentation that has hampered monetary policy transmission during the crisis. On the other hand, it establishes a stable anchor for inflation expectations through our price stability objective.

This approach of "constrained discretion" is what made the track record of the Bundesbank and then the ECB so successful. And this approach is further validated by the strong progress towards restoring the singleness of the euro area's monetary policy observed since the announcement of the OMTs.

Since summer 2012, Target balances have shrunk by about a third. Spreads on long-term sovereign bonds vis-à-vis Germany have fallen by around 350 to 450 basis points for Spain, Italy and Ireland, and by more than 600 basis points for Portugal. Spreads in corporate debt markets have fallen by more than 150 basis points for some important market segments, and thus have made it easier for firms to raise funds in the market.

What challenges are yet to be tackled?

Despite these achievements, several challenges remain. Let me focus on three challenges for the ECB.

One of them relates to a prolonged period of low inflation. Since the review of the ECB's monetary policy strategy, which took place in 2003 under the auspices of Otmar Issing, the ECB has aimed at inflation rates below, but close to, 2% over the medium term.

To be sure, current HICP inflation, which stood at 0.8% in January, can clearly not be considered close to 2%. Is this a reason for concern?

With the average euro area inflation rate standing at 0.8%, we are clearly not in deflation, which is defined as a self-reinforcing fall in prices that is broad-based across items and across countries.

Moreover, inflation expectations for the euro area over the medium to long term continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2%.

What we are experiencing now is a prolonged period of low inflation, which will be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on.

Of course, inflation remaining low for a prolonged period of time is a risk in itself. It implies that there is only a small safety margin away from zero. And it makes structural adjustment efforts more difficult.

Hence, it is important to carefully assess the causes of low inflation. In recent times, energy price developments in particular put downward pressure on headline inflation, a phenomenon that has contributed to weaker inflation at the global level. Moreover, low inflation partly reflects internal rebalancing efforts by way of which several countries, especially those in economic adjustment programmes, have aimed at improving their competitiveness.

However, the low inflation outlook is also driven by continued weakness in demand. At this point in time, we do not have evidence of consumers postponing expenditure plans, which is something one would observe in a deflationary environment. But any setbacks in the absorption of economic slack may give rise to further negative developments.

Against this background, we will remain alert as to whether any indications on further downside risks to price stability emerge and we stand ready to act.

A second challenge we will be facing in the coming months is to make the Single Supervisory Mechanism really work. As I initially explained, the institutional reforms that have been adopted or are being adopted to establish a banking union constitute important progress.

But to meet the ultimate objective of strengthening financial stability, implementation is key. And implementation is well under way: the Supervisory Board has held its first three meetings; a Framework Regulation has been prepared and is now the subject of a public consultation; and work is progressing on the supervisory model of the SSM with the Supervisory Manual.

One of the first major implementation tests is the comprehensive assessment, the health check of the euro area banking system, which is currently being conducted as a prelude to the SSM becoming operational.

Here, the ECB is making good progress in establishing the new structures and ensuring that the exercise will be fair, transparent and stringent. But many more steps still lie ahead of us.

A final challenge relates to the macro-prudential arm of the SSM. As you know, the SSM Regulation gives the ECB the power to apply stricter macro-prudential measures than the national authorities if it deems them necessary. We can also advise on the calibration of instruments. This goes some way towards insuring against an inaction bias at the national level, thus improving the prospects for a more stable euro area financial system.

We will maintain a clear separation of objectives between the macro-prudential policy framework and monetary policy and a clear hierarchy, with price stability remaining the ECB's overall primary objective.

But we are very much aware that both policies may interact. As mentioned before, financial instability may undermine monetary policy's ability to maintain price stability, both directly by its negative impact on credit provision, growth and inflation and indirectly by impairing the monetary transmission process. Conversely, a protracted low interest rate environment necessary to maintain overall price stability may create incentives to search for yield and lead to local bubbles in a heterogeneous monetary union.

In both cases, macro-prudential policy can be used to address financial stability concerns and facilitate our monetary policy conduct. In the first case, where the financial stability concerns are of a systemic nature affecting the whole euro area, those policies will have to be coordinated. In the second case, national macro-prudential authorities may take actions to reduce the risk of local financial imbalances.

In such a case, macro-prudential measures may exert cross-country spillovers that matter for monetary policy. For example, raising capital requirements in one jurisdiction may dampen lending in the whole euro area, while a tightening of loan-to-value ratios may simply shift lending between

respective jurisdictions, leaving the euro area aggregate unchanged. A monetary authority may therefore have a legitimate interest in which macro-prudential measure is used.

Many of these questions are yet to be fully explored and we have to acknowledge that the macro-prudential policy framework is still in its infancy. We are in a learning process. The objectives, transmission mechanisms and effects are still being established, and this is an area where the ESRB's systemic macro-prudential oversight is playing an integral role. Conferences such as today's can provide crucial input here.

Overall, I am optimistic that macro-prudential policies, if properly coordinated at the European level, will strengthen our defences against future financial instability in the euro area, while also addressing some of the side effects that come from a single monetary policy.

Conclusion

Let me conclude. With the three challenges of: (i) ensuring price stability in the face of a prolonged period of low inflation, (ii) setting up the SSM and rebooting the banking system to support credit and growth, and (iii) establishing an effective macro-prudential policy framework to increase resilience in the face of future financial turbulence, the ECB will have its hands full in the coming year. We are committed to doing our job, but do not expect us to do the job of others. It is more important than ever that, in parallel, governments continue to pursue their structural reform agenda.

The return of confidence in the euro area is evidence that the reform efforts will eventually pay off. This is visible from the return of *market* confidence. But, more importantly, it is visible from the return of *political* confidence – as expressed, for example, in Prime Minister Helle Thorning-Schmidt's assessment that joining the euro would be in Denmark's best interest.

Ultimately, the common theme in all our efforts is to further the aims of the European Union. These are to promote peace, its values and the well-being of its peoples. As the recent events in Ukraine demonstrate, these aims remain as attractive and compelling as ever.

Thank you for your attention.

Financial Integration and Banking Union

Speech by Mario Draghi, President of the ECB, at the conference for the 20th anniversary of the establishment of the European Monetary Institute, Brussels, 12 February 2014

* * *

Summary

A banking union will contribute to more sustainable financial integration in the euro area, says ECB President Mario Draghi. Speaking at a conference celebrating the 20th anniversary of the European Monetary Institute in Brussels, Draghi explains how stronger supervision, cross-border banking integration and resolution frameworks can reduce the risk of financial fragmentation. It was that kind of fragmentation which contributed to the recent financial crisis.

Draghi explains that financial integration is necessary for an effective monetary union. But "the euro area did not succeed in achieving sustainable financial integration", the ECB's President says. "And we can see the importance of financial integration all the more in its absence."

According to Draghi, financial integration before the crisis was incomplete. While the interbank market was fully integrated, retail banking remained fragmented. That led to a situation where banks used short-term and debt-based funding to increase lending to favoured domestic sectors such as real estate. "As banks' assets were not well allocated, nor well diversified geographically, they were more vulnerable to domestic shocks. And as their foreign liabilities were mainly interbank, they could not share the subsequent losses with other jurisdictions." So when the crisis hit, the cost of repairing balance sheets fell largely on their domestic fiscal authorities. "The result was the infamous bank sovereign nexus", Draghi says.

A banking union will generate a higher quality of financial integration. The Single Supervisory Mechanism will enable supervisors to mitigate the possible destabilising effects of financial integration. It will also help to maximise the benefits of integration by creating a policy framework more conducive to cross-border banking. If problems still occur, the planned European resolution framework will help by improving private risk-sharing while insulating sovereigns. To reach that aim, Draghi makes a case to improve the design of the Single Resolution Mechanism and the Single Resolution Fund. The proposed ten-year period to mutualise national compartments into a single fund "creates uncertainty", the President says. "We would see merits in doubling the pace of mutualisation to have a genuine European fund within five years."

* * *

Dear Members of the European Parliament,

Dear Alexandre,

Dear Jacques,

Dear Luc,

Dear Governors,

Ladies and Gentlemen,

It is a pleasure to speak today at this conference marking the 20th anniversary of the European Monetary Institute (EMI), and in particular to be part of this session that recognises and celebrates the contribution of Alexandre Lamfalussy.

The discussion today has naturally focused on the EMI, the euro and monetary policy, but I would like to take this opportunity to reflect on another issue which is vital for the single currency, and to which Alexandre has made an immense contribution – that is, financial integration.

Financial integration and the single currency are in many ways two sides of the same coin. One fundamental reason for the single currency was to maximise the benefits of the single market for capital. And, conversely, it was understood when the euro was conceived that integrated financial markets would be necessary for an effective single currency. [1]

Alexandre's experience in academia, the private sector and central banking put him in a unique position to contribute to this process. He contributed intellectually, for example through his leadership of the SUERF [2] network set up to promote discussion of financial and monetary issues among academics, central bankers and market participants. He contributed practically, not least as chairman of Euro-MTS, the European electronic fixed income market, late in his career. And he made significant policy contributions, from overseeing the creation of the TARGET payment system at the EMI to launching what became known as the "Lamfalussy process" for supervisory and regulatory convergence in Europe.

For this reason, the ECB recognised and honoured his role by establishing about ten years ago a "Lamfalussy Fellowship" programme. It sponsors five young economists each year to conduct research on the integration, structure and performance of the European financial system.

However, we know – and to our cost – that ultimately the euro area did not succeed in achieving sustainable financial integration. While financial integration deepened significantly after the euro was introduced, the global financial crisis caused that process to go into reverse. And we can see the importance of financial integration for the single currency all the more in its absence.

In the periphery, financial fragmentation has led to high interest rates for firms and households, and disrupted monetary policy transmission. In the core, it has led to exceptionally low interest rates for savers and potentially distorted asset prices. Consequently, the whole of the euro area would benefit from lasting financial reintegration – and indeed, addressing financial fragmentation has been one of the key tasks of euro area policy-makers, including the ECB, over the past years.

What I would like to focus on today is one aspect of reversing fragmentation that is perhaps underplayed – that is, the importance of raising the *quality* of financial integration in the euro area. My view is that the incomplete financial integration we achieved before the crisis made it susceptible to fragmentation. But I am confident that with a banking union we can create the pre-conditions for more sustainable financial integration in the future.

Financial integration before the crisis: what went wrong?

Let me start by outlining how financial integration evolved before the crisis.

It was always understood that financial integration could have both stabilising and destabilising effects. [3] Some of the main stabilising effects were expected to come from increased portfolio diversification. As banks and other investors became more diversified across borders within the euro area, they could reduce their exposure to domestic shocks, and this would be reflected in greater income and consumption risk-sharing. [4] Indeed, global and European evidence suggested that financial openness and integration had reduced consumption growth volatility. [5]

Another benefit of financial integration was thought to come from improved allocative efficiency. Research suggested that large cross-border banks in Europe could improve overall economic performance, by making sure that productive capital was channelled towards the most efficient firms. This would in turn reduce the risk of crises stemming from mispriced investment risk. [6]

Destabilising effects of financial integration, on the other hand, were expected particularly through risk-taking and contagion. Asymmetric information problems associated with cross-border lending could lead to misaligned incentives and increased risk-taking. Similarly, savings imbalances abroad could compress risk premia and lower financing costs, allowing an increase in leverage in the domestic financial sector. [7] And if negative shocks were to occur, contagion could quickly spread through the interbank market, and lending to the real sector across borders could be affected, too. [8]

As financial integration deepened, it was anticipated that the stabilising effects would overall be more important than the destabilising ones – that is, the welfare benefits of better diversification and improved allocative efficiency would offset the welfare costs of occasionally higher risk-taking and contagion effects. [9] So why were the costs of the European crisis so high?

There are many reasons for this, but in my view one important factor was the incomplete nature of financial integration in the euro area. Price convergence in many asset classes created an appearance of financial integration, but it was in fact relatively shallow, in particular in the banking sector. According to the ECB's financial integration indicators, while euro area interbank markets became almost completely integrated, retail banking integration remained largely fragmented. [10] This mismatch had at least three consequences.

The first was on the asset side of banks' balance sheets. A main channel through which retail banking integration is expected to improve allocative efficiency is by increasing the distance between the main shareholders and management of a bank and the vested interests in the country where the bank operates, i.e. by reducing so-called "related lending". But without meaningful foreign competition, these gains did not materialise in the euro area. In fact, the ability to borrow

freely in interbank markets allowed local banks to increase lending towards favoured domestic sectors such as real estate. This is essentially what we saw in Spain and Ireland. In the process, financial integration concentrated rather than diversified risk. [11]

The second consequence was on the liability side of banks' balance sheets. As banks' funding from abroad came mainly through the interbank market, the composition of their foreign liabilities was short-term and debt-based. This meant that funding could quickly dry up at the first sign of distress. [12] With a more integrated banking sector, however, this effect would have been less dramatic. As foreign banks would have equity stakes, they would have an incentive to maintain cross-border funding within the group. This is what happened, for example, in the Baltic countries where foreign ownership of the banking sector was high. [13]

These two consequences combined to create a third effect. As banks' assets were not well allocated, nor well diversified geographically, they were more vulnerable to domestic shocks. And as their foreign liabilities were mainly interbank, i.e. not equity-based and short-term, they could not share the subsequent losses with other jurisdictions. This meant that when the crisis hit, the cost of repairing their balance sheets fell largely on their domestic fiscal authorities. The result was the infamous bank-sovereign nexus that has perpetuated financial fragmentation in the euro area. [14]

My conclusion from this experience is as follows: the quality and comprehensiveness of integration matters. There are costs which can arise from a type of financial integration that is short-term and reversible; or from having perfect integration in one market and fragmentation in another. A key question for the euro area is therefore: how can we generate a higher quality of financial integration for the future?

Making financial integration sustainable: the role of a banking union

The pre-crisis experience suggests three changes are needed.

First, stronger *ex ante* supervision to mitigate the possible destabilising effects of financial integration. Second, an improved policy framework to maximise the stability benefits, namely by encouraging deeper cross-border banking integration. Third, better *ex post* risk-sharing arrangements, such as resolution frameworks, so as to prevent shocks from spilling over to sovereigns.

I see that a banking union – the Single Supervisory Mechanism (SSM) and the new European resolution framework – can make a significant contribution to these objectives. Let me address each in turn.

Strengthening supervision

To begin with, the SSM will enable supervisors to better identify emerging risks and to act counter-cyclically. This is thanks to its independence, its incentives and its instruments.

The SSM has been designed with the necessary independence to lean against localised booms, being not only legally independent, but also independent of any single government or national financial system. And that independence is reflected throughout its organisational structure, for example by having mixed-nationality joint supervisory teams to supervise each significant bank.

By virtue of its accountability, the SSM also has incentives that are clearly aligned with its European financial stability objective – it has to answer for the failure of any bank in the SSM area. Compared with national supervisors, this gives it all the more reason to take account of excessive risk-taking and the cross-border externalities associated with it, and therefore to be proactive if local financial developments pose increasing systemic risk.

Finally, the SSM has not only micro-prudential powers but also new macro-prudential instruments to counter financial imbalances. For all the instruments in the EU legislation, it may apply stricter measures than national authorities if it observes emerging risks. This further strengthens the capacity at the European level to prevent financial instability.

Deepening integration

The SSM can also help maximise the benefits of financial integration by providing a policy framework that is more conducive to cross-border banking integration.

Before the crisis, supervisory coordination mainly took place through the Lamfalussy process and committees, which were a major step forward and the best that could be achieved at the time. However, they were unable to fully iron out supervisory differences between EU jurisdictions. [15] This presented cross-border banks with substantial compliance costs and reduced the economic synergies of integration.

For example, a Commission survey in 2005 found that opaque supervisory approval procedures were a major deterrent to cross-border banking M&As in Europe. The need to comply with different sets of rules and interact with several different authorities was also reported to be a barrier to cross-border activity. [16]

The lesson from this period was that, while financial integration is ultimately a market-driven process, policy plays a key role in creating the conditions for it to progress. To quote the Lamfalussy report, "the EU has no 'divine right' to the benefits of an integrated market – it has to build one". [17] This SSM should help us in this building process.

A single supervisor automatically removes some of the dividing lines between jurisdictions that create compliance costs. For example, there will no longer be a distinction between home and host supervisors for cross-border banks. Instead, there will be a single supervisory model and eventually a single supervisory culture, rather than one per country. And cross-border groups will be able to report at the consolidated level.

Another benefit of the SSM – and perhaps a more important one – will be the lack of "hidden barriers" to cross-border activity linked to national preferences. With a European supervisor, borders will not matter. Issues such as protecting national champions or supervisory ring-fencing of liquidity will not be relevant. This means that banks will be in a better position to achieve the economies of scale that were promised by the single financial market – and that they also need to be competitive at the global level.

It is of course for banks to decide whether such integration makes business sense. And some obstacles to cross-border integration that lie outside the remit of supervision – like company law and tax – still remain. However, the low profitability and excess capacity of the European banking sector suggests that efficiency gains could be achieved, and without exacerbating the "too big to fail" problem.

Improving risk-sharing

Even with a higher quality of financial integration, we know that shocks may still occur that cannot be contained within the private sector. The US, for example, has a well-integrated financial market, and the Federal Deposit Insurance Corporation (FDIC) still plays a prominent role in managing crises. Our challenge in the euro area is to ensure that, when banks fail and the public sector has to intervene, it does not result in a recurrence of the bank-sovereign nexus. The new European resolution framework will be key to achieving this.

This framework can help insulate sovereigns by improving private risk-sharing within the euro area. First, it will ensure that the costs of bank failure are borne first and foremost by the private sector, with sovereigns providing funds only in exceptional circumstances. The key innovation here is the Bank Recovery and Resolution Directive, which provides the legal underpinning for the bail-in of shareholders and creditors and other resolution tools.

Second, the new framework will allow resolution costs to be more evenly spread across the euro area banking sector, and less concentrated in the affected countries, thus enhancing the potential for cross-border risk-sharing. Specifically, the Single Resolution Mechanism (SRM) will introduce a single resolution fund that is funded by and available to all euro area banks.

Will this help break the bank-sovereign nexus today? In my view, the impact will certainly be positive. The fact that the costs of any bank rescue will fall less on sovereigns should lift expectations of government debt sustainability, thus improving asset quality for banks exposed to their governments. And the fact that bail-ins will precede bail-outs means banks' funding costs should be better decoupled from the fiscal condition of their sovereigns.

That said, in terms of breaking this nexus, there are some elements in the Council agreement on the SRM that I believe could be improved. The main problem is uncertainty about resolution financing arrangements. This is important, because if markets cannot ascertain *ex ante* how resolution will be financed, and in what quantities, they may find themselves having to price-in a residual risk of national government involvement, thus perpetuating the bank-sovereign nexus.

One issue that creates uncertainty is the protracted time period – currently 10 years – over which national compartments are to be mutualised into a single resolution fund. As legacy risks will be addressed by the ECB's comprehensive assessment, this seems an unduly long period. We would see merits in doubling the pace of mutualisation to have a genuine European fund within five years. To be clear, this would not imply that banks have to pay higher fees. The fund would still only reach its target level after 10 years, yet it would be a truly single fund after five years.

Another issue that needs clarifying is what backstop arrangements will be in place in this transition period, and also in the steady state. What makes resolution authorities credible is the knowledge that, when private sector solutions do not suffice, they can draw on temporary public bridge financing. This steadies expectations and supports financial stability.

Indeed, the job of a resolution authority could become more complicated if there are doubts about the adequacy of its resources in times of systemic stress. Even in the US, where such a public backstop is in place, the FDIC felt that its job was complicated during the financial crisis by media scepticism about its finances.

For this reason, we believe that a single resolution fund needs a solid public backstop – be it an ability to temporarily borrow from the market backed by guarantees from participating Member States, or access to a credit line, potentially from the European Stability Mechanism. This would not be a transfer system between taxpayers: as in the US, such borrowing would be recovered by additional levies on the banking sector in the future. Therefore, the only transfer would be an intertemporal one among banks.

Conclusion

To conclude, financial integration is essential for a well-functioning single currency, but it is not something we can take for granted. We have learned a painful lesson here. Incomplete financial integration is an Achilles heel: it creates vulnerabilities and is liable to fragment. With the banking union, I am confident we are laying the foundations for more complete financial integration in the future.

There are two final points I would like to make.

First, while I have spoken mainly about banking sector integration, a single financial market must also ultimately extend to capital market integration – a theme that was close to Alexandre's heart. There are still several barriers to such integration, and these call for the attention of policy-makers. One example is barriers to high-quality securitisation of bank loans, whose removal may help to promote lending to households and SMEs, and reduce fragmentation. In the spirit of Alexandre, we need to begin addressing these issues in a pragmatic manner, while never losing sight of our goal.

Second, we should not forget that fragmentation also comes from the demand side. If less competitive countries undertake structural reforms that promote higher economic growth, their economies will converge towards more competitive ones, and finance will tend to follow. [18] This is why, in addition to the banking union, the re-establishment of country competitiveness is essential to reintegrate financial markets. In other words, *all* participants have to help achieve and sustain financial integration.

Thank you for your attention.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, President of the ECB, Brussels, 16 December 2013

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure for me to be back in your committee at such a decisive moment. The next days and weeks until the end of this legislature will show whether the euro area will be able to take another key step towards banking union. I believe your institution can play a crucial and constructive role in ensuring that this next step will entail a truly European dimension.

This is also the last time that I will discuss with you in detail matters related to the Single Supervisory Mechanism. Pending the appointment by the Council, Danièle Nouy will become the Chair of the Supervisory Board as of 1 January 2014. She will then also become your primary interlocutor with regard to the SSM.

Today, I will first review recent economic and monetary developments in the euro area. I will then explain in greater detail our more recent monetary policy decisions and will present the progress in the preparations of the SSM.

Economic and monetary developments

Since our meeting in September, incoming information has confirmed the ECB's assessment that underlying price pressures remain subdued over the medium term. The economic recovery in the euro area is fragile. Real GDP in the euro area expanded in the last two quarters: From July to September, it grew by 0.1% – quarter on quarter – following 0.3% in the second quarter of this year. Developments in survey-based confidence indicators up to November point toward a modest growth rate also in the last quarter of the year. At the same time, unemployment remains high. Necessary balance sheet adjustments in financial and non-financial sectors continue to weigh on economic activity.

Looking further ahead, we expect output to continue to recover at a slow pace. This is in particular due to some improvement in domestic demand supported by our accommodative monetary policy. Euro area activity should, in addition, benefit from a gradual strengthening of demand for exports. Moreover, the improvement in financial market conditions and reduced uncertainty seems to be gradually transmitted to the real economy. Finally, the progress made in fiscal consolidation has strengthened the confidence of markets in the resilience of the euro area. This should also positively affect the recovery.

Nevertheless, the risks to the outlook remain on the downside. They are mainly related to uncertain developments in global money and financial market conditions. Higher commodity prices, weaker than expected domestic demand and export growth, and insufficient structural reforms in euro area countries could also negatively affect economic conditions.

Annual HICP inflation increased in November to 0.9%, according to Eurostat's flash estimate, following an unexpectedly strong decline in October to 0.7%. Underlying price pressures in the euro area are expected to remain subdued over the medium term. We might experience a prolonged period of low inflation to be followed by a gradual upward movement towards inflation rates below, but close to, 2% later on. This reflects the modest pace of the recovery and the fact that medium to long-term inflation expectations continue to be anchored in line with price stability.

Monetary and, in particular, credit dynamics remain subdued. The annual growth rate of loans to the private sector has stabilised at negative levels. Weak loan dynamics continue to reflect primarily the current stage of the business cycle, credit risk and the ongoing adjustment of financial and non-financial sector balance sheets.

Recent monetary policy decisions

Based on this assessment of the current economic outlook, let me now explain in greater detail our more recent monetary policy decisions. In July this year, we introduced forward guidance to clarify the orientation of our monetary policy going forward in an exceptionally uncertain environment: we stated that we expected key interest rates to remain at present or lower levels for an extended period of time. This statement was conditional on an overall subdued outlook for inflation extending into the medium term, which is currently the case, as I have just explained.

In line with our forward guidance, we decided in November to lower the key ECB interest rates further. The interest rate on the main refinancing operations was lowered by 25 basis points to

0.25% and the rate on the marginal lending facility by 25 basis points to 0.75%. The rate on the deposit facility was left unchanged at 0.00%.

Our forward guidance still remains in place: we continue to expect ECB key interest rates to remain at present or lower levels for an extended period of time. Thus, monetary policy will remain accommodative for as long as necessary.

Adjusting interest rates is not always sufficient to maintain price stability. In this crisis, interest rate cuts have been transmitted more slowly and unevenly across euro area countries due to the fragmentation of financial markets. To address this problem, we adopted in recent years a series of non-standard measures. The purpose of these was – and remains – a more effective transmission of the ECB's interest rate cuts, so that our monetary policy can reach companies and households throughout the euro area.

This was also the purpose of our decision in November to continue conducting all our refinancing operations as fixed rate tender procedures with full allotment at least until July 2015. Thus, we have helped to alleviate funding concerns of banks, which are still hesitant to lend to households and firms.

Two years ago, we provided funding support to euro area banks through two Long Term Refinancing Operations with a maturity of three years each. As the funding situation of banks has improved significantly since then, banks have this year opted to repay about 40% of the initially outstanding amount. Accordingly, excess liquidity in overnight money markets has been gradually receding. We are monitoring the potential impact of these developments on our monetary policy stance. We are ready to consider all available instruments.

As usual, it takes time before our policy decisions work their way through financial markets and affect the economy. The November decisions on interest rates, on forward guidance and on prolonging full allotment in all refinancing operations are working their way through.

Financial markets have taken up our conditional commitment to an accommodative monetary policy stance for an extended period of time. Money market term interest rates and yields on bank bonds declined.

On the other hand, we are fully aware of the downward risks that a protracted period of low inflation entails. Consistent with its forward guidance, the Governing Council is ready and able to act if needed, as I mentioned at the most recent press conference .

Furthermore, we currently see no signs of risks of financial imbalances related to the low interest rate environment. What we observe is still a very subdued trend in monetary and credit developments in the euro area.

Nevertheless, if we were to observe the build-up of such imbalances, this would be the field where macro-prudential authorities would have to intervene with market-specific instruments. Local risks have to be addressed by local instruments. This is why supervisory authorities, including the SSM, are now being equipped with the appropriate micro- and macro-prudential policy tools. I am confident that these will be used if necessary.

State of play of SSM preparations

Let me now update you on the latest developments establishing the Single Supervisory Mechanism (SSM), which are well underway.

Our internal preparations aim at ensuring that the ECB will be ready to assume its supervisory responsibilities in November 2014. We will make sure that the ECB's monetary policy mandate focused on price stability will not be affected by considerations and decisions related to banking supervision. Internal rules are therefore being developed for the separation of monetary policy and supervisory functions: The units involved in decision-making will be clearly separated. We are putting in place an organisational set-up whereby the information flow between the two functions will be limited to a 'need to know' basis. However, we will avoid unnecessary duplication of structures not involved in the decision-making process. This is cost-efficient, and I am sure you will appreciate this.

As regards recruitment of staff, I can say that the process for senior and middle managerial positions is well underway. Further recruitment initiatives will start in due course.

An important element of our preparations is the comprehensive assessment, which comprises a supervisory risk assessment, an asset quality review and a stress test performed in cooperation with the European Banking Authority (EBA). This exercise will increase transparency by enhancing the quality of information available. It will facilitate the repair of the sector by identifying the necessary corrective actions. And it will build confidence by assuring all stakeholders that banks are fundamentally sound. It will be concluded shortly before the ECB assumes supervisory responsibilities.

The ECB convened a series of meetings in November in Frankfurt with the banks that will undergo the comprehensive assessment. These meetings were positively received and provided the useful opportunity to have a first exchange of views, to receive feedback on our communication, and respond to questions. We also explained that we would welcome prompt action from the banks, beginning now, to strengthen their balance sheets including profit retention and equity issuances.

Other elements of the comprehensive assessment are on-going. The process for the selection of asset portfolios to be reviewed for the asset quality review was initiated in November, based on specific data collections. Furthermore, we expect to announce the key parameters of the stress test exercise together with the European Banking Authority (EBA) towards the beginning of next year.

In this context, let me explain again the treatment of sovereign bonds: The Asset Quality Review is a valuation exercise where we will apply the current regulatory framework. It is not for us to change this framework – this is a global discussion, and the Basel Committee is the right forum for it. That said, we will of course "stress" a wide range of assets as part of the stress tests: Sovereign bonds will be among them.

To ensure the credibility and rigour of the comprehensive assessment, backstops should be well specified and in place as soon as possible. The pecking order should be first private sources, then national public backstops and, as a last resort, European instruments.

Turning now from supervision to resolution, I understand you have reached agreement with the Council on the Bank Recovery and Resolution Directive. Let me again strongly welcome this agreement, as it is an important step towards to the completion of the Banking Union.

However, for the credibility of the Banking Union, another step must be taken too: The SSM needs a strong and credible Single Resolution Mechanism as its counterpart. Responsibilities for supervision and resolution need to be aligned at the European level. Thus, I urge you and the Council to swiftly set-up a robust Single Resolution Mechanism, for which three elements are essential in practice: a single system, a single authority, and a single fund. We should not create a Single Resolution Mechanism that is single in name only. In this respect, I am concerned that decision-making may become overly complex and financing arrangements may not be adequate. I trust that the European Parliament, together with the Council, will succeed in creating a true Banking Union.

Thank you for your attention. I am now looking forward to your questions.

Hearing before the Plenary of the European Parliament on the occasion of the adoption of the Resolution on the ECB Annual Report 2012

Introductory statement by Mario Draghi, President of the ECB, Strasbourg, 12 December 2013

President,

Honourable members of the European Parliament,

I am very pleased to take part in this debate on the ECB Annual Report 2012. Today is the last time in this legislature that I participate in the plenary. This represents a good opportunity to take stock of the progress made over the past few years in strengthening the resilience and stability of the euro area.

To introduce the debate, I would first like to review the more recent ECB's monetary policy decisions. I will then address institutional matters of particular interest to your house as well as the progress made so far in reinforcing EMU governance. I will thereby address most of the issues which the ECON Committee highlighted in its draft resolution on the ECB Annual Report.

ECB's monetary policy

Let me begin by describing the economic environment of the past years. The economic recovery that followed the post-Lehman global recession of 2008-09 was aborted in the euro area as the sovereign debt crisis took hold. Financial stability was threatened; the viability of banks that had survived the first phase of the crisis was called into question. Credit was curtailed and the recession that ensued has lasted until the first quarter of this year. Since then, we have been experiencing a weak recovery. Weak economic activity and high unemployment have resulted in a subdued inflation. Against this backdrop, and in respect of our price stability mandate that was assigned to us by the Treaty, we have lowered our key interest rates to historically low levels.

To clarify the orientation of our monetary policy going forward in an exceptionally uncertain environment, we introduced *forward guidance* in July 2013: we stated that we expected key interest rates to remain at present or lower levels for an extended period of time. That statement was

conditional and based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics. In November we acted upon that conditional pledge by reducing two of our key interest rates, as price pressures have diminished further and we anticipate inflation weakness to be protracted. In keeping with these anticipations, we also re-confirmed our forward guidance in its original formulation.

Over the past two years our interest rate cuts were transmitted only unevenly across euro area countries, due to the fragmentation of financial markets along national borders. To address this problem, we adopted a series of non-standard measures. The purpose of these was – and remains – a more effective transmission of the ECB's interest rate cuts, so that our monetary policy can reach euro area companies and households. Our measures addressed those distortions in sovereign debt markets that were due to the redenomination risk and alleviated funding pressures of euro area banks. At our November meeting we also decided to extend the time horizon for the application of the fixed rate full allotment procedures in our liquidity operations until at least July 2015. This decision provides our counterparties reassurance that the liquidity necessary to re-finance their core activities will be forthcoming at our main refinancing rate.

As a direct consequence, bank lending rates for households and non-financial corporations have decreased at the euro area level. In this way, our measures have helped SMEs, too, the backbone of the euro area economy. We have, in addition, taken direct measures to alleviate the funding situation for SMEs through our collateral framework. And we have worked with the European Commission to further improve SME financing conditions.

Institutional Matters

Let me now turn to institutional developments and focus in particular on measures related to accountability and transparency. Since our creation we have always gone beyond the Treaty requirements in making our work transparent and accessible. The monthly press conferences, which were without precedent at the time among major central banks, are a telling example. This year has also shown that the ECB stands ready to adapt its communication policy where deemed necessary. For example, we have published the procedures governing the provision of Emergency Liquidity Assistance (ELA). We have started internal reflections on how to increase transparency of the deliberations in the Governing Council without undermining independent decision-making by its members.

Our commitment to accountability and transparency has also become apparent in the Agreement concluded between our two institutions on the Single Supervision Mechanism (SSM). Supervision necessitates a differentiated form of accountability from monetary policy, while preserving the independence of the ECB as a whole. The Inter Institutional Agreement (IIA) strikes the right balance between ensuring high standards of accountability, transparency and safeguarding confidential information. I am confident that the implementation of the IIA will open a new chapter of successful cooperation between our two institutions. In this context let me also welcome your positive vote on Ms Nouy's nomination. Following her final appointment by the Council, she will become your main interlocutor on all matters related to the SSM as of January 1st.

I would like to also address an issue which, I know, is as much a concern to you as it is to me: the gender balance at the ECB. Today, 17% of our management positions are filled by female staff. It is clearly not enough. This is why the Executive Board decided this summer to introduce gender targets aiming at 35 % women in management positions by 2019. And this is not an empty promise. The ECB has started to implement a diversity action plan that will help us attaining those targets.

Let me now share my thoughts on the process of completing EMU.

Taking stock of the progress made towards a genuine EMU

As this legislature comes to the end of its term, it is an opportune time to reflect on what we have achieved in such a short space of time. Not so long ago the euro area was facing an uncertain future. In the meantime, doubts about the integrity of the single currency have dissipated. Notably, a roadmap for a genuine EMU has been outlined encompassing four pillars: banking union, fiscal union, economic union and ultimately political union.

Through a concerted legislative effort the euro area, and the EU as a whole, has been put on a more stable footing. Your institution has made a decisive contribution to this effort. The establishment of the Single Supervisory Mechanism (SSM) represents probably the most significant change to the EU since the establishment of the single currency and I am happy to report the internal preparations are well underway. I strongly welcome the political agreement on the Bank Recovery and Resolution Directive you have reached with the Council yesterday night.

Swift agreement on the other key component of Banking Union - the Single Resolution Mechanism - is of paramount importance. I trust you will succeed in adopting the relevant legislation before your term comes to an end. These institutions are essential to implement the ‘single rulebook’ in the years to come. Looking ahead we will have a stronger set of rules for capital and liquidity. We will also have a new toolbox for the resolution of financial institutions. And we will have stronger national deposit guarantee schemes.

Banking Union however is not a panacea for eliminating financial market fragmentation and fully stabilising EMU. It is a necessary, but not sufficient condition to break the bank-sovereign nexus and restore sustainable economic growth. Equal borrowing conditions can only be ensured through the joint implementation of other measures. This not only includes continued fiscal consolidation and implementation of structural reforms, but also progress on the other ‘unions’. Only then can we say we have created a genuine EMU. Let us seize the opportunity of the next EP elections to have an open public debate on the further steps needed to strengthen the architecture of EMU.

Thank you for your attention.

Money and monetary institutions after the crisis

Speech by Mario Draghi, President of the ECB, at the conference organised by Banca d'Italia in memory of Curzio Giannini, Rome, 10 December 2013

Summary

Central banks should continue to focus primarily on what they can and are mandated to achieve, which is price stability over the medium term.

Delivering on their mandate is the only way for central bankers to maintain public trust. Pursuit of this mandate must be backed indirectly by public preferences, seen from a longer-term perspective.

The actions undertaken by the ECB have not represented a departure from the ECB's mandate but rather the opposite, namely its pursuit by all the means demanded by the situation.

It is now crucial to complete the reform agenda at European and national level. With this agenda there can be no place for withdrawing into nationalism and protectionism.

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Introduction

Ladies and Gentlemen:

I very much appreciate having the opportunity to intervene in this conference, not only because it honours Curzio Giannini, but also because the issues that were close to his heart have turned out to be fundamental questions concerning the role of central banks in the post-crisis environment.

The morning session has touched upon topics of vital importance for central banks. I would summarise them along two main lines. First, should the objectives (though not necessarily the mandate) of central banks be broadened? Second, and related, how can central banks retain and increase public trust and preserve their legitimacy and independence?

Although these are issues that affect all central banks, I will naturally speak from the perspective of the ECB and our specific institutional context.

The objectives of monetary policy

Claudio Borio has presented a thought-provoking paper on the question of whether central banks had too narrow a focus in the decades preceding the global financial crisis. He now asks whether they should widen their horizon, in particular towards addressing financial imbalances.

Claudio first documents that there is a financial cycle of credit booms and busts that overlaps with the more usual business cycle, but which has a longer duration, in particular in the build-up phase. Although not always easy to detect, this cycle is often characterised by the interplay between soaring real estate prices and easy credit, and both are in principle observable.

Second, Claudio argues that monetary policy (possibly in combination with other policies such as macro-prudential policies) can do something to prevent costly booms and busts – although it has less leverage than commonly thought in a balance sheet recession which often characterises the "bust" phase. Hence, by being more aggressive in preventing risks ex ante, the central bank may have an easier life ex post, and avoid being over-burdened with excessive expectations in the bust phase. A distinct advantage of monetary policy as compared with macro-prudential policies is its robustness to regulatory arbitrage and its ability to "get in all the cracks".

Note that Claudio is careful not to argue that central bank *mandates* should be changed. A stronger focus on the financial cycle could be justified based on central banks' traditional mandate of maintaining price stability.

At the ECB, we are definitely sympathetic to these views. [1] The ECB's monetary policy strategy with its medium-term orientation and emphasis on monetary analysis explicitly involves looking beyond short-term price developments and taking into account the medium-term implications of booming asset prices and credit markets for price stability.

Ultimately, however, the answer to the question how actively monetary policy should be used to "lean against the wind" will depend on the answer to two other questions: i) How effective will the new macro-prudential policy framework be in reining in the financial cycle and maintaining financial stability?; and ii) What is the effect of monetary policy on risk taking and financial stability?

Regarding the first question on the effectiveness of macro-prudential policies, let me just say that the experience with those policies as a stabilisation tool is relatively scarce and often confined to emerging market economies. In the euro area, the Spanish experience with dynamic provisioning shows that increasing buffers during the credit boom can increase the resilience of banks; this was visible in the first phase of the financial crisis. However, at the same time it did not prevent the large run-up in credit and real estate prices and its subsequent painful and protracted bust, suggesting that a more intrusive macro-prudential policy may be necessary. I trust that the new macro-prudential tools created under the Capital Requirements Directive IV, combined with the new role of the Single Supervisory Mechanism in macro-prudential decision-making, will help provide that intrusiveness.

Regarding the second question, there is by now considerable research on the effect of monetary policy on risk taking in the financial sector (also by ECB researchers), but the quantitative importance and hence policy relevance of this channel is still unclear and subject to a lot of debate. It is also unclear whether monetary policy can have an influence on financial stability that would be predictable and systematic enough to allow it to be exploited.

There are additional elements to be considered when conducting monetary and macro-prudential policy in a still heterogeneous economy such as the euro area. Dealing with the financial cycle from a purely national perspective can be detrimental to financial integration, but the common monetary policy cannot fully deal with a financial cycle that is not synchronous across countries. In order to manage this trade-off, the responsibility for macro-prudential policies will in future be shared between the centre (the Single Supervisory Mechanism for the euro area and the ESRB for the entire EU) and the Member States (the national macro-prudential authorities).

In sum, there are many uncertainties associated with the ability of both monetary and macro-prudential policies to rein in the financial cycle. As a policy maker, being confronted with a lot of uncertainty is not new. It is, however, important to acknowledge those uncertainties and draw the necessary implications.

First, central banks should continue to focus primarily on what they can and are mandated to achieve, which is price stability over the medium term. As I will mention later, delivering on this mandate is essential to maintain public trust in the long term.

Second, we need to continue and further strengthen the financial sector reform agenda and build more resilience in the financial system. While our knowledge to fine-tune the financial cycle may be limited, the financial system must be made more robust to shocks by, for example, increasing capital and liquidity buffers. As Don Kohn recently said, *"We may not be able to make better drivers, but we can make cars and roads safer to reduce damage when accidents happen"*. [2] The creation of a banking union and the comprehensive assessment leading up to it are essential steps in improving the governance of the financial sector in the euro area and increasing its resilience.

Trust in central banks

Let me turn now to the question that was perhaps the most fundamental for Curzio, namely how central banks can build trust. Indeed Curzio viewed not only central banks, but also money itself, as an institution backed by public trust. Let me quote from him: *"The mistake that neo- classical theories make is to consider money a commodity. Instead, it is really an institution that is held up by trust: trust in its future purchasing power and trust in the continued convention that payment is complete when money changes hands (even if this is now something of a metaphor)"*.

Trust is important not only as an end in itself, but also because it contributes to economic efficiency. This view, which is now shared by many economists and that Curzio expressed in particularly eloquent terms, stipulates that the ultimate objective of institutions such as central banks is to reduce transaction costs. High public trust, by reducing transaction costs, raises economic efficiency and citizens' welfare.

A high degree of trust by citizens is ultimately the most important safeguard of central bank independence in the long term. Legal provisions for central bank independence are important, but not as important as public trust over the long term. [3] With a high degree of trust, central banks will be able to successfully deal with any potential risks for central bank independence stemming from the use of non-standard measures, for example.

Transparency and accountability are also important pillars of central bank independence and the ECB places a high value on them. Together with delivering on the mandate, they also form the cornerstone of public trust in central banks. The ECB enjoys a high degree of independence in the international comparison, which is matched by stringent transparency and accountability requirements. Indeed, we regard accountability as just "the other side of the coin" of central bank independence.

Looking ahead, central banks should get used to receiving closer scrutiny and in my view should not eschew even higher standards of transparency. It is not surprising that the use of new and non-standard tools attracts closer attention and sometimes even criticism.

How do these considerations apply to the unique case of the euro area? The monetary union is an example of what Curzio called a *"consortium regime"* where monetary sovereignty is permanently transferred to a supranational level. As a consequence, price stability is defined for the euro area as a whole. The challenge for the ECB is to maintain public trust in a multinational environment, in particular when there is a significant degree of heterogeneity in economic structures and preferences.

Trust is intimately linked to acting within the mandate. The ECB is operating and shall operate only within this mandate. A key part of the ECB's aim to retain and build trust is to respect this political legitimization by focusing and delivering on its mandate. Of course, price stability is not important just because it is written in the Treaty. It is also beneficial for economic growth and social cohesion, and indeed available surveys indicate that citizens attach a high value to price stability.

During its 15 years of existence, the ECB has consistently delivered on its mandate to maintain price stability, with average HICP inflation standing at 2.0% between 1999 and now. Moreover, long-term inflation expectations suggest that citizens have a high degree of confidence in the ECB's ability and determination to maintain price stability in the future.

In sum, we have here two aspects which are both essential. On the one hand delivering their mandate is the only way for central bankers to maintain public trust; on the other, their pursuit of their mandate must be backed indirectly by public preferences, seen from a longer term perspective.

I would be the first to acknowledge that there can be a tension between these two dimensions in the short run, and that delivering price stability has been more challenging in recent years, in part due to financial fragmentation in the euro area. The ECB has been addressing financial fragmentation in the euro area since its beginning in 2011. This effort has included the provision of liquidity to the banking system in abundant and uniform terms across the whole euro area, against good quality collateral and subject to risk management limits; as well as securities market purchases, the Securities Market Programme and the covered bonds purchase programme, and the Outright Monetary Transactions (OMT) programme.

I would like to emphasise that these efforts do not represent a departure from the ECB's mandate, but rather the opposite – namely, the pursuit of price stability by all the necessary means that the situation has required.

In short, the ECB has preserved price stability and the necessary conditions for sustainable growth, fought redenomination risks and the fragmentation of financial markets. Time has been gained for other actors to contribute their part in crucial policy domains that do not belong to the competence of ECB as defined by its mandate. The European reform agenda has been put on a new footing.

It is now crucial to complete this agenda at the European and national level. In this agenda there is no place for retreating into nationalism and protectionism. We know better than this and should stay focused on the key reform priorities: completing the banking union, implementing growth-friendly fiscal consolidation, and structural reforms in labour and product markets. I have little doubt that all these reforms are beneficial and trust-enhancing, even though some of them may be opposed by vested interests or entail adjustment costs in the short term.

Our common responsibility for the euro area strengthens the case for reform. As I said recently in Berlin, it is never the case that sound economic policies are good for some in the euro area but not for others, even though they are sometimes portrayed in that way.

A great deal of progress has been made, but more needs to come. Let me conclude by again quoting Curzio: "The EMS crisis could have marked the end of EMU. Instead, it sparked efforts to acquire sufficient institutional capital to support confidence in the new European currency" (p. 213). The crisis has identified some weaknesses in our European construction. But I am convinced, like Curzio, that together we will be able to repair these weaknesses and emerge from the crisis with a stronger Europe.

Thank you for your attention.

Opening speech at the European Banking Congress "The future of Europe"

Speech by Mario Draghi, President of the ECB, Frankfurt am Main, 22 November 2013

Ladies and gentlemen,

Thank you for inviting me to speak to you today.

While the situation in the euro area has improved greatly over the last year, we are still faced with considerable challenges.

We need to secure the economic recovery, reduce fragmentation in the euro area and continue the process of institutional and structural reform.

To achieve this, it is essential that we do not retreat into purely national perspectives, with a narrow view of our interest. We must keep our European perspective – and stand up for our common interests.

I would like to use my remarks today to highlight two areas where this European perspective is key.

The first is the monetary policy. Monetary policy with a single currency will always have different effects in different places. But it is essential to understand that the ECB, by its mandate, must act for the euro area as a whole. And in doing so, it makes the best contribution to prosperity for European society at large.

The second area is the creation of banking union, notably the Single Supervisory Mechanism (SSM). The SSM will create the first ever genuinely European supervision and we must take advantage of the opportunities this provides.

For banks, it offers a unique opportunity to restore confidence and attract private investors, also through the ECB's comprehensive assessment. For the wider euro area, it offers a possibility to deepen financial integration and reduce fragmentation. For this process to be effective, a strong Single Resolution Mechanism (SRM) is essential.

The ECB's monetary policy

Starting with the ECB's monetary policy, our mandate is inherently European – it is to maintain price stability for the euro area as a whole. And this mandate is symmetric; don't forget that price stability works in both directions. We need to act as much when there is a risk that inflation in the medium term might become too low as well as too high.

As I had the opportunity to explain yesterday, when we took our recent decision to cut interest rates, we saw a situation where the inflation outlook deviated too strongly away to the downside from our price stability mandate. Our decision was necessary to comply with our mandate.

I also had the opportunity to address some concerns this decision has raised. Let me briefly come back to this.

One concern is that low interest rates erode people's savings. Another is that low interest rates create risks for financial stability. A third is that they reduce the incentives for governments to reform.

Allow me to address each of these concerns in turn.

First, I understand the concerns about a prolonged period of low returns on savings. But it is important to understand that interest rates are low because the economy is weak. If we raised rates, we would further depress the economy, people would lose their jobs, and then their savings would be lower for longer.

By keeping interest rates at a level that supports the recovery, we should see higher interest rates for savers going forward.

Moreover, the interest rate that matters most to long-term savers is not the main ECB rate, but the rate on safe long-term investments – in Germany, that is long-term Bunds.

It is wrong to think that these rates are solely determined by the ECB. Since the crisis, more powerful factors have been at play. In particular, the low return on long-term Bunds was largely explained by investors seeking safety as other parts of the euro area struggled.

Second, low interest rates can over time threaten financial stability, but we do not see any evidence of this at present.

If we do see low interest rates creating localised risks, then local tools should be used to address them. In particular, national authorities should make full use of macro-prudential tools that they have available.

The third concern is that low interest rates undermine incentives for reform in the euro area. Certainly, monetary policy always has side effects – this is inherent and unavoidable. But one should never forget that the ECB acts for the euro area as a whole in line with our mandate.

I have already reacted to the nationalistic tone that this concern has provoked in some recent commentary. In their deliberations and decisions, Governing Council members are neither German, nor French, nor Spanish, nor Italian but acting as Europeans in pursuit of a European mandate.

To maintain the right incentives for economic policies, countries need to strengthen their frameworks for economic governance. Important steps to strengthen budgetary discipline have already been undertaken. But several countries are further behind in implementing structural reforms. It is therefore high time to bring this area under closer European governance.

The Single Supervisory Mechanism

Let me now turn to the second part of my remarks today – the creation of the Single Supervisory Mechanism.

The SSM offers a tremendous opportunity to move from different national approaches to the treatment of banks to a genuinely European perspective. That is, to take collective responsibility for our banks consistent with the single financial market in which they operate.

The ECB's comprehensive assessment

It is clear that there needs to be much more confidence in banks within and across countries that are joining the SSM.

This is the objective of the ECB's comprehensive assessment. How will the assessment boost confidence?

Primarily, by giving all parties more transparency. Investors should have the facts they need to properly price assets and be assured that banks are sufficiently capitalised.

The exercise aims to achieve this through a supervisory risk assessment, an asset quality review and a stress test. I will not go into the details here as they are being communicated separately, but the key point is that it will be comprehensive and consistent.

Comprehensive because it will cover 128 banks and about 85% of the assets of countries participating in the SSM.

And consistent because it will be centrally led with a rigorous common methodology – there will be no room for perceptions of national bias.

There should be no doubt about the credibility and rigour of the assessment, or the comparability of the results.

Let me add here that, by end-January, we expect to announce the key parameters of the stress test exercise together with the European Banking Authority (EBA).

We have recently been meeting with bank top management along with their national supervisors. We have emphasised in these meetings that to make the exercise a success we need to have high-quality information. In fact our first data request, called the "portfolio selection", has just been issued.

We are aware that gathering this information requires an extraordinary effort for national supervisors and especially for banks. But it is important to note that this is not a permanent or recurrent feature of the SSM.

Since last year banks have been improving the robustness of their balance sheets by increasing capital and provisions. In this sense, the exercise is already producing results – and I encourage banks to continue. Given the improvement in market conditions, market-based solutions should be more feasible than in the recent past.

If private sector solutions cannot be achieved in a timely and realistic manner, there is also a responsibility for the public sector. To ensure the credibility of the exercise, we need clear public backstops at the national and European levels. If they are drawn upon, the Commission has clarified that the state aid rules will provide for a level playing-field in terms of burden sharing, while financial stability will be fully safeguarded.

The ECB's comprehensive assessment therefore provides the first step towards building confidence in euro area banks, and between euro area countries and their competent authorities.

I call on all banks covered by the SSM to join our effort in the coming months by supplying the necessary information to the ECB and the national authorities, by undertaking prior actions where needed, and by proactively responding to the conclusions of the exercise.

Fostering financial integration

Once the SSM is established, it offers a real possibility to take a new, European approach towards governance of the financial sector – and hence to reverse the harmful financial fragmentation we have seen during the crisis.

There are three ways in which I see that the SSM can help.

First, the SSM can supervise in the European interest. As European supervisor it has no incentives related to national champions and its mandate is fully aligned with its European financial stability objective.

The fact that the new European supervisor is not only legally independent but also independent of any single government or national financial system facilitates the pursuit of its objective.

Second, the SSM can increase confidence among supervisors. During the crisis, some supervisors, motivated by uncertainty, engaged in defensive actions such as national ring-fencing of liquidity and national asset-liability matching. This may have been rational given their mandates, but it reinforced fragmentation.

Under the SSM, all supervisors will have the same rules, standards and decision-making procedures. As such, a supervisory assessment from the SSM that a bank is healthy will be a "seal of quality" that is valid from one country to the next.

Third, the SSM can foster trust between banks.

European supervision should make banks more confident to lend to one another across borders, in particular in the interbank market. And it could also make banks more willing to engage in cross-border mergers and acquisitions. This would deepen financial integration and make the euro area more resilient to fragmentation.

Our long-term vision for the SSM involves an environment where a creditworthy firm or household can get a loan from any bank in Europe at comparable conditions – and where location considerations would not be predominant.

Yet, further improvements will be needed in other domains. It is not only different supervision that holds back cross-border banking integration and activity. Also different national legal frameworks, different tax regimes and different rules for corporate governance contribute to fragmentation. These issues warrant consideration to facilitate financial reintegration.

The Single Resolution Mechanism as an essential complement

Another essential element in building a more integrated European banking market is greater harmonisation of how non-viable banks are resolved.

This requires a consistent legal framework between countries and a single resolution mechanism to enforce that framework. The first part has already been agreed by governments; the second part, the SRM, needs to be pursued as a matter of urgency.

A robust SRM would encompass all banks established in member states participating in the SSM. It would have at its centre a strong and independent single resolution authority that can act evenly across countries and take decisions in the European interest. And it would have adequate powers, tools and financial resources to resolve institutions swiftly and effectively.

The key to an effective resolution regime is that it creates legal certainty, consistency and predictability, thus helping to avoid *ad hoc* solutions. To this end, there are two points where I think more certainty is needed.

First, while the new EU resolution framework provides the appropriate resolution toolbox, it would be better to have it available right from the start of the SRM. I therefore support implementing the bail-in tool well before 2018.

Second, to price risk properly, investors need to see a clear pecking order in resolution financing – running from capital write-downs and bail-in to use of a bank-financed single resolution fund.

However, it would be difficult to make such a pecking order credible without a public backstop for the single resolution fund for exceptional cases where its resources are exhausted. Otherwise, investors may suspect that governments would at some point be forced to step in again.

Such a backstop would still result in the private sector paying as any borrowing by the fund would have to be repaid, if needed through *ex post* levies on the banking sector. In other words, the future system would not be about bail-outs or mutualisation – it would be fiscally neutral; the taxpayer would not pay.

Conclusions

Let me conclude.

I have discussed today the benefits of a European perspective to our current challenges. This is not the perspective of idealists. Rather, in a closely integrated monetary union, it is the perspective of realists.

A European perspective is firmly enshrined in monetary policy. And it is equally enshrined in our approach for establishing the SSM. We will overcome fragmentation to create a truly integrated financial market. There is still much more to be done to overcome the challenges that we face, but we have the right orientation.

Thank you for your attention.

Keynote address at the Süddeutsche Zeitung Führungstreffen Wirtschaft 2013

Speech by Mario Draghi, President of the ECB, at Führungstreffen Wirtschaft "Strategies for more growth" organised by Süddeutsche Zeitung, Berlin, 21 November 2013.

Ladies and gentlemen,

The euro area has been through a difficult period of correcting the imbalances of the past. The necessary adjustment has inevitably put our economies under strain, and it has also caused unemployment that is still unacceptably high, especially among the young.

Yet I see signs today that the euro area is slowly advancing on the road to recovery. The latest data suggest that, little by little, economic growth is again taking hold – although it remains weak, uneven and fragile, while the risks surrounding the economic outlook continue to be on the downside.

This gives policy-makers in the euro area an opportunity to alter their focus – to be less absorbed in short-term crisis management, and more focused on building an economy with more stability, more growth and more jobs.

Today I would like to discuss what we can do individually and collectively to achieve that goal.

My key point is that the return of economic growth is not a signal that reform efforts are behind us. On the contrary, to secure the recovery and create jobs, determined action is more important than ever.

All actors in the euro area have a part to play. A sustainable recovery first and foremost requires price stability, which we at the European Central Bank (ECB) will continue to provide. It requires more competitive economies, for which governments must create the right conditions. And it requires dynamic and inclusive business models, which social partners and business leaders can deliver.

We all benefit from a prosperous and dynamic euro area economy, so we all have a responsibility to make it a success – national governments, social partners, businesses and European actors.

Monetary policy

Let me first describe what the ECB is doing to maintain price stability in the euro area. I will start with a quick review of the key principles underlying our monetary policy strategy.

As you know, the Treaty establishes price stability as the ECB's primary mandate. This mandate has guided our monetary policy since monetary union began. And it will continue guiding our monetary policy in the future.

To put our mandate into practice, the ECB's Governing Council has established a transparent, ambitious and verifiable objective – namely, to keep average inflation in the euro area below but close to 2% over the medium term.

The rationale behind this objective was explained at the time we clarified our strategy in 2003, notably in remarks by our then chief economist Otmar Issing. It ensures that inflation remains low enough to avoid distorting the decisions of firms and households in the economy – while preserving a sufficient buffer away from zero.

We need this buffer away from zero to provide a safety margin against deflationary risks at the euro area level. It also prevents countries experiencing inflation rates well below the euro area average as part of their adjustment processes from being forced to operate in deflationary territory for protracted period.

These considerations are the backdrop against which we decided to cut our main policy rates two weeks ago.

The rationale for action

The context of this decision was a gradual but sustained downward drift in inflation that we had observed over several months. Inflation projections by ECB staff, as well as by other major forecasting institutions, had been revised down repeatedly over the last year – from already low levels.

And the process of gradual disinflation did not just affect individual, volatile components of inflation such as energy. Instead, it reflected a broad-based reduction in all major inflation components since last summer.

The disinflationary trend was further confirmed by the latest yearly inflation figures published by Eurostat. These were revised down by almost half a percentage point to 0.7% in October.

Overall, we have been witnessing a disinflation "in slow motion" for several months now. And combined with still weak economic and monetary dynamics, the latest data suggest that we may experience a prolonged period of low inflation going forward.

So why did we act?

It was not because we see deflation risks materialising in the euro area. With the recovery taking hold, we still expect inflation to return very gradually to levels below but close to 2%. This view is also supported by inflation expectations, which over a longer-term horizon remain firmly anchored at levels close to 2%.

Rather, we acted to restore an appropriate safety margin from zero as prescribed by our price stability objective.

By rebuilding the safety margin, our accommodative stance also has an important side effect: it facilitates the continuing process of internal rebalancing in the euro area.

Countries with past competitiveness deficits should accept low inflation rates relative to the euro area average. And monetary policy cannot and should not discourage the ambitious reform efforts that are necessary to achieve such rebalancing.

But if average inflation is allowed to drift too low at the euro area level, it is much harder for those countries to undershoot the average. And in the process, adjustment runs into major headwinds as demand suffers and real debt burdens rise.

Addressing the concerns

I am of course aware that our rate cut has raised some concerns.

One concern is the effect of this decision on different countries in the euro area.

However, it is important to understand that setting monetary policy for a union of 17 member states is not the same as for a single country.

What is the same is the objective – price stability. But what is different is the institutional setting, the decision-making procedures and the instruments for the implementation of monetary policy. And crucially, in monetary union price stability is defined for the euro area as a whole.

This is the mandate that was given to us by the euro area member states and, since the launch of the euro, we have delivered it continuously and in full. Euro area price stability is confirmed and anchored into the future.

Another concern is the implication of low interest rates for savers. This concern is understandable. But the effect of monetary policy on the returns on savings cannot be seen in isolation.

First, we need to take account of the state of the economy.

Interest rates are low because the economy is weak. Accommodative monetary policy is a response to this, designed to restore sustainable growth in an environment of price stability. If we were to raise rates in this situation, it would only depress the economy further.

And this would in turn affect savings.

Why? Because people would lose their jobs or have their wages cut in a prolonged and entrenched recession, thus reducing the amount they can save. Or because they would see returns on assets fall, thus reducing their investment income. When the economy contracts, incomes fall, and savings necessarily fall in tandem.

Moreover, the interest rate that matters most to long-term savers is not the main ECB refinancing rate, but the rate on safe long-term investments – in Germany, that is long-term Bunds.

The ECB's decisions influence these long-term rates but there are also other factors at play. For example, on the day of our rate cut of 25 basis points, interest rates on 10-year Bunds fell by less than 7 basis points. Since then those rates have risen by about 2 basis points.

The current low level of interest rates on long-term Bunds is largely explained by investors that have sought safe assets in the context of sovereign debt tensions in the euro area.

A third concern about low interest rates is that they undermine incentives for reform in the euro area.

It is true that monetary policy decisions can have side effects – I mentioned a positive side effect earlier. Yet we act for the euro area as a whole in line with our mandate, not for individual countries.

If there is concern about reform incentives, we need to ask whether the framework of economic governance is being sufficiently enforced, and if not, what could be done to strengthen it. After all, ensuring sound fiscal and economic policies is ultimately the task of political authorities, not monetary authorities.

Economic policy

In the same vein, we know that monetary policy alone cannot create a sustainable recovery. Restarting growth ultimately depends on governments, business leaders and social partners working together. Governments need to create the conditions that allow entrepreneurs to generate growth.

There is no short cut to growth through debt. Growth ultimately has to come from increasing the productive capacity of the economy – that is, through raising competitiveness and productivity.

This country presents a good example of how to build solid foundations for growth.

Germany has competitive and innovative firms that are embedded in global value chains, notably the Mittelstand. The country has enacted labour market reforms that have helped maintain price competitiveness, and that limit the impact of economic downturns on the young. And it has done this while working in cooperation with social partners, who understand that business models have to adapt to a globalised economy.

In short, Germany has oriented itself in a direction that in my view would benefit all euro area countries: being forward-looking, open to the world and focused on competitiveness and productivity.

Abraham Lincoln famously said that "you cannot make the weak stronger by making the strong weaker". Similarly, the answer to the problems of the euro area is not to weaken its stronger economies. Rather, it is to strengthen its weaker economies.

And in fact, this is what we are seeing in the euro area today.

Most countries that lost competitiveness are regaining it. They are converging towards the most competitive countries, not vice versa. They have learned the fundamental lesson – for which Germany is the model – that in a monetary union, wages have to reflect productivity to maintain price competitiveness.

For example, the countries under full EU-IMF programmes have seen their unit labour costs fall by more than 15 percentage points since 2009, relative to the euro area average. Current accounts are in balance or surplus in all the countries under strain, meaning that they are no longer accumulating external debt and "living beyond their means" – and larger countries would be well advised to follow.

And even though declines in import demand play an important role, the rebalancing in countries under strain is also coming from growth in exports and increasing market shares. In Spain, for example, export volumes are up by more than 20% since 2009.

For this reason, I do not agree with those who say that Europe is in a "lost decade". Euro area countries are using the second decade of the euro to undo the mistakes of the first – and in doing so, laying the foundations for sustainable growth in the decades to come.

The challenge ahead

The task of restoring sustainable growth is still far from complete. Regaining competitiveness is only one part of the challenge. Another essential component is to reverse the damage to the economy caused by the crisis. It has reduced the euro area's output level and perhaps also its growth rate.

To turn that around requires higher investment in human and physical capital – and in all euro area countries. In Germany, for example, investment is still around 1 percentage point of GDP lower than it was in 2007, and in that year it already had the lowest investment ratio in the euro area.

Both the public and private sectors have a role to play here. Generating higher investment is ultimately the job of the private sector. But public authorities have to create the conditions that facilitate and encourage this process.

I see three conditions as crucial: a stable macroeconomic environment; growth-enhancing structural reforms; and a healthy banking sector.

First, a stable macroeconomic environment provides the certainty that is so important for investment.

That entails medium-term price stability, which the ECB is providing. And it entails medium-term economic stability, which governments have to ensure through sustainable fiscal and economic policies and adhering to the euro area rules.

Second, structural reforms are vital to raise growth potential and make new investment attractive – especially in the current environment where firms may have become less optimistic as a result of the crisis.

Of particular importance are reforms that increase competition, which in turn drives innovation, efficiency and productivity growth. Such reforms include opening up protected sectors and removing barriers for new firms to enter the market.

Third, we need a healthy banking sector to ensure that capital can be allocated where productive investment is needed.

Bank lending in the euro area is currently very weak, having fallen for 16 straight months. This in part reflects the state of the economy; in part it reflects balance sheet constraints in the banking sector.

But as the economy picks up next year, we need to ensure that those balance sheet constraints do not hinder the recovery. This is why the rigorous and comprehensive assessment of banks' balance sheets currently being undertaken by the ECB is so important. Prompt corrective actions by banks themselves are welcome.

Taken together, these three conditions will provide firms with the certainty, optimism and financing they need to restart investing – and hence to get the euro area back to a higher growth trajectory.

Conclusion

Let me conclude.

I have today described the actions being taken by all actors in the euro area to ensure stability and raise growth. A great deal of progress has been made, but a great deal still remains to be done. For the sake of those who remain unemployed, we have to persevere.

Now is not the time to relax reform efforts. Nor is it the time to become fractious.

We all benefit from an environment of inflation at below but close to 2% in the euro area. We all benefit from measures to raise productivity and improve competitiveness. It is never the case that sound economic policies are good for some in the euro area but not for others.

I trust that this audience understands our shared responsibility for the euro area. After all, we are the euro area – its citizens, its firms and its institutions. It is only by acting together that we can put the crisis behind us, and move forward towards a brighter, more prosperous future.

Euro area economic outlook, the ECB's monetary policy and current policy challenges

Statement by Mario Draghi, President of the ECB, prepared for the Twenty-Eighth Meeting of the International Monetary and Financial Committee, in Washington D.C. on 12 October 2013

I would like to focus on the euro area economic outlook, the ECB's monetary policy and current policy challenges.

Economic activity in the euro area bottomed out in the first half of the year and is expected to strengthen gradually in the period ahead. Recent economic indicators, which have been predominantly positive, support expectations of a modest and gradual recovery. Output is expected to recover at a slow pace, driven by a gradual improvement in domestic demand supported by the ECB's accommodative monetary policy stance and a gradual strengthening of external demand. Furthermore, the improvements in financial markets seen since August 2012 appear to be gradually working their way through to the real economy, as should the progress made in fiscal consolidation. The risks surrounding the economic outlook for the euro area continue to be on the downside. Developments in global money and financial market conditions and related uncertainties may have the potential to negatively affect the economic outlook. Other downside risks include higher commodity prices in the context of renewed geopolitical tensions, weaker than expected global demand and slow or insufficient implementation of structural reforms in euro area countries.

Underlying price pressures in the euro area are expected to remain subdued, reflecting the broad-based weakness in aggregate demand and the modest pace of the recovery, as well as subdued monetary and credit dynamics. Medium to long-term inflation expectations continue to be firmly anchored in line with price stability. The risks to the outlook for price developments are expected to be still broadly balanced over the medium term, with upside risks relating in particular to higher commodity prices as well as stronger than expected increases in administered prices and indirect taxes, and downside risks stemming from weaker than expected economic activity.

The ECB's monetary policy stance continues to be geared towards maintaining the degree of monetary accommodation warranted by the outlook for price stability. It thereby provides support to a gradual recovery in economic activity. Looking ahead, our monetary policy stance will remain accommodative for as long as necessary. In line with the guidance provided in July, the Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation is based on an overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the economy and subdued monetary dynamics. In the period ahead, the ECB will monitor all incoming information on economic and monetary developments and assess any impact on the medium-term outlook for price stability.

With regard to money market conditions, the ECB will remain particularly attentive to developments which may have implications for the stance of monetary policy and is ready to consider all available instruments.

Further reducing fragmentation of euro area credit markets and improving confidence in the euro area banking sector are essential to ensure an adequate transmission of monetary policy to the financing conditions in the euro area countries and to further repair the credit channel. Financial stability risks have diminished in the euro area. Measures taken by European and national authorities have helped to ease the severe market stress that earlier weighed on sovereigns and banks. The euro area banking sector has made progress in balance sheet repair by improving its regulatory capital ratios, by reducing its leverage since the outbreak of the financial crisis and by shifting its funding structure towards more stable funding sources. Net inflows of capital from abroad as well as a reduction in excess liquidity conditions continue to be observed, reflecting an improvement in financial market confidence. Repayments of funds taken up in the context of the ECB's three-year longer-term refinancing operations conducted in December 2011 and February 2012 have resulted in a decline in the size of the Eurosystem's balance sheet since end-August 2012. We will remain attentive to all developments that influence an adequate transmission of monetary policy to the financing conditions in euro area countries.

Further decisive steps towards establishing a genuine banking union are needed so as to further reduce financial fragmentation, enhance the resilience of the banking sector and strengthen the institutional framework of the euro area. The ECB welcomes the approval of the legal framework of the single supervisory mechanism (SSM) by the European Parliament on 12 September and we look forward to its urgent adoption by the EU Council in the course of October. The entry into force of the SSM legal framework will allow us to further speed up the preparation process, which is well under way. We are committed to delivering on our new supervisory responsibilities by November 2014.

We also strongly support the envisaged timeline for the establishment by the end of 2014 of the single resolution mechanism (SRM), which is a necessary complement to the SSM. The Commission's proposal for the SRM contains three essential elements for the effective resolution of banks, namely: a single system, a single authority and a single fund.

The ECB's forthcoming comprehensive assessment of banks' balance sheets, which will take place before the ECB assumes its supervisory responsibilities, will be an important confidence-building tool, and we are committed to ensuring its consistency and transparency. The effectiveness of this exercise will also depend on the availability of necessary arrangements for recapitalising banks, if and when needed, including through the provision of a public backstop, if private funds cannot be acquired. These arrangements must be in place before we conclude our assessment, in line with the declaration of the European Council of June 2013. It is also noteworthy that strong efforts to repair

bank balance sheets and enhance transparency have already been undertaken in all euro area countries, especially in those that have experienced severe stress.

As regards fiscal policies, substantial fiscal adjustment has been undertaken by the euro area countries over the last few years. The average fiscal position of the euro area countries is much stronger than that of global peers. The authorities should not unravel their multi-year efforts to cut deficits but should reduce the debt ratios without delay, in line with the EU's fiscal framework, which has been considerably reinforced over the past few years. As part of this enhanced framework, the draft budgetary plans that countries will now deliver for the first time under the "two-pack" regulations need to provide for sufficiently far-reaching measures to achieve the fiscal targets in 2014.

Euro area governments must also decisively strengthen their efforts to implement the needed structural reforms in product and labour markets. These reforms are required not only to help the respective countries to regain competitiveness and to rebalance within the euro area, but also to create more flexible and dynamic economies that will generate sustainable growth and employment. As regards intra-euro area imbalances, there has been a major external adjustment in euro area countries with previously high current account deficits. Improved competitiveness indicators, in particular declining unit labour costs and the relatively robust export performance, point to a more lasting effect of the structural reforms undertaken so far. The framework of the European Semester and the macroeconomic imbalance procedure have provided additional tools to secure further progress in terms of structural adjustments in the euro area that will put the euro area in a position to make a positive contribution to global growth and employment creation.

The euro area economy: current prospects and challenges ahead

Speech by Mario Draghi, President of the ECB at the Economic Club of New York New York, 10 October 2013

Ladies and Gentlemen,

I am delighted to be here with you today and I would like to take this opportunity to talk about what is happening in Europe right now.

As you know, the euro area as a whole is undergoing a process of fundamental reform. The overarching objective is to lay the foundations for recovery and more jobs, to foster financial stability and fiscal sustainability and to enhance international competitiveness for the benefit of all parts of the economy and wider society.

Reform will be a lengthy process and while it is far from complete, perhaps for the first time we are seeing signs of significant progress.

National policy-makers in Europe are able to focus a little less on short-term difficulties and a little more on their longer-term responsibilities to strengthen the resilience of their domestic economies while developing their growth potential.

And the monetary policy that we at the European Central Bank (ECB) are implementing will accompany the reform process by maintaining the degree of accommodation that is most appropriate, given our economic outlook and the risks that surround it.

The economic situation and outlook

So let me start with an overview of the current situation and outlook for the euro area economy.

Recent data releases support our baseline outlook of a nascent economic recovery over the coming months. Following six quarters of negative output growth, euro area real GDP rose by 0.3% in the second quarter of this year.

Although more recent data has pointed to a fairly slow start in the third quarter, survey-based confidence indicators give some comfort that the turning point in economic activity that we saw earlier in the year has not reversed.

Taken together, incoming information has confirmed the growth outlook from the September ECB staff projections. While these projections still see real GDP shrinking by 0.4% this year, a positive growth rate of 1% is expected for 2014.

But the pace of recovery is going to be subdued and uneven across countries for as long as it is meaningful for us to look into the future. The unemployment rate, currently standing at 12.1%, remains unacceptably high, and the risks around the outlook continue to be tilted to the downside.

In keeping with the broad-based weakness in aggregate demand, underlying price pressures remain subdued as well. Annual euro area headline inflation is projected to reach 1.5% this year, before declining to 1.3% in 2014.

These levels are historically very moderate, and remain in the lower part of the range of values that the ECB's Governing Council has identified as consistent with the ECB's quantitative definition of price stability.

That said, inflation expectations continue to be firmly anchored in line with our aim of maintaining inflation rates below, but close to, 2% over the medium term. And the risks to the outlook for price developments are expected to be broadly balanced.

Finally, monetary and in particular credit dynamics remain weak. The annual growth rate of loans to the private sector has remained well inside negative territory; and the pace of contraction has actually accelerated over the recent period.

Certainly, weak loan dynamics can largely be explained by the current stage of the business cycle but we have to be attentive to alleviate structural and supply-side factors that may hamper credit provision. The significant improvement in the funding situation of banks since the summer of 2012 has partly offset supply-side restrictions. But it will be some time before the more permissive funding conditions faced by many banks turn into an active spur for credit creation.

The strategy of euro area policy-makers

Against this background, how should policy-makers respond to the still fragile macroeconomic recovery?

In my view, we need a three-pronged strategy:

First, monetary policy has to remain consistently supportive of the baseline outlook and mitigate the risks that surround it. Our price stability mandate is sufficiently precise to keep us concentrated on that mission.

But preserving monetary accommodation is a necessary but not sufficient condition for the recovery to take hold.

A second essential ingredient is that countries continue the adjustment of their domestic policies in a way that removes structural impediments to their economic potential and fosters long-term fiscal sustainability.

Monetary accommodation can accompany and facilitate such a regime shift in economic policy. But we know it can never replace it.

Third and equally important, Europe has to continue the reform process in its banking sector.

Sound finance is part and parcel of a dynamic economy and banks remain a major conduit of finance in the euro area. Hence, we must establish conditions that align incentives of individual financial institutions with those of society.

Let me explain the measures that European policy-makers are taking in each of these areas: monetary policy; fiscal and structural adjustment; and banking reform.

Monetary policy

Let me start with monetary policy.

As you know, the Treaty clearly prioritises price stability as the ECB's primary objective. Within this disciplining framework, we tailor our policy response to the challenges at hand.

In response to the events of the past six years, we've taken swift and resolute action. We cut the main policy rates to record lows. We provided funding support to euro area banks over long time horizons. And we counteracted and removed unwarranted fears of a breakup of the euro area.

In July this year, we again expanded our toolkit to protect the nascent recovery from the risk that it could be choked off prematurely by an unwelcome restriction in monetary conditions.

To that effect, the ECB's Governing Council adopted explicit communication on how it expects its key interest rates to evolve in the future. In particular, we have communicated our expectation that the key interest rates will remain at present or lower levels for an extended period of time.

This expectation is based on our assessment that the subdued inflation outlook extends into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics.

What was the rationale for adopting 'forward guidance'?

In June and July, we observed substantial volatility in money market rates. The pricing of term interbank credit in the money market – the first stage of the transmission of monetary policy to the broader economy – had become increasingly divorced from euro area fundamentals.

Markets tended to overreact to news that was either not directly relevant to the euro area macroeconomic outlook or simply confirmed our baseline scenario.

Against this background, our forward guidance aimed at better aligning money market conditions with our policy intentions.

In interpreting our forward guidance, there are three essential elements.

First, it acknowledges the scope for further cuts in our key interest rates. In other words, the adoption of forward guidance does not imply that we've reached the effective lower bound.

Indeed, the opposite is the case: the Governing Council has unanimously agreed to incorporate an easing bias into our forward guidance that explicitly provides for the possibility of further rate reductions, should the volatility in money market conditions return to the levels observed in the early summer.

Second, our forward guidance is specifically tailored to the ECB's mandate and monetary policy strategy: the path of the policy rates remains conditional on the outlook for inflation; and it will be reviewed over time against the analytical framework underlying the ECB's monetary policy strategy.

This means that we assess whether the medium-term outlook for inflation remains subdued against two types of metrics. On the one hand, economic indicators pointing to persistent slack in the real economy. On the other hand, monetary indicators pointing to persistent subdued dynamics in money and credit.

The third element of our forward guidance is that, by confirming our policy framework, it refocuses attention on what matters most for our monetary policy, namely the medium-term inflation outlook in the euro area. On our side, it induces the sort of prudent language in communicating about the economy and the type of balanced and steady response to economic news that is needed in the exceptional circumstances in which we currently have to steer our monetary policy course.

The observed decline in market uncertainty about future short-term rates indicates that our forward guidance has helped to anchor market expectations.

Going forward, we will carefully assess developments in money markets and liquidity conditions. We have to ensure that interest rate expectations remain firmly anchored around a path that does not add to downside risks to the recovery.

Thus, our monetary policy stance will continue to be geared towards maintaining the degree of accommodation warranted by the outlook for price stability and promoting stable money market conditions. It thereby provides support to a gradual recovery in economic activity.

Fiscal consolidation and competitiveness

But preserving monetary policy accommodation is not sufficient in itself for the recovery to take hold and become self-sustaining.

This leads me to the second element of the policy response: repairing the fiscal and structural problems that hold back individual euro area economies.

A painful lesson from the last few years is that we all underestimated the destructive potential that myopic national policies could exert on the euro area's collective body, and on the world economy as a whole.

It is time to remove the institutional shortcomings that allowed imbalances to build up in the national economies and escalate into systemic threats in the first place.

In the euro area, two such shortcomings were particularly consequential.

First, the EU fiscal rules were weakly enforced and, as such, incapable of promoting prudent fiscal policies in times of favourable economic conditions. Second, there was no mechanism to prevent and correct macroeconomic imbalances within the EU.

This resulted in an incentive vacuum.

Rather than exploiting the advantages of monetary union for a modernisation of domestic economies, several countries simply delayed necessary adjustments.

And the elimination of exchange rate fluctuations and the levelling-off of spreads in sovereign borrowing costs that preceded the downturn deactivated the market forces that previously had disciplined macroeconomic policies at the country level.

European policy-makers are addressing these issues.

Due to a recent strengthening of the EU fiscal rules, Member States now face stronger incentives to adopt sound budgetary policies.

Moreover, a new 'Macroeconomic Imbalances Procedure' has been established at EU level. It requires governments to adopt competitiveness-enhancing policies and tackle potential sources of financial instability in their domestic economies.

Reflecting this reform momentum at the European level, governments are tackling imbalances in their domestic economies. They are implementing reforms to reverse the misguided policies of the past and to create sustainable long-term growth.

Progress is steady and the data increasingly show that governments are heading in the right direction.

Euro area countries have cut their fiscal deficit ratios by half since their peak in 2009. Excluding interest payments, euro area Member States on aggregate are expected to run a small surplus by the end of this year.

This is clearly in contrast to other industrial economies, such as the US or Japan, which last year still recorded primary deficits of 6% and 8% of GDP, respectively.

We are also seeing some noteworthy improvements in competitiveness and external positions.

The countries under full EU-IMF programmes have seen their unit labour costs fall by more than 10% since 2008, relative to the euro area average. Their current accounts have improved by around 8% of GDP since then.

In short, there is progress towards more solid economic fundamentals in the euro area.

But maintaining the current momentum of reform is essential for ensuring stability in the euro area.

Bank balance sheets and banking union

Finally, a sustainable recovery requires healthy financial institutions.

We have seen much progress in the banking sector of the euro area. Since the beginning of the financial crisis in 2007 euro area banks have raised around €225 billion of fresh capital and another €275 billion has been injected by governments. All in all, this amounts to more than 5% of euro area GDP. As a result, the average Core Tier 1 ratio of the largest euro area banks currently stands well above 11% and the majority of euro area banks already comply with the minimum capital requirements of the fully implemented Basel III framework.

Furthermore, in countries under financial assistance programmes, problematic legacy assets have been removed from banks' balance sheets to ensure that they will no longer curb banks' lending to profitable businesses.

More progress is on its way in terms of the institutional architecture. Europe's Economic and Monetary Union (EMU) will be complemented by a European banking union.

Last month, the European Parliament cleared the way for the single supervisory mechanism, which tasks the ECB with overseeing major parts of the European banking system.

By placing this responsibility with an independent institution at European level, the new supervisory mechanism will allow for more stringent and consistent supervision. This will, ultimately, afford an earlier identification of financial risk – in both individual institutions and the financial sector as a whole.

Looking forward, two objectives need to be addressed: First, we need to create full transparency about the risks on banks' balance sheets. And, second, we need to align investors' incentives with those of society.

A comprehensive balance sheet assessment will be a crucial preparatory step before we begin our new supervisory task in autumn 2014. This will serve to strengthen transparency and to mitigate the risk of the possible emergence of problem banks in the early days of operation of the new supervisory mechanism. This balance sheet assessment, to be conducted by the ECB together with national supervisors and an independent third party, will consist of a supervisory risk assessment and a thorough asset quality review that in turn will be an input for a stress test to be jointly carried out with the European Banking Authority (EBA). The three elements combined will ensure a comprehensive assessment, identifying remaining risks on banks' balance sheets.

To strengthen incentives, the institutional architecture will be augmented by the single resolution mechanism. As a first step to overcoming the existing problems of incentive incompatibility, harmonised rules and procedures for bank recovery and resolution are currently being developed at

European level. These harmonised frameworks should be implemented at national level as soon as possible.

But to ensure a fully consistent and effective application of these rules, their implementation should be placed within the remit of an independent authority that reinforces the new supervisory framework at a European level.

To that effect, the EU's institutional architecture should be augmented by a single resolution mechanism that executes bank resolution in a timely and impartial manner and formulates its decisions from a clear, encompassing European perspective.

By enhancing transparency and incentive compatibility, the combination of the single supervisory mechanism and the single resolution mechanism will help Europe return to a situation in which investment decisions will be based on business prospects, not on geographical location.

Conclusions

Let me conclude.

The recovery remains in its infancy. Given the prolonged build-up of macroeconomic imbalances in the past, we have to be prepared for a protracted and anaemic process in the future.

Yet we should also not exaggerate the euro area's challenges. While the unemployment rate has increased more in the euro area than in the US during the crisis, the employment rate in the US has fallen further than in the euro area, which makes the figures difficult to compare.

Moreover, the euro area has a strategy to return to sustainable growth and employment, and that strategy is being executed. What is essential is that all policy-makers in the euro area play their part and stay the course. The rewards that will result from the reform of our economic institutions cannot be overestimated.

Thank you for your attention.

Europe's pursuit of 'a more perfect Union'

Lecture by Mario Draghi, President of the ECB, at Harvard Kennedy School, Cambridge (USA), 9 October 2013

Introduction

Ladies and gentlemen,

I am delighted to have been invited to give this year's Malcolm Wiener lecture on international political economy. It is always a pleasure to be back in this country, particularly here in Cambridge where I studied for my PhD back in the 1970s.

The United States has often been described as a young nation, but the institution that I have the honour of leading is considerably younger. The European Central Bank (ECB) and the single currency began operations nearly 15 years ago at the beginning of 1999. Today I would like to give you a flavour of both the circumstances of our beginnings and the challenging environment of our teenage years.

As you will all be aware, Europe is currently engaged in a far-reaching process of reform.

Many of those reforms are taking place within the Member States of the European Union (EU) – to make their public finances more sustainable; to make their economies more competitive; and to strengthen the balance sheets of their domestic banks.

But there is also an important stream of reforms taking place at the European level – the counterpart of what you call the federal level here in the US. New rules and institutions are being created that will change the relationship between the Union and the Member States.

It is this process and its implications on which I want to focus in my remarks today.

The preamble of the European Treaty makes 'ever closer union' a goal of the EU. For some people, this creates anxiety. It seems to promise an inexorable movement towards a future super-state. Many Europeans, with different national histories and cultures, feel that they are not ready for that.

So it is important to understand that the agenda facing Europe today is not adequately captured by the phrase 'ever closer union'. In my view, it is better encapsulated by wording borrowed from the Constitution of the United States: the establishment of a 'more perfect union'.

By this, I mean that we are 'perfecting' something that has already begun – namely, the economic and monetary union that was launched in 1999. Policy-makers are following through the consequences of the decision to create a genuine single market supported by a single currency.

In what follows, I would like to describe several of those consequences. In doing so, I will explore two broad themes.

First, I will argue that a single market necessarily has political implications, in which a partial sharing of individual and national sovereignty can be the best means to preserve that sovereignty.

Second, I will explain how the concepts of a banking union and a strengthened fiscal setup are supportive of the single market and the single currency.

The political implications of a single market

To understand the EU and the euro area, it is important to appreciate the difference between a free trade area and a true single market.

A free trade area is a partial and reversible arrangement. A single market, by contrast, is a universal and permanent union. This is a distinction with fundamental implications.

Because a single market is universal and permanent, governments and parliaments forfeit, both in principle and by Treaty, the ability to reinstate border controls. This means that, unlike in a free trade area, they cannot act alone to protect their constituents from unfair or unlawful competition from abroad.

Yet such underpinning at the political level is vital for a market to function. There cannot be a free market without such fundamental elements of law as the protection of property rights and the enforcement of contracts. [1]

So while a free trade area can be managed through intergovernmental cooperation, a single market requires a supranational organisation. There has to be a judiciary with the power to enforce competition law at the level of the market. In Europe, this authority is devolved to the European Commission and the European Court of Justice.

If there is a judiciary, there naturally has to be a legislature, to write the law enforced by the judiciary. In Europe, the EU Council and the European Parliament jointly perform this role.

And if there is a legislature and a judiciary, then there also has to be an executive able to implement their decisions. Here again, in Europe, the European Commission is entrusted with executive responsibility.

This is what I mean when I say the single market necessarily has political implications. Indeed, it is well known that the short commerce clause of the Constitution of the United States, which grants Congress "power to regulate commerce (…) among the several states", forms the basis of a considerable body of federal legislation governing economic matters.

Sharing sovereignty in a single market

The more difficult question in Europe is the degree to which powers must be transferred to the supranational level to support the single market – or put differently, how much sovereignty needs to be shared. In my view, one way to approach this question is by considering more carefully what we mean by sovereignty.

One way to look at sovereignty is normative, and was historically favoured by absolutists such as Jean Bodin in the sixteenth century. Sovereignty here is defined in relation to rights: the right to declare war and treat the conditions of the peace, to raise taxes, to mint money and to judge in last resort.

Another way to look at it is positive. Sovereignty relates to the ability to deliver in practice the essential services that people expect from government. A sovereign that is not capable of effectively discharging its mandate would be sovereign only in name.

This second approach is more consistent with the writings of the political philosophers who most influenced our modern democracies. John Locke, in his second treatise of government, affirms that the sovereign exists only as a fiduciary power to act for certain ends. It is the ability to achieve those ends that defines, and legitimises, sovereignty.

The same argument is made by James Madison in federalist paper 45, in which he states that "no form of government whatever has any other value than as it may be fitted for the attainment of [the public good]".

I see this positive view as essentially the right way to think about sovereignty. And I think it needs to be the guiding principle when deciding which powers should be at national or European levels. We need to look at effectiveness, not at abstract principles that may be empty in today's world.

Such an approach moves us away from a zero-sum view of sovereignty as power, where one body loses sovereignty and another gains it. Instead, by placing the needs of citizens at the centre, it allows us to view sovereignty in terms of outcomes – and this can be positive-sum.

This way of thinking is in fact already embedded in the EU Treaty under the principle of subsidiarity. This states that powers cannot be transferred to the level of the Union unless action is more effective at that level than at a lower level of government. In other words, it places the emphasis squarely on the efficacy of policy.

In my view, it is this pragmatic focus on policy efficacy that should be the motor of further integration.

From a single market to a single currency

Policy efficacy was indeed one of the main motivations for monetary union – in particular, to maximise the potential gains from Member States forming a single market.

A first argument in favour of the single currency related to the desirability of a single means of payment and unit of account in a single market. A single currency is not necessary for trade, but it is helpful, to the extent that it eliminates currency conversion costs and increases price transparency.

A second argument related to the conditions for fair competition in a single market. In a system of floating exchange rates, individual governments may be tempted to manipulate their currency to pursue 'beggar thy neighbour' policies, which constitutes a distortion of competition. An economy that increases productivity and competitiveness can be deprived of the benefits it should enjoy in terms of increased market share because of currency depreciation in competing countries.

Indeed, the instability of exchange rates post-Bretton Woods has arguably vindicated the views of economists such as Ragnar Nurkse, who, in an influential study commissioned by the League of Nations and published in 1944, warned of the economic losses resulting from currency volatility. [2]

It is also worth remembering that Nobel laureate Robert Mundell developed his theory on optimum currency areas as a critique of flexible exchange rates in a single market, not in support of such an arrangement. He said that he 'could not see why countries that were in the process of forming a

common market should saddle themselves with a new barrier to trade in the form of uncertainty about exchange rates' [3].

In any case, the desire to limit exchange rate volatility in the EU was formulated very soon after the collapse of the Bretton Woods system in the early 1970s. It has been reflected in successive fixed exchange rate arrangements, such as the European Monetary System and its successor the Exchange Rate Mechanism.

And it has been reflected in the Treaty requirement that each Member State treat its exchange rate policy as a matter of common interest.

Free trade and capital movements could clearly not be sacrificed in a true single market. Also, Europeans saw fixed exchange rates as an important component of fair competition. It was thus the national sovereignty over monetary policies that would have to be let go. In this sense, the single currency became a way of maximising the benefits of the single market. And the empirical evidence suggests that sharing a currency has indeed boosted trade, although the effect may be smaller than was earlier suggested. [4]

Let me also add that, for several Member States, joining the single currency implied not only greater policy efficacy, but paradoxically, greater national influence.

Whether Austria before 1999 or Latvia today, many Member States pursued a fixed exchange rate policy or currency board vis-à-vis a bigger neighbour – Germany in the past, the euro area today. This meant that they were effectively importing a monetary policy over which they had no say. Now, as members of the euro area, they have a say. When Latvia adopts the euro on 1 January next year, my colleague, the governor of the central bank of Latvia, will partake fully in the formulation of the ECB's monetary policy. The same cannot be said of the countries that peg their currencies to the US dollar, some of which are considerably larger.

From a single currency to a banking union

The implications of the decision to set up a genuine single market are not limited to the creation of the single currency. The single currency itself has consequences, of which the most pressing is a banking union.

The establishment of a banking union has been agreed by the Heads of State and Government in Europe and is now being delivered in stages, starting with the single supervisory mechanism. This has been entrusted to the ECB and has recently been approved by the European Parliament. We trust that a single resolution mechanism will enter into force by the beginning of 2015.

To understand why a banking union is a consequence of the monetary union, it is worth recalling that only a small fraction of money is "outside" money, meaning the liability of the central bank. The bulk of money used in the economy is "inside" money, meaning the liability of a commercial bank.

For money to be truly single within a currency area, there has to be full substitutability between its different forms. This means that one euro in a bank in any euro area country has to be fully substitutable with a euro in another. The only way to achieve this is to remove the differences in the banking system that can create fragmentation along national lines – and the most important difference is the way banks are supervised and, when necessary, resolved by national authorities.

We are thus moving these functions to the European level to ensure that the single currency is matched by a single banking system. And this is consistent with the positive definition of sovereignty I gave earlier: a genuine banking union can give citizens more trust in their money than can different national approaches.

Moreover, there is an important positive feedback effect here. While there is a chain of logic from the single market to the single currency to a banking union, a banking union in turn supports the single market. When fragmentation of the banking system takes place, it does not only undermine the singleness of money, but it also undermines the conditions of competition. This is because it results in a dispersion of bank lending rates along national lines, as we have seen in recent years.

Let me be clear here: there is no reason *per se* why a Spanish firm should be able to borrow at exactly the same price as a Dutch firm. If the operating environment of both firms is different, then this can reasonably affect their credit risk and therefore the rate at which they borrow.

But in a single market, a Spanish firm should be able to borrow from a Spanish bank at the same price at which it would borrow from a Dutch bank. If that is not the case, if the risk premium paid by a bank client in one country is not idiosyncratic but systemic, then there no longer truly is a single market for capital. Location would matter. And this is what a banking union aims to reverse.

In Europe, such a banking union is even more important than in the US because over two- thirds of firms' external financing takes place in the form of bank loans. For small and medium-sized enterprises this share is even higher. In the US, by contrast, the role of banks in firms' external finance is only about one-third or even less. Hence, a banking union is crucial also for the euro area real economy.

But, it can reasonably be asked, if a banking union is so important, why did this only become apparent in the last few years?

The main reason is that the potential for financial fragmentation in the euro area was not recognised. Policy-makers and observers did not fully appreciate the extent to which diverging fundamentals between different economies could feed through to the banking system. This applies notably to sovereign debt, and the two-way interaction between sovereign distress and bank distress.

Certainly, a banking union can play a major role in breaking the vicious circle we see in Europe between banks and their sovereigns. But there is also a strong onus on governments to ensure that sovereign debt performs its expected function in the financial system – that is, as a risk-free, safe asset. Let me therefore briefly turn to fiscal policies.

The implications for fiscal policies

It is welcome that governments in the euro area have made significant progress in consolidating their budgets, and hence removing some sovereign risk from the financial system. The primary fiscal deficit for the euro area has fallen from 3.5% of GDP in 2009 to around 0.5% in 2012. In the United States, by comparison, it was around 6% of GDP in 2012.

That said, we need to ensure time consistency. We all know the experience of the first decade of the euro. Fiscal rules enshrined in the Maastricht Treaty were not sufficiently binding; market discipline likewise did not work in an effective way. [5]

For this reason, the ECB has long argued in favour of moving towards more effective rules in the fiscal domain. We are convinced that they are crucial for the stability of the common currency in the longer term. I am therefore encouraged that policy-makers in Europe have been taking significant steps to strengthen the common fiscal rules.

These steps include new ways of dealing with countries that do not comply with recommendations from the European Commission. They include giving the Commission the right to inspect national budgets before they go before national parliaments – a power the US federal government does not have over the states. And they include inserting balanced budget rules into their national constitutions or equivalent. We look forward to a full and transparent implementation of this new regime.

These changes do to some extent represent a transfer of powers to the European level. But as with a banking union, I do not view it as a loss of sovereignty. Rather, I see the strengthening of the fiscal pillar in a manner that lends credibility to fiscal policies as a way to restore the efficacy of policy: for the Union as a whole, as countries are less affected by spillovers from fiscal difficulties in an integrated financial market; and also for the Member States themselves.

This budget stabilisation capacity through the automatic stabilisers is diminished if governments are unable to run a deficit at the low point of the cycle – or put differently, if the credit of the government deteriorates to the point where its debt is no longer regarded as a safe asset. Indeed, if the credit of the government is impaired, and behaves like private credit, then government's relative cost of borrowing increases at precisely the time when it needs to borrow.

One can see this as the real loss of sovereignty. It prevents national governments from using normal fiscal policy for macroeconomic stabilisation. In this sense, steps that restore faith in public credit, such as more credible fiscal rules, restore the ability of governments to exercise the functions that citizens expect from them.

This is particularly important in a monetary union where the burden of macroeconomic stabilisation cannot be entirely shifted onto the shoulders of the central bank. Our monetary policy mandate is to deliver medium-term price stability in the euro area as a whole. Fiscal policy has to absorb idiosyncratic or asymmetric shocks at a national level.

And unlike in the United States, as fiscal policies are decentralised, such stabilisation takes place entirely at the sub-federal (or national) level in the euro area. However, if the fiscal rules and institutions are credible, there is ample scope for national policies to perform this role.

Looking forward

Overall, the changes taking place in the euro area are making our monetary union more robust. At the national level, consolidation and structural reforms are helping most countries reach a more sustainable external position.

At the European level, we are approaching a balance of competencies which, taken in combination, should provide more effective stabilisation.

That said, it would seem misplaced to exclude that over time the euro area may move to a new equilibrium. Integration is a dynamic process and we need a certain degree of humility about where it will lead. If we look at the US, we see that it strengthened its union in different stages, with each stage eventually begetting the next. The creation of the Federal Reserve System in 1913, for

example, was followed twenty years later by the creation of the FDIC, a key pillar of America's banking union. The federal budget also developed significantly at this time.

In Europe today, we are in some ways undergoing an analogous process. It is not analogous in the sense that the destination is the same. We do not know this. What is analogous is the guiding principle. Like the US, our orientation is pragmatic and driven by a desire for policy efficacy and to provide the functions citizens expect of government. We are then drawing the policy conclusions that follow, at the time when they are relevant.

In the dark days of the crisis, many commentators on this side of the Atlantic looked at the euro area and were convinced it would fail. They were wrong in their medium-term macro view. The euro area has created 600,000 more jobs than the US since 1999. And while the unemployment rate has increased more in the euro area than in the US during the crisis, the employment rate in the US has fallen further than in the euro area, which makes the figures difficult to compare.

But they were wrong in a more fundamental way. They had underestimated the depth of Europeans' commitment to the euro. They mistook the euro for a fixed exchange rate regime, when in fact it is an irreversible single currency. And it is irreversible because it is born out of the commitment of European nations to closer integration – a commitment which, as the Nobel committee recognised last year, has roots in our desire for peace, security and transcending national differences.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, President of the ECB, Brussels, 23 September 2013

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure for me to be back with your committee, shortly after the important vote of your assembly on the SSM regulation. This vote has been preceded by intense interaction on the interinstitutional agreement on accountability and transparency, and I would like to thank President Schulz, your Committee and the negotiating team for the commitment to a successful establishment of the SSM. Our two institutions share a common interest in a swift and effective implementation of banking union. The draft inter-institutional agreement ensures high standards of transparency and accountability, while safeguarding the protection of confidential information. We will continue working with a similar constructive spirit in the months ahead and hope that this will allow a swift set-up of the Supervisory Board.

Today, I will first review recent economic and monetary developments in the euro area. I will then address the two topics that you have selected for our discussion: the impact of our non-standard measures; and the new tasks of the ECB in the reformed EMU architecture.

Economic and monetary developments

Since our meeting in July we have received positive data for the euro area economy. Following six quarters of negative output growth, euro area real GDP rose by 0.3%, quarter on quarter, in the second quarter of 2013. Measures of confidence and surveys of production have given some support to the view that euro area economic activity should continue its slow recovery in the current quarter, despite weak production data for July. Looking forward, economic activity should benefit from a gradual improvement in domestic demand, supported by the ECB's accommodative monetary policy stance and strengthening external demand for euro area exports. However, unemployment in the euro area remains far too high, and the recovery will need to be firmly established.

Annual euro area inflation declined to 1.3% in August 2013, down from 1.6% in July. Underlying price pressures are expected to remain subdued, reflecting the broad-based weakness in aggregate demand and the modest pace of the recovery. Medium to long-term inflation expectations continue to be firmly anchored in line with price stability. The risks to the outlook for price developments are expected to be still broadly balanced over the medium term.

Monetary and, in particular, credit dynamics remain subdued. The annual rate of change of loans to the private sector and, notably, to firms weakened further in July. Weak loan dynamics continue to reflect the current stage of the business cycle but also heightened credit risk and the ongoing adjustments in the balance sheets of borrowers and lenders. The significant improvement in the funding situation of banks since the summer of 2012 has not yet fed through into higher credit provision.

Review of recent monetary policy decisions

Against this background, the Governing Council has pledged to maintain monetary policy accommodative for as long as necessary. In order to re-affirm and clarify this conditional pledge, in a context of volatile money market interest rates, the ECB has introduced forward guidance in July, stating that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation, which has been reconfirmed in August and September, is based on a subdued outlook for inflation extending into the medium term, given the broad-based weakness in the economy and subdued monetary dynamics. We will maintain the degree of monetary accommodation warranted by the outlook for price stability and aim at promoting stable money market conditions.

To ensure an adequate transmission of monetary policy to the financing conditions in the broader economy, it is essential that effective measures be taken to further reduce fragmentation of euro area credit markets and to strengthen the resilience of banks where needed. Monetary policy contributes to these objectives, but it can only address impairments in transmission insofar as they are not related to more structural barriers.

By giving unlimited access to central bank refinancing against adequate collateral, our non-standard measures have been pivotal in relieving bank funding stress. The collateral framework has been adjusted as necessary to ensure continued adequate risk protection for the ECB's balance sheet, while at the same time promoting transparency, for example in markets for structured finance products. Ensuring that solvent banks remain liquid has contributed to avoiding an abrupt deleveraging which would have deeply damaged the economy.

The Outright Monetary Transactions (OMTs) announced a year ago have prevented risks of destructive scenarios with potentially severe challenges for price stability in the euro area. OMTs serve as a fully effective backstop, within the ECB's mandate, and under formal conditionality so as

to preserve the appropriate incentives for governments to ensure fiscal solvency and adopt those structural policies that can put the economy on a sustainable path.

Over the past twelve months, confidence in the euro area has returned. As a consequence, fragmentation in euro area funding markets has been receding. This improvement owes not only to the ECB's non-standard measures, but also to progress by governments in improving the euro area governance and in pursuing reform agendas. Deposit outflows from stressed countries have been reversed. Market access for banks has improved. Reliance on ECB funding support has been steadily declining. These improvements are reflected primarily in the on-going advance repayments of funds by several banks which had borrowed from the ECB under the two three-year longer-term refinancing operations. While repayment of central bank credit is certainly a sign of normalisation, the resulting reduction in excess liquidity can reinforce upward pressures on term money market rates. We will remain particularly attentive to the implications that these developments may have for the stance of monetary policy.

The tasks of the ECB in the reformed EMU architecture

Let me finally address the tasks of the ECB in the reformed EMU architecture. The Maastricht set-up has been substantially strengthened since the start of the crisis. Europe has reinforced fiscal and macroeconomic surveillance, created a permanent crisis management mechanism, the ESM, and has improved its institutional framework. It is moving swiftly towards the Single Supervisory Mechanism (SSM) for banks in the euro area. A key priority of the agenda for the last quarter of 2013 is to complement it by a Single Resolution Authority and Single Resolution Fund as proposed by the European Commission. The ECB strongly supports the envisaged timeline for the establishment of the SRM by 1 January 2015, which adequately reflects the urgency.

Let me make a few remarks on the specific role of the ECB in the progress towards a fully-fledged banking union. Already in 2010, with the decisive contribution of your institution, the ESRB was created to oversee macro-prudential risks in the financial system as a whole. The ECB ensures the Secretariat and thereby provides support to the ESRB. This year, a further-reaching step is being made with the imminent launch of the Single Supervisory Mechanism. The ECB is fully committed to assume its new responsibilities and to discharge accountability accordingly. Preparatory work has started in order to ensure that the new tasks are performed at the highest level of effectiveness and professionalism.

While synergies between the new supervisory and existing monetary policy functions exist, the ECB will strictly respect the principle of separation between monetary policy and banking supervision, as foreseen in the SSM Regulation. Such separation will ensure that the ECB will continue to fulfil its primary mandate of price stability in complete independence, in line with the Treaty.

The effective separation of monetary policy and bank supervision decisions will be implemented both at the decision making level and at the technical staff level. A separate Supervisory Board will be created to draft and enforce decisions. Furthermore, deliberations of the Governing Council on supervisory matters will be strictly separated from monetary policy decisions. This separation between the two tasks will be underpinned by separated agendas and meetings.

Finally, let me say a few words on the involvement of the ECB in the troika. Back in 2010, we were asked by the Council to provide our technical expertise to the design and monitoring of EU/IMF financial assistance programmes. In the meantime, the ECB has been allocated a number of specific tasks by the ESM Treaty and EU secondary legislation. We act in liaison with the Commission to

provide technical advice, based on our expertise. As we have done in the past, we remain ready to share our views on the situation in programme countries with the European Parliament and to explain the advice provided as part of the troika. However, it is important to recall that the Eurogroup is the body which actually decides whether to grant financial assistance and under which terms.

Thank you for your attention. I am now looking forward to your questions.

Keynote speech at the conference "Europe and the Euro – A Family Affair"

Speech by Mario Draghi, President of the ECB, at the conference organised by Bundesverband der Deutschen Industrie and Bundesvereinigung der Deutschen Arbeitgeberverbände, Berlin, 16 September 2013

Ladies and gentlemen,

Thank you for inviting me to speak to you today. It is a great pleasure to be part of an event that brings together entrepreneurs and family businesses from across the euro area.

Such a gathering reflects many of the reasons why Europe established a single currency in the first place – to deepen the integration of our economies by making it easier for firms and households to exchange across national borders; to encourage the small- and medium-sized enterprises that are so important for growth and job creation; and to give citizens across Europe an impetus to work together.

Reading the resolution that you plan to adopt at this conference, I am very encouraged by the determination that you show to take the euro area forward – and I naturally support your central objectives of promoting sustainable growth.

Today, I would like to share with you some thoughts on how to achieve sustainable growth in the euro area from an ECB perspective. There are two main components.

The first component is stabilising the euro area, as without a stable foundation there can be no growth. The second component is strengthening the euro area – by ensuring sustainable economic policies in all member countries, by increasing the competitiveness of our economies and by completing the institutional architecture of economic and monetary union (EMU).

My main message is that we have made significant progress on the first step, stabilising the euro area. But there is still work to do to transform this achievement into higher growth and employment. Strengthening the euro area through sustainable policies, higher competitiveness and stronger common institutions is therefore our priority for today.

Stabilising the euro area

Let me begin by reviewing the measures that have been taken to stabilise the euro area.

Last year, the euro area faced difficult circumstances. Fears about extreme events were leading to severe tensions in financial markets. Borrowing costs for some governments had risen to very high levels. And market sources of financing for banks in some countries were drying up: for example, between April and July 36 billion euro of Spanish bank bonds matured, but no more than half a billion euro could be newly issued during that period.

These market events were starting to harm the real economy. Corporates in stressed countries were struggling to issue debt, and bank loans were becoming prohibitively expensive.

But today, the situation is improving. Borrowing costs for most governments have returned to more sustainable levels. Funding for banks in countries under stress has improved significantly, even if this has not yet been fully reflected in the cost of credit. And measures of systemic risks have dropped to pre-2011 levels.

Why has this happened?

The role of governments

The first reason is that governments are addressing their fiscal policy challenges. Thanks to their consolidation efforts so far, the primary fiscal deficit for the euro area has fallen from 3.5% of GDP in 2009 to around 0.5% in 2012. This is projected to turn into a primary surplus from 2014 onwards.

This improvement in public finances has helped send a signal to investors that government debt levels will stabilise and then fall in the future. This has been crucial in reassuring markets about debt sustainability. But the average public debt level in the euro area is still very high, at around 95% of GDP. This means that consolidation efforts need to be maintained in the years to come.

The role of the ECB

The second reason for the improvement in markets is actions by the ECB, notably through the announcement of Outright Monetary Transactions (OMT).

Our measures have countered investors' fears about the future of the euro area that emerged last year. As such, they have helped restore the normal functioning of markets, and removed the uncertainty that was paralysing the economies of some countries.

The impact of the OMT announcement has naturally been largest in countries where the uncertainty was greatest. But its effects have been felt across the euro area.

Capital has started flowing back from the core to the periphery, unwinding some of the distortions in interest rates we saw last year. In Germany, for example, long-term interest rates have risen significantly, despite the ECB cutting rates in that time. Target2 balances have fallen by around 30% from their peak.

More generally, the risk of an extreme event in the euro area has fallen – and therefore the risk of an adverse impact on price stability.

This threat to euro area price stability was the reason we had to act. We had to preserve our mandate. But I am encouraged that throughout this period, inflation expectations remained firmly anchored. This shows that markets and citizens trust the ECB to maintain price stability.

Strengthening the euro area

This improved situation in financial markets, however, has not yet translated into a broad-based economic recovery. Let me turn therefore from stabilising the euro area to the measures that are needed to strengthen it.

It is welcome news that the euro area recorded 0.3% GDP growth in the second quarter, after six straight quarters of negative growth. But the recovery is only in its infancy. The economy remains fragile. And unemployment is still far too high. Given the overall subdued outlook for inflation extending into the medium term, the ECB's Governing Council expects the key ECB interest rates to remain at present or lower levels for an extended period of time.

So what can we do collectively to raise growth and employment? As I mentioned, in my view there are three key elements: sustainable policies, higher competitiveness and a more complete EMU.

The first element is sustainable policies because this is a prerequisite for the others. Only if there are sound fiscal and macroeconomic policies in all countries can firms prosper and compete effectively. And only if all countries can maintain a sustainable position can there be closer euro area integration. EMU was not set up for some members to be permanent creditors and others to be permanent debtors.

Why competitiveness matters

With this basis in place, the second element is to improve competitiveness. This can be broadly defined as the ability of firms to remain profitable in an open market economy, and to sustain or expand market share.

Competitiveness can be measured in a number of ways, but its essence is a comparison of relative costs and relative productivity. Within the euro area, as countries share an exchange rate, a key measure of competitiveness is the relative cost in particular of labour compared with relative productivity – in other words, unit labour costs.

In the first decade of monetary union a focus on unit labour costs and their implications for competitiveness was largely missing. This was based on the false presumption that current accounts did not matter in a single currency area. As a result, competitiveness imbalances emerged. We saw wages and productivity diverging in several euro area countries. For some of them a significant competitiveness gap and large current account deficits emerged.

Why does this matter?

It is not only because persistent current account deficits create vulnerabilities, such as a dependence on external financing and an over-indebted banking sector. It is because, since 2008, countries that are more competitive have on average seen higher business margins, lower public debt levels, higher growth, and higher employment.

This correlation suggests that closing the competitiveness gap is a key component of improving the current economic situation.

Closing the competitiveness gap

One way to regain competitiveness quickly is to address the numerator in unit labour costs – nominal wages. Another, longer-term approach is to increase the denominator – to achieve higher productivity. In my view, in the euro area today we need both.

On the first count, there are already some encouraging signs of rebalancing in the euro area in terms of cost competitiveness. Thanks in part to the structural reforms introduced in several countries, relative costs are adjusting where they had become misaligned in the past.

For example, Spanish export volumes grew by more than 20% since 2009. Over time, rising mark-ups should allow Spanish firms to expand capacity and increase hiring.

But let me be clear here that I do not see competitiveness as a race between euro area countries with winners and losers. That is why the longer-term challenge of raising productivity is also key. While cost adjustments increase competitiveness only relatively, productivity gains, by increasing trend growth, can be absolute and benefit all countries.

So how do we raise productivity?

In my view the key issue is the connection between three "I's": innovation, investment and incentives. As innovation and investment mostly take place within the private sector, most interesting from a policy perspective are incentives – namely, the role that government can play in encouraging these other factors.

Take investment as an example. Total investment in the euro area is currently 17% lower than in 2007, while in Germany and France, it is still 2% and 6% below 2007 levels, respectively. Certainly, this derives in part from macroeconomic uncertainty, and in some countries from spare capacity. But there is also a strong microeconomic dimension linked to incentives.

In many jurisdictions, some regulations deter private investment and hinder cross-border projects. This makes a strong case for fully completing the Single Market.

More generally, firms' incentive to invest is linked to their optimism in the business environment. This is affected by issues such as the burden of administrative procedures, or the speed and quality of the judicial system. These are areas where governments, through reforms, are in a position to make a difference.

Measuring progress in these areas is not straightforward, but in one indicator that measures the overall business environment, the euro area is currently ranked 26th in the world. This suggests that several countries could make improvements.

But it is notable that in this same indicator Germany has risen from 6th to 4th place in the last year, while achieving full employment. This underscores once again that competitiveness creates jobs.

The need to strengthen the institutional architecture of EMU

Let me turn to the third key element in our collective efforts to strengthen the euro area – and that is to build a stronger architecture for EMU. There are several areas in which we can make progress, as we outlined in last year's "Four Presidents' Report". For now, I see the priorities as banking union and economic union.

Banking union serves a range of aims, but in the current circumstances restarting lending to the real economy is the key priority. One barrier to bank lending at present is lack of transparency over bank balance sheets. Having a single European supervisor will help address this, as we plan to conduct a comprehensive balance sheet assessment of banks we directly supervise.

Another barrier to bank lending is low investor confidence, which is in part created by different rules for banks across jurisdictions and a lack of comparability. The future European supervisor will also help here, not least by leading to harmonised treatment across the banks it supervises – for example, of loan classification, forbearance and provisioning.

Beyond that, banking union should help speed up the repair of banks – that is if, as I hope, we end up with a strong single resolution mechanism. We need a mechanism that allows non-viable banks to be wound down without financial stability risks, as we see in the US. This tends to support a quicker recovery from banking crises and more stable credit provision to firms and households.

Economic union is also intended to help the real economy, as it aims to help countries reorient their economic policies to benefit more from sharing a single currency. We need to ensure that countries can maintain sustainable growth and high levels of employment without developing internal and external imbalances. This is a prerequisite for the stability of the euro area as a whole.

One way to achieve this would be to develop better ways of measuring economic performance – for example, more structural indicators of competitiveness. Another possibility would be to encourage structural reforms that make economies function more efficiently, and in a way that is more inclusive and benefits all groups in society. Here an idea currently being contemplated is so-called "reform contracts". Such concepts are still at a relatively early stage, and I look forward to them being developed further in the next few months.

Conclusion

Let me now conclude.

As I have explained, the euro area has taken important steps to restore stability. But we now need to build on those foundations to create higher growth and employment.

The good news is that we understand the challenges we face: to strengthen EMU; to ensure sustainable policies; to improve competitiveness. And to meet these challenges, we can look to several countries for examples.

But the key is to persevere on the path of reform – and to take inspiration from others that are succeeding. Within the euro area, we all benefit from each other's prosperity. I hope that the range of businesses from across the euro area here today will join me in spreading this message.

Thank you for your attention.

Euro Conference - Latvia

Keynote Speech by Mario Draghi, President of the ECB, Riga, 12 September 2013

Ladies and gentlemen,

I expect that many of you are familiar with the film Dream Team 1935. One of the most popular films in Latvia last year, it tells the story of the Latvian team that won the first European basketball championship in 1935. The film shows how the players overcame a series of obstacles to win the competition – and the vital contribution of their resolute team spirit.

This story reflects on Latvia and the euro in two ways.

First, it reminds us of Latvia's historic position as part of Europe. Since Riga became a member of the Hanseatic League in 1282, this region has been an essential part of European integration. I am pleased that by joining the euro next year, Latvia is strengthening its place at the heart of Europe.

Second, the story highlights the determination of Latvians to strive for their goals. The crisis in 2008 dealt this country a severe blow. Yet the people here have shown remarkable resolve to overcome their difficulties and meet the criteria for euro entry.

The authorities have protected citizens' wealth and ensured financial stability by maintaining the exchange rate within the agreed band, despite pressure from some outside advisers to devalue. They have undertaken an effective fiscal consolidation. And the nominal wage adjustment that has taken place across the country has, among other factors, helped to close the current account deficit by more than 10 percentage points of GDP since 2008.

It is no wonder that many observers have pointed to Latvia, a country that is outside the euro area, as an example to those that are inside.

I understand that some people here have questions about adopting the euro. Joining the single currency is a decision of great importance for any country. But I would like to reassure those with concerns that there are many good reasons to join the euro area today. In particular, new members of the euro area can benefit from the lessons we have learned since 1999.

There are three lessons that I would like to emphasise here today.

First, we have learned that the euro as a currency works. Second, we have learned the types of policy that lead to prosperity within Monetary Union, and also the ones that do not. And third, we have learned that we need to complete the institutions of our Economic and Monetary Union.

Let me discuss these lessons in a little more detail.

The success of the euro

The euro works – that is, in my view, plain to see.

Since 1999, the euro area has grown to a community of more than 330 million people. It is the world's second largest economy, accounting for around a quarter of global exports and more than

15% of global investment. And the euro has established itself as a strong and stable reserve currency.

In that time, the European Central Bank (ECB) has maintained price stability in line with its mandate, despite the most severe crisis since the 1930s. We have defended our currency against unfounded fears about a break-up of the euro area. All this means that countries that join the euro area today can be confident that its central pillar, its monetary policy, is sound.

I understand that there are some concerns here about the changeover to the euro potentially leading to opportunistic price rises. But the Latvian authorities are taking measures to prevent this. These measures build on the experience from 17 previous euro changeovers. I call on all those involved to remain attentive to these initiatives.

For its part, the ECB will be conducting a communication campaign to ensure that the people of Latvia are well informed about the euro coins and banknotes, in particular the security features of the banknotes.

Ensuring sustainable convergence

The second lesson we have learned is that to prosper within Monetary Union, countries need to ensure sustainable convergence.

Sustainable convergence means more than meeting a set of nominal targets at a certain point in time. It requires real economic, legal and institutional convergence prior to adopting the euro. And crucially, it requires continued efforts once inside monetary union.

The reason that many countries are making painful adjustments today is that once inside the euro area, they allowed themselves to diverge too much.

I know the authorities here are aware of the key challenges of maintaining convergence. These include, first of all, avoiding a renewed boom-bust cycle in Latvia following euro adoption. This implies that the authorities need to continue with sound fiscal policies, and to ensure that labour cost developments remain conducive to competitiveness.

The challenges also include strengthening further the efficiency and effectiveness of institutions in Latvia. And finally they include safeguarding the long-run stability of the banking and wider financial sector.

I am therefore confident that by keeping the right policy orientation, the ingredients are present for Latvia to thrive within the euro area.

Completing Economic and Monetary Union

The third lesson we have learned since 1999 is that we need to complete our economic and monetary union.

We live in a rapidly changing world, where the traditional role of the nation-state is being questioned. In my view, the key to maintaining sovereignty in this world is to share more sovereignty by integrating more deeply.

This point has been understood for some time in monetary policy – and it is particularly relevant for Latvia. By joining the euro area, this country will no longer have a fixed exchange rate, with all the constraints that it entails for monetary policy. It will have a national central bank that participates in decision-making for the entire euro area. Governor Rimšēvičs will be taking part in monetary policy-making for the world's second largest economy.

But the crisis has also strengthened the case for sharing sovereignty in other policy areas.

National governments have experienced the difficulty of managing cross-border capital flows without a common supervisory policy – a problem with which this country is familiar. They have seen how, without a credible framework for fiscal policies, they can lose effective sovereignty to financial markets.

The solution is to complete Economic and Monetary Union – for Monetary Union to be accompanied by a banking union, a fiscal union, an economic union and ultimately a political union. This is a vision for the future and it will require much work to implement. But new members can be encouraged that the process is underway, in particular on banking union.

On this note, I welcome the vote today by the European Parliament on the new European supervisor, the Single Supervisory Mechanism (SSM). The ECB and the Parliament share a common purpose in ensuring proper accountability arrangements for the SSM, and I fully support the draft agreement we have reached. This agreement is testament to the hard work and commitment of the negotiating team from the Parliament's ECON Committee. It also reflects the personal efforts of President Schulz, to whom I would like to express my particular thanks and appreciation.

Let me add here that sharing sovereignty, however, does not mean losing national identity. There are many smaller countries – such as Malta and Luxembourg – that have not changed their individual character within the euro area. At the ECB we have always placed a high value on Europe's cultural diversity: this year, for example, the ECB's Cultural Days are dedicated to Latvia.

Conclusion

Let me conclude.

Joining the euro area is a historic commitment – to the deeper integration of our continent – and to the mutual prosperity of the different countries that share the single currency.

I am confident that Latvia is making this commitment at the right time: when it has done the hard work to be ready for membership – when the responsibilities of membership are clear – and when the process of building a genuine Economic and Monetary Union has begun.

I therefore warmly welcome our 18th member. Welcome Latvia!

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, President of the ECB, Brussels, 8 July 2013

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a great pleasure for me to be back with your committee for our last exchange of views before the summer break.

At this time, it is worth taking stock of progress over the past 12 months. Clearly, financial conditions in the euro area today are more stable and resilient than they were last summer. This is partly due to our determined monetary policy actions. Governments and parliaments have also played a key role in the relative return of confidence and stability by undertaking courageous reforms, at both the national and European levels.

Yet despite this progress, the euro area still faces considerable challenges. The economy is still weak. Financial fragmentation remains. This challenges the very concept of the Single Market. Small and medium-sized enterprises (SMEs) can find it difficult to access credit, particularly in countries under strain; and several key steps remain to be taken to complete the banking union. These are the three topics that I will address in turn today.

1. Economic and monetary developments

Let me first briefly discuss our recent monetary policy decisions. In May, the Governing Council of the European Central Bank (ECB) decided to lower the interest rate on the main refinancing operations by 25 basis points to 0.50% and the rate on the marginal lending facility by 50 basis points to 1.00%. The rate on the deposit facility was left unchanged at 0%. These policy decisions took account of subdued underlying inflationary pressures over the medium term and they are expected to improve funding conditions across the whole monetary union.

Following its July meeting, the Governing Council stressed that the monetary policy stance is geared towards maintaining the degree of monetary accommodation warranted by the outlook for price stability and promoting stable money market conditions.

It reiterated that its monetary policy stance will remain accommodative for as long as needed. Furthermore, the Governing Council sharpened its communication by announcing that it expects the key ECB interest rates to remain at present or lower levels for an extended period of time. This expectation was based on the overall subdued outlook for inflation extending into the medium term, given the broad-based weakness in the real economy and subdued monetary dynamics. In the period ahead, we will monitor all incoming information on economic and monetary developments and assess any impact on the outlook for price stability.

The accommodative stance of our monetary policy, together with the significant improvements in financial markets since mid-2012, should help to support prospects for an economic recovery later in the year and in 2014.

On non-standard measures, the Governing Council decided in May to continue conducting all refinancing operations as fixed-rate tender procedures with full allotment, at least until mid-July 2014. This measure will help to support a smooth transmission of the ECB's monetary policy stance. In particular, it will ensure that banks' lending decisions are not impaired by funding constraints.

The Governing Council also decided in May to start consultations with other European institutions on initiatives to promote a functioning market for asset-backed securities (ABS) collateralised by loans to non-financial corporations.

Before discussing this issue in more depth, let me briefly comment on the economic outlook. Economic activity in the euro area contracted for a sixth consecutive quarter in the first quarter of 2013. Labour market conditions remain weak. Recent confidence indicators based on survey data have shown some further improvement, albeit from low levels. Overall, euro area economic activity should stabilise and recover over the course of the year, although at a subdued pace.

The risks surrounding the economic outlook for the euro area continue to be on the downside. The recent tightening of global money and financial market conditions and related uncertainties may have the potential to negatively affect

economic conditions. Other downside risks include the possibility of weaker than expected domestic and global demand and slow or insufficient implementation of structural reforms in euro area countries.

Annual inflation in the euro area has continued to moderate, falling from 2.5% in 2012 to 1.6% in June. Looking ahead, the underlying price pressures over the medium term are expected to remain subdued, reflecting the broad-based weakness in aggregate demand and the modest pace of the recovery. Inflation expectations nonetheless continue to be firmly anchored in line with the Governing Council's aim of maintaining inflation rates below, but close to 2%.

Risks to the outlook for price developments are expected to be still broadly balanced over the medium term. Upside risks relate to stronger than expected increases in administered prices and indirect taxes, as well as higher commodity prices. Downside risks stem from weaker than expected economic activity.

Consistent with our expectations of low underlying inflationary pressures over the medium term, monetary and, in particular, credit dynamics remain subdued. The annual growth rate of loans to the private sector remains negative. To a large extent, weak loan dynamics continue to reflect primarily the current stage of the business cycle, heightened credit risk and the continuing adjustment of financial and non-financial sector balance sheets.

2. Financial fragmentation and SME financing

Let me now turn to the second topic namely the financing of SMEs. It is important to recall that the euro area financial system is mainly bank-based: around 80% of the debt of non-financial corporations consists of bank loans. There can be no sustained recovery without a sound banking system capable of effectively intermediating funds across the whole euro area.

Over the recent past, this intermediation process has suffered from two issues:

First, financial fragmentation, between peripheral and core countries; and

Second, higher challenges for SMEs relative to large firms.

On the first issue, lending rates are very heterogeneous across euro area economies. This reflects divergent bank funding conditions as well as country-specific macroeconomic developments that affect the creditworthiness of borrowers. The ECB took action, within our mandate, to alleviate this fragmentation: explicitly, we took action that alleviated funding constraints and reduced the dispersion of bank funding costs not least through the three-year long-term refinancing operations (LTROs). Still, the dispersion in lending rates across countries and borrowers remains substantial.

As regards the second issue, access to financing is more challenging for SMEs than for large firms. Spreads between bank lending rates for small-sized loans and large loans are still high by historical standards, although they have broadly declined since the last quarter of 2012. Difficult access to credit by SMEs is an issue for investment and growth in parts of the euro area, especially in countries under strain.

In Spain, for instance, the interest rate on small loans is almost 2.3 percentage points greater than interest rates on large loans. In France, by contrast, the difference is only 1 percentage point. Given their high dependence on bank credit, SMEs in countries under strain suffer particularly from financial fragmentation.

In this context, the Commission and the European Investment Bank (EIB) are looking into possible ways to support SME financing, notably in the form of joint risk-sharing instruments. These would combine the lending capacity of the EIB and the European Investment Fund as well as resources from national promotional banks to finance special activities in EU priority areas.

A number of options – of both a short- and longer-term nature – are being explored, including the provision of guarantees, credit enhancements of SME loan pools to revive structured credit markets over a longer time horizon; and third, purchases of asset-backed securities (ABS) by the Commission and the EIB.

Initiatives to foster the developments of the capital market, including the securitisation market, to complement the role of the banking system are particularly useful in the euro area.

With respect to securitisation, we have to be aware of the numerous constraints on the revival of ABS public issuance. These include in particular some proposed changes to the regulatory framework, which may reduce incentives to invest in certain types of ABS in the long term. Such constraints need to be properly addressed. The regulatory treatment for securitisation should acknowledge the credit performance and ensure an unbiased level playing field with other securities regarding risk, rating and maturity.

I would also like to make clear that with regard to the ABS market the ECB now has an advisory role.

3. Banking union

Policy-makers have made strong commitments on moving towards banking union – now it is essential to deliver on those commitments. The objective is effectively threefold: reinstating beyond doubt the soundness of the banking system; re-integrating the banking system; and delivering a supervisory and resolution framework that will prevent a repeat of the past risk build-up.

All core elements should fall into place swiftly to reap the full benefits of a banking union. The stakes are too high to afford undue delays. To complete such an essential project, resolute action has to be taken in the months to come – and this Parliament has a key role to play.

First, until the regulation on the single supervisory mechanism (SSM) is adopted, we at the ECB cannot formally take decisions. In this context, it is my understanding that the supervisory accountability arrangements with the Parliament, in line with the SSM regulation, are nearing finalisation on the basis of a constructive stance by both parties.

In view of the adoption of the regulation, we have already launched the process of internal preparations, on which I would like to give you a brief update.

We are working in close and constructive cooperation with the national authorities for the establishment of the SSM. This includes five main workstreams: first, mapping the euro area banking system to identify in particular systemic institutions; second, addressing legal issues in the development of the new supervisory processes at SSM level; third, preparing a harmonised supervisory data reporting framework; fourth, developing a supervisory model and manual; and fifth, designing and implementing the balance sheet assessment required by the SSM Regulation.

Let me be clear about the importance of that fifth workstream. A credible and thorough balance sheet assessment is an indispensable step towards restoring full confidence in the banking system. Transparency on asset valuation is necessary to subsequently assess the capital position of banks and also to facilitate market transactions on bank assets.

The balance sheet assessment will be complemented by a stress test, in coordination with the European Banking Authority, that will cover all banks supervised directly by the ECB. We expect to conclude the comprehensive assessment when the SSM becomes operational. It is crucial to have a commitment to ensure that effective backstops are available, in order to ensure that the assessment is duly and timely concluded.

A second cornerstone of banking union is the Bank Recovery and Resolution Directive (BRRD). By providing the tools and powers in national laws, it will form a basis on which to build a single resolution mechanism (SRM). The ECB welcomes the fact that an agreement on BRRD was reached at the last ECOFIN meeting. I trust that this Parliament, together with the Council, will reach an agreement by the end of this year.

This will in turn pave the way for a swift entry into force of the European Stability Mechanism's direct bank recapitalisation instrument. We welcome the political agreement reached at the last Eurogroup meeting. This instrument will usefully complement the existing European backstop and will contribute to the further decoupling of banks from their respective sovereigns.

A single resolution mechanism is the next crucial pillar of the banking union. It is an indispensable complement to the single supervisor and should ideally be in place once the SSM is operational. The ECB looks forward to the Commission's proposal for an SRM with a strong single resolution authority at its heart and a single resolution fund at its disposal.

Thank you for your attention. I am now looking forward to your questions.

Introductory remarks at the French Assemblée Nationale

Speech by Mario Draghi, President of the ECB, Paris, 26 June 2013

Presidents,

Honourable Members of Parliament,

I would like to thank you very warmly for having invited me to address this historic chamber.

As President of the European Central Bank, it is an honour to speak in a nation that has done so much to promote and further the cause of European integration.

It was exactly 300 years ago, in 1713, that the Abbé de Saint-Pierre presented his *Project for Perpetual Peace*, one of the first visions for a union between European nations.

That this vision emerged into reality is thanks in large part to generations of French thinkers and pioneers, like Jean-Jacques Rousseau, Victor Hugo, and Aristide Briand. It is also thanks to the makers of the modern European Union like Robert Schuman, Jean Monnet, and Jacques Delors.

In other words, this country has played a key role in building the peaceful, open and united Europe we see today.

But as you know, the EU, and the euro area in particular, is faced with important questions about its direction. It needs a new consensus on how to move forward.

I am confident that France will again play a key role in that process.

In my introductory remarks today, I would like to focus on three topics: the ECB's monetary policy, growth and adjustment in the euro area, and the progress towards building a deeper economic and monetary union.

I am here today to present the ECB's views, but also to listen and to learn. I look forward to hearing your opinions and taking your questions.

The ECB's monetary policy

Let me begin with the ECB's monetary policy.

The ECB's mandate is to maintain price stability, which is essential to support long-term growth, defend citizens' purchasing power and maintain sustainable and high employment. In order to deliver our mandate, the ECB has done a great deal to support the euro area economy.

First, we have reduced our main interest rate to the historic low of 0.5%.

Second, we have introduced a series of measures to ensure that banks can pass on these low interest rates to borrowers in the real economy.

These measures include allowing banks to borrow as much liquidity from the ECB as they need; expanding the range of collateral they can use to access that liquidity; intervening in bond markets that were malfunctioning, like the sovereign bond market or the covered bond market; and launching two three-year Long-Term Refinancing Operations (LTROs), which injected more than 1 trillion euro into the euro area banking system.

Overall, our balance sheet increased from just below 1.5 trillion euro before the crisis to more than 3 trillion euro at its peak.

Our measures are primarily focused on banks because, in the euro area, bank lending is the main channel through which firms and households get access to finance.

Around three quarters of firms' external financing comes from banks, compared with only around one quarter in the United States. Supporting the banking system is therefore essential to support growth in the euro area – and to fulfil our mandate to maintain price stability.

More recently, the ECB has acted to remove unfounded fears about the future integrity of our monetary union. These fears were creating severe turbulence in financial markets and preventing our low interest rates from reaching the countries where they were needed most.

As a result, we saw a risk of a widespread credit crunch in these countries. Questions over fiscal sustainability and growing market distrust were starting to spill over into their respective banking sectors. The effects for growth and employment would have been severe.

Indeed, investors were suddenly losing confidence that the euro area could survive in its current composition. The prospect that claims on governments and private companies in certain countries could not be discharged in euros had become a possibility.

Our response was to introduce the programme of Outright Monetary Transactions (OMT), which allows for *ex ante* unlimited interventions in sovereign debt markets. OMT has been effective in restoring market functioning and trust in the euro area.

For example, since the OMT announcement, bond markets have steadied, providing discipline without becoming destructive. Spreads on long-term bonds for Spain, Italy and Ireland have declined by around 150-250 basis points, and for Portugal by almost 500 basis points.

And this has helped reduce financial fragmentation within the euro area, as shown by the best indicator we have for fragmentation, the level of Target balances. These have declined by 285 billion euros, or 25%, since the peak last year. France, like all other member states, has benefited significantly from this stabilisation.

In short, the ECB has been very active in responding to the crisis. We have robustly defended the stability of our monetary union and therefore of our money. And we stand ready to act again when needed.

However, it is important to acknowledge that there are limits to what monetary policy can achieve. This is not a question of the scope of our mandate. It is fundamentally about what different institutions are empowered to do.

One pertinent example is the current shortage of credit for many households and small- and medium-sized enterprises. Credit provision requires funding, capital and a positive risk assessment. The central bank can help ensure funding and address macroeconomic risk. But it cannot provide capital, nor can it affect banks' assessment of the creditworthiness of individual borrowers.

Similarly, monetary policy cannot create real economic growth. If growth is stalling because the economy is not producing enough or because firms have lost competitiveness, this is beyond the power of the central bank to fix.

Yet, the euro area needs sustainable growth.

There are currently more than 19 million people unemployed in the euro area. Almost a quarter of young people are out of work. Such high levels of joblessness are a tragedy.

Moreover, a weak economy means fewer taxpayers and lower revenues. This puts pressure on public finances, and ultimately on our social models.

So what is the best way to achieve the growth Europe needs?

Let me turn to this issue now and share with you some reflections on this subject.

Growth and adjustment in the euro area

Some euro area countries have in the past relied on debt to support growth and fund social spending. But this path has led them to a difficult situation today. They have ended up with high public debts while growth has steadily fallen.

In this country, for instance, public debt has risen from around 20% of GDP in 1980 to over 90% of GDP today. In that time, annual GDP growth averaged 2.3% in the 1980s, 1.9% in the 1990s, and 1.8% in the 2000s up to the crisis.

This suggests that, for all euro area countries, a new approach is needed. An approach that can deliver growth and jobs, and sustain social models, without creating an unsustainable debt burden for future generations.

In my view, this requires two complementary responses.

The *first response* is to ensure that fiscal consolidation, which is necessary to contain debt levels, is made as growth-friendly as possible.

For instance, relying less on tax increases would help sustain citizens' disposable income. Prioritising capital investment over current spending would do more to lay the foundations for future growth.

Structural fiscal reforms, for example to pension systems, would also help support fiscal sustainability without negative effects on the economy today.

The *second response* is to raise competitiveness and increase the underlying productive capacity of our economies.

Here, the frontier is reforms that target the structure of the economy. These include reducing barriers to entry for new firms and young people, and removing burdens on business like complex tax and labour laws or distortionary regulations. Reforms to the labour market are also essential to create the highest possible opportunities for employment.

We are already seeing progress on rebalancing in the euro area: unit labour costs are coming down in countries where they had grown excessively; current account deficits are narrowing where there had been large imbalances in the past; and export growth is generally picking up in countries under strain.

But in many euro area countries, the gap the between wages and productivity is still out of line with competitiveness. To increase employment, this gap should be closed and all the many policy levers that can contribute to this should be used. Changes to two-tier employment systems that protect insiders and harm outsiders are one such lever.

Let us not forget that those who suffer the most from unreformed labour markets are often young people, as evidenced by the very high levels of youth employment today. I therefore welcome the joint initiative of the French and German Labour ministers to tackle this issue.

This underscores an important point about reforms: by restoring competitiveness and creating opportunities for a wider range of people, they benefit the many, not the few. Reforms are an expression of solidarity between citizens. Solidarity *across* countries is also important, but it would be meaningless without solidarity *within*countries.

Building a stronger EMU

What role can the euro area as a whole play in supporting growth and stability across Europe?

Governments are today reflecting deeply on this question. They are considering what was missing in the original design of Economic and Monetary Union (EMU): what responsibilities need to be shared at the European level, and what not, to make EMU function effectively.

In my view, this debate should be driven by a single question: how can we best protect the vital interests of euro area citizens? And where the answer involves transferring sovereignty to the European level, we should not hesitate to do so.

The best example of this is Banking Union.

Banking Union is essential to ensure that we make permanent the progress made in reintegrating financial markets; that financial conditions in both core and periphery countries return to normal; and that our monetary union becomes truly single again.

It has two indispensable elements: a strong Single Supervisory Mechanism (SSM) and a strong Single Resolution Mechanism (SRM).

A strong system of common supervision is key to increase confidence in the health of euro area banks, which has been damaged due to supervisory failures in the past. Progress is already well underway here, and the Single Supervisory Mechanism will take over supervision one year after the legislation is adopted.

But to ensure that common supervision is credible, it needs to be accompanied by a mechanism that can wind down failing banks without causing financial instability. This is why we need a Single Resolution Mechanism. And it needs to have a strong European dimension to be able to deal effectively with large, cross-border banks.

But Banking Union is not the only example of where closer union is needed. Ultimately, the euro area needs to be drawing closer in all fields of economic policy.

The recent call from the leaders of France and Germany for closer economic union shows that this message is being understood. But it is important that form is fully aligned with substance. In my view, a true economic union means three things.

First, it means every country ensuring its national economy functions properly, without external imbalances and high unemployment. We cannot have a strong economic union without strong national economies.

Second, it means transferring some sovereignty over decision-making to the European level – accepting decisions that are made for the good of the euro area as a whole, even if, at that moment in time, individual countries may disagree with them.

Third, it means applying the same rules to all members of monetary union. This is not only a condition of fairness between countries, but also a pre-condition for deeper integration. Only if there is trust that each member will play by the rules can a union of mutual solidarity become possible.

For these reasons, moving towards closer economic union also requires an equivalent deepening of political union. Greater authority at the European level must be matched by greater democratic legitimacy. And here both the European Parliament and national parliaments have a key role to play.

As Herman van Rompuy has reminded us, national parliaments have become EU institutions.

Conclusion

Let me now conclude.

The euro area has made much progress in recent years, but it still faces many challenges. Solving them requires EU institutions and national governments to work in concert.

The ECB has done as much as it can to stabilise markets and support the economy. Now governments and parliaments need to do all they can to raise growth potential, strengthen competitiveness and build a stronger, more stable EMU.

I was impressed to learn that, back in 1871, Victor Hugo called in this Assembly for a United States of Europe.

France today can be equally ambitious in taking the euro area forward.

Thank you for your attention.

Stable Euro, Strong Europe

Speech by Mario Draghi, President of the ECB, at the Wirtschaftstag 2013 Berlin,25 June 2013

Ladies and Gentlemen,

It is a great pleasure to speak to you today. And I am grateful for the invitation from the Wirtschaftsrat, an institution grounded on the principles of the Soziale Marktwirtschaft in the tradition of Ludwig Erhard.

In a speech here in Berlin just 18 months ago, I quoted Erhard's famous dictum: 'Die soziale Marktwirtschaft ist ohne eine konsequente Politik der Preisstabilität nicht denkbar'.

So I am happy to accept our host's invitation to reflect on the importance of a stable euro and a strong Europe.

All policy-makers can and should contribute to preserving the stability of our common currency and to building a stronger and more prosperous Europe. I would like to emphasise my personal commitment to this goal.

I am confident that through our joint efforts to complete the institutional architecture of economic and monetary union (EMU), we can serve this collective mission.

The European Central Bank (ECB) has an unambiguous mandate against which our performance can be measured: medium-term price stability, understood as an average annual inflation rate of just below 2%.

The ECB's task and track record

With this objective, we are continuing for 17 countries what the Deutsche Bundesbank achieved for Germany. Our history is younger, but it is with some pride that I say that the ECB has accomplished this objective for almost 15 years. And it is with emphasis that I say that we are committed to taking the exact same objective into the future.

The euro's track record demonstrates the ECB's success in attaining this objective. According to our projections, by the end of 2014, the average annual inflation rate since the start of the euro will decline to 1.97%.

This inflation record over such a long period is well below those recorded in any larger country now part of the euro area in the half-century preceding the euro and also compares very well in an international context. The ECB's track record is therefore remarkable.

Our commitment to taking the exact same objective forward is reflected in inflation expectations. They confirm that the currency is stable. Survey- and market-based measures of inflation expectations are firmly anchored at levels consistent with our definition of price stability.

In the spirit of Ludwig Erhard, the ECB is making its contribution to the social market economy.

The ECB's response and instruments

Having the same objective does not necessarily mean using the same instruments. The ECB has inherited its objective from the Bundesbank, but it is operating in a new and different environment.

Today's economic and monetary union is larger and more diverse than a single country, such as Germany. It is highly integrated but still at times fragmented. And it comprises a very large number of policy-makers on fiscal, structural and other economic matters.

All policy-makers have to recognise that we belong to EMU together and that policies as well as policy inaction create spillovers for other members. This is an enormous responsibility for governments and other economic policy-makers.

For the ECB to operate in this environment, and to be responsible and effective in accomplishing its objective, we have to use a wide range of instruments. Some instruments are standard, some non-standard, but all are based on the ECB Statutes. The use of these instruments has been essential in safeguarding our objective during the financial and sovereign debt crisis.

In the run-up to the crisis, inappropriate fiscal, structural and other economic policies fostered an excessive build-up of risk in the financial sector and created vulnerabilities on a global scale.

When the crisis erupted, these vulnerabilities placed a heavy burden on central banks. In particular, the threat of a financial meltdown jeopardised their capability to counteract downside risks to price stability.

The ECB acted on that threat according to our unambiguous mandate to deliver price stability.

We have reduced our main policy rates to historical lows. This contributed to stabilising investment and consumption decisions in the euro area. Our actions prevented a steeper fall in aggregate demand and ensured the conditions for stable prices in the euro area.

In a bank-based economy like the euro area, monetary policy works through banks, and banks lend to each other, based on mutual trust. In the crisis, that trust got lost, and the banks no longer lent to each other. Facing the threat of a euro-area wide funding crisis, they turned to the central bank.

We, the central bank, provided liquidity to banks because we have to work through them. They are our counterparts – and we had to act. There was no guarantee that the liquidity provided would all end up in the real economy but because we acted, we avoided an even larger credit crunch and a collapse of parts of the banking system.

We designed our instruments so as to provide long-term credit to banks and give them reassurance that they could satisfy their liquidity needs over an extended period. This gave banks a clear funding perspective and put them in a position to provide credit lines to the real economy, in line with their business assessment of credit risks.

ECB policy responses over the past 12 months

By mid-2012, the crisis took a new turn. We saw the risk of a complete collapse of all credit markets. Risks to fiscal sustainability and growing market distrust in some euro area countries started to spill over into their respective banking sectors. Close links between sovereigns and banks threatened the stability of the entire banking sector in some countries.

While impairments to the transmission of monetary policy eased in some countries, they became entrenched and more acute in others. Fractures in transmission – a new phenomenon since the start of EMU – appeared along national borders.

Investors suddenly lost confidence that the euro area could survive in its current composition. In fact, the prospect that claims on certain governments and private companies in certain countries could not be discharged in euros had become a possibility.

International investors started divesting securities issued by governments of non-core economies and of private institutions domiciled in those countries.

Germany became the destination of ‘safe-haven’ flows. Capital, deposits and central bank liquidity were leaving the periphery and concentrating in the core. Market interest rates in Germany fell as bond prices were driven upwards, and at some point, German bond market rates were lower than ECB refinancing rates!

At the same time, the loss of liquidity and bank funding capacity in the periphery produced a tightening of credit conditions in those economies. Interest rates for bank customers, firms and households were dropping in the core and rising in the periphery.

Eventually, the fragmentation of financial conditions became so severe that we were effectively losing the steering ability of our monetary policy for the euro area as a whole. In this environment, we once again had to act.

As our main instrument, we announced the programme of Outright Monetary Transactions (OMT) in secondary government bond markets. The aim is to eliminate redenomination risk, namely uncertainty about the survival of the euro.

Since OMT was announced almost one year ago, its benefits have been widely acknowledged.

The glut of liquidity in core economies has been partly reabsorbed, as deposits and savings have returned to the periphery.

Interest rates in Germany have increased and they have fallen in the periphery.

Target balances, a powerful summary indicator of fragmentation, have come down by one quarter from their peak last year.

Funding costs in the countries under stress have fallen substantially. Both banks and firms in stressed countries have been able to regain access to market financing, both for funding and raising capital.

Our initiative has therefore been beneficial to all: banks, companies and households – and it has benefited both periphery and core countries.

Let me highlight a few features of OMT that are essential to bear in mind.

First, OMT comes with strict and effective conditionality attached to a programme with the European Stability Mechanism (ESM). The initiative is activated only if a country submits to policy conditionality that leads to policy reforms.

Governments are not presented with a choice between reforms or OMT. OMT comes only with reforms. And reforms need a disciplined process of monitoring and international surveillance for the country concerned. Otherwise, there is no OMT activation.

Second, conditionality enhances the independence and the effectiveness of our monetary policy. The reason is that conditionality is a necessary but not sufficient condition to activate OMT. We would only act if the right conditions for effective use of this monetary policy instrument were in place.

Third, the ECB would not act to compress spreads artificially; on the contrary, we believe that spreads should naturally reflect the underlying fiscal position of the sovereign and the economic prospects of the country. This is also why we emphasised that a sovereign needs to have market access to qualify for OMT.

Fourth, OMT does not entail a transfer of risks from periphery to core countries via the ECB's balance sheet, over and beyond risks that are inevitable and inherent in the implementation of a single monetary policy for 17 sovereign states.

The OMT announcement has lowered risks for core countries: the risks of a euro area break-up; the risks arising from Target balances in such a scenario; and the risks from market interest rates distorted by safe-haven flows.

Because of OMT, the euro area is a more stable and resilient place to invest in than it was a year ago.

Indeed, I would say that OMT is even more essential now as we see potential changes in the monetary policy stance with associated uncertainty in other jurisdictions of the integrated global economy.

Essential reforms going forward

So where do we stand?

In terms of monetary policy, price stability is assured, and the overall economic outlook still warrants an accommodative stance. We see some signs of stabilisation in sentiment, even though uncertainties remain. And we expect that monetary stimulus and improvements in financial markets will support a recovery later in the year.

The situation has improved; fragmentation has receded; and tentative signs of stabilisation have occurred.

But monetary policy is only a small part of the overall policy agenda for overcoming the crisis and laying the foundations for sustainable growth and renewed employment creation. Governments, social partners and other important economic decision-makers have to live up to their responsibilities, too.

One key issue is structural reform to make euro area economies more business friendly and more competitive in the global economy. There is a host of indicators – from the Global Competitiveness indicators to the Ease of Doing Business indicators – that lay out the reform agenda in no uncertain terms: only a handful of euro area countries rank highly on these indicators. Germany is among them, thanks to the resolute structural reforms implemented in this country ten years ago. These reforms are an inspiration for other countries.

Many European countries have structural problems: it takes longer to get licenses, permits and other administrative authorisations than in other countries; the judicial system is slower; and regulation is more complex. Structural reforms

may hurt a few vested interests, but they would clearly strengthen the effectiveness, competitiveness and, yes, also the fairness of our economies.

Another key issue is growth-friendly fiscal consolidation. We have to be mindful that debt-based fiscal spending is no way to growth. Euro area government debt has risen by almost 20 percentage points of GDP in the last 15 years and by over 50 percentage points in the last 30 years. At the same time, growth has fallen, from 3.8% on average in the 1970s to 2.1% in the 1990s and roughly zero now. Debt spending has not avoided the stagnation of economic growth.

But fiscal consolidation can be made much more growth-friendly by cutting unproductive expenditures, by establishing credible and detailed medium-term fiscal plans and by lowering the tax burden where it is harming economic activity and job creation in particular.

The third key issue is ensuring a sound financial system. This is where current efforts to establish a European banking union are crucial. The aim of the banking union is to establish transparency, stability and incentive-compatibility in the euro area financial market.

Conclusion

I have outlined what we at the ECB have been doing – and what needs to be done in other key domains of European economic policy.

The June 2012 summit was so important because in times of great uncertainty it provided a clear vision of what is necessary for a stable and genuine economic and monetary union. Much of it is being implemented. And I am confident that the project for Europe will continue to evolve towards renewed economic strength and social cohesion based on mutual trust, both within and across national borders, and above all stability.

Thank you very much for your attention.

Opening remarks at the session “Rethinking the Limitations of Monetary Policy”

Speech by Mario Draghi, President of the ECB, at the farewell conference honouring Governor Stanley Fischer, The Israel Museum, Jerusalem 18 June 2013

Ladies and gentlemen,

The topic for this session – “the limitations of monetary policy” – is one that has attracted a great deal of attention since the beginning of the financial crisis. Circumstances have forced all major central banks to resort to instruments and policies carefully tailored to the unusual situation. Alex Cukierman and Michael Woodford, who will present their views on the issue in a few minutes, are among the prominent academics that have written about it extensively. [1]

Before handing the floor to them, let me say a few words about the current situation in the euro area, about our perspective at the European Central Bank (ECB) on today’s topic and about longer-term issues for the euro area.

In terms of the current situation, the euro area economy is still in a phase of adjustment. Real GDP fell by 0.6% in the fourth quarter of 2012 and by 0.2% in the first quarter of 2013. Output has thus declined for six consecutive quarters, labour market conditions remain weak and public and private sector balance sheet adjustments continue to weigh on economic activity. Unacceptably high levels of unemployment, particularly youth unemployment, are the prime concern of economic policy-makers.

Recent survey data suggest some improvement, but from low levels. Export growth should benefit from a recovery in global demand. Domestic demand should be supported by accommodative monetary policy; by the recent real income gains from lower oil prices and lower inflation; and by the confidence and wealth effects stemming from the improvements in financial markets since last summer.

The ECB's Governing Council has stressed that that monetary policy will remain accommodative for as long as necessary. In the period ahead, we will monitor very closely all incoming information on economic and monetary developments and stand ready to act if necessary.

In the meantime, it is important to note that economic and financial fragmentation in the euro area has declined significantly since last summer. This has had beneficial effects for the real economies of all euro area countries.

Banks in stressed countries have been able to regain access to interbank and capital markets – and they have raised funds as well as capital. Larger corporations have benefited from lower borrowing costs in capital markets. And small and medium-sized enterprises have seen borrowing costs from banks somewhat reduced. All of this should support investment.

Target balances, which provide a powerful summary indicator of fragmentation, have declined by almost 300 billion euros or 25% from their peak. The costs of protection against risks of deflation have fallen from peaks twice their long-term average last summer to slightly below average now. [2]

Overall, monetary policy has regained steering capacity, which had become lost for large parts of the euro area in mid-2012. This is an important positive development.

Let me turn now to the limitations of monetary policy. Here I see two possible dimensions.

The first is positive and refers to the effectiveness of central bank actions at the margin – for example, when interest rates are close to zero.

The second is normative and refers to the constraints imposed on us by our mandate and to the fears that boundaries between central bank policies and other policies might become blurred.

I will not dwell on the first dimension because I do not think that we are materially challenged in our ability to deliver our objective of price stability by the low level of interest rates.

Looking back, despite extraordinarily testing economic circumstances, inflation in the euro area has remained on the whole consistent with the ECB's objective of below but close to 2%.

Looking forward, Eurosystem staff project annual HICP inflation at 1.4% in 2013 and 1.3% in 2014, but medium-term inflation expectations remain anchored in line with our definition of price stability.

One reason why inflation expectations have remained broadly stable is that we – and other major central banks around the world – have prevented the materialisation of deflation risk by adopting both standard and non-standard measures as and when necessary.

In the euro area, one such non-standard measure was the introduction of the outright monetary transactions (OMT) programme last year, the stabilising effects of which are widely recognised.

There are numerous other measures – standard interest rate policy and non-standard measures – that we can deploy and that we will deploy if circumstances warrant.

At the same time, I have also made clear that some of those measures may have unintended consequences. This does not mean that they should not be used, but it does mean that we need to be aware of those consequences and manage them appropriately. We will look with an open mind at these measures that are especially effective in our institutional setup and that fall within our mandate.

This leads me to the second dimension of discussion of the limitations of monetary policy, namely the risk of a blurring of the boundaries of central bank policy.

To approach this question, it is useful to refer to the framework put forward by another prominent scholar in central bank matters. Marvin Goodfriend classifies central bank actions into three categories. [3]

The first category is what he calls "monetary policy" proper – changes in the size of the monetary base via purchases and sales of government securities.

Second comes "credit policy" – changes in the composition of the central bank's assets between government securities and claims on the private sector of various kinds.

Third is “interest on reserves policy” – changes in the opportunity cost for banks to hold reserves or excess reserves.

Goodfriend argues that all three categories have fiscal implications. And he states that credit policy and interest on reserve policy involve the use of public funds in a way that may imply an allocative role – and which may therefore blur the respective roles of the monetary and fiscal authorities.

In this context, it is worth recalling that the monetary constitution of the ECB is firmly grounded in the principles of ‘ordoliberalism’, particularly two of its central tenets:

- First, a clear separation of power and objectives between authorities;
- And second, adherence to the principles of an open market economy with free competition, favouring an efficient allocation of resources.

More explicitly, and by reference to another famous framework – the three basic policy functions that Richard Musgrave described as allocation, stabilisation, and distribution, and which aim delivering what Tommaso Padoa-Schioppa later described as efficiency, stability and equity – our policy is concerned only with macroeconomic stabilisation through the pursuit of price stability. We do not and should not play an active role in the functions of allocation and distribution. [4]

At the same time, our operational framework has always included elements of what Goodfriend qualifies as credit policy.

The ECB manages liquidity and steers money market rates by lending to banks in temporary credit operations against a broad range of collateral.

Furthermore, we have always remunerated reserves.

Does the fact that our operations entail some credit risk on the balance sheet of the central bank imply a violation of our ordoliberal principles? Does it imply that the ECB policy interferes with credit allocation? My answer is no.

The risks we take onto our balance sheet in the context of our operations are controlled, and they are accepted only insofar as they are strictly necessary for the pursuit of price stability. This is entirely consistent with the concept of monetary dominance, which stipulates that fiscal considerations cannot stand in the way of the achievement of price stability.

Indeed, ECB credit is backed by adequate collateral, which implies that the amount of residual risk borne by the central bank is buffered. There are two layers of protection.

The first is founded on the ECB’s recourse to the borrowing institutions and the full credit and guarantee represented by their balance sheets.

The second – when the first is exhausted – is given by the appropriation of the collateral posted as backing of the loan. If a counterparty defaults, the underlying collateral assets allow for the recovery of the amount lent. The use of risk control measures such as valuation haircuts and variable margins further mitigate the exposure to credit risk.

The same risk control principle applies in the context of the OMT programme, through limitations on the maturity of eligible securities (one to three years) and through the strict conditionality for a country to be eligible for the programme.

Another aspect of our operations is that they are designed precisely with the goal of achieving neutrality in credit allocation.

The ECB’s policy framework was designed with a view to allowing the participation of a broad range of counterparties.

The framework rests on the fundamental principle of equal treatment of counterparties.

Equal treatment is also reflected in the collateral framework, which features a broad range of assets and a set of eligibility criteria that apply to all Eurosystem credit operations without distinction.

A further observation is that lending to banks is consistent with an untargeted monetary policy.

In the euro area, the majority of credit intermediation is processed via the banking system, as opposed to financial markets. Banks lend to households and to financial and non-financial firms of any size across the credit spectrum. Influencing bank funding conditions amounts to influencing credit conditions across the whole economy.

What I have said applies in normal times, but it also largely applies in the specific circumstances of a fragmentation of the financial system – circumstances that we have faced and continue to face, albeit to a diminishing extent.

Financial fragmentation in itself creates a distortion of the allocation of resources. It undermines the concept of a free market economy because it alters the conditions of competition.

In this context, the measures that we have implemented through the crisis do not have an allocative or distributive role. On the contrary, by supplementing financial intermediation where it had become dysfunctional, they have contributed to re-establishing the allocative and distributive neutrality of markets.

The liquidity measures that we took early in the crisis can be interpreted in this light. At that time, central banks had to substitute for the sudden disappearance of interbank market activity by acting themselves as a money market intermediary when necessary.

For the ECB, this task was facilitated by the wide range of counterparties accepted in refinancing operations and by our broad collateral framework. Other central banks had to innovate more through the use of various targeted facilities outside their normal operating framework in order to reach out to the broad economy.

The ECB could also mobilise its collateral framework to relieve the liquidity constraints faced by banks. We expanded the list of eligible collateral, so that banks could liquefy their balance sheets and mobilise assets that had become difficult to trade.

In addition, the ECB could further contribute to alleviating the banks' funding uncertainty by providing banks with assurance that they could rely on our refinancing operations for extended periods.

The maximum maturity of our operations increased from three months to three years. Through these measures, the ECB decisively addressed the liquidity pressures faced by euro area banks and avoided a genuine credit crunch.

Professor Fischer,

Ladies and gentlemen,

What must be clear from what I have said so far is what constitutes the limitations to our actions, consistent both with the letter of our mandate and with the philosophy of the market economy that underpins it. We have been able to regain better control of monetary conditions in the euro area economy, which is very important for providing the appropriate monetary policy impulse to the economy.

Part of this achievement is due to the announcement of the OMT programme. But equally important has been the progress in economic reform and adjustment at both the country level and the euro area level.

Such reforms need to continue. There is still a rich reform agenda, especially structural, at the country level for many members of the euro area. There is also an important reform agenda at the European level. One key aspect of that is the banking union, which rests on single supervision and single resolution, the latter with an effective backstop if necessary.

Preparations for single supervision at the ECB are advancing, and naturally we are working closely with the relevant national authorities. Five work streams are underway: first, on mapping the euro area banking system to identify systemically important banks; second, on the supervisory model to be adopted, which is most likely to be centred around joint supervisory teams; third, on supervisory data reporting; fourth on legal issues; and fifth, on the asset quality review that we will undertake prior to taking any bank under supervision.

Formal adoption of the legal texts by the European Parliament will allow us to formalise the preparations and launch them so that we can be operational one year after adoption.

Effective supervision requires effective resolution, which in turn requires establishment of a single resolution mechanism. We count on the European Commission to make a proposal in due course.

Once these processes are launched, the banking union will be within operational reach. It should provide an answer to many of the challenges currently facing the euro area, including uneven credit conditions and the fragmentation of financial markets.

When observers from outside look at our Economic and Monetary Union, they often emphasise how unfinished it appears compared with fully established unions such as the United States. In so doing, they highlight a number of

unresolved issues, for example that in a monetary union of 17 otherwise sovereign states, a credit or transfer across Member States is viewed differently from a credit or transfer within an individual Member State. The equivalent of Target balances, for example, is a non-issue in the United States. However, such observers vastly underestimate the political capital invested in the euro by our leaders, as well as the political significance that such an investment has for the future of Europe.

Of course, much work remains to be done for economic policy-makers across Europe. But I am confident that together we can build a stronger economic and monetary union that ultimately delivers jobs, growth and a return to prosperity for the citizens of the euro area.

Thank you for your attention.

Responsible leadership in times of crisis

Address by Mario Draghi, President of the ECB, on the occasion of receiving the ESMT Leadership Award 2013, Berlin, 13 June 2013

Good afternoon.

It is a great honour to receive this award for Responsible Leadership and I would like to thank Mario Monti for his kind introductory words. I regret that I am not able to join you in person today in Berlin but am pleased I can address you via Video.

The fact we have a single currency and a European Central Bank is itself testament to the role of leadership. Many of you are too young to remember, but those of us who can recall Europe 20 years ago know how unimaginable it once was to speak about a single currency. Today, it is an integral part of our lives.

But as this award reminds us, the key aspect of leadership is responsibility. In the words of Peter Drucker, “rank does not confer privilege or give power. It imposes responsibility”.

As you know, the primary responsibility of the ECB is to maintain price stability in the euro area – to secure the value of our common currency. We take this responsibility with the utmost seriousness as it directly affects the lives of 330 million citizens of the euro area. Since the launch of the euro in 1999, we have fulfilled our mandate even through difficult times. We will continue to fulfil this task.

I am very proud to be personally contributing to the historic project that the euro represents as the most tangible sign of European integration. But this pride is accompanied by a deep feeling of responsibility.

There is no doubt that the recent period of economic and financial turbulence has tested us in new ways. We have had to take new measures to fulfil our responsibility for price stability. We had to look at all the data, assess all the evidence, and decide what measures were necessary to ensure the stability of the euro.

One such decision was to combat market fragmentation by Outright Monetary Transactions (OMT), based on a country committing itself to strict and effective conditionality under an EU/IMF economic adjustment programme.

At almost one year from its announcement, the benefits of OMT are visible to everybody:

Banks have been able to re-access the market, for both funding and for raising capital, and the strong divergence in funding costs across constituencies has receded.

Deposits have flown back: banks in stressed countries have seen the deposits by the euro area money-holding sector increasing by about 200 billion euros since August 2012.

Another sign of normalisation, and a very important one for German savers, has been the increase in German government bond yields, previously suppressed by panic-driven safe-haven flows, which have edged up by around 25 basis points.

And Target balances, which are a summary indicator of fragmentation, have declined by 285 billion euros, or 25%, since the peak last year, and now are at the same level as in late-2011. Therefore, also perceived risks for creditor countries such as Germany have greatly diminished.

The establishment of OMT has therefore been beneficial to everybody: sovereigns, corporations, banks as well as individuals, and it has benefited both periphery and core countries.

The decision on OMT was necessary. It was effective. And it was in line with our mandate.

It was *necessary* to remove severe obstacles to the appropriate transmission of monetary policy that were putting the singleness of our monetary policy at risk and which were harming the economy of the euro area very deeply.

And it is fully in line with our mandate because it is designed to preserve price stability for the euro area and uses instruments foreseen in the Statute.

In short, for the ECB responsible leadership has meant being true to our founding Treaty. Staying independent from the voices calling for us to “do more” or to “do less”; staying fully focused on our mandate to secure price stability for the citizens of the euro area.

For the euro area to now move forward and establish itself on stronger ground, we need all decision-makers to take their responsibilities. Governments to put right their public finances and address the structural challenges to growth in their economies; and the euro area as a whole to build a stronger economic and monetary union based on shared sovereignty and greater legitimacy.

There is a great deal of work ahead of us. But I am sure we will succeed.

Thank you for your attention.

Strengthening financial resilience

Speech by Mario Draghi, President of the ECB, at the 2013 International Monetary Conference, Shanghai, 3 June 2013

Ladies and Gentlemen,

Introduction

It is a great pleasure to speak to you at this year’s International Monetary Conference.

Let me start by congratulating the organisers for devising a programme that precisely pinpoints the key challenges that policy-makers must address on the path towards a more resilient financial sector.

The financial sector constitutes the main link between monetary policy and the real economy. So the challenges associated with financial stress and the prospects for financial reform are close to the heart of every central banker.

The economic situation in the euro area remains challenging but there are a few signs of a possible stabilisation, and our baseline scenario continues to be one of a very gradual recovery starting in the latter part of this year.

The drivers of such a gradual recovery are the highly accommodative monetary policy and export growth, caused by growing foreign demand. There is an adjustment happening across the board, with fiscal deficits and external deficits declining. The price of energy is declining as well and finally there are a number of important wealth effects that can

support consumption and investment. These effects come from the rebound of financial markets that is benefitting virtually all economic agents, including corporations, banks and households.

Nevertheless, vulnerabilities remain, and I would like to take this opportunity to share my thoughts on the appropriate policy response to remaining financial and economic vulnerabilities from a euro area perspective. In doing so, I will focus on the banking system, which accounts for around two thirds of financial intermediation in the euro area.

When analysing the capacity and willingness of euro area banks to lend, it is useful to distinguish three factors: their funding situation; their capital position; and their attitude towards risk.

Each of these factors may, at times, require targeted policy intervention to overcome obstacles to bank lending. But the *types* of policy intervention and the *domains* of policy responsibility fundamentally differ across these three factors.

In this context, let me outline what I believe are the three major lessons of the crisis.

First, the crisis has reconfirmed both the scope and the limits of what central banks can do to support the economy.

Central banks play a pivotal role in stabilising funding conditions at times of acute market turmoil. But they cannot compensate for weaknesses in banks' capital positions. And they cannot substitute for reforms to boost the growth potential of economies.

Second, in the euro area, the crisis has demonstrated the capacity and unwavering commitment of the European Central Bank (ECB) to support the economy in its pursuit of price stability.

We have adopted monetary policy measures that are unprecedented in scale and scope. In doing so, we have benefitted from the array of different perspectives on the Governing Council. These different perspectives collectively shape the single monetary policy for all euro area countries and form a durable basis for our united institutional decisions.

Third, the crisis has shown the need to adjust our monetary policy toolkit to a new reality. A very important new tool have been the two 3-year LTROs (long-term refinancing operations) that helped avoid a massive euro area wide credit crunch in early 2012. But the most salient feature of this new reality is financial fragmentation across euro area countries.

In response, the ECB has adopted Outright Monetary Transactions (OMTs). This policy initiative was *necessary* to counteract the threats to price stability; it has been*effective* in mitigating fragmentation and especially in fulfilling our mandate of *maintaining price stability*.

Let me explain in a little more detail.

Improving banks' funding situation

As the crisis has demonstrated forcefully, a sudden retreat of market liquidity can severely rattle financial markets.

Unable to refinance their illiquid assets, banks are forced either to explore alternative sources of funding or to engage in large-scale fire sales to shrink that part of their assets that remains tradable, although at falling prices.

To avoid socially costly fire sales and in common with most other central banks, the ECB compensated for the shortfall in private finance by providing solvent banks with additional central bank liquidity against adequate collateral.

In doing so, the Governing Council followed three avenues.

First, we provided these banks with ample access to central bank liquidity – both by reducing our main policy rate and by expanding the collateral pool against which we would lend to euro area banks.

Second, we provided reassurance to market participants that ample access to central bank liquidity would persist over the relevant planning horizon. Most notably, our two three-year long-term refinancing operations (LTROs) assured banks that their liquidity needs would be met over horizons that stretch beyond the usual maturity of central bank credit. In fact, the LTROs come closer to matching the average maturity of their loan books.

Third, we forcefully confronted financial fragmentation which has weakened the impact of monetary policy in the very parts of the euro area where it is most needed. Fragmentation has created divergent borrowing conditions for firms and households with equal creditworthiness but different country codes.

As our main tool to combat fragmentation, we adopted Outright Monetary Transactions (OMTs). OMTs allow for targeted intervention in euro area sovereign debt markets – provided the country concerned commits itself to strict and effective conditionality under an EU/IMF economic adjustment programme.

A closer look at OMTs

At almost one year from its announcement, the benefits of OMT are visible to everybody:

Spreads in sovereign debt markets have fallen substantially. Since the OMT announcement, spreads on long-term bonds for Spain, Italy and Ireland have fallen by around 250 to 300 basis points and for Portugal by almost 600 basis points.

Spreads in corporate debt markets have fallen by about 150 to 200 basis points for important market segments, and made it easier for firms to raise funds in the market. This has been the case for highly rated large corporations as well as for other corporations.

Banks have been able to re-access the market, for both funding and for raising capital, and the strong divergence in funding costs across constituencies has receded somewhat.

Deposits have flown back: banks in stressed countries have seen the deposits by the euro area money-holding sector increasing by about 200 billion euros since August 2012.

Another sign of normalisation, and a very important one for German savers, pension funds and insurance companies, has been the increase in German government bond yields, previously suppressed by panic-driven safe-haven flows, which have edged up by around 25 basis points.

And the best summary indicator for fragmentation and related payment flows in the euro area, the level of Target balances, has shown a decline by 285 billion euros, or 25%, since the peak last year. Target balances now roughly stand at levels prevailing before the launch of the two 3-year LTROs in late-2011.

The establishment of OMT has therefore been beneficial to everybody: sovereigns, corporations, banks as well as individuals, and it has benefitted both periphery and core countries.

Therefore, I would like to reflect in more detail on this measure. What is its purpose?

OMTs are aimed at eliminating redenomination risk from the markets – the unwarranted anticipation of euro area breakup.

Redenomination risk undermined our ability to preserve price stability and contravened the singleness of monetary policy.

The possibility that financial claims may be redeemed in a different unit of account than the one in which they were denominated at issuance – that is, the euro – was the prime source of panic that fractured transmission of monetary policy a year ago.

OMTs priced that risk out of market values and act as a deterrent against a resurgence of fundamentally unjustified redenomination fears. But their role is cast within a robust framework in which the ECB can fulfil its primary task of ensuring stable prices in steady financial conditions. And the fiscal authorities can take care of their solvency conditions and concentrate on structural adjustment.

One concern that has been raised with regard to OMTs is that they may discourage reform at the national level.

Quite the opposite is true. OMTs can be applied only if governments accept policy conditionality that leads to reforms. At the same time, it was the requirement of effective conditionality embedded in OMTs discourages governments and parliaments from requesting a programme unless strictly necessary.

They can either reform *without* OMTs and retain economic sovereignty or they can reform *with* OMTs but give up some of their economic sovereignty. Either way, they have to persevere in their reform efforts.

So it is quite misleading to compare OMTs to historical episodes in which governments relied on central bank support to replace fiscal consolidation.

Another concern made against OMT was that conditionality weakens the independence of monetary policy. The reality is that OMT's are not tied to political decisions since the Governing Council retains its full discretion, even after a country has engaged in a programme. In addition, that same conditionality ensures that the governments remain solvent, which in turn protects the freedom of action of monetary policy.

A third argument made against OMTs suggests that they would reintroduce excessive compression of euro area bond yield spreads, as observed prior to the crisis.

This too is inaccurate.

OMTs are designed to keep government bond yields just below 'panic' levels, as previously defined, not to bring them down to levels that would somehow help government solvency.

As we have seen, the mere existence of OMTs keeps government bond yields from rising excessively: the market expects that if yields rose too much, governments would apply for the programme and ECB purchases would bring yields back down. OMTs have therefore had a self-fulfilling downward effect on yields, just as before, in absence of OMT, there was a self-fulfilling upward effect with a potentially catastrophic risk for the euro area.

But this downward effect does not mean that spreads are forced to converge. In fact, ECB intervention under OMTs would not address those parts of sovereign bond yield spreads that are fundamentally justified.

The implication of a high backstop rate is that governments continue to have the incentives to raise their primary balance towards stabilising levels and to engage in structural reform. These are the only two options for them to lower their funding costs well below the backstop level implied by the OMTs.

For governments and parliaments, the ultimate driver of their actions remains employment. It is important to recall that always and especially in the present situation, the need for governments and parliaments to reform does not stem so much from the bond market but from the dramatic conditions in the labour market. Unfortunately, millions of unemployed are a much greater driver to reform that the interest rate to be paid on sovereign debt. And unfortunately, OMTs have almost no effect on the sources of employment creation. Indeed, while OMTs have eliminated one dimension of financial fragmentation (the risk of euro breakup), they only have a muted and indirect effect on the other source of fragmentation – the adverse feedback loop between sovereigns and banks.

A final criticism of OMTs is portraying them as a means of transferring risks from peripheral to core euro area countries via the ECB balance sheet. Quite the opposite has happened: the elimination of catastrophic outcomes strongly benefits core countries.

To see this, recall that the tail risks that OMTs seek to address distort financial prices and quantities in both the core and the periphery. Tail risks generate a glut of liquidity in core banking systems, as monetary assets are relocated by panicking investors from fragile countries to safe-havens.

With OMTs, pressure to reform remains on peripheral countries, while re-establishing confidence in the euro area reduces the flows of money from the periphery to the core countries like Germany.

So what do the data say? I mentioned already the large decline in overall Target balances, and it is important to add here that this improvement has materialised also for Germany: the Target claim of Germany has fallen from a peak of 760 billion euros in the middle of last year to about 590 billion euros last month. This is a decrease of 170 billion euros or 22%.

This important improvement largely reflects the removal of unwarranted fears of a systemic collapse of monetary union that was previously priced-in by markets. Today, the euro area is therefore a more stable and resilient place to invest in than it was a year ago.

And not a single euro of government bonds has been purchased under the OMT programme.

Strengthening banks' risk absorption capacity

Banks' capital position clearly lies outside the remit of central banks. In fact, it is – first and foremost – the responsibility of shareholders to ensure that their bank is solvent and able to sustain its core business. And if the private sector is unable or unwilling to provide the capital necessary to achieve solvency, it is for the fiscal and regulatory authorities to decide whether and how to act.

Monetary policy cannot substitute for or subsidise either of these policy domains.

But the euro area has achieved significant progress in terms of solvency. Banks have received fresh capital. Problematic legacy assets have been removed from banks' balance sheets, notably in countries under financial assistance programmes

More remains to be done. In particular, two policy initiatives should take precedence.

First, we need to create full transparency about the risks on banks' balance sheets. Such transparency is a pre-condition for the banking sector to return to lasting health. And a healthy banking sector is a pre-condition to revitalising bank lending.

Second, we must align investors' incentives with those of society. This means that market participants that stand to benefit from the upside of risky activities should also bear commensurate losses on the downside.

Europe is making some progress in these areas too.

To strengthen transparency, we are establishing a Single Supervisory Mechanism (SSM), which tasks the ECB with overseeing major parts of the European banking system. By placing this responsibility with an independent institution at European level, the Single Supervisory Mechanism will ultimately allow earlier identification of financial risk.

To strengthen incentives, the institutional architecture is being augmented by rules to facilitate investor participation in dealing with distressed banks. In particular, harmonised rules and procedures for bank recovery and resolution are currently being developed at European level. To ensure a fully consistent and effective application of these rules, their implementation should be placed within the remit of an independent Single Resolution Mechanism.

Before the ECB takes over the SSM, it will conduct together with the national supervisory authorities and with an appropriate involvement of private sector companies, a balance sheet review of those banks that it takes into the SSM. To this end, the national budgets and where needed, the ESM will have to provide adequate backstop.

Mitigating macroeconomic risk

The final determinant of banks' capacity and willingness to lend concerns their attitude towards risk.

Like any central bank, the ECB cannot control microeconomic risk – how banks assess whether a specific potential borrower will fail to repay a loan.

But the ECB is actively contributing to a reduction in macroeconomic risk: by firmly stabilising inflation expectations, it provides a nominal anchor for the economy as a whole. This supports lending and borrowing decisions, and ensures that longer-term investment projects remain profitable.

But it is the responsibility of national governments to eliminate uncertainty about growth and the sustainability of public finances.

Without unravelling the progress already achieved, it will be essential to focus consolidation on the fiscal composition of the budget, reducing those expenditures that make the least contribution to growth and reducing the tax burden on economic activity. To inspire confidence, policy-makers must follow-through with their fiscal reform agenda. In fact, little would be gained from a loosening of fiscal adjustment today if it creates market expectations that additional tightening will become necessary tomorrow.

In the medium term, we need to ensure that the adjustment is based on increasing the productivity of our economies.

Only through steadfast pursuit of such structural reforms can the competitiveness of euro area economies in the global marketplace be restored.

Summary and outlook

Let me summarise.

Strengthening financial resilience requires ambitious policy efforts in various areas. Lending to the real economy can only be expected to resume if accommodative monetary policy is accompanied by swift balance sheet repair and determined fiscal and structural reforms.

Within the euro area, recent progress suggests that decision-makers are ready to tackle the simultaneous tasks of reforming their domestic economies and completing the institutional architecture at the European level.

The ECB will continue to support macroeconomic performance by ensuring price stability in the euro area.

In calibrating our policy response to future challenges, the ECB will remain deeply committed to our monetary policy framework.

That framework is characterised by pursuing unambiguously price stability, firmly preserving our central bank independence and tailoring our policy instruments to the specific challenges at hand, while maintaining fixed our price stability objective.

As such, our framework is inspired by successful experiences of other central banks which have demonstrated the benefits for monetary policy to rely on a sound institutional anchor, and have earned trust and respect based on their clear commitment to price stability. The ECB has the same commitment and has the task to implement its monetary policy not in a single-country but in a multi-country setting.

This different context and the unprecedented threats to financial stability during the crisis have required new instruments to achieve the same objective of medium-term price stability for the whole of the euro area. We have consistently delivered on that commitment ever since the euro was launched. Over these last 13 years, inflation expectations have on average been at 1.9%.

Thank you for your attention.

Building stability and sustained prosperity in Europe

Speech by Mario Draghi, President of the ECB, at the event entitled "The Future of Europe in the Global Economy" hosted by the City of London Corporation, London, 23 May 2013

Ladies and Gentlemen,

Introduction

Let me begin by thanking you, Lord Mayor, for this kind invitation.

I have always been deeply impressed by the sense of commitment that motivates distinguished City of London professionals such as yourself to take on the demanding role of your office.

No doubt this sense of responsibility to the community has been instrumental in delivering the longevity and stability of the City of London Corporation. This institution has played an important role in developing the Square Mile into the premier financial centre of the world.

I cannot say which of the two sets of arguments is stronger, the economic or the political ones, but what I can say is that Europe needs a more European UK as much as the UK needs a more British Europe. To limit myself to matters that are close to my own professional capacity, let me note a few reminders of the depth of the interconnection:

More than twice as many euros are traded in the UK's foreign exchange market as in all the countries of the euro area combined and more than in the US.

All major euro area banks have important branches in the City of London – and UK banks are leading players in financial markets of the euro area.

Around 40% of the deposits placed with euro area banks from outside the euro area come from the UK.

At the same time, an equally large share, i.e. 40%, of all loans granted by euro area banks to non-euro area residents goes to UK borrowers.

In fact, 40% seems to be a key figure when looking at the UK's linkages with the euro area: it is also approximately the share of the euro in all the foreign currency-denominated loans as well as deposits in the UK.

Finally, the euro area is the UK's largest export market. It may not come as a surprise to you by now that no less than 40% of all the goods and services exported by UK businesses are delivered to euro area countries. In 2012 this amounted to 240 billion euros, or just short of 200 billion pounds.

With such deep interconnections, the UK and the euro area share a common interest: stability in the functioning of our economic system and particularly of our financial markets.

As a long-established financial powerhouse, London is no stranger to crisis. 'Lombard Street', the classic work of Walter Bagehot on the London money market recounts multiple instances of panic gripping this market. [1]

Bagehot's book also made a series of recommendations for how the Bank of England should react to such bouts of market instability. Today, these recommendations are commonly regarded as having set out the principles by which central banks should conduct lender of last resort operations.

Of course the world has changed since Bagehot was writing in the second half of the 19th century. And the crisis that we are facing today is much more multi-faceted than an isolated panic in a specific market segment. This means that the policy response must also be multi-faceted – and it must involve a wide array of institutions.

We as central banks have acted as crisis managers. Our response was immediate and forceful. When called on to act, central banks have been able to draw on a wide and powerful toolkit to steer the economy in difficult times.

In my remarks this evening I would like to share with you a euro area perspective on the challenges of the crisis and how we can build an economy that will ensure stability and sustained prosperity for the people of Europe. I will discuss the monetary policy of the European Central Bank (ECB), the actions of national governments as well as initiatives at the level of the European Union as whole.

The ECB's role in addressing the crisis

Let me first look at the ECB's approach to the crisis. The success of the ECB's monetary policy is based on two pillars: respect of the European Treaty (Treaty on the Functioning of the European Union) and a realistic assessment of the financial and institutional framework through which the effects of our monetary policy are propagated to the real economy.

Article 127(1) of the Treaty assigns to the ECB the responsibility for maintaining price stability. This has been defined by the Governing Council as a rate of inflation that is positive and close to but below 2% in the medium term. This clearly stated objective and the ECB's compliance with it have firmly anchored inflation expectations, which since 1999 have been on average 1.91% and thereby protecting the purchasing power of the citizens of the euro area. It is precisely this high credibility in reaching its primary objective that has allowed the ECB to tailor its response to the crisis in the most suitable way.

And in defining the appropriate response, we must take into account the structure of our credit markets, where the role of the banks is more important than it is in the UK or in the US: in fact in the euro area about two thirds of financial intermediation go through the banking system as opposed to about one third in the UK and one fifth in the US. [2]

Before the crisis, banks were all interconnected and, by and large, could fund themselves everywhere in the euro area. Changes in interest rates were equally transmitted through banks to all parts of the euro area economy.

But a key feature of this crisis has been the fragmentation of financial markets along national borders. Businesses based in stressed countries now face worse borrowing conditions than equally risky competitors in non-stressed countries.

We have responded to this situation by deploying measures that are part of a central bank's toolkit but go beyond adjustments to policy rates. These measures have evolved as the crisis itself has morphed. And while they were targeted at specific immediate challenges, the overriding aim has been consistently to achieve our medium-term price stability objective.

Let me give two examples. In late 2011 and early 2012 we launched two 3-year long term refinancing operations (LTROs). Our LTROs gave banks sufficient reassurance that access to liquidity will not be a problem over a relevant planning horizon. Without these operations, banks would have defaulted on their maturing obligations or would have discontinued and withdrawn existing credit lines to companies.

The LTROs, therefore, helped to avoid a major credit crunch.

Similarly, my second example, the Outright Monetary Transactions (OMTs) have been designed with a view to combatting fragmentation while preserving the credibility of the ECB's monetary policy objective. The OMTs are aimed at eliminating "redenomination risk" – the unwarranted perception of a risk of euro breakup. OMT interventions in government debt markets are tied, however, to an effective macroeconomic adjustment programme. This prevents them from becoming a subsidy for unsustainable national policies. It therefore safeguards the monetary policy nature of the interventions and bolsters the independence of the ECB in pursuing its medium term objective.

Through countering fragmentation OMTs aim to preserve the singleness of monetary policy and to ensure the proper transmission of our monetary policy stance to the real economy throughout the euro area. This falls clearly and squarely within our mandate.

Some critics have argued that because of our determined policy action, the shoring up of bank capital and the consolidation of fiscal positions have been delayed. My answer is simple. Our measures gave breathing space from markets driven by panic, which were forcing the economy into a position where inappropriately high interest rates would make default a self-fulfilling prophecy. Adjustment would have been impossible. Instead of better capitalised banks and stronger fiscal positions we would have been left with financial and economic meltdown.

Today we are seeing some encouraging signs of tangible improvements in financial conditions. Spreads in sovereign and corporate debt markets have narrowed considerably. Banks in stressed countries have seen the deposits placed with them by euro area non-banks increasing by about 200 billion euro since August 2012. TARGET2 balances – the large intra-central bank positions that had accumulated due to the malfunctioning of financial markets – of the national central banks in these countries have declined by about 250 billion euros or 25% since their peak. Recourse to borrowing from the Eurosystem has also abated.

We have, therefore, started observing convincing signs that fragmentation on the funding side for banks has decreased greatly. And although bank lending to businesses and households remains anaemic, we are now seeing some signs of slight improvement on the lending side as well, as our regular surveillance of bank lending conditions and access to finance shows.

These improvements are in no small part due to the fact that unwarranted tail risks of a systemic collapse of the monetary union that were being priced-in by markets have now been largely removed.

We can, therefore, safely say that our Economic and Monetary Union (EMU) is a more stable union today than it was a year ago.

And the markets are fully confident that the euro is a strong and stable currency. To give you an example, the volume of international trade invoices denominated in euro is second only to those denominated in US dollars.

The responsibility of national governments

However, economic conditions in the euro area remain challenging. Real GDP contracted again in the first quarter of 2013. Output has therefore declined for six consecutive quarters. Labour market conditions remain weak.

To maintain and expand the productive capacity of our societies, national governments need to improve the structural functioning of their respective economies. Let me outline some examples.

First, competition in product and service markets needs to be enhanced without regard for the vested interests that are fighting to supress it. This is necessary in its own right – but it is also important to temper the social consequences of the required adjustment in labour markets.

Second, narrowing the gap between labour compensation and productivity growth, also across countries, is absolutely essential for improving competitiveness in euro area countries.

Third, the structure of labour markets in some countries needs to be reformed to allow nominal adjustments to play out, and to avoid that the weight of more flexible labour market conditions falls disproportionately on young generations.

In particular, reforms are needed to ensure inter-generational fairness by tackling the phenomenon of 'insiders versus outsiders'. In some euro area countries, this phenomenon is driving youth unemployment to levels that threaten the very fabric of society.

Since the crisis started, there has been important progress in labour market reforms and fiscal consolidation in euro area countries, particularly those under an EU/IMF programme.

And the painful measures taken are starting to bear fruit. We see this very clearly, for instance, in the impressive improvement in export performance in Ireland, Spain and Portugal and in the recent uptick in industrial production in the latter two countries.

The role of European policies and progress towards a banking union

Let me turn now to my third and final theme. National policies alone are not enough to leave the crisis behind us once and for all. Policies at the European level are also necessary.

For one, European measures to complete the single market, especially in the area of services, are needed. And I know that this is a need that is urgently felt in this country.

However, major progress has been made in defining a vision and a path towards a genuine economic and monetary union.

The banking union is a major element of this effort. A first step towards establishing it has been taken with the decision to create the Single Supervisory Mechanism, and to entrust its responsibility to the ECB.

This first step is important as it will pave the way towards severing the link between banks and their respective sovereigns. It is this link that lies behind the fragmentation in the financial markets of the euro area.

But to sever this link completely, it is also imperative to create a Single Resolution Mechanism. Such a mechanism, much like the FDIC in the US, could give markets certainty about the ranking of creditors and the procedures that would be followed in the case of a bank resolution.

If we are successful in establishing an effective banking union – as I am convinced we will be – the benefits will be large, not only for euro area countries but for all EU members.

A more stable union will be one where financial contagion will have disappeared, where business for the financial centres will vastly increase, where financial market integration will resume.

A stable union, however, is not only about building new rules and procedures but also about applying existing ones. In the past, credibility of European procedures has at times been weakened because they were not followed with sufficient rigour. It is now important that existing and new rules be applied in a steadfast manner.

Conclusion

Let me draw to a close.

Today we need to focus on securing economic stability and prosperity for the people of Europe. With so many young Europeans feeling deprived of the opportunities and the prospects enjoyed by previous generations, the urgency of advancing this vision has never been greater.

After a deep financial and economic crisis, we now see the restart of the European process, building on the agreement of the June 2012 Summit. This process ultimately entails some transfer of national sovereignty in the areas of budget and structural policies. And the efforts made by Germany and France in this regard are particularly encouraging.

Last summer, speaking here in London, I said that “[w]hen people talk about the fragility of the euro, [they] underestimate the amount of political capital that is being invested in [it].” Since then, even more political capital has been mobilised. The answer to the crisis has not been less Europe but more Europe.

The ECB, as an institution at the frontier of European integration, has played an active role in addressing the crisis. The credibility of the ECB’s steadfast commitment to its primary objective is unshaken in the eyes of both the markets and the people of Europe. And this is because our credentials in preserving price stability have been tested both when risks were on the upside and when markets driven by panic were threatening to send the economy in a downward spiral.

This is a time when the strength of all our institutions is being tested; first, by the financial crisis, then by the recession. The European Union and the European Monetary Union are no exceptions. The choice is between adapting them to the new conditions or do nothing and risk their dissolution. These institutions were created through the efforts of millions of

European citizens since the end of World War II. These institutions have lifted Europe from the darkness of its past. They have given Europe peace and prosperity. Today, I am certain that our democracies have the determination and the cohesion to find a common way to strengthen these institutions further so that they will remain for our future generations the same source of peace and prosperity that they have been for us.

Thank you for your attention.

The euro, monetary policy and reforms

Speech by Mario Draghi, President of the ECB, on receiving an honorary degree in political science, LUISS "Guido Carli" University, Rome, 6 May 2013

My first grateful and fond mention goes to Guido Carli. My gratitude goes to the university that bears his name, to its Rector, Professor Massimo Egidi, to its Senatus Academicus, which has honoured me with this title, and to Professor Messori for his kind words, as well as to the entire academic body of this university.

The origins of the crisis in the euro area

Until a few years ago monetary policy was considered a textbook discipline, almost a mechanical skill involving the implementation of computational applications by conscientious experts. In the period known as the Great Moderation, from the middle of the 1980s to the beginning of the global financial crisis, inflation had been brought under control. Macroeconomic volatility was contained and this was a source of great pride for all central bankers. Some foresaw a future of genteel and honourable oblivion for monetary policy. This is no longer the case. The experience of the first five years following the crisis shows that all central banks have adjusted their monetary policies along hitherto unexplored lines: some have been abandoned and no new paradigm has yet been formulated, the wish is to put an end to the emergency and return to normality where the rules are based on a well-established discipline of long standing, but it is not known with any certainty what reality will emerge in the long term. Furthermore, although the precise shape of monetary policy has always been influenced by the respective institutional and historical context – consider the varying "mandates" of the central banks – the various forms that the crisis took in different parts of the world reinforced this correspondence between the specific institutional and financial contexts and the monetary policies pursued in them.

In the euro area, the extraordinary success of the single currency concealed for years the risks that were building up. The governments of the Member States considered themselves free from previous constraints: with the exception of Germany and a few other countries, they delayed structural reforms that could have redressed the competitiveness of obsolete economic structures to meet the challenges of relentless globalisation; they undermined the limits introduced in the Stability and Growth Pact, jeopardising their own credibility as partners in a Monetary Union.

In the years preceding the crisis, this Union began to divide countries with positive trade balances and sound budgets from those with growing budget deficits and external deficits financed by private credit flows increasingly sourced from the first group of countries and not used for investments to increase competitiveness, but rather to finance unproductive spending, or property bubbles. No one ever imagined that the Monetary Union could become a union divided between permanent creditors and permanent debtors, where the former would perpetually lend money and credibility to the latter.

A profound change in the governance of the Union became necessary, with new rules whereby the solidarity clamoured for had as its counterpart the transfer of national powers. But this too was delayed and its urgency was downplayed in the face of the requirements of a purported national sovereignty which was in reality weakened by globalisation and growing levels of public debt.

The global financial crisis, which swiftly and dramatically increased market perceptions of risk, rudely awakened all the actors from this long, complacent amnesia.

The external deficits, budget deficits and levels of public debt of the countries in the second group fast became unsustainable once they were no longer financed externally and in particular by the rest of the Union, the inadequate governance of which was then laid bare.

This brief scrutiny of the origins of the crisis in the euro area shows how the response of economic policy cannot be other than composite: in it, monetary policy plays an important but by no means exclusive role.

The crisis and the ECB's monetary policy

The epicentre of the crisis in the initial phase was liquidity, an economic measure that had been neglected by the theory for many years since a lack thereof seemed so unlikely. The day after Lehman Brothers collapsed, the money markets stopped functioning. The liquidity required by banks to refinance their maturing assets suddenly became extremely scarce.

Generally speaking, banks borrow at short-term or very short-term from savers with a strong preference for the immediate availability of funds, or for "liquidity". If savers suddenly refuse to roll over their deposits with the banks, the banks then attempt to discontinue the credit that they supply to the economy. If this is not possible owing to long maturities, banks seek to liquidate first of all those assets in their portfolio that are traded on the market at known and verifiable exchange prices, in an effort to avoid insolvency. But a sudden financial retreat by many financial institutions simultaneously cannot occur without generalised financial suffering, and without banks incurring substantial capital losses.

Asset prices fall rapidly and bank capital declines. The interbank markets dry up. The economy loses an indispensable mechanism for generating income and allocating resources, namely the intermediation of savings.

In a second phase beginning in 2011, the lack of credit to the more vulnerable sovereign issuers became the centre point of the crisis. The euro area governments responded with actions that, while individually effective, revealed the political unsustainability of a Union in which the countries that pay and the countries that receive are always the same. Sovereign debt in the euro area is no longer risk-free: it depends on the sovereign and the quality of its policies. This process, beneficial in and of itself, revolutionised the risk structure on which the functioning of the European financial markets was based for so many years. In addition, without a single Union government and economic policy, it led to an abnormal increase in risk premia, which reached systemic proportions. Premia were no longer based on the creditworthiness of borrowers, which was admittedly shaky for reasons already mentioned, but rather could only be explained by the manifestation of expectations regarding the end of the euro.

Risk premia and non-standard measures

But what are risk premia?

The compensation required on a long-term financial contract must be at least equal to what could be obtained with a short-term contract that is continuously renewed until the end of the term. Long-term investors require a return that, at the very least, establishes financial equivalence between the two strategies. But, in general, equivalence is not enough. Creditors expect additional compensation for the risks they take on relating to not being paid back promptly. These risks are varied and the markets attach a price – or risk premium – to each one. The pure risk relating to postponing the availability of capital for a period of time is compensated by a term risk premium. The risk that a creditor is forced to liquidate a long-term financial investment before maturity in difficult market circumstances is compensated by a liquidity risk premium. Finally, the risk that the borrower does not meet his/her repayment obligations at the end of the contractually-agreed term is compensated by a credit risk premium.

In a period of deep financial crisis, the increase in all risk premia is, as I mentioned, out of proportion because market participants are no longer willing or able to bear them.

The non-standard measures adopted by the central banks in the larger countries in the five years since the start of the financial crisis can be identified according to the type of risk premia they were intended to tackle.

For example, the large-scale purchasing of assets, or quantitative easing, carried out by the Federal Reserve System affects the term risk premium. The main aim of quantitative easing is to reabsorb the quantity of term risk held in the economy as a whole and thereby compress its price – the corresponding risk premium.

The ECB initially adopted non-standard measures primarily aimed at cutting the financial premium linked to liquidity risk. At the dawn of the crisis, shortly after the collapse of Lehman Brothers in 2008, the liquidity risk in the interbank market shook to its foundations the very structure of the payment system. This catastrophic risk led to an exceptional reassessment of the liquidity risk premium on credit between transactors. In this context, the ECB took the place of the interbank market, which had cut off its supply of short-term and very short-term credit to banks. The ECB subsequently changed its own instrument for providing banks with liquidity, adopting a system whereby it supplied unlimited credit at a fixed interest rate – known as the fixed rate full allotment policy. In this way, the ECB allowed banks to refinance their assets using its own credit, rather than through asset fire sales in the market. A situation in which sound and solvent banks became insolvent was thus avoided.

In order to reassure banks that access to central bank liquidity would indeed be extended in line with their refinancing needs in the medium term, we extended the maturity of our credit lending from the standard three months pre-crisis, to six months after the collapse of Lehman Brothers, to one year by mid-2009 and, finally, to three years at the end of 2011.

From the second half of 2011, we witnessed the emergence of a new source of stress, which has been defined as the risk of "redenomination", resulting from the potential exit of a country from the euro or even from the potential collapse of the single currency. A particular form of credit risk premium was associated with these possibilities, which was unrelated to the assessment of a borrower's solvency but which, in fact, came about owing to unfounded concerns regarding a systemic breakdown in the euro area. The ECB therefore launched the OMTs (Outright Monetary Transactions), a monetary policy instrument aimed at eliminating the financial risk premium caused by this specific systemic risk.

OMTs allow the ECB to buy sovereign bonds with a remaining maturity of up to three years in the secondary market, where necessary in order to remove the risk of "redenomination" (i.e. the risk related to concerns about the end of the euro) from the financial markets. The bond-issuing governments which request the activation of OMTs agree, in conjunction with the European authorities and, if possible, with the International Monetary Fund, on a recovery programme to address macroeconomic and structural weaknesses. This is a necessary, but not sufficient, condition as the ECB has full discretion to decide on the start, continuation or suspension of OMTs. Furthermore, the excess liquidity created by these purchases will be reabsorbed by the ECB.

The conditionality associated with the programme to which governments and the European authorities agree is a crucial element in being able to preserve monetary policy independence. It is important in providing the ECB with adequate assurance that interventions supporting sovereign debt bond prices do not mutate into financial subsidies for unsustainable national policies in the medium term.

By way of drawing a parallel between OMTs and our standard liquidity operations: as the credit provided to banking counterparties cannot be, and must not be, interpreted as an injection of capital into failing banks; in the same vein, under OMTs, in compressing the premium for the risk of "redenomination", the ECB cannot and does not intend to provide financial support to governments which reinstate solvency conditions which have not already been approved ex ante.

In both cases, the ECB's non-standard measures were triggered by the need to restore the functioning of monetary policy transmission channels, first by reducing liquidity premia and then by reducing the redenomination risk premium.

Diverging financing conditions in the euro area

Throughout the two phases of the crisis – the banking crisis and the sovereign debt crisis – our approach to liquidity provision was elastic, with adjustments made in response to demand for support from banks more severely affected by market pressures. At first, this demand was widespread across large parts of the euro area. In 2008 and 2009, those banks more exposed to sectors and activities under stress were ostracised by the market, no matter where they were based. Then, in the second phase of the crisis, the obstacles to liquidity provision became linked to territory. The banking sector and financial market in the euro area gradually fragmented along national borders. These borders separate banking sectors which, irrespective of the intrinsic quality of their intermediaries, are considered robust, because the country in which they are based is able to cope with a banking crisis, from those considered to be fragile, where the markets consider this capacity to be lacking. These borders thus separate countries that are competitive and have sound balance sheets from those characterised by fragile balance sheets and a lack of capacity for growth.

The measures decided on by the ECB (fixed rate full allotment, LTROs, OMTs, assessment and quality of collateral, guidance on the duration of fixed rate full allotment) helped to overcome, to a large extent, this fragmentation that characterised the funding of the banking system until mid-2012. The dispersion in the growth rate of bank deposits has now returned to 2007 levels.

Progress on the lending front has been much slower. In the first group of countries, we are generally seeing normal or accommodative financing conditions for firms and households. In the second group, we are seeing a persistent tightening of credit, possibly decreasing in intensity in some countries, with retail bank loan rates that are much higher than those applied by banks located in the first group of countries and more stringent collateral requirements for loans.

The ECB's recently published "Survey on the access to finance of SMEs in the euro area" [1] provides a clear picture of the difficulties this sector, so crucial for the euro area economy, finds itself in. Among the principal causes for concern cited by the SMEs interviewed, access to credit was second only to the difficulties encountered in finding customers for their products. The obstacles to obtaining credit (linked to the refusal to grant credit) persist, and represent one of the main factors of heterogeneity between countries in the euro area, though they are not confined to those countries under stress. In fact, in addition to SMEs in Greece, Ireland and Spain, a large number of SMEs operating in The Netherlands are encountering significant obstacles (around 45% of the firms surveyed). These figures reflect the considerable heterogeneity in borrowing conditions, as also shown by the most recent bank lending survey.

This fragmentation is all the more troublesome in an economy such as that of the euro area, in which financial intermediation is bank-based for at least three-quarters of firms' financing. And it penalises all the more those enterprises, often of a small or medium size, which depend more heavily on the banking system. This is particularly serious considering that this sector employs around two-thirds of workers in the euro area. [2]

Banks are not lending for a number of reasons: lack of funding, investment alternatives, lack of capital, risk aversion. The ECB has done a great deal on the first two fronts, providing liquidity and reducing the redenomination risk premium on government bonds. We cannot subsidise governments by buying their bonds, and we cannot subsidise bank shareholders by removing the need for them to strengthen their balance sheets by means of necessary recapitalisation measures. We can do little directly to reduce the risk aversion which is holding back bank lending. In other financial systems, a large share of credit is transmitted to the economy via capital markets; financial assets are traded on the basis of known, verifiable prices and are often subject to ratings. A central bank that wished to try to reduce the risk premia on such assets would not face great operational obstacles. In the euro area, the capital market is much smaller, and a central bank that wished to intervene would have to purchase from the banking system the loans the latter had made to the economy, for which there is only a very limited market. This would be a very complex undertaking, even without taking into account the institutional context which would necessarily involve intervention in 17 countries.

But the ECB has taken a number of measures on this front too. Banks have for some time been able to use credit claims as collateral when obtaining funding from the ECB. And we should not underestimate the effectiveness of traditional monetary policy when general conditions change. As mentioned, the Governing Council of the ECB cut interest rates to 0.5% at its last meeting, bringing them to a historic low after eight months in which they had been unchanged at 0.75%. This is because macroeconomic weakness is now also affecting parts of the euro area in which the transmission of monetary policy had never been an issue, and also because we are seeing some signs that fragmentation is receding with regard to lending in some of the euro area countries experiencing stress.

In this regard, national measures can also be effective, as already put into practice in some countries, with the involvement of governments, public banks and development agencies. The ECB has launched initiatives with the EIB and the European Commission with the aim of reducing the fragmentation of lending in the euro area.

We must not forget the extraordinary progress made on this front by the European Council in bringing together the national supervisory systems in a single European mechanism – the management of which has been assigned to the ECB – and in creating a European mechanism for the resolution of banks. These initiatives will go the furthest in breaking the link between banks and sovereign debt which is behind the current fragmentation.

But we should not forget that growth is currently weaker in some countries than in others, and not just because credit is scarce. It was weaker even before the crisis, notwithstanding often turbulent growth in public spending, because structural weaknesses were not tackled. In the wake of the crisis, the burden of this failure is now being felt by all of us.

Structural reforms for growth and more solidarity in society

The reforms aim to untie the knots that curb competitiveness and suffocate growth. Effective promotion and safeguarding of competition; an adequate degree of flexibility in the labour market that is properly distributed across the generations; the cutting of government red tape that is an obstacle to growth; human capital that is equipped to face the challenges posed by global competition; and a better environment – these are all fronts on which, despite recent progress, much remains to be done, albeit to varying degrees across individual countries.

Fiscal policies must follow a sustainable path, separate and distinct from cyclical fluctuations. Without this prerequisite, lasting growth is not possible. Particularly for countries with structurally high levels of public debt, rather than temporarily high levels as a result of the current crisis, this means not slipping back from the goals already achieved. Let us not forget that, in an institutional context in which the solvency of sovereign states is no longer an established fact and the governance of the Union is still incomplete, when a country's public finances lack credibility its banks are quickly cut off from the rest of the euro financial market in the absence of private sector credit in that country: this is what we are now seeing.

However, to mitigate the inevitable recessionary effects of fiscal consolidation, the composition of such measures must favour the reduction of current public spending and of taxes, particularly in a context such as in Europe where taxation is already high by international standards.

There is no doubt that lasting growth is essential for reducing unemployment, particularly among young people. In some European countries youth unemployment has reached levels that damage people's faith in prospects for a decent life and which risk giving rise to extreme and destructive forms of protest.

Output growth was essential for the success of the European social model. The extraordinary economic growth during the so-called “Golden Age” – namely the thirty years that followed the Second World War – allowed a significant improvement in the material wealth of a large portion of the European population.

At the same time, this wealth strengthened the growth process. At that time the foundations were laid in Europe for modern welfare systems aimed at protecting individuals against the risk that unemployment, illness or old age could lead to a deterioration in their living standards. It is in part thanks to these instruments that the financial crisis and the recession have not had the same devastating social effects as the Great Depression.

Many years ago Rudi Dornbusch said, exaggerating rather, that Europeans were so rich they could afford to pay everybody for not working. This is no longer the case, but we do not wish to lose the solidarity which inspired that model in such very different times. Therefore, today we must adapt that model in line with the changes that demographic dynamics and the new environment of global competition demand. This must be done to reduce youth unemployment, increase consumption and preserve the very essence of welfare.

Another aspect of growth sustainability, in a European context, that I would like to draw your attention to today is that of income distribution.

For almost twenty years there has been a trend towards a higher concentration of family income in Europe to the detriment of the poorest households, as statistics published by Eurostat show.

A more equal share in the fruits of the production of national wealth helps foster a culture of saving and, therefore, of collective involvement. A sense of being an integral part of a country and of having a stake in its economic future strengthens social cohesion and encourages individual economic behaviour that leads, in the aggregate, to economic prosperity for all.

There are a number of tools governments can use to achieve this aim, but first of all social cohesion must be sought by removing the barriers which limit individuals’ opportunity to pursue their goals and which allow family background to dictate life choices. In eliminating vested interests in a non-competitive system, structural reforms are more than just a tool for growth creation. By encouraging everyone to be involved in the process of production, they ensure that the drive for a more equal income allocation is not the task of state-led redistribution alone. In this way, reforms aim to harness individual potential to the growth of the economy.

Nevertheless, looking to the not-too-distant future, national virtues – while indispensable for strengthening solidarity among Member States along the way – won’t be enough to make Europe a goal all its citizens can consider their own.

It will also be necessary to introduce reforms that further reduce the barriers between individual Member States, in particular to the development of a single European labour market, and that affirm the principle of solidarity, as proposed recently in the “Four Presidents’ Report” [3].

To build, with passion and vigour, a shared future in which the conditions for growth are more favourable, in which all citizens feel that their skills are fully valued, in which individual well-being goes hand in hand with collective well-being. We are all working today, each within our own mandate, to achieve that goal.

Thank you for your attention.

Short address on the occasion of the launch of the Europa series €5 banknote

Speech by Mario Draghi, President of the ECB
Bratislava, 2 May 2013

I mentioned this at the end of today's press conference, but let me say again that I'm very pleased to be here today to see the launch of the new 5 euro, the first banknote of the Europa series.

The new banknote will join 15 billion euro notes already in circulation. They are the most visible and tangible symbol of European integration, used from one end of the continent to the other. With the Europa series, we are giving a face to our currency. A portrait of Europa, a figure from Greek mythology, has been incorporated into some of the security features of the new series.

After centuries of division, the European Union was awarded the Nobel Peace Prize last year for its contribution to "the advancement of peace and reconciliation, democracy and human rights in Europe".

We all know that Europe is experiencing some challenging times. Governments and citizens are making extraordinary efforts to put their economies on a sounder footing and to build a more stable future for the European Union. In times like these, it's important to remember what the Union and the euro have achieved and what they mean in the longer term, especially for young people.

The children who are here today are growing up in a continent of peace. They belong to the "euro generation" – they have only known one currency. We invited them to attend a photo event with the Governing Council this morning. We are happy for them to be with us on this occasion to mark the launch of the next generation of euro banknotes.

Hearing before the Plenary of the European Parliament on the occasion of the adoption of the Resolution on the ECB Annual Report 2011

Introductory statement by Mario Draghi, President of the ECB, Strasbourg, 16 April 2013

President,

Honourable members of the European Parliament,

I am very pleased to take part in this debate today. It forms a central part of the ECB's accountability towards the European Parliament to which the ECB attaches utmost importance.

Since 2011 the ECB has taken a number of important measures to address severe distortions in the financial markets and to address fragmentation. Although I have had many occasions to discuss the ECB's policies during my regular hearing before the ECON Committee, today is an opportunity to take a broad view on recent economic developments and monetary policy decisions, as well as to discuss the adjustment in the euro area and the outlook for EMU governance. This will allow me to cover several issues highlighted in the draft resolution.

1. Economic developments and monetary policy decisions

Following two years of recovery, the euro area moved into recession in 2012. Unemployment has reached unprecedented levels, especially among young people. This economic weakness was driven by declining private consumption and faltering investment, in an environment of weak business and consumer confidence and financial market tensions.

We expect a gradual recovery in euro area economic activity for the second half of this year. But this scenario is subject to downside risks.

In 2012, headline HICP inflation in the euro area was 2.5%, reflecting elevated energy prices and increases in indirect taxes and administered prices. Annual inflation rates have since declined to 1.7% in March this year.

The Governing Council remains firmly committed to its price stability mandate. This is fully reflected in long-term inflation expectations which have remained firmly anchored in line with our price stability objective of below but close to 2 %.

2011 and 2012 were years in which much of our focus was on the proper transmission of our monetary policy. When changes in policy rates are not appropriately transmitted to the real economy, this is a matter of concern.

In a context of large refinancing needs and persisting funding stress for banks, the ECB launched two long term (i.e three years) refinancing operations in late 2011 and early 2012. These operations, in combination with our measures to enhance the availability of collateral, were pivotal in preventing a disorderly process of lenders' deleveraging and a large-scale credit crunch. This action was instrumental in maintaining price stability.

Later in 2012, a renewed confidence crisis, in part reflecting unwarranted investor fears about the reversibility of the euro, caused a severe deterioration in financial markets. Sovereign bond and bank lending rates in some countries increased dramatically, thereby impairing access to financing of the real economy.

To safeguard the singleness of monetary policy and to ensure an effective transmission of the ECB's policy intentions to the broad economy, in August, the Governing Council announced its readiness to undertake Outright Monetary Transactions (OMT). OMTs have proven to be an effective backstop against unfounded fears of reversibility. Strict conditionality contains moral hazard on the side of governments. It ensures that they will adopt the reforms that are necessary to secure their solvency and to foster conditions of steady growth for their economies. As I said before, the repair of the transmission channel cannot be done by the central bank alone, governments need to do their part. Let me therefore turn to the on-going adjustment in Member States, and the euro area more generally.

2. The adjustment in the euro area

During the past five years, a number of euro area countries have seen a significant correction of their external and domestic imbalances. In Ireland, Greece and Portugal current account balances improved by more than 7 per cent of GDP between 2008 and 2012. A large part of this adjustment has been driven by a contraction in domestic demand, triggered by the unwinding of long accumulated unsustainable developments and by the cyclical downturn. At the same time, in Ireland, Spain and Portugal export performance has been very strong compared with the pre-crisis period. This is a sign that a genuine structural correction is taking place and resources are being moved from the non-tradable sector to the production of traded goods.

We have also seen some improvement in cost competitiveness, which has contributed to the external adjustment. Between 2008 and 2012, in the three programme countries the cumulated unit labour cost growth was about 10pp below the euro area average. The adjustment has been mainly driven by an increase in average productivity, largely reflecting labour shedding, rather than by a reduction in nominal wages. The latter adjustment has been much more limited so far.

This has contributed to increasing the real cost of adjustment and the burden borne by the more vulnerable members of society. It calls for greater determination in further addressing rigidities in wage setting and increasing competition in many segments of the economy. Reducing rents is not only a matter of efficiency in the adjustment process: it is also a matter of equity in sharing the burden of adjustment.

3. The outlook for EMU

Prior to the crisis, Member States did not internalise fully what it means to be part of EMU. Fiscal and economic policies were not sufficiently geared towards the conditions of being a member of a single currency zone. But the lessons of the crisis have been learnt. EU Heads of State and Government have taken action and strengthened the governance framework.

The current deepening of EMU is essential, in particular as regards banking union. It is of utmost importance that the legislation on the Single Supervision Mechanism (SSM) is finalised before the summer break now that a political agreement has been found. This is an absolute prerequisite if we want to embark upon our preparatory work in a timely and effective fashion, so that the SSM is operational by mid-2014. Equally important is the swift set-up of a Single Resolution Mechanism (SRM): it is a necessary complement to the SSM and a key element of banking union. The Commission's intention to put forward a legislative proposal before summer is highly welcome. In the meantime, the Directive on Bank Recovery and Resolution will hopefully be adopted and provide for a coherent EU-wide set of rules.

Deeper economic union means more than fixing the financial system. We therefore welcome the proposal to conduct ex-ante coordination of structural reforms initiatives, which should be implemented as a best-practice benchmarking exercise. In the same vein, reform contracts, in which Member States commit to concrete reforms with specific timelines, would also facilitate the recovery of competitiveness.

But new rules are only as good as the commitment to actually implement them. It is of key importance that the existing legislation is applied forcefully during the ongoing European Semester: this represents a true test of the credibility of EMU's governance framework.

I thank you for your attention and stand at your disposal for questions.

The role of monetary policy in addressing the crisis in the euro area

Speech by Mario Draghi, President of the ECB, at the "Room for discussion" of the Study Association SEFA and the Faculty of Economics and Business, Amsterdam,15 April 2013

Introduction

There was a time, not too long ago, when central banking was considered to be a rather boring and unexciting occupation. In the era of the "Great Moderation", mostly seen as the period between the mid-1980s and the beginning of the global financial crisis, inflation was tamed and macroeconomic volatility was contained. Some thought that monetary policy could effectively be placed on auto-pilot. I can confidently say that this time has passed.

The ECB's monetary policy in the crisis

The global financial crisis has put an end to that period in a way that has been very abrupt and certainly lasting for quite some time to come. In this country, the outbreak of a financial crisis brings back memories that go quite far into history. In 1763, exactly 250 years ago, Amsterdam was the centre of a deep financial crisis. Highly leveraged investors were faced with a situation of falling asset prices. The rolling over of existing obligations became very difficult and the liquidity crisis became severe. Investors could not refinance themselves other than through fire sales of distressed assets. Amsterdam bank houses went bankrupt and merchants suffered significant losses. [1]

The 1763 crisis has some important resemblances with today's crisis. In the first stage of today's crisis, liquidity was at the epicentre. Money markets seized up and several market participants found themselves unable to roll-over funding positions. Concerns regarding bank solvency rapidly surfaced and the crisis then morphed into a banking crisis. Finally, at the beginning of 2010 the latest turn: several euro area countries' debt and deficit levels were found to be unsustainable. It was a sovereign debt crisis.

But differently from the crisis in 1763, the determined actions of central banks prevented the destructive downward spiral of abrupt deleveraging, fire sales and ultimately deflation. The ECB, and indeed all major central banks, reduced its policy rates to unprecedented lows. In addition, the ECB has implemented various non-standard measures to restore monetary policy transmission, also with a view to supporting credit flows to the real economy. This is a necessary pre-condition for fulfilling our ultimate objective of lasting price stability.

Our liquidity support gives banks unlimited access to central bank money at a fixed price against adequate collateral. To make it fully flexible and facilitate banks in their attempt to liquefy their assets at times of stress, we expanded the set of eligible assets that can be used as collateral.

Furthermore, in order to give banks sufficient reassurance that access to liquidity will not be a problem over a relevant planning horizon we have extended the maturity of our lending. The longest maturity of our long-term refinancing operations (LTROs) has been raised from the standard 3 months before the crisis to 6 months after the post-Lehman cataclysm, to one year by mid-2009, and to three years at the end of 2011.

More recently, we have announced the Outright Monetary Transactions (OMTs), in order to eliminate the pricing of unwarranted tail risks in the bond markets. OMTs entail interventions in government bonds with a remaining maturity of up to three years. OMTs have a number of characteristics: they require the government concerned to accept a programme involving support by the European Stability Mechanism that entails strong and effective conditionality. Such conditionality is important in particular to preserve monetary policy independence. Interventions would be ex ante unlimited, which is essential to ensure their effectiveness. All interventions would be sterilised so as to ensure that there is no impact from these measures on the overall monetary policy stance. There would be transparency as the stock of securities acquired under the OMT programme would be published regularly, together with the average duration.

Like previous non-standard liquidity operations, OMT cope with extraordinary risk premia that markets require when self-fulfilling expectations of catastrophic events prevail. In 2008, the dominant fear had originated from the collapse of the payment system following the Lehman bankruptcy. In the first half of 2012, the prevailing fear had been caused by unfounded doubts about the continued existence of the euro.

There is another parallel between our early liquidity operations with banks and OMTs. In providing liquidity to our banking counterparties, we cannot and do not want to subsidise banks that are failing. Our liquidity support is not and should not be equity support. Likewise, in pricing out break-up risk in sovereign debt securities, we cannot and do not want to subsidise governments.

Placing the ECB's monetary policy in the broader context of central bank non-standard measures

Let me briefly digress to put our monetary policy and its impact on borrowing conditions in the context of unconventional monetary policies deployed by central banks more generally.

To begin with, the remuneration that investors demand on a long-dated security should be at least as large as the expected return from a strategy of rolling over short-term instruments and the risk premia that investors demand over and above the return from the rolling over strategy. Premia, in turn, are a composite object. They compensate investors for different risks attached to term investments:

1. The *term risk premium* for holding on to an asset for a specific period of time;
2. The *liquidity risk premium* as the compensation for the possibility of incurring losses when selling the asset back to the market before maturity and at short notice; and
3. *Credit risk premia* of various types as compensation for the possibility of not receiving at maturity repayment for the principal because, for instance, borrowers may renege on their contractual obligations.

At the risk of oversimplifying, one can distinguish the main types of unconventional measures depending on which component in this decomposition they are aiming to address.

Forward guidance about the intended path of the central bank's monetary policy rate in the future mainly aims to manage expectations regarding the future evolution of the short-term interest rates. It thus addresses the expectations component I was referring to before. Changes in the level of the current policy rate always have an intrinsic signalling content with respect to possible changes for short-term rates in the future. But during crisis times, when short-term nominal rates are at zero or close to zero, they cannot be adjusted further down. The central bank may then engage in active communication reassuring markets that the future path of policy rates would not deviate from the current low level for a certain period or until certain observable conditions are verified.

Large-scale asset purchases, or quantitative easing, instead, mainly aim to compress the term premium. [2] This type of policy intervention works through reducing the supply of securities with long duration and increasing the supply of reserves or liquidity. With less term risk to hold in the aggregate, the market should require a lower premium to hold that risk.

The ECB's non-standard measures I mentioned earlier are geared towards addressing primarily two types of premia: the liquidity risk and the redenomination risk. The ECB's liquidity operations, such as the 3-year Long-Term Refinancing Operations (LTROs), are intended to relieve banks of liquidity and funding stress. They, therefore mainly aim to reduce liquidity risk in the money market.

Central banks have adopted different approaches as regards their non-standard measures. For instance, the Fed, the Bank of England and the Bank of Japan all engage in Large-Scale Asset Purchases. The Fed also uses forward guidance.

When viewed, however, from the perspective of the framework I just described, most non-standard measures employed by the major central banks around the globe seem remarkably similar. They aim to implement the desired monetary policy stance, in conditions in which the stance may not be smoothly and homogeneously transmitted to the economy, or where a further easing of the stance through standard policy rate adjustments is hindered by the lower bound constraint. The unifying overall goal is to improve the effectiveness of monetary policy, in ways that can support the attainment of the monetary policy objectives.

Yet, the varying emphasis on instruments and the approaches used by central banks around the globe are tailor-made to the particular challenges of their economies. The particular challenge of the ECB is to operate in a multi-country environment: one monetary policy for 17 countries that constitute our currency union.

Unlike economies with a single fiscal authority or with a fully-fledged federal structure, the euro area comprises multiple sovereign states. The debt of each of these states has different liquidity and risk characteristics. In such a set-up there is no uncontroversial way to define the term structure of the risk-free rate. As a matter of fact, this means that there is no univocal measure of the term premium for the euro area as a whole.

At the same time, during the crisis, normal heterogeneity has turned into detrimental fragmentation: a landscape with natural diverse scenery has turned into a dangerous surface with jagged cliffs and stumbling blocks. Liquidity risk, which was a widespread concern for banks throughout the euro area at the start of the crisis, has become more concentrated as the crisis has progressed. Fault lines between banking sectors with structural funding surpluses and banking sectors still suffering from a precarious access to credit run across national borders.

The banking sector and the financial market of the euro area has become fragmented. This is harmful as the euro area is a bank-based economy. Around three quarters of firms' financing comes from banks. So if banks in some countries will not lend at reasonable interest rates, the consequences for the euro area economy are severe.

Although we see a decrease in fragmentation on the funding side, our very accommodative monetary policy stance is only partly passed on to the financing conditions faced by firms and households in some euro area countries. Companies headquartered in stressed countries face worse borrowing conditions than equally risky competitors in non-stressed countries. And, within the same stressed economy, Small and Medium-sized Enterprises (SMEs) suffer relatively more than large companies that have easier access to capital markets and are less dependent on the banking system. This is especially disconcerting given that SMEs account for about three quarters of euro area employment.

Our non-standard monetary policy measures have, therefore, the task of removing these stumbling blocks to ensure that our single monetary policy in fact reaches all parts of the euro area. This is crucial for fulfilling our mandate.

Beneath the surface: the root causes of the crisis in the euro area

Within the limits of our mandate we have acted with determination. Our balance sheet has expanded substantially, to almost three times its pre-crisis size. While it has shrunk since its peak, the expansion is comparable to the increase in the balance sheet of the Fed during the crisis. [3]

Tail risks have been largely removed from the pricing of euro area assets. Financial fragmentation has been receding: banks in stressed countries have seen the deposits placed with them by euro area residents increasing by about 130 billion euro since August 2012, TARGET2 balances of the National Central Banks in these countries have declined by more than 200 billion euro or about 20% since their peak and also banks' dependence on ECB liquidity intermediation is waning to some extent.

Nevertheless, problems in the euro area economic landscape still loom large. This understandably triggers calls for more action to be taken by the authorities that shoulder the responsibility to navigate the economy through these troubled waters.

To address these calls, one needs to take a sober look at the root causes of this crisis.

Most of the stressed euro area economies –and certainly the ones that are finding it most difficult and painful to adjust– have suffered from a chronic loss of competitiveness while being members of the monetary union. The erosion of their competitiveness has meant that these economies started running large current account deficits and some of them have accumulated large external debt positions.

In some cases the expanding external debt was driven by increasing public sector indebtedness. Imprudent fiscal policies were masking the private sector's lack of competitiveness in an effort to shield and even improve living standards.

In other countries it was the banking sector's leverage that increased fast. This in turn reflected a strong increase in lending to domestic firms and households. In these cases the lack of competitiveness was triggering a shift of the economies towards domestic consumption and activities shielded from international competition, such as the housing sector.

On top of that, banking supervision and regulation did not always mitigate the destabilising tendencies. There were cases when banks were not induced to develop sufficient capital and loss buffers in good times.

The way out is to restore competitiveness. And the way to do this in the context of a monetary union is to pursue with determination an ambitious structural reform agenda. Such an agenda comprises a number of national measures to make sure that the functioning of product and labour markets is fully compatible with participation in monetary union. One specific aspect is to fight vested interests that hamper competition, structural weaknesses of productivity and to allow, where needed, the nominal adjustments to play out.

And such an agenda also comprises a number of European measures to fully complete the Single Market especially in the area of services and to allow for higher labour mobility within the euro area.

Since the crisis started considerable progress has been made in making structural reforms in euro area countries, particularly those under an EU/IMF programme. And the painful measures taken are starting to bear fruit.

In Greece, Ireland and Portugal current account balances have improved by more than 7 percentage points (relative to GDP) between 2008 and 2012. In Spain the current account has improved even more substantially.

Also, we have seen reductions in unit labour costs. Ireland has seen an 18 percentage point improvement relative to the euro area average. In Greece, Portugal and Spain the improvement has been about 10 percentage points. As I have recently stressed to the Euro Area Heads of State and Governments, narrowing the gap between wage and productivity growth is absolutely essential for improving competitiveness in euro area countries. [4]

To conclusively address the root causes of the crisis these efforts need to be maintained and, in some countries, stepped up. In the meantime, however, what I referred to earlier as the symptoms of the crisis also need to be tackled. Fiscal positions need to be maintained on a sustainable path and balance sheet weaknesses in the banking sector need to be repaired.

And let me be clear: undertaking structural reforms, budget consolidation and restoring bank balance sheet health is neither the responsibility nor the mandate of monetary policy. Monetary policy can only avert an abrupt deleveraging that would have been conducted in an environment of panic and fire sales. And this is what we have done in order to avoid deflationary downward spirals that would have prevented us from delivering on our mandate of preserving price stability in the euro area.

Monetary policy can support the reform progress by safeguarding price stability and anchoring inflation expectations. But it cannot substitute for actions that other actors, including the private sector itself, must take.

Completing the euro area's institutional architecture

In addition to the role of misguided or imprudent national policies, the narrative of the crisis that I have just spelled out clearly points to some serious shortcomings in the institutional architecture of the euro area.

To begin with, the only policy sphere where some form of supra-national surveillance was in place was fiscal policy. And even in this domain, the mechanisms that were envisaged to prevent and correct unsustainable fiscal performance by Member States proved to be lacking. No framework was foreseen for monitoring competitiveness and heterogeneity within the euro area and for enforcing corrective action when needed. What's more, in interconnected financial systems an entirely national perspective on bank regulation and supervision turned out to be insufficient. Finally, no crisis management framework had been set up to complement the national shock absorption capacity of euro area countries.

The creation of the EFSF and more recently the ESM has addressed this last shortcoming. And in our joint work with the Presidents of the European Council, the European Commission and the Eurogroup, we have set out a vision and a process for building a genuine Economic and Monetary Union. This is designed to cover the other gaps in the institutional architecture that I previously referred to.

The genuine Economic and Monetary Union comprises four pillars: a banking union with a single supervisor; a fiscal union that can effectively prevent and correct unsustainable budgets; an economic union that can guarantee sufficient competitiveness to sustain high employment; and a political union that can deeply engage euro area citizens.

Progress is underway in all these directions. As regards the banking union in particular, a first and important step has been made with the decision to create the Single Supervisory Mechanism (SSM), the responsibility for which has been assigned to the ECB in the last Ecofin. I am confident that the SSM's euro area perspective will make a significant contribution to safeguarding financial stability in the monetary union. In this sense, it will also support the conduct of monetary policy, as a stable financial system is a prerequisite for the proper transmission of our policy signals.

But I would like to stress the importance of quickly complementing the SSM with a Single Resolution Mechanism. This is necessary to guarantee timely and impartial decision-making, particularly in the cases where cross-border resolution is required. What's more, a Single Resolution Mechanism is essential to ensure that the SSM's supervisory decisions for resolution can be followed up with action, without reinforcing the vicious link between banks and sovereigns. Finally, a Single Resolution Mechanism will credibly pursue the least-cost resolution strategy from a euro area perspective, also taking into account cross-border spill-overs.

Conclusion

When considering the challenges that euro area economies are still facing, it is important to remember the economic hardship that many of our fellow citizens in parts of the euro area are experiencing, and in particular the massive unemployment, especially among the youth.

But there are also reasons for confidence. Most of the elements needed to address the root causes of the crisis and to build a genuine Economic and Monetary Union have been set in motion. The ECB's monetary policy will continue to make its contribution to this endeavour, in line with its mandate.

The heavy task of implementing the important decisions already taken lies ahead. All parties involved in this comprehensive reform agenda must persevere. And we must all work with conviction and determination towards our shared vision. If we do so, I am confident that restoring stability and ensuring prosperity in the euro area are within our reach.

Opening remarks at the conference 'Post-trade harmonisation and the integration of financial markets: a joint effort'

Speech by Mario Draghi, President of the ECB, Frankfurt am Main, 19 March 2013

Ladies and gentlemen,

I am very pleased to welcome you to Frankfurt today and to open this important conference on post-trade harmonisation and financial market integration in Europe.

This conference is the result of a joint effort between the European Central Bank and the European Commission, and I would like to thank the organisers for putting together such an excellent programme.

I am very pleased to see that so many distinguished speakers from both the public and private sectors have agreed to share their views on how post-trade harmonisation will contribute to financial integration in Europe.

In times of severe economic challenges, it is particularly important that our commitment to achieving a truly single European market is reaffirmed. As we all understand, a well-functioning internal market generates many benefits, including lower prices, more freedom of choice for individuals and better opportunities for firms.

What Europe has achieved so far is indisputable – and it is often taken for granted. People sometimes focus on perceived difficulties caused by the single market from an individual or national perspective. But it is important to acknowledge the huge benefits of European integration for our daily lives and day-to-day business.

Greater financial integration is a key part of building the single market – and something that improves the functioning of national financial systems. Financial integration leads to better risk-sharing and diversification, it makes markets deeper and more liquid, and it encourages competition, which in turn reduces the costs of intermediation. In addition, financial

integration fosters more efficient allocation of capital, higher productivity, and stronger and more sustainable non-inflationary economic growth.

Financial integration is essential to making Europe stronger, so it is very important to the ECB's Governing Council. We are fully committed to making it happen, especially at a time when the fragmentation of the single financial market has led to fragmentation of the single monetary policy.

As you will be aware, the disruptive effects of severe fragmentation in the single financial market have tangible consequences, such as diverging funding costs for banks. This has resulted in the uneven transmission of our interest rate reductions to firms and households across the euro area. For this reason, the ECB has had to identify the most effective policy tools for repairing these disruptions, while remaining within its mandate.

Financial integration is clearly in the interests of the market and it is strongly supported by the post-trade harmonisation initiatives that are taking place within the EU at the legislative, operational and business levels. These initiatives all aim to remove national barriers and thus reduce the fragmentation of the European post-trade landscape.

The integration of market infrastructure, the harmonisation agenda triggered by T2S and the regulatory framework are the key elements of a coordinated harmonisation effort that complements and supports financial integration.

It is through this lens that the topic of today's conference should be analysed. Key questions include: how can we contribute to improving post-trade harmonisation? What will this process change? And what actions can we take to benefit from it?

The speakers will give us their answers and explore the various harmonisation initiatives, linking them with changes in the regulatory framework and in market infrastructure.

Last May, I participated, along with some of you, in the signing of the contractual agreements between the Eurosystem and those CSDs that had decided to participate in T2S. I stressed that the fundamental objective of T2S is to contribute to making Europe a better place to invest. Let me say that this objective is not unique to T2S. It is the objective of all the harmonisation efforts that are being undertaken in the post-trade field, by all parties.

It is definitely a joint effort, and what I see is not just the commitment of public authorities at the European or national level, but also the commitment of market participants, CSDs and CCPs. I am sure that we all share the same goal, namely making Europe stronger and more attractive for both domestic and foreign investment, thus stimulating and sustaining growth.

Through the coordinated action of so many stakeholders, financial markets will become safer, more transparent and, therefore, more efficient and integrated. Dismantling legal and operational barriers, which is the aim of current EU legislative proposals and new infrastructure such as T2S, will benefit those who adapt their business models to a more competitive landscape. It is important to highlight that the benefits of T2S will be fully achieved if the current harmonisation efforts are successfully implemented at the European level and especially at the national level.

Let me be specific here by giving you a few examples.

In terms of infrastructure, T2S is the necessary platform for setting up a single European market for securities services. In terms of benefits for Europe, T2S will make the post-trade environment safer and more efficient. It will reduce the cost of settling securities transactions and bring about significant collateral savings for market participants. These collateral savings are particularly valuable at a time when demand for high-quality collateral continues to increase, as a result of both the crisis and new regulatory developments.

But reaping the full benefits from the launch of T2S requires that it is complemented by the provisions laid out in the CSD regulation proposed by the Commission. Both initiatives are supported by the harmonisation agenda which has been advanced by the Eurosystem and other European fora.

The CSD regulation is critical to post-trade harmonisation efforts in Europe. The ECB's Governing Council has stated its strong support for the proposed regulation, which will enhance the legal and operational conditions for cross-border settlement in the EU in general and in T2S in particular. In this respect, the ECB has recommended that the proposed regulation and the corresponding implementing acts are adopted prior to the launch of T2S.

Work is also in progress at the Eurosystem level to improve the possibilities for the cross-border use of collateral for Eurosystem credit operations, which will increase efficiency. Further benefits are expected from market-led initiatives to enhance the interoperability of triparty services in Europe.

I do not want to pre-empt the interesting discussions that you will have today, so let me conclude by saying that everyone needs to be involved in this process. Every contribution matters; and every action is relevant.

I am confident that today's conference will further clarify the role that each of us has to play in this important phase of European integration, and I look forward to continuing to work on it together.

Thank you very much for your attention.

The policy and the role of the European Central Bank during the crisis in the euro area

Speech by Mario Draghi, President of the ECB, at the Katholische Akademie in Bayern, Munich, 27 February 2013

Excellencies,

Ladies and Gentlemen,

I am delighted to be here in Munich at the Catholic Academy and thank you for this kind invitation. As befits this setting, I would like to begin my remarks by noting the momentous nature of the current period for the Catholic Church, on the eve of the last day of the pontificate of Benedict XVI.

Pope Benedict, a great son of Bavaria, used his eight years at the helm of the Church to address a variety of pressing concerns of the modern world. Among them was an emphasis on ethical concerns in the economic relationships of our globalised world.

Those concerns have become more relevant than ever during the economic and financial crisis that now extends into its fifth year.

The crisis has dented people's confidence in the capacity of markets to generate prosperity for all. It has strained Europe's social model. Alongside the accumulation of staggering wealth by some, there is widespread economic hardship. Entire countries have been suffering from the consequences of misguided past actions – but also from market forces that are sometimes beyond their control.

In a sense, the "social question" of the 19th century, which inspired the Catholic Social Doctrine, has re-emerged – but today it transcends national borders: what is the right framework for reconciling free enterprise and individual profit motives with concerns for the common good and solidarity with the weak?

In recent decades, this question seemed to be approached from a purely economic perspective. The invisible hand of the market, if only left unconstrained, would eventually generate better outcomes for all. The rational actions of *'homo oeconomicus'* were seen as divorced from ethical concerns about compassion, charity and decency. It seemed forgotten that Adam Smith, the philosophical father of market economics, saw his "Wealth of Nations" as inextricably linked to his "Theory of Moral Sentiments".

Thankfully not everywhere. At the Jesuit school in Italy where I was educated, we had a fundamental guiding principle: our striving for excellence had to be paired with integrity and a moral message – an ultimate sense of purpose in the service of social justice and fairness.

I have previously noted that "without ethics, there cannot be a genuine development". We cannot have an economic model that allows excesses to go uncorrected, which relies exclusively on self-regulation of markets and in which individuals believe that "anything goes". [1] Ultimately, we must be guided by a higher moral standard and a profound belief in creating an economic order that serves every person.

Here I find myself in the company of Marx. Not Karl, but Reinhard. Cardinal Reinhard Marx has rightly insisted that *"the economy is not an end in itself, but is in the service of all mankind."*

And caring for the welfare of our neighbours is not only an ethical principle of the Christian faith: it also makes eminent economic sense. No-one knows this better than the successful entrepreneurs of Bavaria. Interdependence is not just a catchword. The economic health of the countries around you affects us here and now.

So these are the challenges facing European policy-makers today: how do we recreate confidence in the capacity of our economies to grow and generate prosperity so that they can ultimately serve the people? How do we shape our economic model so that it reconciles individual freedom and social justice? And how, as the European Union, do we strike the right balance between the responsibilities of individual countries and those of the Union as a whole?

How the ECB plays its part

Let me begin by focusing on the role of the European Central Bank (ECB).

We have been given a special responsibility by the people of the euro area to ensure price stability. Price stability is the foundation of a functioning economy. It is also the basis for a just and fair society. It is a common good for all Europeans.

As Walter Eucken, the philosophical father of ordoliberalism, noted, *"all efforts to establish a liberal order are futile unless a certain monetary stability is guaranteed. Monetary policy therefore has a primary importance for the liberal order."* [2]

Price stability ensures that the market mechanism works properly, which is the best way we know to create growth, jobs and prosperity for all. It preserves the purchasing power of our money and the value of our savings.

And it has profound social implications. Stable prices support the weakest members of our societies – including pensioners and the unemployed – who depend on fixed incomes to live. In that sense, a stability-oriented monetary policy is a key component of the Social Market Economy.

I do not say this based on theory: the history of this country has taught us that inflation undermines not only economic wealth but also political stability. The deep-seated fear of inflation is therefore more than understandable. Your own national experience is at once a powerful reminder and steadfast obligation for the central bank.

The challenges of the crisis

But preserving price stability today requires different actions than it did in the past. We have required new tools to ensure that our monetary policy decisions are able to reach firms and households.

This is because the crisis has severely fragmented the euro area's financial system. It has disrupted the way our interest rate changes are passed on by banks to the wider economy. As a result, our low interest rates have simply not been getting through to people in some parts of the euro area.

This may sound like a technical matter. But the transmission of interest rates is fundamental. The euro area is a bank-based economy. Around three quarters of firms' financing comes from banks. So if banks in some countries will not lend at reasonable interest rates, the consequences are dire.

Perfectly healthy companies would be forced to close. Credit for new investment would not be available. Not because business models are flawed or because investment projects are too risky, but because firms happen to be located in the wrong place.

Worse still, in the first half of last year fragmentation in the euro area had become so serious that some investors were questioning the future of our currency. Fears of a potential break-up were sending capital fleeing from the periphery to the core. For some in the financial markets, the most fundamental notion of confidence in a currency – that a euro is a euro regardless of where you are – was no longer a given.

But a currency whose integrity is in doubt cannot be a stable currency.

So we had to decide: do we passively let events take their course and accept severe risks for price stability? Or do we assume the responsibility, within our mandate, to defend the stability of our currency and our monetary union?

Those were difficult and existential decisions. They required deep reflection, a proper assessment of risks in the short and long term, and a clear-headed judgement of possible alternatives. They also required the courage to face the inevitable criticism and engage with those who disagreed.

But we chose to act – because we judged this to be right and necessary to safeguard price stability.

Defending the transmission of monetary policy

First, we acted to remove blockages that were stopping banks from passing on our low interest rates to borrowers.

We allowed banks to take as much liquidity as they needed from our operations. We allowed a wider set of collateral that banks could use to access this liquidity. And we extended the maturity of our operations, going up to 3 years.

Second, we acted to remove the unfounded fears about the future of the euro area that were undermining the stability of our currency.

We launched a new measure called Outright Monetary Transactions (OMTs) to provide a fully effective backstop in the sovereign bond market.

We focused on this market because it has a “knock-on” effect on other markets. Fears in the sovereign bond market were seeping into the banking system. They were paralysing the economy, and ultimately threatening price stability. By putting in place a credible backstop, we were able to remove those fears at the source.

Those fears were unjustified by economic fundamentals. They were the result of market failure: a situation where investors seem to act rationally, but collectively they create destructive outcomes. Countries that were fundamentally adjusting were being driven to the wall by panic. And the result would have been unnecessary hardship and suffering.

Much has been written about this measure, especially in this country, and some fundamental questions have been raised:

- Is the ECB still independent?
- And will the ECB stay focused on fighting inflation?

The answer to both these questions is a categorical “yes”.

First, we always protect our independence.

We take all our monetary policy decisions in full independence. And we have designed the OMTs so that these decisions could never be dominated by fiscal policies. This is why a pre-condition for access to the OMTs is a strong economic adjustment programme. It ensures that we would only ever intervene in situations where fiscal discipline is firmly ensured.

Second, we keep a permanent watch on inflation.

We understand and take very seriously people’s concerns about possible inflationary threats. But it is a fallacy to make a mechanical connection between the creation of central bank liquidity and a rise in the money supply. The liquidity we provide to banks is used in the markets where banks lend to each other. It does not automatically increase credit or money in the economy – and so does not automatically lead to price pressure in the economy.

Indeed, money growth is currently well below an inflationary level. Credit provision to the private sector is overall weak, and contracting in large parts of the euro area. And inflation expectations are firmly anchored. So risks of inflation down the road are firmly in check.

The euro area dimension to our actions

It is also important to understand that our measures are designed not only to help the people in countries under stress. In fact, in line with our mandate, they serve the citizens of the whole euro area.

Many of the financial developments that concern people in this country – such as meagre returns on their savings or large imbalances in the Target-2 payment system – are really only the mirror image of fragmentation in the rest of the euro area.

As money flows out of stressed countries and into safe-haven countries like Germany, it pushes up interest rates in the stressed countries, and pushes down interest rates here. These flows cause Target-2 imbalances to increase.

What has not been sufficiently acknowledged, however, is that these imbalances would only affect German taxpayers in the event of a break-up of the euro area. This means that actions by the ECB that protect the euro area against such outcomes – like the OMTs – *also* reduce hypothetical risks for German taxpayers.

And this is exactly what we have seen. Since the announcement of the OMTs, the Bundesbank's Target-2 exposure has decreased by more than 100 billion euros.

In sum, the ECB has acted, and will continue to act, to fulfil its mandate. We are committed to preserving the integrity of our currency, in the interests of all people of the euro area.

We do not act to help banks. We do not act to help governments. We act to help maintain the flow of credit to real firms and households. We act to preserve price stability.

Incidentally, while some in this country are wondering whether the ECB does "too much", elsewhere in the euro area I am asked why the ECB does not "do more". I just returned from the Spanish Parliament in Madrid – and the concerns expressed there are very different from what I hear in Germany. People worry that a stagnating economy will lead to the emergence of a "lost generation", where young people have no jobs, and even worse, no hope.

But our answer – both to those who want us to do less and to those who want us to do more – is the same: we will preserve price stability. This is our mandate.

How governments play their part

It is important to stress that the ECB's mandate only extends so far. There are clear limits to what monetary policy can and should aim to achieve.

We cannot repair unsound budgets. We cannot clean up struggling banks. We cannot solve deep-rooted problems in the structure of Europe's economies.

Our monetary union was deliberately constructed so that these policies would be the preserve of elected governments in each Member State. Sharing a common currency would only be sustainable if each country assumed its own responsibility.

This reflects the subsidiarity principle embedded in our European Treaties. And in that sense, it also echoes a central tenet of Catholic Social Doctrine. As Pope Pius XI wrote in 1931, *"It is a fundamental principle that one should not withdraw from individuals and commit to the community what they can accomplish by their own enterprise and industry."* [3]

Individuals have to do what they can to help themselves before they seek help from the community. The same is true for the countries in the euro area.

Fortunately, this is what we are seeing across Europe today.

Governments have already done a lot to tackle the imbalances that accumulated in previous years.

Progress in implementing economic reforms has been extraordinary. Deficits are being reduced. Current account imbalances are being unwound. Wide-ranging structural reforms are underway.

Particularly impressive is the scale of the adjustment that has taken place in countries receiving financial assistance.

In many countries these efforts have largely removed the underlying drivers of the sovereign debt crisis. But while sovereign debt markets have improved, bank lending is still very fragmented across the euro area. Credit in some countries is still difficult to obtain. The benefits of the painful actions undertaken so far have not yet materialised.

And this means that economic adjustment is coming at a heavy social cost. Economists often speak about "inevitable adjustment costs", which to some sounds cold, heartless and lacking compassion. But we are fully aware of the human dimension that lies behind it.

Euro area GDP is currently lower than it was in 2008. Almost 19 million people are unemployed – more than the population of the Netherlands.

Unemployment is a tragedy. It squanders the vitality of our workers. It prevents people from playing a full and meaningful part in society. It induces a sense of hopelessness, which drains the inspiration from our young.

Reform as the path to growth and fairness

Reducing unemployment is therefore a pressing challenge.

Governments need to address the structural problems in their economies. They need to enact fundamental reforms that boost the potential of their economies to grow.

We need reforms that make doing business easier. That guarantee that those who owe taxes actually pay taxes. That ensure that public services actually serve the public.

And these reforms should aim not only to create more growth and jobs, but also to make society fairer.

Fairness starts *within* countries.

In one country in the euro area, more than fifty percent of young people cannot currently find jobs. Is it fair that, as a result, this generation has to bear the bulk of the burden in the downturn?

In another country, an estimated 55 billion euros of tax revenue remains unpaid. Is it fair that, as a result, other people who are taxed on their salaries have to make up the difference?

This is why I say that reforms that make economies work better also make them fairer.

And fairness also matters *between* generations.

Many countries have to think hard about how they can support ageing populations and generous welfare states. The unsustainable option is to keep increasing debt. But this means nothing else than passing the burden onto future generations. There is no real equity through debt.

The sustainable option is to generate the higher growth that is needed to maintain Europe's social model. And this is only possible by walking the path of determined reform.

There is no doubt that this is the hard path. But it is also the courageous path. It is the path that will create jobs; that will support our social model in the future; and that, in the end, will contribute to a fairer society.

For this reason, it is wrong to claim that countries are undertaking reforms only to please the markets or to satisfy the demands of technocrats in Brussels, Frankfurt or Washington. They are doing it for their own benefit. And it is time that this message gets more emphasis.

The place for mutual support

But what if countries cannot succeed on their own?

The ethical imperative when we see others in need is to help. It is to do what we can to limit their hardship.

Should this not also apply within the euro area? Should countries support those in difficulty?

The answer is yes. Catholic Social Doctrine makes absolutely clear that subsidiarity has to be paired with support. But what binds these together is *trust*.

Trust that each will put its own house in order – even if it is politically difficult.

Trust that each will play by the rules – even if this imposes unpopular choices.

Trust that each will constrain its sovereignty – even if this means making a break with the past.

Such trust has to be built through actions, which is a further reason why the process of reform across the euro area is so important. It shows that countries are ready and willing to be full members of the community. And this makes mutual support between them possible.

Certainly, countries in Europe are already doing a lot to help each other. They are providing generous financial assistance on condition that underlying problems are fixed. But in my view, once trust is established, we should go further still.

We should take stronger collective responsibility over national economic and financial policies, to ensure that countries do not get into trouble in the first place. We should make better use of common resources, to encourage reforms and restore the dynamism of our economies.

In other words, we should aim to build a strong and deep economic and political union in Europe, which would be to the benefit of all members of the single currency.

As I said at the beginning of my remarks, today's social question is not just a national one. It transcends borders. And this path – building a stronger union based on mutual trust – is the way to answer that question for Europe.

Conclusion

Let me conclude by returning to the theme of Cardinal Reinhard Marx – that the economy should be in the service of humanity.

Our common currency exists not as an end, but as a means. As Nobel Prize winning economist Amartya Sen has reminded us, our *"instrumental objectives – like the single market and monetary union – should not overshadow our social commitment to the well-being and basic freedoms of the people."* [4]

The euro is a means to foster peace between nations; and a means to further our collective prosperity.

In many ways, we have already achieved this. War among the countries of Europe is unthinkable. We have integrated our nations and our markets. The ECB has overseen the longest period of price stability in post-war history.

But there are also important ways in which we have not succeeded. The terrible economic hardship in some parts of the euro area is testament to this.

So what we cannot afford now is to stay where we are.

Federal President Joachim Gauck recently called upon all of us to have more courage for more Europe: *"What Europe needs now are not doubters but standard-bearers."* [5]

We need to reinvigorate our social models by reforming our economies.

And we need to harness the market mechanism in the service of humanity.

In this way we can safeguard our primary capital, which is the human person in his or her integrity .

Thank you for your attention.

Introductory statement at the hearing of the Committee on Economic and Monetary Affairs of the European Parliament

Speech by Mario Draghi, President of the ECB, Brussels, 18 February 2013

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure to be back here in Parliament and in front of your Committee for our regular exchange of views.

We enter 2013 in a more stable financial environment than in recent years. This has been achieved through concerted reforms by governments and parliaments and decisive actions by European institutions. But considerable further efforts are needed to ensure that Europe continues emerging from the crisis, re-creates confidence among investors and citizens, and re-establishes stability and growth.

This house has a key role to play in the reform agenda. I am thinking in particular of the adoption of the legislation for the Single Supervisory Mechanism. This is of crucial importance for progress towards financial union.

Today, I will first review economic and monetary developments in the euro area since December. I will then address the two topics that you have selected for our discussion: the impact of a low interest rate environment; and the establishment of a Single Resolution Mechanism.

Economic and monetary developments

Since our last meeting, the Governing Council has left key ECB rates unchanged: the main refinancing rate currently stands at 0.75%; the rate on the deposit facility stands at 0%; and the rate on the marginal lending facility stands at 1.50%.

Economic activity contracted for a third consecutive quarter in the fourth quarter of 2012. Available indicators signal further weakness at the beginning of 2013, with domestic demand remaining dampened. This is due to weak consumer and investor sentiment and to the necessary balance sheet adjustments in both the public and private sectors. Foreign demand also remains subdued.

Economic weakness in the early part of 2013 is expected to be followed by a very gradual recovery later in the year. Strengthening global demand, our accommodative monetary policy stance and the improvement in financial market confidence across euro area countries should all work their way through to spending and investment decisions and support the recovery.

Even though we have yet to see sustained improvement in the real economy, survey indicators have confirmed earlier evidence of a stabilisation of business and consumer confidence, albeit at low levels. Taking a somewhat longer view, the improvement in financial market confidence since last summer has been significant. As regards the exchange rate, let me be clear that the exchange rate is not a policy target, but it is important for growth and price stability.

Another sign of improved confidence is the larger than expected early repayment by counterparties in the first of our two three-year longer-term refinancing operations settled in December 2011 and March 2012. This indicates that banks are less uncertain about their funding prospects than a year ago. We will closely monitor conditions in the money market and their potential impact on the stance of monetary policy, which will remain accommodative with the full allotment mode of liquidity provision.

The risks surrounding the economic outlook for the euro area continue to be on the downside. They relate to the possibility of weaker than expected domestic demand and exports, slow implementation of structural reforms in the euro area, as well as geopolitical issues and imbalances in major industrialised countries which could both have an impact on developments in global commodities and financial markets. These factors have the potential to dampen the ongoing improvement in confidence and thereby delay the recovery.

Annual inflation in the euro area has continued to moderate, falling from 2.5% in October to 2.2% in November and December and 2.0% in January, as we had foreseen. Inflation is expected to decline to below 2% in the near term.

Risks to the outlook for price developments continue to be seen as broadly balanced over the medium term, with upside risks relating to higher administered prices and indirect taxes, as well as higher oil prices, and downside risks stemming

from weaker economic activity and, more recently, the appreciation of the euro exchange rate. Inflation expectations for the euro area remain firmly in line with the Governing Council's aim of maintaining annual inflation rates below, but close to, 2%.

Our monetary analysis is consistent with price stability. The underlying pace of monetary expansion and loan dynamics remain subdued. The annual growth rate of loans to the private sector remains negative. To a large extent, subdued loan dynamics reflect the current stage of the business cycle, heightened credit risk and the continuing process of deleveraging.

Overall, inflationary pressures should remain contained over the policy-relevant horizon. Taking the evidence together, this allows our monetary policy stance to remain accommodative.

The impact of a low interest rate environment

Let me turn to the first topic that you have chosen for our meeting today, namely the implications of a low interest rate environment.

The impact of the global financial crisis on the economy and, potentially, on price developments has been unprecedented. We have taken unprecedented measures in response, aiming pre-emptively and forcefully to avert risks to price stability, in accordance with our primary mandate.

First, we have reduced our key interest rate to 0.75%, a level previously unseen in virtually all euro area countries. The interest rate in the overnight interbank market is now even lower, close to zero.

Second, we have acted to prevent an abrupt reduction in the supply of credit to the real economy. We have given banks unrestricted access to central bank funding in all our refinancing operations. We have extended significantly the average maturity of these operations. We have broadened the set of eligible collateral. This assurance of funding to banks has prevented disorderly deleveraging in the financial sector and averted a collapse in money and credit, with potentially severe implications for price stability, and thereby employment and growth.

All these decisions have ensured price stability and stabilised inflation expectations during an exceptional period.

Naturally, the ECB is aware of the challenges arising from a protracted period of low policy rates and ample liquidity. Let me elaborate on the three main challenges.

The first is that low interest rates may affect the ability of savers and investors to generate returns. This is especially the case for institutions targeting nominal returns, such as insurance companies and pension funds. Yet, by ensuring price stability throughout the crisis, monetary policy has contributed to more stable financial conditions. This is central to the interests of savers and investors: there can only be sustainable returns in a stable environment.

The second challenge relates to incentives. A protracted period of low interest rates and ample liquidity facilitates rolling-over loans at very low costs. Banks may therefore have less incentive to monitor credit risk properly and may provide too many loans to non-profitable business. Over time, such misallocation of financial resources would undermine overall productivity and depress growth and employment.

The third challenge is that protracted monetary accommodation may fuel bubbles in house prices and other asset markets. As the crisis has painfully demonstrated, the bursting of such bubbles inflicts large costs for the real economy.

In this context, a natural question is whether monetary policy should be used actively to contain asset price booms and bubbles – a response known as 'leaning against the wind'. Thanks to our monetary policy strategy, implicitly we do this to some extent. We focus on the medium-term horizon and take account of monetary developments in assessing risks to price stability.

Having said that, let us be clear that changes in policy interest rates are normally not the first best instrument for addressing financial imbalances. They should be considered only under very special circumstances, for example when a widespread rise in asset prices threatens price stability in the euro area as a whole. In the absence of such imbalances relevant from a euro area perspective, the appropriate tools to counter imbalances in the financial sector and possible asset price misalignments are at the country level. To avoid the build-up of excessive risks in the financial system or housing markets, national authorities have appropriate tax and supervisory instruments at their disposal.

The establishment of a Single Resolution Mechanism

Let me turn to your second chosen topic, the establishment of a Single Resolution Mechanism.

The Single Resolution Mechanism should be centred in a Single Resolution Authority with a European Resolution Fund at its disposal. I welcome the European Council's December statement that during the course of 2013, the Commission will submit a proposal for such a mechanism for Member States that are participating in the Single Supervisory Mechanism.

The ECB shares the European Council's view on timing for the Single Resolution Mechanism, namely that it will be required once bank supervision is effectively moved to the Single Supervisory Mechanism. We therefore welcome the European Council urging the co-legislators to examine the proposal as a matter of priority with the intention of adopting it during the current parliamentary cycle.

There are four main reasons for a Single Resolution Mechanism, with a Single Resolution Authority at its centre.

The *first* reason is that only a Single Resolution Authority will ensure timely and impartial decision-making focused on the European dimension. In a situation where a cross-border resolution is required, the Single Resolution Authority would avoid national focus and pursue the optimal resolution strategy, thus mitigating coordination problems.

The *second* reason is that the Single Resolution Authority would credibly pursue the least cost resolution strategy, assessing possible cross-border spillover effects and systemic concerns, and ensuring that resolution costs are first and foremost borne by the private sector. It would thereby minimise resolution costs without recourse to taxpayer money.

The *third* reason is that the Single Resolution Authority is an essential complement to the Single Supervisory Mechanism. The Single Supervisory Mechanism will provide a timely and unbiased assessment of the need for resolution, while the Single Resolution Authority will ensure prompt and efficient action once the trigger is reached. This will avoid misaligned incentives that could arise with supervision moved to the European level while resolution responsibility remained national.

The *fourth* reason is that a Single Resolution Authority would help to break the vicious bank-sovereign nexus.

The Single Resolution Authority naturally needs to be strong and effective to deliver what is needed. This requires three features to be fulfilled:

First, the Single Resolution Authority needs to dispose of a robust resolution framework, one that provides it with enforceable resolution tools and powers. In this respect, the proposed bank recovery and resolution directive is key. Adoption of the directive, ideally by June, is an urgently needed step towards a strong European resolution framework.

Second, the Single Resolution Authority needs access to resolution financing. It should therefore have a European Resolution Fund at its disposal, which should be financed by the private sector via risk-based ex ante levies. The European Resolution Fund should be backed by a public backstop mechanism, the support of which would need to be recouped via special ex post levies on the private sector. This means that it would be fiscally neutral over the medium term.

Third, the Single Resolution Authority should have an institutional set-up that allows for independence, sufficient operational capacity and a robust accountability framework with effective judicial protection against resolution decisions ex post.

The Commission is currently assessing the options for the institutional anchoring of the Single Resolution Authority. I am looking forward to its proposal, which will need to ensure these three essential features.

Thank you for your attention. I am now at your disposal for questions.

G20 priorities under the Russian Presidency

Speech by Mario Draghi, President of the ECB, at the G20 Ministers and Central Bank Governors meeting, Moscow, 15 February 2013

Dear President Putin, ladies and gentlemen,

First, on behalf of all my G20 colleagues, I would like to thank you, President Putin, for hosting us today in Moscow and in the Kremlin this afternoon. I feel honoured to be able to speak here on behalf of my colleagues.

The main objective set out by Russia when it assumed its G20 Presidency for this year was to "stimulate economic growth and create jobs". As premier forum for international economic cooperation, the G20 indeed plays a central role in supporting policies aimed at strong, sustainable and balanced growth globally.

The overall G20 agenda, proposed by Russia for this year, spans much wider, and is fully in line with the original mandate of the G20 to cover both financial stability as well as longer-term growth-related issues. As President Putin has just outlined, we have a lot of hard work ahead of us. I am looking forward to making progress in all of the areas earmarked.

At today's and tomorrow's meeting of G20 Ministers and Governors we will have a fruitful exchange of views on the global economy, on the progress in our financial regulatory reform agenda, on further reforms of the international financial architecture, and on investment financing, among other things. These are all issues which the Russian Presidency has given due importance as they address key questions currently occupying economic policy makers all over the globe:

- How can we create jobs?
- How can we get back to strong, sustainable and balanced growth?
- How can we progress on financial regulation, so as to further strengthen our financial systems?
- What are the further steps to complete our international financial architecture to support stability and growth?
- And how can long-term investment financing be better geared towards delivering long-term global growth, development and job creation?

The first three issues – the agendas for growth, financial regulation and financial architecture – have been occupying us ever since the global crisis emerged and G20 Leaders met in November 2008. The Russian Presidency has given special attention to the fourth issue, long-term investment financing for growth and development. And rightly so in my view, considering the key role played by investment not only in increasing output in the short term, but also boosting potential output over the medium term.

Policy actions, notably by G20 members, have been able to bolster confidence and improve financial market sentiment.

Conditions in the banking sector, and in financial markets more generally, have significantly improved since the summer of last year. This is manifested by rising global equity prices and a decline in financial market volatility and global risk aversion. Global capital flows have picked up again. Spreads on sovereign and corporate bonds are narrowing.

But we have to remain prudent. We should continue to press ahead with reforms to avoid abrupt changes in financial market sentiment. And we can only acknowledge that for some of the G20 members this improvement in financial markets has not yet found its way through to the real economy. The key responsibility for us, economic policy makers in the G20, is therefore to continue our action based on the three pillars:

- commitment to the policy goals that we have set out
- consistency in their implementation, across time, across countries and across policy domains
- and collaboration among all of our constituencies.

I have no doubt that the G20 will, under the Russian Presidency, contribute to restoring growth and job creation for the global economy. Thank you.

Introductory Statement at the Congreso de los Diputados de España

Speech by Mario Draghi, President of the ECB, Meeting with Members of Parliament, Madrid, 12 February 2013

Dear President Posada,

Honourable Members of Parliament,

I would like to thank you most warmly for your kind invitation to appear before this chamber of Parliament.

As President of the European Central Bank (ECB), it is an honour to have this opportunity to discuss the big challenges facing the euro area economy and to explain the major policy actions that we are taking in response to those challenges.

After outlining what we have done, I will be very keen to hear your views – on Europe's economy, on ECB policies and on the future design of our economic and monetary union. By the end of this session, I hope that we will have reached a good mutual understanding – one that will allow us, within our respective institutional mandates, to make further progress on the twin challenges of strengthening our union and returning to sound and stable growth.

Over the past few years, we have seen how deeply the economies of the euro area countries are interconnected. It is an emphatic reminder of how economic policies in one country have significant effects on other countries.

As the democratically elected representatives of the Spanish people, you are responsible for domestic economic policy. Yet in the exercise of those duties, just like all national parliaments in the euro area, you influence the functioning of our economic and monetary union as a whole. As the President of the European Council Herman van Rompuy has said, national parliaments have become European institutions. It is important that we all recognise these mutual interests.

In my introductory remarks today, I would like to focus on three topics: the state of the economy, the ECB's monetary policy and the longer-term vision for our economic and monetary union. I will then be happy to hear your views and take your questions.

Adjustment in the euro area economy

Let me begin with the overall situation. As you know, the euro area economy is undergoing an important adjustment. This process is necessary, but it is particularly painful and protracted in those areas where past misalignments of policies created vulnerabilities. Particular difficulties stem from the large imbalances of highly indebted sectors and unsound public finances in some euro area countries.

But we are seeing the first positive results of the adjustment. For example, euro area countries have almost halved their fiscal deficits from 6.2% of GDP in 2010 to an estimated 3.3% in 2012. Excluding interest payments, the primary deficit of the euro area as a whole is virtually zero. This contrasts with the United States and Japan, which recorded primary deficits of around 6% of GDP in 2012.

Several euro area countries are addressing their external imbalances, among them Spain, whose current account deficit fell substantially – from almost 10% in 2008 to about 1% in 2012. According to the latest data, your country's exports have increased notably – by about 20% in volume between 2009 and last year. There has been a similar increase in Portugal and, to a somewhat lesser extent, in Ireland.

Over the same period, the share of exports in GDP increased by around 10 percentage points in Spain, Ireland and Portugal. Exports are providing a strong positive contribution to real economic growth. These economies are also seeing a fall in unit labour costs, which will improve their competitiveness and provide a platform for sustainable growth.

Notwithstanding these signs of improvement, the adjustment has not yet had a visible impact on people's daily lives. Frustration in some parts of the population is thus understandable. Reform efforts take time to reveal their full beneficial effects – and they must reach a critical mass before they lead to a fundamental turnaround in economic prospects.

The top priorities on the reform agenda remain correcting misalignments and restoring the capacity of the economy to create value, incomes and jobs. Governments must persevere on the path towards sound and stable growth. National parliaments are key contributors to this process, notably in effective communication to the public of the ultimate goals.

In saying all this, I am acutely aware of the significant social costs that the adjustment entails, especially for those who have lost their jobs. I am very conscious of this human dimension of the recession, particularly the difficulties facing many of your constituents. But the reforms should not be seen in isolation: they aim to create stronger, better functioning and, yes, also fairer economies, for the benefit of all citizens.

Countries undertaking painful but necessary reforms should not feel that they have been left to fend for themselves. Creating a more stable and prosperous future for Europe is the goal that unites all euro area countries. To make progress, we need a shared sense of direction, a sense of cohesion across countries and a sense of solidarity within societies.

The shared sense of direction is expressed in laying the foundations for sustainable growth. In some countries, this implies re-orienting the main engines of growth towards productive sectors. It also implies regaining competitiveness by containing or reducing costs via a combination of accelerated productivity and wage restraint.

The sense of cohesion is expressed in the single market, the single currency and common European institutions to ensure good governance and, when needed, mutual assistance and support.

The sense of solidarity within societies should be expressed by ensuring that the burden is not borne disproportionately by certain sectors or groups of people.

The ECB's monetary policy

Let me now turn to the specific policy actions that the ECB has taken in response to the challenges to the euro area economy.

There are two key elements. The first has been to reduce our key interest rate to 0.75%, a level previously unseen in virtually all euro area countries. The interest rate in the overnight interbank market is now even lower, close to zero.

The second element has been to give banks unrestricted access to central bank funding through both our short- and long-term operations. This policy meant that banks did not have to shrink their balance sheets unnecessarily at a time when market funding became unavailable or excessively costly. It prevented a potential deflationary scenario, thus ensuring delivery on the ECB's primary objective of maintaining price stability in the euro area.

At the same time, the policy has alleviated funding constraints for banks that decide to renew or extend their loans to firms and households. This removes one obstacle to growth. Since three quarters of firms' external finance in the euro area comes from banks, we need them to be delivering a sound supply of credit to support investment and job creation.

We have provided banks with assurance that, with adequate collateral, they can draw unlimited volumes of central bank liquidity at our key interest rate. We effectively stood in for the interbank market: when that market stopped functioning, our actions allowed banks to continue lending. The overall size of our refinancing operations increased from less than €450 billion before the crisis to more than €1.2 trillion at its peak.

We have also provided banks with assurance that they can rely on our refinancing operations for extended periods. The maximum maturity of these operations increased from three months to three years. Without the two three-year refinancing operations launched in late 2011 and early 2012, there could have been a major credit crunch.

Through these measures, the ECB has decisively addressed the liquidity pressures faced by euro area banks. Here in Spain, for example, the liquidity support extended to the banking system currently corresponds to a quarter of the country's GDP, about eight times what it was before the crisis.

To ensure delivery on the ECB's primary objective of safeguarding price stability, it was essential to create an environment in which liquidity is not an obstacle to credit creation. But liquidity is not the only factor determining banks' capacity and willingness to lend to firms and households. There are two additional factors: banks' availability of capital; and the general perception of risk in the economy.

Provision of capital is not among the tasks of a central bank. It is the task of shareholders to ensure that banks are solvent and able to sustain their core business. When the private sector is unable or unwilling to provide capital, it is for the fiscal authorities – governments and parliaments – to decide whether and how to act.

Here in Spain, the authorities have been proactive, even in strained conditions, embarking on an ambitious financial adjustment programme with the assistance of their European partners. The programme – which is proceeding on schedule – has removed from the balance sheets of the weakest banking institutions the troubled assets that had been a drag on their business. The programme has recapitalised these institutions with fresh funds and laid the foundations for their return to health and active lending.

The general perception of risk is the third determinant of credit. Just like any other central bank, the ECB cannot control *microeconomic* risk – how banks assess whether a potential borrower will fail to repay a loan.

Microeconomic risk is related to the conditions prevailing in the specific sector in which a firm operates or to the firm's cost structure and capacity to innovate and create value. It is the role of structural, sectoral and fiscal policies to facilitate the reallocation of resources to activities that have real economic value.

For its part, the ECB is actively contributing to a reduction in *macroeconomic* risk: by firmly stabilising inflation expectations, it provides a nominal anchor for the economy as a whole. This is important for all lending and borrowing decisions, particularly the financing of longer-term investment projects.

Our decision last summer to prepare for Outright Monetary Transactions (OMTs) in government bond markets can be seen in this light. OMTs are designed to focus on bonds with a remaining maturity of up to three years, aiming to keep medium-term inflation expectations stable by avoiding a highly damaging breakdown in the transmission of monetary policy.

The ECB can only consider OMTs if there are major problems in the transmission of monetary policy and if there is strict and effective conditionality attached to an appropriate European Stability Mechanism (ESM) programme.

There are two reasons for this conditionality framework. First, OMTs are a backstop against destructive speculation. They are not a subsidy for government financing. OMTs should remove only the part of the interest rate at which governments borrow that is due to unfounded expectations of destructive scenarios for the euro area.

But our interventions are conceivable only if the risk of fiscal dominance is firmly excluded. This requires certainty that governments will maintain fiscal discipline and that continuous reforms will correct underlying weaknesses. Only strict and effective conditionality can generate that kind of assurance.

The second reason for conditionality is that an ESM programme is a catalyst for reform. It can change the economic prospects of a country towards a higher growth potential, complementing monetary policy in its efforts to support the economy.

In the past few months, we have seen a gradual easing of financial conditions. Credit spreads on sovereign and corporate bonds have fallen. Equity prices have recovered. Banks have regained market access. And money has flowed back into European debt markets.

ECB policies have played a pivotal role in this improvement, as has resolute action by governments, parliaments and the private sector. All should persevere in these efforts with confidence. The ECB, for its part, will continue to safeguard price stability, as it has done over the past 13 years.

The longer-term vision

Let me turn briefly to the longer-term vision for Europe. As you know, it is widely understood that our monetary union needs to be complemented by a financial union, a fiscal union, a genuine economic union and eventually a deeper political union.

The most urgent project – financial union – is taking tangible shape. The ECB is expected to become the single supervisor for a large part of the euro area's banking sector. We stand ready to launch our internal preparations as soon as the European Parliament and the European Council reach an agreement on the legislation.

The proposal for a single resolution framework is also in the pipeline. Taken together, these two reforms will re-establish confidence in the euro area's banking sector.

It is also essential that we complete economic union by creating the conditions for each country to find its place in the open market economy that is the euro area, and to exploit its comparative advantages to generate jobs and growth.

This is the meaning of a well-functioning economic union. And it will only happen if we restore competitiveness across the euro area, if we improve the functioning of product and labour markets, and if we invest in skills and innovation.

The idea of ‘mutually agreed contracts for competitiveness and growth’ or ‘reform contracts’ could be very helpful here by targeting policy actions in areas that are key to restoring competitiveness. We would also benefit from a thorough review of product and labour markets to ensure that they are compatible with the functioning of monetary union.

Conclusion

Let me conclude. We have begun this year with a more stable financial environment. This has been achieved through concerted reform efforts by governments and parliaments and decisive actions by European institutions.

As I said at the beginning of my remarks, all national parliaments in the euro area influence the functioning of our economic and monetary union. Spain plays a prominent role in this process.

Throughout the current phase of economic adjustment, communication between European and national policy-makers and consensus-building efforts within domestic constituencies are of critical importance. This is the best way to safeguard our future collective prosperity.

Thank you for your attention. I will now be pleased to hear your views and take your questions.

Address at the New Year’s Reception of the Frankfurt Chamber of Commerce and Industry

Speech by Mario Draghi, President of the ECB, Frankfurt am Main, 22 January 2013

Minister-President Bouffier,

Lord Mayor Feldmann,

President Müller,

Ladies and gentlemen,

It is a great pleasure for me to be here with you this evening, and I would like to thank the Chamber of Commerce and Industry very warmly for inviting me.

I am pleased to meet many representatives of the business community and public life of the region Rhein-Main and Frankfurt, the city in which the ECB is so well hosted and where I also feel personally very comfortable.

A New Year’s reception is always the occasion to look back on what has happened in the past year and to look forward to what lies ahead.

2012 was a year full of challenges. Yet it was also a year of surprises and new beginnings.

We began the year in an environment of exceptional uncertainty. The euro area was faced with deep, even existential challenges.

This led some experts to make bleak predictions about the future. They doubted the resilience of our economies. They worried about the stability of our single currency. They even questioned its future existence.

To illustrate just how far some doubts went, let me quote the from the Economist’s annual publication “The World in 2012”, which in the autumn of 2011 said the following:

“If you were sitting down with a blank sheet of paper, you would advise the euro zone to complement its one-size-fits-all monetary policy by pooling sovereignty and creating new institutions. You would set up a European mini-IMF with enough funds to assist troubled countries that adjust their economies. A pan-European banking regulator and a bail-out fund could ensure that large European banks were not at the mercy of their vulnerable sovereign borrowers. […] And, to stop governments from exploiting these mechanisms, euro-zone countries would agree to submit their fiscal policies to the say-so of everyone else. It amounts to a blueprint for the United States of Europe. And it is utterly beyond reach.” [1]

If we look back at 2012, on virtually all of these issues, Europe is moving forward or is already there. So the ambition is not “utterly beyond reach”. Indeed, it bears out what Walter Hallstein, the first President of the European Commission, once said: that “anyone who does not believe in miracles in European matters is not a realist”. [2]

Due to resolute actions by euro area governments and European institutions, the year 2012 turned out quite differently than predicted. The darkest clouds over the euro area subsided. Countries renewed their commitment to reforms. The euro area took strides forward in its common governance.

Europe’s policy-makers, including the European Central Bank (ECB) within its mandate, left no doubts about their commitment to our common currency and to its stability.

We can begin 2013 on a more confident note, precisely because significant progress was made during 2012.

Significant progress in 2012

First of all, governments did their part to ensure stability.

During the last year, an important change took place “on the ground” in the economies of Europe. The necessary rebalancing of the euro area economy gathered pace. A comprehensive adjustment in the deficit countries is now taking place.

Many countries are making solid progress in bringing their public finances under control. They are enacting structural reforms to increase competitiveness. This is especially true for the countries under an EU/IMF programme, where adjustment has been extensive.

Reducing the imbalances is certainly a difficult and painful process. But it is essential to restore sustainable public finances and growth. The people in the countries concerned have broadly understood this and backed this course of action. The progress made deserves public recognition and respect.

Governments also came together in 2012 to strengthen the euro area and its ability to prevent and react to crises.

The European Stability Mechanism became active and provides a solid safety net if needed.

The new rules for governing the euro area economy were applied to strengthen oversight of budgets and to monitor emerging imbalances more effectively.

Member States agreed to put debt brakes in their national constitutions.

Most importantly, Europe’s leaders recognised that monetary union needs to be complemented by a financial union, a fiscal union, a genuine economic union and eventually a deeper political union. Discussions are underway with clear timelines in the months ahead.

The most urgent project – financial union – is now taking tangible shape. The ECB is expected to become the single supervisor for the biggest part of the euro area’s banking sector. This is probably the most significant integration step since the Maastricht Treaty. Advances towards a common resolution framework for dealing with non-viable banks are also in the pipeline.

Of course, the ECB also made a contribution in 2012, notably with our special measures. We have shown our commitment to do what is necessary within our mandate to safeguard the stability of the euro. Only a currency whose future existence is not in doubt can be a stable currency.

Is the ECB still focused on price stability? And is it acting in full independence?

I would like to state categorically that the answer to both of these questions is ‘yes’.

Let me start with price stability. The ECB remains steadfastly committed to its primary mandate of ensuring price stability. All of our measures are designed to achieve this goal. And looking at current and expected inflation rates, there is simply no evidence that could substantiate fears about any deviation from price stability.

Last year, we saw a situation where fears about the future of the euro area were creating fragmentation in financial markets. This fragmentation had very tangible consequences for the real economy: bank funding costs diverged

significantly across countries, and this led to marked differences in bank lending rates to firms and households across the euro area.

In some countries, reductions in ECB interest rates were fully passed on; in others, bank lending rates declined only a little, if at all; and in some they even rose.

Interest rates do not have to be identical across the euro area, but it is unacceptable if major differences arise from fragmented capital markets or unfounded perceptions about the long-term sustainability of the euro. In an economy like the euro area, where around three quarters of firms' financing comes from banks, fragmentation has very severe consequences for the real economy, for investment and employment and ultimately for price stability.

We therefore acted to remove unfounded fears about the euro and to safeguard our ability to ensure price stability for the whole euro area.

Let me explain how we safeguard our independence.

In the summer of last year, passive inaction was no more an option because it would have posed the greatest risks. Therefore, the ECB, learning from previous experience and in compliance with its mandate, had to act - but it would only intervene within a framework that would ensure full fiscal compliance by the governments concerned. It is for this reason that there is a requirement of countries having an adjustment programme to be considered for Outright Monetary Transactions (OMTs). Such a programme must entail conditionality that ensures fiscal discipline.

With fiscal discipline, monetary policy cannot become captured by fiscal dominance. And therefore, the central bank can continue its pursuit of safeguarding price stability in full independence.

And there is one more important lesson from 2012 that we must keep in mind: measures to stabilise the euro area, particularly the OMTs, are not only essential for price stability. They also reduce Target2 balances and, because they foster the cohesion of the euro area, they reduce possible risks for German taxpayers.

To sum up, the facts support an ultimately more confident review of 2012.

Prospects for 2013

As regards the coming year, I would like to suggest three things we need to focus on in 2013:

First of all, we need perseverance.

Despite the good progress so far showing that adjustment is happening, reform efforts need to be sustained. Adjustment is inherently difficult and will remain with us for some time to come. Politicians and their populations will need to persevere, especially on structural reforms that improve competitiveness. Countries need competitiveness to sustain growth. They must move away from debt-financing. There is no possibility of sustained growth based on permanent debt accumulation; and by the way, there is no social fairness based on permanent debt accumulation.

Second, we need continued ambition.

Relative calm in financial markets should not lead to a lowering of our ambitions to fix the structural flaws in the governance framework of the euro area. After the many advances that have been made in creating new rules and institutions, this coming year should focus on implementation.

Third, we need patience.

I am very well aware that for many people in the countries under adjustment, the personal economic situation can be very difficult. But there is simply no alternative to the path of reform.

The crisis has several facets that are of different importance in different countries: there is a debt crisis that needs fiscal consolidation; there is a competitiveness crisis that needs structural reforms; there is a banking crisis that needs a strong financial union; and there is a confidence crisis that needs strong commitment by all policy-makers, including by the central bank expressed through our programme of OMTs.

The social consensus behind the reforms will need to be maintained. These reforms are not undertaken to please Brussels or Frankfurt or Washington but for the deep self-interest of the economies concerned and of the whole euro area. They will make the economies function better, more efficiently and, yes, also more fairly.

Before drawing to a close, let me say a word on the prospective single supervisory mechanism and the role that the ECB shall take on.

Later this year, once the legal texts have been adopted, the ECB will assume a major new responsibility to prepare for becoming the new euro area banking supervisor, as home and heart of the single supervisory mechanism. This will be a major organisational challenge. Internal work is already underway. You can rest assured that we will work hard to ensure that the ECB will deliver on its responsibilities to the highest possible standard.

In the first press conference on this matter, when the single European supervisor had not yet been decided, I said that if it were to be the ECB, the following five principles would need to apply:

- the framework for supervision had to be effective and ensure coherent oversight;
- supervisory decision-making and monetary policy had to be clearly separated;
- national supervisors had to be properly involved through appropriate decentralisation;
- the Single Market had to be preserved for countries that did not join; and finally,
- there had to be full democratic accountability.

Conclusion

Ladies and gentlemen,

The establishment of the supervisory function in Frankfurt is a further tribute to the city as a financial centre. The ECB will also continue to contribute to the cultural life of the city, not least through the ECB Cultural Days that we organise every year and which this year will focus on Latvia. And in the eastern part of the city, we will see the Großmarkthalle emerge in its former glory together with our new tower that is scheduled for completion next year.

Let me conclude. We begin 2013 with more confidence than we had in January one year ago. This confidence is to a large extent built on the progress that all of us – governments, parliaments, the EU and the ECB – have been able to make during 2012. But it is also crucially built on the expectation that progress will persist.

The ECB for its part will be there to continue, as it has done successfully now for 14 years, to safeguard price stability.

Thank you very much for your attention.

Unveiling of the 5 euro banknote of the new Europa series

Short address by Mario Draghi, President of the ECB, at the Archaeological Museum in Frankfurt am Main, 10 January 2013

Ladies and Gentlemen,

I too would like to warmly welcome you to today's event and thank you for having accepted our invitation. In particular, I would like to thank you, Mr Wamers, for your kind words. I am very pleased that you have made available this special setting of the Archaeological Museum for the unveiling of the new 5 euro banknote and for the hosting of the "New Face of the Euro" exhibition.

Frankfurt is one of the European Union's financial capitals, a very international city and an important one for trade and finance in Germany. This is one of many reasons why Frankfurt has become the City of the Euro and the seat of the European Central Bank.

This museum, among its many treasures, displays items from classical antiquity. So it is quite appropriate for Europa, a figure from Greek mythology, to be on show here and for us to unveil the new banknote that includes her portrait. The 5 euro will be the first banknote of the second series of euro banknotes, the so-called "Europa" series.

It will gradually replace the first series of euro banknotes, which was introduced on 1 January 2002. That's the date most people remember – it was when the euro finally became "real" for 300 million citizens in the then 12 euro area countries. And it was one of the milestones laid down by the founding fathers of Economic and Monetary Union in the Treaty of Maastricht more than 20 years ago.

Over the years, euro banknotes have become the most visible symbol of European integration. The single currency, the euro, was conceived as a key step towards that goal. Despite the challenges facing the euro area, progress was made in 2012 and I am confident that 2013 will bring a deepening of Economic and Monetary Union and will strengthen European integration.

The ECB plays a key role in bringing the countries of Europe closer together. Besides our core function and mandate to guarantee price stability in the euro area as a whole, one of our tasks is to develop what we could call " *our product*", the euro banknotes. The new series of banknotes will continue to reflect the unity and diversity of our continent. The word 'euro' is now written in the Cyrillic as well as in the Latin and Greek alphabets. Today, 332 million people in 17 countries use euro banknotes every day. And worldwide, the value of euro banknotes circulating is roughly the same as that of US dollar bills. Last month that value was almost 913 billion euro, with around one-quarter of that value circulating outside the euro area, notably in its neighbouring regions. The euro is in fact being increasingly used as a global currency and its banknotes have been circulating inside and outside Europe with ease.

With 15.7 billion of them in circulation, euro banknotes are a success story. However, we do not rest on our laurels. The ECB strives to ensure that the banknotes are steadily developed and enhanced, and are "state of the art" in terms of security and technology. The Europa series will be "smarter" and even more secure than the current series.

The new 5 euro banknote will be issued throughout the euro area as of 2 May this year. For the next two months it will be on display here as part of the "New Face of the Euro" exhibition. The exhibition also includes the vase from which the portrait of Europa was taken. I would like to thank very much the Louvre museum in Paris for the loan of this ancient artefact, which is over 2,000 years old.

Let me also express on this occasion our thanks to Mr Gerstetter, the designer of the Europa series, who is with us today.

Without further ado, let me now sign the first 5 euro note of the Europa series.

Introductory statement at the hearing of the Committee on Economic and Monetary Affairs of the European Parliament

Mario Draghi, President of the ECB, Brussels, 17 December 2012

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure to be back here in Parliament and in front of your Committee for our last exchange of views in 2012.

This year has not been an easy one. It has been a year when the ties that bind the Member States of the euro area have been tested. But it has also been a year in which a longer-term vision for Economic and Monetary Union (EMU) has been formulated. And it is a year in which that vision has begun to be translated into actions, including on vital reforms of European governance.

We end the year on a positive note with the re-launching of that longer-term vision, with the proactive steps taken by governments and European institutions towards a genuine EMU and, most recently, with the unanimous agreement by the ECOFIN to establish a Single Supervisory Mechanism (SSM).

Let me congratulate your Committee for the swift adoption of its position on the SSM and its ambitious European approach. This a clear demonstration that European institutions are determined to act in a timely and decisive way to complete EMU. And it is a clear demonstration that euro area Member States are ready to agree to a substantial sharing of sovereignty when circumstances require.

Recent agreements mark a major qualitative step towards a stable EMU. The establishment of the SSM can be expected to be a key turning point in the resolution of our current challenges.

The SSM will contribute to restoring confidence in the banking sector across the euro area. It will help to revive inter-bank lending and cross-border credit flows, with tangible effects for the real economy. And combined with possible direct recapitalisation of banks by the European Stability Mechanism and an envisaged single resolution mechanism, the SSM will go a long way towards breaking the vicious feedback loops between sovereigns and banks.

I hope that the legislative process can now be concluded swiftly. After the adoption of the relevant legal acts, the European Central Bank (ECB) will launch the preparations so that the SSM can be established within the timeline foreseen by the legislators.

In my introductory remarks today, I will first briefly summarise the economic and monetary situation. I will then address the relationship between monetary policy and financial supervision. And I will close by outlining my views on the priorities for 2013 in implementing the shared longer-term vision for EMU.

1. Economic and monetary developments

Since our last meeting, the ECB has left its key interest rates unchanged: the main refinancing rate stands at 0.75%; the rate on the deposit facility at 0%; and the rate on the marginal lending facility at 1.50%.

On non-standard monetary policy measures, the Governing Council decided in December to continue conducting all refinancing operations as fixed rate tender procedures with full allotment, at least until July 2013.

The medium-term outlook for economic activity remains challenging. Economic activity contracted for a second consecutive quarter in the third quarter of 2012, and indicators for the fourth quarter signal further weakness, although some recent survey indicators have stabilised at low levels and financial market sentiment has improved further. Domestic demand is dampened by still weak consumer and investor sentiment and the ongoing balance sheet adjustments in the banking and business sectors, which continue to weigh on investment decisions.

We expect economic weakness to extend into next year with a very gradual recovery in the second half of the year. The recovery is expected to be supported by strengthening global demand, a highly accommodative monetary policy stance and significantly improved confidence in financial markets, all of which should work their way through to spending and investment decisions.

Annual inflation in the euro area has continued to moderate, falling from 2.5% in October to 2.2% in November. Looking ahead, inflation is expected to decline further. This should support real disposable incomes.

Risks to the outlook for price developments are broadly balanced. Inflation expectations for the euro area remain firmly in line with the Governing Council's aim of maintaining annual inflation rates below, but close to, 2%.

Our monetary analysis paints a picture consistent with price stability. Looking at developments over several months, the underlying pace of monetary expansion, when accounting for special factors, remains subdued. Loan dynamics are also subdued and in many parts of the euro area, credit has been contracting. This is the result of balance sheet adjustments by banks and businesses as well as the current economic weakness.

2. Monetary policy and financial supervision

Let me now turn to the first topic chosen for our exchange of views, namely the relationship between monetary policy and financial supervision.

The discussions leading to the recent decision to establish the SSM have raised questions about how monetary policy responsibilities and supervisory responsibilities should be appropriately separated.

In recent years, many central banks have, for good reasons, assumed supervisory roles. Fourteen of the 17 national central banks in the euro area have a role in supervision and so too do several major central banks elsewhere in the world.

Indeed, the global financial crisis has generally led to closer ties between central banks and financial supervision. The Bank of England, for example, will soon assume supervisory responsibilities previously assigned to the Financial Services Authority. In the US, the role of the Fed in financial supervision has been strengthened.

This all suggests that the relationship between monetary policy and financial supervision is particularly important in times of crisis. It is not by chance that historically the first central banks were supervisors of commercial banks.

The ECB will establish clear guiding principles and internal operating practices to ensure effective separation of monetary policy and financial supervision. Let me briefly elaborate.

First, the ECB's involvement in financial supervision has no bearing whatsoever on our primary objective of price stability. It bears neither on the objective itself, which is statutory, nor on its quantified expression of inflation rates below, but close to, 2%.

Second, a supervisory board will form the centre of gravity for the conduct of financial supervision. It may encompass a geographical entity that is somewhat wider than the euro area if, as we hope, several countries that are not currently euro area Member States decide to join the SSM.

Third, separation between monetary policy and financial supervision will in particular take the form of independent analysis and prescription for the use of policy tools for each of the two functions. This will rely on strong governance.

We will establish appropriate internal procedures that ensure clear functional separation. Here we will follow international best practice.

While separation of the two functions is essential, it is an established fact that stronger supervision facilitates the conduct of monetary policy. Let me give you just two examples.

First, in the absence of financial stability, standard monetary policy tools – namely, changes in the short-term interest rate – lose some of their potency. Effective supervision that contributes to a stable financial system can only benefit the smooth transmission of monetary policy.

Second, effective financial supervision can counteract excessive leverage and exuberant credit expansions, which can generate inflationary pressure over the longer term. Thus, in mitigating the build-up of macroeconomic imbalances, effective supervision can foster a stable macroeconomic environment with stable prices.

Monetary policy will stay credibly oriented towards price stability. In so doing, it secures the trust of markets and the public in the stable purchasing power of a currency. This stabilises market expectations, lowers volatility and creates an environment for stable financial markets.

We have begun internal reflections on all these issues, together with the national central banks, and we stand ready to launch the formal preparations as soon as the legal framework has been adopted.

3. A genuine economic and monetary union

Let me now turn to the second topic chosen for our exchange of views, namely a genuine economic and monetary union.

In the spring of this year, after three years of severe economic and financial challenges, it became clear that what the euro area needs is a coherent longer-term vision for EMU. At our April hearing, we discussed such a vision, following earlier discussions in this Committee about the Fiscal Compact and Growth Compact. The vision was then laid out in greater detail for the Heads of State or Government.

Since that time, remarkable progress has been made. The June European Council was an important milestone. Institutional changes that were not conceivable less than a year ago have been put on the EU political agenda or are about to be finalised. The SSM is a prime example of such political momentum.

Last week, the European Council set out further steps towards the completion of EMU. The in-depth discussions of structural reforms and the challenges of competitiveness have been particularly important – and they are reflected in the Council's conclusions.

From an ECB perspective, I see two main priorities for 2013. First, we should improve the functioning of economic union. Excessive imbalances within the euro area have destabilised EMU. This must not be allowed to happen again.

It is encouraging that adjustment is now visibly underway. For example, exports of goods and services have increased by 27% in volume in Spain since 2009 – and by 14% for Ireland, 22% for Portugal and 21% for Italy. These four countries are also experiencing gains in relative unit labour costs.

Economic reforms bear fruit, even if, in the short term, the costs to individual citizens can be considerable. But the reforms are the right path. Governments should persevere.

What can be done at the European level to provide even more support for this process? The proposed 'reform contracts' between euro area Member States and EU institutions are a promising avenue. Combined with a carefully designed framework of targeted and temporary financial support, they should contribute to fostering structural reforms and thereby strengthening competitiveness.

Ideally, the reform contracts should focus on countries with the largest competitiveness challenges. They should identify the structural bottlenecks to improving competitiveness and target the reforms in a way that will remove those bottlenecks. This would establish a clear link between reforms and restoring competitiveness, which is essential for growth and job creation.

Smooth functioning of product and labour markets is a prerequisite for growth and job creation in EMU. I therefore welcome the announcement that next year the European Commission will undertake a systematic review of product and labour markets. For euro area countries the review should allow to assess whether these markets are fully compatible with participation in EMU. Here, product and labour markets must provide for enhanced adjustment capacity to adapt to a changing global economic environment and ensure sustained high levels of employment.

The second priority for 2013 from the ECB's perspective is the completion of financial union with the establishment of a single resolution mechanism. The aim of resolution is to deal with non-viable banks through measures that include their orderly winding down and closure while preserving financial stability. Such a mechanism will make it possible for banks to fail in an orderly manner.

Improving economic union by restoring competitiveness and the functioning of product and labour markets on the one hand, and setting up a single resolution framework on the other hand are key priorities for 2013.

This Committee has always pushed for ambitious European solutions in the field of financial and economic governance. I am confident that you will again play an instrumental role in moving the agenda forward and adopting the relevant legislative proposals. Thank you for your attention. I am now at your disposal for questions.

Interview with Financial Times

Mario Draghi, President of the European Central Bank, spoke to Lionel Barber, Financial Times editor, and Michael Steen, Frankfurt bureau chief, in Frankfurt on 11 December 2012 and published on 14 December 2012.

The following is an edited transcript of the interview.

FT Do you think when historians look back, that they will say this was the year that the euro was rescued?

MD This year will in my view be remembered as the year when the long-term vision for the euro and the euro area was re-launched. The June summit, especially, was a key event. It's also the year when euro area governments achieved substantial progress in adjusting their economies. And it's the year when the ECB has stepped in to remove tail risks.

FT Why was the June summit so important?

MD The June summit was important because, for the first time in many years, it laid out a medium-term vision for a genuine economic and monetary union, made by four pillars: fiscal union, the so-called banking union, economic union and political union, endorsed by the leaders. That was an important milestone.

FT This was the extension to the Maastricht framework that had proven to be inadequate?

MD Exactly. The leaders built on Maastricht with a stronger fiscal discipline. In the euro area a country cannot pursue its economic policies in a completely independent way, ignoring their implications for other member states. This was one of the main conclusions of that summit. Sovereignty is something that needs to be shared.

FT Was the June summit the precondition for OMT?

MD No, the decision for OMT was meant to pursue, within our mandate, our objective to deliver price stability. The removal of tail risks related to unfounded fears regarding the euro was essential to fight fragmentation of the euro area markets. And that has been important because with fragmentation – I've stressed this many times – we are not in a position to deliver price stability for the euro area as a whole.

FT When did it become clear that you had to take that step as a central bank?

MD Clear visible signs of fragmentation had been with us since the second half of last year, gradually leading to a euro area-wide credit crunch by year-end. Then the ECB conducted the two LTRO operations, which removed another type of risk, namely the possibility of a banking crisis caused by lack of liquidity. They had a very powerful effect of calming financial markets for some time. But then, by the end of April this year, we saw all types of spreads widening again, and the amount of short positions against the euro picking up. These signs made clear that fragmentation had reached points beyond which we would not be able to deliver price stability.

FT I'm going to explore this crucial approach, which you adopted on OMT and which you clearly said, one, that it would be conditional. And, two, that you were acting within the ECB mandate. But before I do that, I just want to turn the reel back to when you started and ask you about strategy, because it seems to me that you have had a strategy. You may not have been convinced that you could save the euro, or, at least, re-launch the euro, but you had a strategy. Is that right, or have you more improvised?

MD There certainly was a deep reflection going on in the months before, both in the ECB and in the Governing Council, about how to cope with this fragmentation. The objective was and still is to restore a financially integrated monetary area. The OMT was the result of this reflection. The first element of which was the acknowledgment that we were in what economists call a "bad equilibrium", namely, a situation in which you have self-reinforcing expectations that, if left on their own, produce disruptive outcomes. It's a vicious circle that we had to break, but we should never forget how we found ourselves in that "bad equilibrium" to begin with, and that was because during the previous ten years several governments of the euro area pursued economic policies which were either plainly wrong, or they were simply missing, in a world that was changing fast.

FT But the crucial point is that this was a different quality of intervention and approach from earlier years in the ECB. You said it will be conditional and unlimited, whereas earlier it was limited and unconditional.

MD That's the difference between the OMT and the SMP.

FT But did you say, look, we understand, historically and politically, why it's been limited and unconditional, but this isn't working. We have to move beyond that. Was that you arguing that, or do you think that was within the ECB, everybody understood it?

MD There was a sense among us that the SMP had run out of steam in terms of its effectiveness.

FT All the top financiers were saying that they've got to have unlimited ECB capacity. Of course, but the conditionality was crucial for winning support within the Governing Council, but even more important in Berlin.

MD The decision was taken in total and full independence. Certainly, conditionality, in a set-up like ours, is essential for two reasons. One is that it's a form of a credit enhancement in the bonds issued by the country that applies for OMT because the more it will comply with conditions, the more creditworthy will be its bonds. The second reason is that with any type of intervention, moral hazard has to be avoided and fiscal discipline, in particular, has to be ensured. That's why conditionality is crucial, but it is only a necessary condition because in any event the Governing Council assesses independently the state of monetary fragmentation. Let's not forget our objective is fight financial fragmentation and deliver price stability.

FT Let me just go back to the political element. I respect what you're saying about the ECB's paramount independence, but, at the same time, you're not monks in cells. You don't sort of deliberate within the monastery and come up with something.

MD Today most central banks are independent, headed by non-elected officials, and quite powerful. This set-up is acceptable only if independence is limited by the mandate. That's the framework that legislators have given us – independence limited by our mandate. That's why we are so keen about respecting the mandate, because that's the true guarantee of our independence, which especially in the euro area set-up is crucial for our credibility. And credibility is essential for delivering price stability.

FT Surely it's also important for you, though, that politically you're seen to be within your mandate.

MD Certainly and that's why the ECB should be transparent and accountable.

FT Returning to the question of conditionally, there are important critics, particularly in Germany, who say that it removes the incentive of governments to act. How do you counter that?

MD Quite the contrary. Conditionality makes sure that governments will make the necessary reforms and maintain fiscal discipline.

FT Let me rephrase the question. How can you restore enduring confidence if there is a high level of conditionality? I'm talking about a kind of resolution of the crisis, and if the conditionality is too tight, too severe, governments don't act and, therefore, nothing happens.

MD The assessment of conditionality is primarily in the hands of the European Commission, the ESM, and the IMF. But also do not forget that the ultimate assessment of whether to act or not is entirely in the hands of the Governing Council.

FT You announced the programme; there was immediately a favourable reaction in the markets, remarkable. Many people assumed then that the governments would apply, but they haven't. What conclusions did you see?

MD The purpose of the OMT is to remove the tail risks. It's up to the governments to decide upon a programme. We never took a stance which was proactive in the sense of encouraging governments or discouraging governments to apply. Let’s not forget that the ESM is tax-payers’ money, the decision over which should be taken by governments and by national parliaments. And the same is true for the potential applicants’ reforms and budget consolidation. The role of the ECB, in that stage, should be on the back stage, not front line. It’s up to the governments to decide.

FT Again, let's just step back a minute. It's been a tumultuous, extraordinary year. You have been a leading player in this drama. There are others, obviously. Chancellor Merkel, Mario Monti. What were the moments that stick out in your mind? Let's just look where you said the risks are really high and we need to act, if you think about that in the blur of events.

MD The speech in London on 26 July was such a moment. If you look at the verbatim, it doesn't say anything that's outside our mandate. But indeed it's an especially strong speech that makes a firm statement on the preservation of the euro.

FT It was a very, very firm statement. How did you come up with that wording? “Whatever it takes... And, believe me, it will be enough,” – with a dramatic pause before.

MD Again, there was a sense that we had to overcome the limitations of the SMP, and make sure that the signal to the market would be proportionate to the gravity of the situation. That's actually what is behind that statement.

FT Did you rehearse the pause?

MD No, I’m not really that theatrical. But the situation at this moment was clearly showing that tail risks were increasing. So my intervention was made important by the very critical situation that was evolving.

FT You intended to have a reaction in the market. Was that your intention?

MD What I thought was that the markets should know what our stance was. This was the objective of this speech. It was meant to be absolutely clear about our determination. I also made the point that it was not only our determination but it was also our leaders' determination to carry out the June summit conclusions. I said that markets underestimated the leaders' determination and the amount of political capital they have invested in the euro. This is what I said first and then added that it's our intention to be firm and to do whatever it takes but within our mandate.

FT And, just to be really clear, you did not clear that speech, those remarks with anybody outside in the capitals?

MD No, absolutely not.

FT So that was a seminal moment. What was the moment in 2012 where you felt perhaps a sense of some relief? Without over-confidence, but that maybe the mood had shifted.

MD Was there such a moment?

FT I was hoping you'd say that.

MD That's what I feel like.

FT I just want to come back to this question of public opinion, which is very important. When did you decide and why did you decide to go to the Bundestag?

MD In an interview with Süddeutsche Zeitung the journalists asked whether I would speak in the Bundestag if I were to be invited, to explain better in Germany what we do and our intentions are. I responded that if I was invited, I would be ready to go. A few days after the interview I received the invitation from President Lammert. There was a genuine interest from the Bundestag to know in greater detail about our policy decision, at the time controversial in Germany, but applauded in the rest of the world.

FT There's a serious point about German public opinion. Do you think it's become more euro-sceptical this year, with all the difficult economic circumstances?

MD The difficult economic circumstances are everywhere in the euro area and this might have caused a different sense of perception of the euro. These are very serious moments. When I'm asked whether I can persuade the German public opinion, I say that I don't know. But I know that we have the duty to explain, and we are really working very, very hard on that front. Hopefully the results will follow. And this holds true for the all euro area public opinion.

FT You can see it in Britain where it's moving towards questioning membership of the European Union. Can we perhaps turn now to the question of what comes next – economic growth and the adjustment process? So, while it is true that current account deficits are shrinking and governments are doing, in many ways, courageous things, they're passing reforms, there's still the question of economic growth. What is your prognosis for the next 12 months?

MD Last week we published our new staff projections, showing the beginning of a slow recovery in the second part of next year. We have a serious situation in front of us. At the same time, there are some encouraging signs. The spreads are tighter than they were four months ago. Liquidity conditions are better, banks and corporates are funding themselves. Bond issuance has restarted. And for the public sector, the distressed countries have basically completed all their sovereign funding plans. Furthermore we think that our very accommodative monetary policy stance will find its way into the economy in the coming months. That's why we're saying that we may see a recovery in the second part of the year. Also, at some point, one will see the benefits of fiscal consolidation and structural reforms. So far we've only seen the contractionary effect of the fiscal consolidation. We haven't seen yet the positive effects of structural reforms because, obviously, they take effect with a certain lag. And third, we will be seeing a more buoyant world growth, which will help sustain exports of the euro area.

FT Are you bullish of America if they get through the fiscal cliff?

MD I'm confident they will find an agreement.

FT And even beyond that with shale gas revolution, re-shoring, property market recovered. They've fixed their banks.

MD I think they are well poised for a positive outcome. It's interesting though that until two months ago when people were asked about the major source of uncertainty and risk in the world, the answer was the euro crisis. And now it's the fiscal cliff.

FT Just going back to the forecast you were talking about. Those are actually a pretty dramatic downward revision. And this better mood in financial markets is pretty fragile, as Mario Monti's resignation shows. It just sounds like you're painting the picture of the glass being half full when that might be a bit on the optimistic side.

MD Indeed it's a significant revision downward. At the same time, the medium term outlook for price stability hasn't changed in any dramatic way. And you see these positive signs in the soft data coming out.

FT There are many critics of fiscal consolidation as you know. I know you've talked about this before. But is it problematic as the ECB to be pushing the case for it so hard, particularly in countries like Spain and Greece where this is causing real human misery, given, as you said before, you're unelected and you have to stick closely to your mandate. If there is no risk over the medium term for price stability, maybe there is a case to say there's too much austerity right now.

MD We're fully aware that the economic situation in several countries, not only Spain and Greece, is very serious, and we are not underestimating the difficulty of the situation at all. Let's not forget that the reason why fiscal consolidation became central for the policy advice of the ECB is because one can't have systems built on debt and deficits that the

financial crisis has shown to be unsustainable. And there has been progress. To give up now, as some suggest, would be tantamount to waste the great sacrifices made by the citizens of Europe.

FT Yes, and what about the Martin Wolf critique that adjustment is a two-way process and that while the austerity should be pursued rigorously in the peripheral countries, the creditor countries must also adjust. They must also do their bit, which, in effect, means a somewhat more expansionary policy to counteract…

MD First of all one must stress that inflation is not a policy tool. One doesn't toy with inflation. Especially in an area made up by several sovereign states. The second point is that – in our institutional set-up – if you had to choose one policy objective that would be to increase competitiveness. The countries that have been successful in adjusting and in reforming have mitigated the short-term contractionary effects of fiscal policies. Countries that can actually manage this policy combination have a chance to reduce the difficulties that come from fiscal consolidation.

FT Are you thinking about Italy?

MD No, I'm thinking about Ireland.

FT A couple of other questions, one is the banking union because, in addition to all the questions that we've just discussed, these huge challenges for the eurozone and for the ECB, now you're going to have to take on the extra responsibility of supervision of at the least the large banks in the eurozone. Is the institution ready for this? Are you ready for this?

MD We will be ready. After the Council Regulation will enter into force, it'd take about a year to set up organisation of the SSM. There have been many discussions on how fast we should move and how broad should be the scope. One has to remember that we are a passive actor. We are in the hands of our legislators. It's clear that we want to move in a timely fashion, but it's more important to move well. And we intend to take the time that's needed for that.

FT Would one of the things about doing it right be that you need there to be some sort of European-wide bank resolution scheme in place before you take over the supervision, otherwise you're in a situation where you're nominally in charge of supervising all these banks. If one of them needs to be wound up, for whatever reason, you're completely at the mercy of the local supervisor and the local arrangements. You don't actually have the powers to do anything.

MD A European Resolution Authority is an important complement to the SSM, and it will likely be in place by the time the SSM takes up its responsibilities. But even in its absence, the single supervisor's assessment of the possible non-viability of a bank would be such a strong statement that it would likely trigger the national government's policy response.

FT A personal question, it's a human question, here you all this incredible pressure on you. If you had to think of a few people in the world, you're definitely in the top five who've got most pressure from all the places, trying to hold this together. How do you cope with that, number one? And, number two is there anything that surprised you after being in this place for one year?

MD The way to cope with these pressures is to never forget that they are part of the set of responsibilities that one carries with this job, responsibilities to deliver price stability; to take policy decisions that affect the welfare of millions of people.

I really can't answer your second question because to say that something has surprised you, you have to be able to look back and say, oh, that thing actually surprised me. And this is not the way I function. I look forward, being naturally inclined to focus on the future. At least I think. But you should ask my colleagues too.

FT Anything to add?

MD I'd like to give you this quote of Professor Zygmunt Bauman, a Polish sociologist who has become best known for his analyses of postmodernity and consumerism. It has to do with the fact that you don't lose sovereignty when you share it, but you actually regain it. Countries with high debt and deficits should understand they have lost sovereignty a long time ago over their economic policies in a globalised world. Working together in a stability-oriented union actually means to regain sovereignty at a higher level.

FT They've lost it to the markets?

MD Yes. And sharing common rules for them actually means to regain sovereignty in a shared way rather than pretending to have sovereignty they've lost a long time ago. That's the point.

A central banker's perspective on European economic convergence

Speech by Mario Draghi, President of the ECB at the Anchor 2013 Conference organised by the Magyar Nemzeti Bank, Budapest, 7 December 2012

Ladies and Gentlemen,

It is a great pleasure to be here in Budapest and to participate in the annual Anchor conference. I understand that this will be the last Anchor conference for András Simor in his position as Governor of the Magyar Nemzeti Bank. So this is an excellent opportunity for me to pay him a sincere tribute for his work here and as a valued member of the General Council of the European Central Bank (ECB).

In my remarks today, I would like to focus on the process of *economic convergence* in Europe. As the experiences of recent years have made clear, this process does not end with a country's adoption of the euro. Nor does participation in the single monetary policy provide automatic delivery of convergence.

I will first talk about the challenges facing the euro area as a result of shortcomings in the process of convergence and integration. I will then discuss the challenges of convergence for those members of the European Union (EU) that have not yet adopted the euro.

1. Two challenges in the process of European integration

The institutional challenge

Over a period of many years, the EU has provided an unprecedented framework for successful regional integration. The process of integration has involved not only the creation of a common market and the harmonisation or coordination of several economic policies, but also the conduct of some of these policies at a supranational level.

A central pillar of the EU's institutional architecture has always been the principle of subsidiarity. This is the rule that action shall only be taken at the supranational level if the objectives to be pursued cannot be sufficiently achieved by EU members, either at the level of central government or at the regional and local level.

While we should continue to preserve the principle of subsidiarity, the recent challenges for the euro area have provided us with a major institutional lesson: maximising the benefits of the single currency requires not only a strong ECB; it also requires additional strong common institutions.

We need strong institutions to guarantee competitiveness and to encourage sustainable growth; to guide fiscal policies and ensure fiscal sustainability; and to supervise and stabilise the single financial market. We also need strong institutions to engage citizens more closely in the European project.

In other words, the future prosperity of Europe hinges on our ability to complement monetary union with economic union, fiscal union and financial union. This more advanced institutional architecture will in turn need to be embedded in some form of political union that engages citizens more deeply in European decision-making. As a result, joining the euro area in the future should imply greater sharing of sovereignty and a deeper European accountability than it did ten years ago.

The institutional challenge is the first major challenge with which we are currently confronted. We have already made much progress in addressing the challenge. But a great deal of work remains to be done.

The economic challenge

The second and complementary challenge is economic. The benefits of adopting the euro are greater the more consistent the economic structures of existing and prospective members are. Convergence can be broadly defined as a process in which cross-country differences in economic structures are reduced over time. The success of the convergence process ultimately depends on the *sustainability* of the underlying policies.

Shortcomings in the process of convergence across euro area members have been at the root of the challenges we have faced since 2010. But I am pleased to report that progress in addressing those shortcomings is being made.

External imbalances and fiscal imbalances are starting to be unwound. Efforts to regain price and non-price competitiveness are bearing early fruit. Deleveraging is generally proceeding in an orderly way, even though credit flows to the real economy seem to be negatively affected in parts of the euro area. Debt is being reduced in some countries, while others are devising strategies to make debt reduction sustainable over time. And financial sector weaknesses are being addressed along with their links to sovereign risk.

As I have said, progress is being made but much still needs to be done. The recent experiences of some current euro area members also serve as a cautionary tale to EU members bound by the Treaty to adopt the euro in the future. I will now turn to the challenges facing these countries in the process of convergence.

2. The perspective of EU countries which have still to adopt the euro

The framework for convergence

With two exceptions, all EU members that are not yet in the euro area are expected to adopt the single currency on meeting certain convergence criteria. As you know, the Treaty defines these criteria along three dimensions.

The first dimension is the degree of *nominal* convergence with the euro area. This implies achieving price stability; ensuring the sustainability of the government's financial position; realising sustainable convergence of long-term nominal interest rates; and maintaining a stable exchange rate between the national currency and the euro.

The Treaty also requires that nominal convergence is sustainable. This is not possible without it being underpinned by a high degree of *real* convergence. According to this second dimension, adopting the euro makes sense only if the economic structure of a prospective member has converged sufficiently towards the prevailing structures in the euro area.

The success of the real convergence process in turn depends on the sustainability of the relevant policies. The challenges that we have faced since 2010 highlight the dangers that large and persistent macroeconomic imbalances pose, not only for the stability of domestic economies, but also for the smooth functioning of the euro area as a whole. We all know the dire implications of prolonged losses of competitiveness, excessive indebtedness and housing market bubbles.

Recognising this fact, EU members have moved towards stronger surveillance of domestic policies. Let me remind you of two examples. One is the new*Macroeconomic Imbalance Procedure*, which aims to prevent the build-up of new macroeconomic imbalances and enforce the correction of existing imbalances. The other is the ' *fiscal compact*', which was signed by all EU members except the UK and the Czech Republic in March this year and which strengthens the sustainability and credibility of fiscal policies.

The third dimension of convergence is *institutional*. The relevant national legislation, including the statute of the national central bank, needs to be compatible with the EU Treaties and the Statute of the European System of Central Banks (ESCB).

More generally, a lesson we have learned the hard way is that the strength of the institutional environment is crucial for the sustainability of economic integration and convergence. Improvements in the institutional environment entail, among other things, better regulations, better governance, better quality of statistics and a more business-friendly environment. Removing impediments to the efficient use of factors of production helps to enhance the growth potential of each country.

How to achieve a high degree of sustainable convergence?

So how can countries best prepare their economies to reap the benefits of closer European integration? There are four building blocks: monetary policy, structural policy, fiscal policy and financial policy. Let me reflect briefly on each of these.

Monetary policy

First, monetary policy, which, before the euro is adopted, remains a national responsibility. But a number of Treaty obligations already apply at this stage. In particular, the main objective of monetary policy should be price stability, and exchange rate policy should be treated as a matter of common interest.

Monetary policy best contributes to growth through the delivery of price stability. Overall price stability creates a predictable environment that fosters the efficient adjustment of relative prices and bolsters investor and consumer confidence. It also protects the purchasing power of the most vulnerable members of the population.

Different monetary policy frameworks have been devised to deliver price stability. Some EU members outside the euro area have fixed the exchange rate of their domestic currencies to the euro, which has a very good track record of low inflation. A different approach – which has been adopted by Hungary – has combined exchange rate flexibility with a regime of inflation targeting.

I understand that Governor Simor will focus his remarks on the past and future of inflation targeting in Hungary. So I will limit my comments to the importance of*central bank credibility* for the success of inflation targeting.

The ultimate success of a central bank in maintaining price stability depends on its credibility. Credibility anchors inflation expectations in line with the definition of price stability adopted by the central bank. Well-anchored inflation expectations in turn align the choices relevant for wage and price setting.

A key prerequisite for a credible monetary policy is the *independence* of the central bank. This principle is enshrined in the Treaty and the Statute of the ESCB. Each central bank in the EU should have institutional, personal, functional, and financial independence. Institutional and personal independence protect the central bank and members of its decision-making bodies from direct or indirect influences of third parties in the performance of their tasks. Functional independence requires that the central bank has the necessary means and instruments for achieving its objective independently of any other authority. And financial independence guarantees that the central bank has access to and control over sufficient financial and human resources to fulfil its mandate.

Credible inflation targeting in small open economies also depends on central banks' recognition of the impact of their monetary policy decisions on the *exchange rate*.

For example, in the presence of heavily indebted private and public sectors with large open foreign exchange positions, central banks have little space for manoeuvre when faced with a flagging economy. This is especially true when inflation is already high and there is not yet a critical mass of structural and institutional reforms capable of reducing the country risk premium to sustainable levels.

In these circumstances, lowering the policy rate to stimulate the economy may risk sparking depreciation pressures on the domestic currency at some point in time. Depreciation of the currency may in turn further fuel inflation and offset the impact of economic stimuli through negative balance sheet effects on consumption and investment.

Structural policies

The second building block is structural policy. The sustainability of nominal convergence is to a large extent conditional on a sufficient degree of structural, or real, convergence. A broad indicator of the degree of real convergence with the euro area is the *catching-up* of per capita incomes and price levels of new members with those of the euro area.

Convergence in real per capita GDP levels has to be fostered by far-reaching structural and institutional changes aimed at enhancing the growth potential of the economy. Such reforms typically aim at strengthening the flexibility of adjustment mechanisms in the economy and improving the business environment.

When goods and labour markets are rigid, inflation and inflation expectations may remain high even in the presence of monetary regimes committed to the achievement of price stability. Both governments and social partners share responsibility for ensuring that wage determination takes sufficient account of labour market conditions and does not jeopardise competitiveness and employment. Active labour market policies should tackle persistent bottlenecks, such as skill mismatches.

Finally, protection of vested interests in the product markets and lack of mobility and adaptability in the labour markets undermine job creation, in particular for young and less qualified workers, as well as for all those who face problems entering the labour market. Lowering barriers to entry will increase competition, particularly in those domestic service sectors that are sheltered from international competition, and thus support price stability.

Economic growth led by the private sector needs to be fostered by a stable and business-friendly policy environment. In this respect, governments should strive for transparency and predictability of the policy regime, a low compliance burden, and effective governance in applying the rule of law.

Fiscal policy

It is also crucial that the achievement of price stability is supported by sound fiscal positions, the third building block of convergence. Irresponsible fiscal policies can jeopardise credibility, as higher inflation becomes desirable to reduce the real value of government debt.

Fiscal policies should be sustainable and oriented to the medium term. They should further aim at mitigating undesirable trend growth differentials through 'high quality' expenditure and tax policies. In particular, high and inefficient public expenditure can put a brake on economic activity by imposing a high tax burden on the economy and channelling resources into unproductive uses.

Financial policies

The fourth building block is financial policy. A sound banking sector, liquid and well-functioning capital markets are important for the sustainability of nominal convergence.

On the one hand, well-functioning banking sectors and capital markets ensure efficient financing of capital accumulation in the economy, thus supporting potential output growth. On the other hand, they sustain the smooth functioning of the monetary policy transmission channels, such as the interest rate and bank lending channels. In this regard, financial sector vulnerabilities pose great challenges for the conduct of monetary policy.

Conclusions

Let me draw to a close. The experiences of the past few years have shown that participation in a monetary union places important demands on national economic policies.

Euro area governments are hard at work responding to those demands. They are correcting macroeconomic imbalances. They are establishing a stronger framework of governance to keep countries on the path of sustainable convergence. And they are improving the institutional set-up underpinning monetary union.

For those EU members that have not yet adopted the euro, the challenge is to achieve a high degree of sustainable convergence with the euro area. This requires credible commitment on the part of their central banks to achieve price stability and treatment of exchange rate policies as a matter of common interest.

For the members of the euro area, the challenge is to achieve full compatibility of their economies with participation in monetary union. Product and labour markets must possess sufficient adjustment capacity to buffer shocks while maintaining high output and employment. It is in this area that progress is most needed.

As I have indicated, much work remains to be done – in both the current and prospective members of the euro area, and both *individually* in each EU member, and jointly across Europe. But I have no doubt that this opportunity to continue progress will be seized and that together we will reap the benefits of sustainable economic convergence and lasting regional integration.

Thank you for your attention.

Competitiveness: the key to balanced growth in monetary union

Remarks by Mario Draghi, President of the ECB,
Treasury Talks
'A European strategy for growth and integration with solidarity',
A conference organised by the Directorate General of the Treasury, Ministry of Economy and Finance – Ministry for Foreign Trade,
Paris, 30 November 2012

Ladies and gentlemen,

I am delighted to be here in Paris and to have the opportunity to discuss with you the challenges of restoring growth and job creation to the European economy.

We are doing so against the background of a relative stabilisation of market conditions, and more generally of improved confidence about the stability of the euro area. Fears that the euro could be reversible have been addressed. The recent announcement of the Outright Monetary Transactions (OMTs) can be taken as an example of how to address tail risks, with possible severe consequences for price stability over the medium term and how to bring confidence back to the euro area financial markets.

The confidence effect of the OMT announcement has been significant, and rightly so. Excessive government bond spreads have gone down, corporate bond and covered bond spreads have tightened, and a number of banks in stressed countries have been able to regain market access. These developments are very important for the prospective financing of the real economy.

The relative stabilisation that has occurred, however, does not rely solely on the determination that we have shown at the ECB. It also relies, crucially, on the determination of governments to validate two assumptions:

First is the collective commitment of all governments to reform the governance of the euro area. This means completing economic and monetary union along four key pillars:

- a financial union with a single supervisor at its heart, to re-unify the banking system;
- a fiscal union with enforceable rules to restore fiscal capacity;
- an economic union that fosters sustained growth and employment; and
- a political union, where the exercise of shared sovereignty is rooted in political legitimacy.

To borrow a turn of phrase from our late colleague Tommaso Padoa-Schioppa: these are not short-term matters. But they are urgent matters.

The second condition for lasting stabilisation is the individual commitment of each government to maintain or restore in their own country the conditions of competitiveness that are at the source of balanced growth and employment.

This is the aspect I would like to focus on now.

I welcome the consensus that now exists in France that competitiveness is a key policy concern. Indeed, it is a key concern in every country of the euro area. And it is of fundamental importance to the euro area as a whole.

Europe's future prosperity requires member countries to be competitive individually in order to be competitive jointly and thrive in an open, global economy.

External and internal competitiveness of the euro area

Let me begin by defining a competitive economy. In essence, it is one in which institutional and macroeconomic conditions allow productive firms to thrive. In turn, the development of these firms supports the expansion of employment, investment and trade.

Prices, costs and wages are important factors for firms to develop and maintain shares of the global market. But there are other factors that have become increasingly important in the past decade, especially for advanced economies. As low-cost competitors have emerged elsewhere in the world, specialisation in high-value products and innovative technologies, which are our comparative advantages at a global level, has become vital.

These are two areas in which the euro area performs well, exporting mid-tech and high-tech products to a wide range of advanced and emerging markets.

Reflecting the increased importance of emerging economies in the past decade, all major advanced economies have lost export market shares. But compared with the United States and Japan, the euro area has held up relatively well, largely by adjusting the range of products in which it specialises.

Since the launch of the euro, the concentration of exports in high-tech and research-intensive products has increased faster than in other sectors. This has been one factor explaining why the current account of the euro area as a whole has never deviated much from balance. Since the time the euro was launched, all the other main economic areas have either run large surpluses or large persistent deficits. China, for example, has run a surplus of up to 10% of GDP, while the US deficit has reached up to 6% of GDP.

But the balanced position for the euro area as a whole masks quite different positions among countries. The pattern of global imbalances, of large deficits and large surpluses, repeats itself within the euro area. For example, just before the crisis, some countries were running deficits close to 15%, while others posted surpluses close to 7%.

Moreover, the relatively resilient export performance of the euro area hides very uneven experiences at the country level. For example, German and Spanish exports have held up very well, only losing around 10% of their market share since 1999. Other countries, particularly large manufacturers such as Italy and France, have seen their share of world trade fall by between 30% and 40%, similarly to the United States and Japan.

The roots of these uneven performances lie not only in divergences in price and cost competitiveness that have emerged in the euro area, but also in different abilities to orient exports to the fastest growing products and partners.

The crisis has made one thing absolutely clear: large imbalances within the euro area can become a fundamental issue for the stability of economic and monetary union.

Why do I say this? Because it is inevitable that a union of sovereign states can become fragile if some states are permanent creditors and others are permanent debtors. This is particularly true if the imbalances are on a large scale.

Such a situation undermines mutual trust. It can then damage the overall functioning of the union, which will in turn spill over to all members. It can also make the conduct of monetary policy much more challenging.

This is the fundamental reason why improvements in competitiveness are so vital for all of our organisations and institutions, including the ECB. And it is the fundamental reason why reforms to strengthen national economies are so essential.

Reforms are not only in the individual interest of euro area countries: they are also in the collective interest of the union, because they will help to restore its stability and cohesion.

Recent progress in euro area convergence

So how can these severe divergences within the euro area be addressed? Certainly, there has been some recent progress in the convergence of relative costs and of internal and external imbalances.

This reflects to a large extent stronger policy action in the fields of fiscal consolidation and structural reforms as well as deleveraging in the private sector. Trade balances have also improved in most euro area countries, which had experienced excessive domestic demand and substantial losses in price and cost competitiveness before the crisis.

In most cases, this improvement has resulted from a combination of relatively strong export growth (particularly in Spain or Portugal) and very weak or negative import growth (notably in Greece).

The contraction of domestic demand continues to play a role in this adjustment. Part of this is cyclical, but it also reflects rebalancing away from previously unsustainable domestic demand growth. Demand has to be contained and supply has to increase, it is only that the supply adjustment takes more time.

There are also signs that competitiveness gains have contributed to recent improvements in current accounts. Exports have held up relatively well in view of the weakening of external demand. Exports of goods and services have increased by 22% in volume for Spain since 2009 – and by 15% for Ireland, 22% for Portugal and 19% for Italy.

More importantly, some countries that lost export shares before the crisis have since registered positive export performance, notably Spain and Portugal. This shows improvements in cost competitiveness and gains in export market shares in most of the countries where the need for adjustment is largest.

The downward adjustment of unit labour costs is proceeding in these countries.

The countries with the largest imbalances have notably recaptured some of the losses in competitiveness incurred previously. For example, the countries under full EU-IMF programmes have seen their unit labour costs improve by more than 10% since 2008, relative to the euro area average. Their current accounts have improved by around 8 percentage points of GDP since then.

This is welcome, but it would have been preferable if these adjustments had occurred before the EU-IMF programmes had to be put in place.

The gains in cost competitiveness respond not only to adjustments in relative wages. Productivity matters. In low-productivity sectors, labour shedding has increased aggregate productivity, particularly in Ireland and Spain, but also, to a lesser extent, in Greece and Portugal.

We expect, however, that progress in structural reforms, especially those that improve the functioning of labour markets, will help lower unemployment and facilitate new employment opportunities. The reform momentum has been particularly pronounced in some countries with relatively rigid labour markets, which in many cases coincide with those countries that face the largest adjustment.

Despite the adjustments in relative unit labour costs, the overall price adjustment has been much less pronounced. There is clear evidence that increasing profits contributed to a large extent to upward pressures on prices in some countries.

It is of paramount importance here to address the lack of competition in a number of areas with strong vested interests. This is imperative to ensure that the flexibility of wage costs translates into the necessary gains in price competitiveness. This is true in particular for the service sectors that have been most shielded from competition.

Policies for improved competitiveness

What more can be done to maintain the positive performance momentum and to integrate those parts of the euro area that are lagging behind?

Some euro area countries are not taking full advantage of their well-educated labour forces and of their potential in terms of innovation and global reach. They could greatly benefit from reorienting their productive structure towards more sophisticated products, upgrading their quality and redirecting their exports towards strongly growing markets.

Innovation is crucial in this respect. This means for a start that where profit margins are restored, they should serve to fund research and development to a higher extent. But innovation potential is not always translated into actual, marketable, employment-creating and growth-sustaining innovation.

What is key in translating potential into actual innovation and growth, is the regime of economic incentives. And it is indeed this system of economic incentives that the current wave of structural reforms in the euro area is addressing.

Another crucial element for a country's innovativeness and potential growth is education, the quality of a country's human capital. For this reason, in fiscal consolidation efforts, an eye must be kept on not only maintaining but also further improving the quality of education.

At the same time, research on innovation shows that to exploit fully the potential embedded in a country's labour force, the economic and institutional environment must be conducive for knowledge to be used effectively for economic development.

A central challenge for our economies is to set conditions so that the skills and capabilities of the labour force, especially of our young people, can be profitably employed in competitive firms, or in the new enterprises that they will go on to set up.

In this vein, removing rigidities in product and labour markets clearly raises the potential for growth and job creation. And the resumption of economic growth is fundamental for returning to a sustainable fiscal position.

Concretely, we must identify the bottlenecks that prevent the vast resources of the euro area from being used most fruitfully. This process is already under way: the World Bank's latest Doing Business report highlights Greece as one of ten countries that have most improved the ease of doing business, albeit from a rather unfavourable level. The momentum of reform is clearly going in the right direction, although much remains to be done.

Spain and Portugal were among the countries that made resolving insolvent firms easier, a crucial ingredient for efficiently restructuring the economy in this transition period, as resources must shift from unproductive to productive activities. It is the latter that create jobs.

This reallocation process, though sometimes painful in the short run, carries the seed of future prosperity: a growing body of knowledge shows that by increasing the ability of the economy to adjust, so that factors can be reallocated to the most competitive firms, aggregate labour productivity can increase substantially. Some studies indicate a gain of as much as 20-30%.

The current focus on competitiveness in France, leading towards an institutional and fiscal set-up that can support firms' investment and innovation, is therefore a welcome step in the right direction. It would be particularly welcome if this improved in particular the functioning of labour market for young people, so that they can find a job.

For the euro area, too, increased labour mobility across borders is crucial. We should see that the current institutional arrangements of the welfare state do not stand in the way of such mobility. The portability of entitlements across borders is a crucial pre-condition for such mobility and should be fostered.

Competitiveness and market integration

Another important aspect is the growth and competitiveness-enhancing potential of further market integration in Europe.

One example is a very recent study, which finds that applying the EU Patent would raise the gains for European firms from patenting inventions by 60%. Furthermore, if all countries also adopted best practices, those gains would more than double.

I quote this example to show that improving competitiveness in Europe does not imply a race between euro area countries, but rather the exploitation of their comparative advantages in the single market and a global economy that offer far greater growth possibilities than each economy on its own.

Improving competitiveness by setting the conditions for boosting productivity is not about ranking: it is about raising the bar for each country to enhance its potential and use it.

The policy challenge

Let me now conclude.

We at the ECB have responsibility to maintain price stability. As part of this mandate, we acted to remove unfounded doubts about the irreversibility of the euro. This is a necessary condition for price stability and will help restore the stability and prosperity of the euro area.

But it is not a sufficient condition: it is the responsibility of individual governments to adopt policies that ensure the full responsiveness of wages and prices, facilitating the efficient use of our large potential resources, thus revitalising growth.

Euro area governments have made significant progress, but their work is not yet complete.

What I see in France, and in many other parts of Europe, is a consensus that the erosion of competitiveness has to be reversed. This is meaningful.

What I also see in France, and in many other parts of Europe, is a growing debate on the best possible functioning of product and labour markets. This is essential.

Given that the full effect of many structural reforms will only emerge with a time lag, it is indeed of utmost importance that national policies continue to focus not only on fiscal measures but at the same time address key structural problems in labour and product markets.

This would – and, indeed, will – complement full compliance with the reinforced EU fiscal and governance framework, including rapid implementation of the fiscal compact. Full compliance is important to send a strong signal to markets and strengthen confidence in the soundness of public finances.

This would – and again I expect I can say it will – also complement the reform of governance of the euro area that I mentioned earlier.

The recent signs of stabilisation allow us all to face the medium-term challenges for the euro area with a degree of confidence. All policy-makers should take advantage of this situation to continue their reforms with determination. The challenge is substantial. But the prize – balanced growth, price stability, employment and social progress, is significantly larger.

Thank you for your attention.

Rationale and principles for Financial Union

Speech by Mario Draghi, President of the ECB, at the 22nd Frankfurt European Banking Congress, Frankfurt am Main, 23 November 2012

Lord Mayor Feldmann,

Dear Mr. Blessing,

Dear Mr. Fitschen,

Ladies and Gentlemen,

It is a pleasure to be here today to address the Frankfurt European Banking Congress.

A year ago, I gave my first speech as President of the European Central Bank (ECB) at this venue. It has been an intense year for the ECB and for Europe – challenging yet promising.

Introduction

The European financial crisis intensified at first, due to several interconnected factors: deteriorating fiscal and banking conditions in some countries, including large ones, increased financial fragmentation, and the first signs of a renewed weakening of the European economy.

The ECB reacted in a proactive way, by successively lowering policy interest rates and by devising at the end of last year a monetary policy instrument that was particularly effective in the specific circumstances at that time. To counter the impending risks for European banks, that were then concentrated mainly on the funding side, we supplied liquidity at very long maturity and at low rates, fully accommodating the demand by the market. We succeeded in calming the immediate tensions, averting a credit crunch that would otherwise have had grave consequences for the euro area economy, employment and price stability.

But that action in itself could not prevent a further fragmentation of financial markets, increasingly driven, in the early summer, by “redenomination fears” – the concern that euro area membership could prove unsustainable for some countries. The danger was concrete that the adverse loop between weak public finances and banks could propagate to a large set of countries in the euro area, leading to an uncontrollable spiral of rising interest rate spreads and feeding into the real economy. Credit and economic growth were falling, leading to rising unemployment and reduced consumption and investment. All of this meant that the outlook for the euro area economy as a whole was increasingly fragile.

The disruption of the monetary policy transmission due to financial fragmentation is something deeply profound. It threatens the single monetary policy and the ECB’s ability to ensure price stability. This was why the ECB decided that action was essential and that a credible backstop against disaster scenarios was required, which led to the announcement of Outright Monetary Transactions. In this sense, the ECB has shown resolve and foresight in addressing within its mandate challenges in the economic and financial situation, so as to contribute to the stability of the euro area economy as a whole.

But also the cohesion and resolve of the European leaders was crucial in this period. In June this year, European leaders decided to accelerate the move towards a “financial union”, by creating a single bank supervisor centred around the ECB and by linking to it the possibility that European banks, in due time and under certain conditions, could receive direct capital support from the European Stability Mechanism (ESM). Together with the announcement on the OMT, this led to the much more benign market conditions that have prevailed in the recent months.

Therefore, I can address you today against the background of a relative return of confidence in the prospects for the euro area.

The return of confidence is justified, but it relies on three things:

First, given that the return of confidence was related in part to the announcement of Outright Market Transactions, I would like to assure financial markets that we stand ready to implement this programme as and when required.

Second, euro area governments need to continue to pursue structural reforms at the national level. This is essential to regain competitiveness where it has been lost, and to lay the foundations for sustainable and balanced growth in the future.

Third, at the European level, leaders need to follow up with determination on their commitment to make the institutional reforms needed to complete economic and monetary union. That is what will fully restore stability to our continent.

The message conveyed in June by Presidents Van Rompuy, Barroso, Juncker and myself is that to succeed, institutional reforms must extend to the financial system, to the fiscal and economic policy framework and to the area of democratic legitimacy and accountability.

These building blocks form a consistent and interconnected whole. They can be addressed within different time frames and following a logical sequential order, so long as the commitment to address all four of them is unwavering.

In my remarks today, I would particularly like to elaborate on the rationale and principles for establishing a Single Supervisory Mechanism. It is important to understand exactly why we need such a mechanism to determine how it would be designed.

On the ideal schedule for establishing the single supervisor, I agree with those who say that we need to do it in a timely fashion but above all, we need to do it well. What is essential is to have the legal basis as soon as possible, ideally on 1 January 2013, so that preparations can begin.

The rationale for a financial union

The crisis has highlighted a fundamental inconsistency between the single monetary policy of the euro area and the responsibility of national authorities for financial policies. The single currency needs a single financial system that is not fragmented along national lines.

Moreover, for the effective functioning of the single monetary policy, and therefore for delivering price stability in the euro area, banks are key in transmitting monetary policy impulses to the real economy. It is important to avoid significant differences in transmission arising from the countries in which banks happen to be located. Yet such fragmentation within Europe’s financial system has occurred as a consequence of the sovereign debt crisis.

The relationship between the credit of sovereigns and that of their financial system is well understood; it runs both ways. Divergence in sovereign credit has resulted in divergence in bank funding conditions at the national level. This in turn has brought about differences in lending conditions, which hamper the transmission of monetary policy.

Banks facing funding pressures react by tightening the lending conditions for firms and households, which ultimately leads to a breakdown in the relationship between lending rates and monetary policy rates that prevails in normal times.

The adverse feedback loop between banks and sovereigns also has negative effects on efforts to re-establish fiscal sustainability. Countries undergoing fiscal adjustments are increasingly penalised by financial markets because of their additional burden of supporting domestic banks.

Against this background, the need to break the loop between banks and sovereigns at the national level, by taking responsibility for financial stability to the European level, becomes evident. This is why a financial union is a necessary step to improve investors’ confidence. By restoring financial stability, it also provides the most effective response to the fragmentation of Europe’s banking markets. Monetary stability, financial stability and defence of the single European market are all closely linked.

The principles and key elements of a single supervisory mechanism

Financial crises differ in many respects, but they tend to have common origins. These include the rapid expansion of credit, increasing leverage, asset price bubbles and rapidly declining credit quality standards.

National supervisors were often lenient in the face of these developments, partly because of regulatory arbitrage, partly because they were subject to a variety of constraints and pressures.

The single supervisor should possess all the qualities necessary to guard against these risks on a durable basis. It should be rigorous and even-handed, free from local pressures and interests. It should have the vision and take on a broad-ranging approach, independently assessing the situation of individual banks in a systemic context.

As to the specific institutional arrangements, several alternatives have been proposed. The solution chosen by European leaders – to build the system around the ECB – is the only pragmatic one in the present circumstances. Fourteen out of seventeen national central bank governors in the Eurosystem already have a supervisory role. Therefore, working jointly with the national supervisory authorities, the ECB will have the legal authority and technical capability to carry out this complex task successfully.

As part of the European System of Financial Supervision, the single supervisor will closely cooperate with national authorities and with the existing European authorities, notably the European Banking Authority (EBA). Moving supervisory powers to the European level should not and will not change their respective roles and tasks.

But some observers have suggested that the presence in the same institution of monetary policy and supervisory decisions can lead to excessive burdens, a potential confusion of roles and/or distorted incentives.

These concerns must be taken seriously. To guard against them materialising, certain principles must be fulfilled. Let me elaborate, based on reflections that are being conducted within the ECB's Governing Council.

Rigorous separation of monetary and supervisory policies

The first principle is the need for rigorous separation of monetary and supervisory policies.

Let me emphasise that we are taking this issue very seriously and we have envisaged ways to address it. The ECB has the advantage of having a very clear goal of price stability, expressed in a transparent and measurable way. This objective has never been compromised in the 14 years of the euro so far and it will not be compromised in the future. The ECB's attachment to the primary objective of price stability remains unquestioned.

The proposal of the European Commission provides for the establishment of a separate Supervisory Board within the ECB, which will include representatives from national authorities. This proposal allows for a pooling of supervisory expertise and knowledge, and will help to ensure that decision-making lines on monetary and supervisory policy are clearly separated.

To separate day-to-day activities, the Governing Council will define internal procedures, making a clear distinction between the monetary and supervisory functions within the organisation. We can build on a wealth of experience in this field, looking at best practices from the many central banks in Europe and around the world that combine supervisory and monetary policy functions.

Independence and higher standards of accountability

The second principle is the need to safeguard the ECB's independence, implying higher standards of accountability. Independence is not a new concept to the ECB. Neither is accountability.

We are proud of our independence, and in the context of supervision, the ECB needs to be safeguarded from external interests and national bias. With the activation of article 127/6, the provisions of the Treaty are extended to the new supervisory task. These include independence in the preparation of supervisory assessments. In addition, the ECB as supervisor will enjoy operational independence, as foreseen by the Core Principles of the Basel Committee on Banking Supervision with which it will be compliant. It is essential that independence extends to all members of the Supervisory Board. Such independence in the assessment is crucial for the credibility of the supervisory system.

At the same time, it is equally crucial that these strong supervisory powers should be matched with very strong arrangements for accountability. Let me assure you that we are eager to comply with the highest standards of democratic accountability at all levels, that is vis-à-vis both European institutions and national institutions.

Complete range of supervisory instruments

The third principle is that the single supervisor should possess a complete set of supervisory instruments.

All banks established in participating Member States would in principle fall within the remit of the single supervisor. This is important to ensure a level playing field. It will also prevent fragmentation in the financial system, which is precisely what we are aiming to repair.

One lesson of the financial crisis is that not only large cross-border banking conglomerates have the capacity to destabilise the financial system. Due to interlinkages and mechanisms of contagion, even smaller institutions may turn out to be systemically important.

Such banks have a strong presence in Europe: in almost half of the euro area countries, more than 60% of the total bank assets are held by smaller banks. Taking the euro area as a whole, approximately 30% of the total bank assets are held by smaller banks [1]. These are significant amounts. To preserve financial stability, the Supervisory Board would be able to assert control over all banks in participating countries.

Let me say something more on how such a system could operate.

The European supervisor will work as a decentralised system with the Supervisory Board at the centre. The Supervisory Board will itself be predominantly composed of top representatives of the national supervisory authorities; hence the working method and decision-making will be collective, based on a collegial approach and will directly benefit from the skills and experience of the national supervisors. They will be prime actors in the framework, not passive performers subject to a central authority, and will contribute with knowledge of national, regional and local banking markets.

The intensity of centralised supervision will be the highest for those institutions deemed systemically important. But also for these institutions, close cooperation with national authorities on daily activities will remain. The role and responsibilities of national supervisors will increase when going down the dimensional scale, to banks of predominantly national or local relevance.

The single supervisory mechanism should also strengthen the single European market. Therefore, all Member States, also the ones that have not adopted the euro, should have the possibility of participating in the single supervisor. I am confident that the proper legal framework that serves this objective can be identified and adopted.

How European banks can benefit from a single supervisor

I have touched on the elements needed for the new authority to function successfully. Let me now address what I see as the main implications for banks.

A strong area-wide supervisor, capable of acting quickly and effectively, can restore and uphold business confidence in all banks, regardless of their location. It can therefore contribute to a revival of interbank and credit markets.

Second, the single supervisor should ensure homogeneous supervision, convergence of practices, a level playing field and therefore a reduction in banks' compliance costs. An important element to achieve convergence is the single rulebook that the EBA is developing. But ensuring convergence of regulation is not enough. Supervisory practices also need to converge. The envisaged creation of a single supervisory handbook by the EBA is complementary to this approach. Best practices should become standard practices. The single supervisory handbook should also ensure that in cases where banks are supervised in a decentralised manner within the system, practices are consistent across countries.

Third, the single supervisor will more easily identify cross-country linkages and exposures, and therefore contribute to a reduction of systemic risk.

The next steps towards a financial union

The establishment of a Single Supervisory Mechanism would represent a major step towards a financial union. But in case we were in need to resolve financial institutions, we want to be able to do so without taxpayer money and without disrupting the payments system, even in the case of systemically important institutions. For that we need a common resolution regime and an independent European resolution authority.

The existing legislative proposal on bank recovery and resolution is a development in the right direction, and the ECB supports its rapid adoption. It would best be implemented through an independent European Resolution Authority, immune from national bias and national vested interests.

Conclusions

The establishment of a financial union in Europe is a major component of the institutional framework for a genuine economic and monetary union. The Single Supervisory Mechanism forms an integral part of this framework.

With the new system in place, a critical cause of instability – the link between fiscal authorities and banks at the national level – will largely be removed and a level playing field will be ensured. This is one important step towards a more stable European economy.

Over the course of this last year, the ECB has continued to follow its monetary responsibilities in a highly demanding environment and continued to exert its mandated role in coping with the crisis with a high degree of responsiveness and farsightedness.

Three things have been essential here. First, the ECB has not stepped in to any roles that belong to governments – they too have to take their responsibilities for coping with the crisis in a resolute manner. Second, the ECB has continued to cherish its independence. And third, the ECB has continued to deliver what it is tasked to deliver: price stability for the euro area.

Thank you for your attention.

The monetary policy of the European Central Bank and its transmission in the euro area

Speech by Mario Draghi, President of the ECB, Università Bocconi, Opening of the academic year 2012-2013, Milan, 15 November 2012

Financial markets and the disruption caused to the transmission of monetary policy

The year that is about to end will be remembered not only for the effects the European sovereign debt crisis has had on the euro and for the significant weakening of the European economy, but also for the responses to these challenges by the ECB, national governments and the European Union.

The artificial calm in the markets prior to the crisis had, in Europe, for a long time allowed misguided economic policies or simply encouraged inaction in countries that had profound need for fiscal consolidation and structural reforms. The outbreak of the crisis substantially increased risk aversion: the weaknesses of these countries were exposed; in an environment of already weak growth, investors turned away, sovereign spreads started to rise.

Soon, the solvency of the governments of these countries was questioned, and with it the solvency of the financial institutions located there. Within the euro area, less and less money circulated between banks in different countries. Doubts about the future of the euro area in its current form encouraged a speculative movement which lead to further increases in sovereign spreads. All the governments of the weaker countries responded with fiscal consolidation policies, initially hesitant, then more vigorous. But economic activity continued to weaken and spreads continued to grow.

It was a situation which has brought into focus the nature of the “ideal” fiscal consolidation – one which reduces the deficit and the debt with the least negative consequences for a country’s GDP.

The prevailing evidence indicates that it should be concentrated on reductions in current spending and not on tax increases. Even those who do not share this approach agree, however, that it is essential that the process be perceived as credible, irreversible and structural so that it can affect sovereign spreads, and that price stability conditions as well as conditions on financial markets are such that they do not interfere with fiscal consolidation.

In response, the ECB lowered its benchmark interest rates. Under normal circumstances, such reductions would have been transmitted in a relatively uniform way to households and firms across the euro area. But that’s not what we found.

In some countries, the rate cuts were fully passed on. In others, the interest rates charged on bank loans to the real economy declined only little, if at all. And in a others still, some lending rates have actually risen.

Why this divergence? The concept of “monetary policy transmission” is fundamental to the activities of a central bank, i.e. the process by which changes in the benchmark rate of interest of a central bank are transmitted through the financial system to the real economy.

In a system that is working properly, there is a stable relationship between changes in the central bank’s rates and the cost of bank loans for households and firms. Central banks can thus influence the overall economic situation and maintain price stability.

But the financial system of the euro area has witnessed a severe fragmentation of the single financial market. The costs of bank financing differed greatly in different countries. Many banks, and in some countries the entire banking system, have in fact had no access to the euro area interbank market. Increases in interest rates on government securities have exacerbated the funding costs of domestic banks and severely limited their access to markets.

This has made difficult the transmission of impulses coming from an accommodative monetary policy through adjustments in interest rates on loans to households and firms by banks. Interest rates do not have to be identical across the euro area, but it is unacceptable if significant differences arise because of the fragmentation of capital markets or the perception of a break-up of the euro area. In an economy like that of the euro area, where about three-quarters of corporate finance comes from the banking sector, the impact on the real economy, investment and employment are serious. The fragmentation of the single financial market has led to a fragmentation of the single monetary policy.

For this reason, the countries most exposed to the crisis of confidence were not able to take advantage, except to a limited extent, of the low rates of interest: they had entered a vicious circle.

Economic growth was falling. Public finances were deteriorating. Banks and governments were being forced to pay even higher interest rates. And credit growth was falling further, leading to rising unemployment and reduced consumption and investment.

The outlook for the euro area economy as a whole was increasingly fragile. There were potentially negative consequences for Europe’s single market, as access to finance was increasingly influenced by location rather than creditworthiness and the quality of the project.

The disruption of the monetary policy transmission has profound implications. It threatens the single monetary policy and the ECB’s ability to ensure price stability in both directions. This was why we acted.

Restoring the proper transmission of monetary policy

To decide what type of action was appropriate, we had to make two key assessments. First, we had to diagnose precisely why the transmission was disrupted. And second, we had to identify the most effective policy tool to repair those disruptions, while remaining within our mandate to preserve price stability.

The countries most affected are those where the economic policies of the past tended to be inappropriate, where the response of governments at the start of the crisis was half-hearted and hesitant. It is up to the governments of those countries to make a major effort to regain credibility.

The responses of all these governments have been remarkable for its intensity and speed, and yet interest rates continued to rise. There was a fear factor in the market valuations that governments alone did not seem able to dispel.

A situation of systemic instability was occurring; it was undermining the euro area and dashing hopes for the positive effects of the reforms undertaken to restore the transmission of monetary policy. It was necessary to allay the unfounded fears about the future of the euro area. It was necessary to create a credible support mechanism capable of averting destructive scenarios, and the exercise of that support falling within the mandate of the ECB.

The OMTs have been designed for this purpose, to restore the transmission of monetary policy.

The OMTs provide for interventions in the markets for government securities, with no *ex ante* limits, but not in an uncontrolled or unconditional way. These interventions relate to bonds with a residual maturity of up to three years. It is a clear signal to investors that their fears about the future of the euro area are unfounded.

But we have not forgotten the origin of the problems of the sovereign debt market in Europe. One of the requirements for conducting OMTs is that the countries concerned must have negotiated with other governments in the euro area a

programme under the European Stability Mechanism (ESM) which imposes strict, effective and credible conditions over an extended period of time. In this way, governments are obliged to continue the necessary reforms, even in a scenario where the ECB intervenes. The participation of the International Monetary Fund (IMF), with its experience in monitoring adjustment programmes, is an additional safeguard.

The consequences of the ECB's actions

First, OMTs will not lead to disguised financing of governments. We have specifically designed our interventions to avoid this. They will take place solely on secondary markets, where bonds that have already been issued are traded. If interventions take place, they will involve buying government debt from investors, not from governments. All this is fully consistent with the Treaty's prohibition on monetary financing. Moreover, they will focus on shorter maturities and leave room for market discipline on longer maturities.

Second, OMTs will not compromise the independence of the ECB. The ECB will continue to take all decisions related to OMTs in full independence. It will decide whether to intervene based on its own assessment of monetary policy transmission and with the aim of safeguarding price stability. The fact that governments have to comply with conditionality will actually protect our independence. The ECB will not be forced to step in because of a lack of policy implementation.

Third, OMTs will not create excessive risks for euro area taxpayers. Such risks would only materialise if a country were to run unsound policies. This is explicitly prevented by the ESM programme. And we have been very clear that each time a programme starts being reviewed, we will routinely suspend operations and resume them only if the review has been concluded positively. This will ensure that the ECB intervenes only in countries where the economy and public finances are on a sustainable path.

Finally, OMTs will not lead to inflation. We have designed our operations so that their effects on monetary conditions will be neutral. For every euro we inject, we will withdraw a euro. In our assessment, the greater risk to price stability currently is associated with the possibility of falling prices in some euro area countries. In this sense, OMTs are not in contradiction to our mandate: in fact, they are essential for ensuring we can continue to preserve price stability.

Moreover, we have no evidence that the announcement of the OMT programme has affected inflation expectations. They continue to be firmly anchored. This is testament to our track record on price stability over the last decade and our credible commitment to preserving it. We have all the necessary tools at our disposal to maintain it and to withdraw any excess liquidity in case of upward risks to price stability.

Since the announcement of the possibility to undertake OMTs, there have been several signs of greater tranquillity in financial markets: the significant decline of sovereign spreads, the resumption of capital flows by money market funds in the United States, which had stopped for about a year, some issues of corporate and sovereign bonds from countries that had lost access to the market for almost three years, such as Ireland and Portugal, the completion of the financing plans of the Italian and Spanish treasuries, the fact that the share of Italian public debt held by non-residents has increased, and lastly a stabilisation of TARGET2 balances, which are the true measure of the economic and financial imbalances in the euro area. Finally, it is yesterday's news that recourse to the ECB by banks in some large countries that were in difficult funding conditions has declined for the second consecutive month. It is important to understand that financial stability in the euro area is in everyone's interest, but primarily in the interest of creditor nations which have greater exposures.

There is no doubt that these improvements would not have been sustainable, nor would they be so in the future without an extraordinary, persistent and, above all, structural consolidation of public budgets and structural reforms in all euro area countries.

Completing economic and monetary union

It is worth looking back to remind ourselves of the difficulties that the process of European integration has encountered in the past, and overcome.

Tommaso Padoa-Schioppa's tenure at the Banca d'Italia and at the European Commission was punctuated by realignments in the exchange rate mechanism of the European Monetary System. He famously pointed out the key problem of the "inconsistent quartet" – fixed exchange rates, free trade, capital mobility and national monetary policies.

The single currency was identified as the solution.

Today, we see that this solution was incomplete. The crisis has exposed the need to complete economic and monetary union.

In my joint work with the Presidents of the European Council, the European Commission and the Eurogroup, we have identified four pillars on which to build a stable and prosperous Europe: a banking union with a single supervisor; a fiscal union that can effectively prevent and correct unsustainable budgets; an economic union that can guarantee sufficient competitiveness to sustain high employment; and a political union that can deeply engage euro area citizens.

Progress is under way in all these directions. Of course, it is not straightforward to implement such an ambitious vision. But I am confident that Europe will once again emerge stronger from its present difficulties.

Tommaso was convinced that “a strong currency requires a strong economy and a strong policy, not only a central bank that is strong and authoritative”. I share his conviction.

The ECB’s response to the crisis has a clearly defined relationship with the process of European integration.

With our non-standard policy measures, we have preserved the functioning of the monetary policy transmission mechanism and thus been able to maintain a steady course for the objective of price stability inscribed in our mandate. Potentially disastrous outcomes to the crisis have been thwarted; valuable, though not infinite, time has been gained.

But the ECB cannot replace the actions of national governments with respect to either economic policy effectiveness or democratic legitimacy. Ultimately, it is up to governments to dispel once and for all the persistent uncertainties that markets perceive and citizens fear.

The ultimate goal is political union, a stable and integrated Europe with a common destiny. This will take a long time and the path will be an uncertain one. But in the meantime, it would be wrong not to act.

A great deal has been achieved already. Governments have implemented corrective actions for public finances. The fiscal compact envisages the principle of balanced budgets in national legislations. The ESM provides for the possibility of financial assistance for countries in difficulty to keep the crisis from spreading. And the ECB’s non-standard policy measures will be complemented by banking union, a single supervisory mechanism for European banks.

It is essential that all parties involved in Europe’s large and complex path of reforms stick to their commitments. We have to proceed along this path with calm pragmatism, asking ourselves what the minimum requirements for completing Economic and Monetary Union are. They are all within our reach, including fiscal reform and structural policies to support competitiveness and growth.

Along the way, we must remain guided by the principle that no country is justified in pursuing policies that harm other members of the community to which it belongs. The construction of an institutional architecture for Europe based on this foundation is not only a response to a need for responsibility. Without the sharing of national sovereignty at European level, the very sovereignty of individual states is in danger.

This is the first lesson of the crisis for us Europeans. It is not only a matter of economics and finance. We can, together with Zygmunt Bauman, extend it to much broader areas.

He wrote: “The European house is not to the detriment of national cultures, but provides a sort of roof covering local traditions, values and differences. And the paradox is that each country is much more at risk of losing its specific identity if it is exposed without protection, that is, without this European shield, to the global forces which are violently and blatantly supranational, which disregard local issues and specificities”.

Let me finish with an anecdote about Tommaso, to whom we are dedicating this professorship today. As you know, in recent months I have repeatedly stressed the irreversibility of the euro. This was precisely the sentiment of one of Tommaso’s most noted quips. Speaking in 2004 about the “EMU”, an abbreviation for Economic and Monetary Union, he remarked that it was also the name of an Australian bird rather like an ostrich. And he added: “Neither of them can go backwards”.

Thank you for your attention.

President’s address at Wirtschaftstag Volksbanken Raffeisenbanken

Speech by Mario Draghi, President of the ECB, at Wirtschaftstag 2012 "Kapitalismus in der Krise? Die Zukunft der Marktwirtschaft" der Volksbanken Raiffeisenbanken organised by Genossenschaftsverband e.V., Frankfurt am Main, 7 November 2012

Sehr geehrte Damen und Herren,

Es ist mir eine große Freude, heute hier bei Ihnen zu sein.

I am very pleased to have the opportunity to speak to you today. Small- and medium-sized enterprises – and the banks that finance them – are the backbone of the German economy. Your continued success is vitally important – not only for Germany, but also as a key driver of growth and employment in the euro area as a whole.

For this reason, you are a very important constituency for the European Central Bank (ECB). We pay close attention to your experiences and your views of the future. For example, through surveys that we conduct twice a year, we are able to gather valuable information on the access to finance of smaller companies in the euro area.

The most recent survey was released only last Friday and relates to the period from April to September 2012. It contains information from about 7,000 small and medium-size firms throughout the euro area, of which around 1,000 are from Germany.

The findings are encouraging for firms in Germany. Banks remain willing to provide them with loans. But the situation for SMEs in the euro area overall is more difficult. Many are reporting a deteriorating financing situation. The availability of bank loans for SMEs across countries has become increasingly divergent.

These developments reflect the fact that the economic and financial situation in the euro area remains challenging. I would like to use my address today to discuss that situation and to share with you the ECB’s views. I will focus on two themes in particular.

My first theme will be the important steps being taken by governments to put the euro area on the path back to stability. Individually, they are addressing their deep-rooted economic challenges. Collectively, they are working to strengthen the foundations of the euro area.

My second theme will be the measures taken by the ECB to maintain price stability and to remove unfounded fears about the euro area. These measures are essential to ensure that our low interest rates are passed through to the real economy.

The current economic situation

Let me begin with the current situation in the euro area.

Unemployment is deplorably high. Overall economic activity is weak and it is expected to remain weak in the near term. And the growth of money and credit are subdued.

In this context, inflation is well contained. We expect it to fall below 2% next year.

Germany has so far been largely insulated from some of the difficulties elsewhere in the euro area. But the latest data suggest that these developments are now starting to affect the German economy. This is also evident in the KfW-ifo-Mittelstandsbarometer.

Germany is an open and integrated economy, so it is not surprising that a slowdown in the rest of the euro area has an impact here. Intra-euro area trade amounts to around 40% of German GDP. And around 65% of foreign direct investment in Germany comes from other euro area countries.

But it is less often noted how problems in the wider euro area affect the *financial situation* in Germany. It is the weak euro area economy that is keeping interest rates here at very low levels. And it is the crisis of confidence in some euro area countries that is causing safe-haven flows of money into Germany, depressing interest rates even further.

This highlights the fact that countries in a single currency area are connected like communicating vessels. A change in one vessel creates an equal change in all the others.

As interest rates rise in countries in difficulty, they fall in strong countries like Germany. As TARGET2 liabilities increase in some countries due to capital outflows, TARGET2 claims increase in Germany due to capital inflows.

Financial developments in Germany are the mirror-image of financial developments in the rest of the euro area. And this means that measures to ensure the stability of the euro area as a whole will also be to the benefit of Germany.

So let me now turn to the actions being taken by governments to achieve that goal of stability.

Actions by governments to restore stability

Across the whole euro area, governments are making determined efforts to reverse economic imbalances. They are implementing reforms to redress the misguided policies of the past and to create sustainable long-term growth. It is a difficult road and there is still a long way to go. But the early signs are encouraging.

Fiscal consolidation is progressing well in most countries. The International Monetary Fund (IMF) forecasts that the euro area's primary budget will be almost in balance this year. By comparison, Japan will have a primary deficit of 9% of GDP, the United States 6.5% and the UK more than 5%.

We are also seeing some noteworthy improvements in competitiveness. Price competitiveness has improved significantly in several euro area countries. And current account deficits are falling.

For example, the countries under full EU-IMF programmes have seen their unit labour costs improve by more than 10% since 2008, relative to the euro area average. Their current accounts have improved by around 8% of GDP since then.

Governments have also taken measures to strengthen the rules and institutions that guide economic policies in the euro area. This is important to ensure that the positive developments do not simply reverse when economic conditions improve and markets stabilise.

One notable example is the new fiscal compact, which will provide a strong tool for keeping budgets close to balance in the future. Governments have also set up a new framework to prevent and correct unsustainable developments in the private sector.

In short, some hard work has been done in the euro area to unwind imbalances and to reinforce governance. But there is still a lot more hard work to do. Maintaining the current momentum of reform is essential for putting the euro area on the path back to stability.

Fragmentation in monetary policy transmission

Let me now turn to the measures being taken by the ECB.

The confidence crisis and the process of adjustment across the euro area has weighed on short-term growth and dampened inflationary pressures. To maintain price stability, the ECB has lowered its interest rates to historically low levels.

But before August this year, our low interest rates were not reaching companies and households evenly across the euro area. In some countries, interest rate reductions were being fully passed on. In others, lending rates barely declined. And in a few countries, they had actually risen.

This divergence happened because banks in some countries had found it increasingly expensive to obtain funding from market sources. They therefore could not pass on the lower interest rates to their customers.

This meant that monetary policy was unable to support the real economy in these countries. Smaller companies were affected the most, as was clear from our surveys of SMEs. And as companies in the euro area are very dependent on bank loans for financing, some economies were being forced into a damaging cycle.

Economic activity was weakening. Public finances were deteriorating. Banks and governments were being forced to pay even higher interest rates. And credit and economic growth were then falling further, leading to rising unemployment and reduced consumption and investment.

This situation posed serious risks not only for the countries concerned, but for the whole euro area. It was hindering the overall economic recovery. It was even damaging the single market, as healthy companies were being curtailed in financing solely because of their location.

If this situation had been left unaddressed, it could have created a risk of deflation and threatened the ECB's ability to ensure price stability. That is why we decided that action was essential.

Understanding the ECB's response

How did the ECB respond to this situation?

In our analysis, a key reason why our low interest rates were not being passed on was that, earlier this year, some investors had become influenced by imagined scenarios of disaster. They were therefore charging very high interest rates to governments and private borrowers in countries they perceived to be most vulnerable.

These interest rates went beyond levels warranted by economic fundamentals and justifiable risk premia. Interest rates do not have to be identical across the euro area. But it is unacceptable if the reason for large differences is the fragmentation of capital markets caused by fears of a euro area break-up.

It was clear to us that governments could not address these break-up fears alone. The only way to restore market confidence and the proper transmission of our monetary policy was a fully credible backstop against disaster scenarios.

Our new programme of Outright Monetary Transactions provides this backstop by allowing for unlimited interventions in government bond markets. This commitment has generated a lot of debate. But we have to understand how markets work. Our actions have to send a clear signal to markets that their fears about the euro area are baseless.

It is important to stress that 'unlimited' does not mean uncontrolled. Most importantly, to qualify for interventions, countries must have agreed a European Stability Mechanism (ESM) programme with strict conditionality and IMF involvement. The ECB will only intervene if the policy conditions under that programme continue to be met.

Conditionality is very important. It ensures that countries continue to reform while the ECB is active. It provides a clear basis for us to terminate our operations if the programme is not complied with in full. And it also protects the ECB's independence, as we will not be forced to substitute for a lack of actions by governments.

Consequences of the ECB's actions

So what can citizens expect will be the consequences of the new programme? Let me emphasise three key points.

First, our actions will not lead to disguised financing of governments.

Interventions will take place solely on the secondary market, where bonds already issued are traded. This is fully consistent with the Treaty's prohibition on monetary financing. And since we will only purchase bonds with a remaining maturity of between one and three years, there will still be ample room for market discipline on governments at longer maturities.

Second, our actions will not lead to inflation.

The weak overall economic situation, combined with slow money growth, means that the risks of inflation are currently very low over the medium term. Our interventions will not change this outlook. In fact, for every euro we inject with our interventions, we will withdraw a euro. So they will not affect monetary conditions.

Furthermore, we see no signs that our announcement has affected inflation expectations. They are firmly anchored because we have always delivered price stability. And citizens can trust that we will continue to do so: price stability remains our mandate and our sole objective.

Third, our actions will not lead to greater risks for taxpayers in Germany.

Taxpayers are protected by the fact that our interventions will take place *only* in countries with sound economic and fiscal policies. Their continued commitment to these policies will be ensured by the ESM programme. And the ECB will assess compliance with this programme in full independence.

Moreover, by normalising conditions in financial markets, our actions will help reverse the capital flows into Germany that are creating some distortions here. This should ultimately support the savers, pension funds and insurance companies that depend on interest income. And it should reduce TARGET2 imbalances.

In other words, ECB actions that support market confidence are of benefit not only to countries in difficulty, but also to the euro area as a whole. Our measures ensure the proper transmission of monetary policy, which means neither excessively high interest rates nor excessively low interest rates. The measures enable the ECB to continue to maintain price stability for the benefit of all citizens of the euro area.

The announcement on OMTs has already triggered positive effects. Sentiment in financial markets has improved significantly. Excessive government bond spreads have gone down, a number of banks in stressed countries have been able to regain access to markets and Target2 balances have broadly stabilised.

The way forward

Let me draw to a close.

Actions by the ECB can build confidence in the euro area in the near term. But only actions by governments can secure confidence in the euro area over the longer term. In particular, governments need to work together to establish a stronger institutional structure for the euro area.

This process began in June this year with what has been called the “Four Presidents’ Report”. That report – of which I am a co-author – identified four key pillars on which a stable and prosperous monetary union should be built. These pillars are financial union, fiscal union, economic union and political union.

In the near term, the most important pillar is financial union. Financial union is essential in a single currency area where cross-border capital flows can lead to credit booms and other imbalances – and where the negative effects of a bust can spread rapidly to other members.

One essential part of financial union is a single banking supervisor. As you know, the European Commission has recently proposed that the new supervisor should be based at the ECB. This is important to ensure consistency across the euro area and to prevent regulatory capture. Day-to-day tasks, however, would remain with national supervisors who have the competence and resources to implement them.

But financial union does not have to imply the pooling of deposit guarantee schemes, an issue that I know is of concern in this country. Organising and funding deposit guarantee schemes can remain a national responsibility, with comparable effectiveness.

In the longer term, all four pillars are equally important. They are the bedrock for the enormous potential of the single currency for Europe’s citizens.

Completing economic and monetary union would give citizens greater security against any future crisis. It would create the foundations for sustainable growth and employment. For all citizens of the euro area, it is therefore essential that Europe’s leaders stay on course.

Thank you for your attention.

Interview with Der Spiegel

Mario Draghi, President of the ECB, conducted by Michael Sauga and Anne Seith on 22 October, published 29 October 2012

SPIEGEL: President Draghi, do you have a savings account?

Draghi: Yes.

SPIEGEL: Do you know how much interest you are getting?

Draghi: Around 1.75%, that's the current rate on savings in Italy.

SPIEGEL: The rate on a German savings account is even lower than that. The returns are not anywhere near sufficient to make up for rising prices. Are savers picking up the bill for the euro crisis?

Draghi: No. If we do not resolve the euro crisis, we will all pay the price. And if we do resolve it, we will all benefit, particularly German taxpayers and savers. Interest rates in Germany are at a low level, with some negative bond rates, not because of our measures, but because Germany receives safe-haven flows from other parts of the euro area.

SPIEGEL: Nevertheless, many people, particularly in Germany, are worried about the value of their money, because the European Central Bank has reduced interest rates to a historically low level and announced its intention to make large-scale purchases of government bonds issued by indebted southern European countries. Are people right to be worried?

Draghi: We take the worries of the people very seriously. People are right to ask why we felt it necessary to announce the programme for government bond purchases. One thing should be clear: responding to the crisis of confidence, while maintaining price stability, will benefit German taxpayers and savers.

SPIEGEL: Then please explain it to us.

Draghi: The crisis of confidence means that money is flowing to Germany. This depresses interest rates in Germany and increases interest rates in other countries to unjustifiably high levels. Put simply, interest rates reflected, among other things, speculation that the euro area could break up. This speculation was unfounded, and we had to counter it.

SPIEGEL: And so you decided to help out the governments in Rome and Madrid.

Draghi: No, the decisive factor was something else. The high bond yields also caused interest rates on corporate and housing loans to shoot up. This put the effectiveness of our monetary policy at risk: no matter how much we cut interest rates, there was no longer any effect on the real economy. We couldn't just sit back and do nothing.

SPIEGEL: Many experts have expressed doubts that the interest rates on loans in Spain and Italy were really at alarming levels.

Draghi: There is no reason for this; we have a great deal of evidence. Take the bank in Spain that could barely issue a bond, although it was, objectively speaking, just as solvent as a credit institution in Germany. No wonder that banks charge completely different interest rates on loans depending on which side of the border they are resident. Also, for this reason, a married couple can get totally different mortgage conditions for an apartment in Madrid than in Munich.

SPIEGEL: It is not unusual for interest rates on loans to vary from country to country.

Draghi: That is true, but the scale of the differences had exceeded all normal levels. Interest rates do not have to be identical across the whole euro area, but it is unacceptable if major differences arise from broken capital markets or concern about a euro area break-up. In addition, short-term rates were higher than long-term rates in some countries, which we always see as a warning sign. All of our analysis indicated that we were facing a serious crisis of confidence, and that we urgently needed to do something about it.

SPIEGEL: But many people, particularly in Germany, believe that your measures are illegal. You are circumventing the prohibition on financing government deficits by printing money.

Draghi: That is incorrect. We are prohibited from buying bonds directly from governments, and we abide by this prohibition. But we are allowed to purchase bonds on what is known as the secondary market – that is, from banks or financial institutions – if it is necessary for our monetary policy. And that's exactly what we are doing.

SPIEGEL: The question is why you had to frighten people with the comment that you were preparing to purchase "unlimited amounts". Didn't you realise that this would make people anxious?

Draghi: I chose the word "unlimited" in order to clearly indicate our determination to defend the euro. One has to understand how markets work. But unlimited does not mean uncontrolled; on the contrary, we will only buy bonds from those countries that accept strict conditions, and we will check very carefully whether those conditions are adhered to.

SPIEGEL: We have our doubts about that. Would you really refuse to help a country that does not fulfil the reform requirements?

Draghi: Of course. If a country does not adhere to what has been agreed, we will not resume the programme. We have announced that we will suspend operations once a programme country is under review. We will then ask the International Monetary Fund and the European Commission to assess whether the country is keeping the conditions of the agreement, and only after a positive assessment will we resume operations.

SPIEGEL: One only needs to consider the example of Greece currently to get an idea of how credible such statements are. The government in Athens repeatedly broke their commitments to the troika (made up of the IMF, ECB and European Commission) and yet they are now about to receive the next tranche of financial assistance anyway.

Draghi: That is not an appropriate comparison. Greece will not be considered at all for our programme because it is targeted exclusively at countries that finance themselves, now as before, on the capital market. This is something completely different.

SPIEGEL: Many people are nevertheless concerned that the ECB wants to take a vast amount of high-risk government bonds from southern Europe onto its balance sheet. You already have on your books around €200 billion in securities from countries such as Portugal and Ireland. Will it be the taxpayer who ultimately has to jump in if the countries cannot service their debt?

Draghi: I do not anticipate this; quite the opposite. So far we have actually made a profit on our bond purchases, which has gone to the national central banks, in turn profiting the governments and taxpayers.

SPIEGEL: Can you guarantee it will stay this way?

Draghi: One thing is clear: if the governments in southern Europe continue with the successful implementation of policy reforms seen in the last few months, German taxpayers will make a profit from our purchases. There is no better protection against the euro crisis than successful structural reforms in southern Europe.

SPIEGEL: This can also be expressed in a different way: your balance sheet is dependent upon political developments in Madrid, Rome and Lisbon. Do you think it is wise for a central bank to make itself dependent on governments in this way?

Draghi: We are not making ourselves dependent, quite the opposite. When the crisis escalated in early summer, the ECB had three options: first, do nothing, allowing the crisis to get worse and worse with greater risks, particularly for the German taxpayer; second, provide support unconditionally; or third, provide support under certain conditions. The ECB chose the third option because that was the best way to combat the causes of the crisis. Governments must commit to sound economic and financial policies. This is how we ensure reform in the euro area – and our independence.

SPIEGEL: Experience teaches us somewhat differently. If you artificially lower interest rates, it makes it easier for governments to become indebted and decreases the pressure for reform.

Draghi: High interest rates are the most significant source of pressure for a government resisting reform, I agree with you there. This is exactly why we insist on adherence to strict conditions. Moreover, we do not want to completely eliminate differences in interest rates between countries. We will only intervene if the differences become excessive.

SPIEGEL: Many experts doubt that you can make a clear distinction in this regard.

Draghi: We would disagree. There are models and indicators available that will help us to make an informed judgement.

SPIEGEL: When you announced your programme, interest rates in Spain, for example, stood at 6.5%. What proportion of this was speculative?

Draghi: I will not tell you that: we have decided not to give exact figures for our programme that we could later be pinned down to. What I can tell you is that a good analysis will provide you with the necessary indications regarding at which point the differences give cause for concern.

SPIEGEL: We fear that you are getting entangled in hopeless political discussions with the European governments. In order to put Monetary Union on a firm footing, you are in favour of, for example, greater centralisation of economic and financial policy. Up to now we have seen little of this.

Draghi: This is not how I see it. Governments are on the right path. They have committed themselves to transferring more competencies for budgetary and financial policy to the European level. They need to take the necessary decisions on this at their summit meeting in December.

SPIEGEL: Up to now, governments have only been ready to concede greater powers to the Commission regarding the control of their budgets. The actual decisions will continue to be taken at the national level, however.

Draghi: The governments have taken decisions that would have been inconceivable even one year ago. This is progress, but it is not enough.

SPIEGEL: Why not?

Draghi: If you want to restore confidence in the euro area, you need rules. But that is only the first step. You also need to ensure that the rules are adhered to. This is what was lacking in the past and what governments need to work on.

SPIEGEL: Finance Minister Wolfgang Schäuble has proposed giving the EU Commissioner for Economic and Monetary Affairs a direct say in national budgets. What do you think of that proposal?

Draghi: I am fully in favour of it. Governments would be wise to seriously consider it. I firmly believe that, in order to restore confidence in the euro area, countries need to transfer part of their sovereignty to the European level.

SPIEGEL: But it is precisely that that many governments are unwilling to do. Why are they so against it?

Draghi: A lot of governments have yet to realise that they lost their national sovereignty a long time ago. Because, in the past, they have allowed their debt to pile up, they now need the goodwill of the financial markets. That sounds like a paradox, but it is nonetheless true: it is only once the euro area countries are willing to share sovereignty at the European level that they will gain sovereignty.

SPIEGEL: The second measure with which you wanted to place Monetary Union on a firmer footing was the establishment of a single supervisory mechanism (SSM), with the ECB at the helm. However, it will now not be up and running on 1 January 2013, as planned. Are you disappointed?

Draghi: Not at all. What is more important is that the SSM works well, not when it starts. Otherwise, the reputation and independence of the ECB are at risk.

SPIEGEL: Why do you think that the ECB will do a better job of supervising banks than the competent national authorities have been doing until now?

Draghi: It is not that we want to replace the national supervisory authorities; on the contrary, we want to work closely with them. However, they need to be independent of their governments in their assessment of the problems. In the past, problems in the banking sector have been hushed up time and again.

SPIEGEL: Like in Spain…

Draghi: I am not going to mention any names. However, I am certain that we will be able to act more independently and quickly if Frankfurt is at the heart of the decision-making.

SPIEGEL: But that means that the independence of your monetary policy will come under threat. Will you still be able to take an impartial decision on interest rates if there is the danger that major banks will be pushed into financial ruin?

Draghi: I am aware of the risk, which is why there must be a strict separation between the two areas at the ECB. The Governing Council of the ECB should assign most of the supervisory tasks to an independent committee composed primarily of supervisors.

SPIEGEL: That sounds modest, because you now actually have more responsibilities than any other central banker before you. You are the biggest creditor of many euro area countries; you are the chief banking supervisor and are designing a new structure for the euro area alongside the President of the European Council, Herman Van Rompuy. Would it be wrong to call you the most powerful man in Europe?

Draghi: That is certainly not the way I see myself. With regard to the banking union for example, we are only providing technical assistance, because we were asked to.

SPIEGEL: You are in the news after every EU summit along with world leaders. Are you trying to say that you don't have any influence?

Draghi: I can see how I may give this impression, but I am well aware that I am a central banker without a political mandate, who only acts together with the Governing Council of the ECB.

SPIEGEL: In Germany, people have several reservations about your crisis policies. Were you surprised to receive so much criticism?

Draghi: I had the opportunity of a very deep and wide-ranging exchange of views with members of the Bundestag last Wednesday. My impression was that I was able to explain a number of issues, in particular how the measures comply with our mandate to safeguard our independence and to ensure price stability in the medium term.

SPIEGEL: This fear stems from historical experience. Germans have learnt that, if central banks flood the markets with money, this always leads to inflation.

Draghi: We have to take these fears very seriously. But the correlation is not so simple. In some cases, such as in the Weimar Republic, printing money caused inflation. But in other cases, proactive central bank action did not.

SPIEGEL: You mean the Federal Reserve System's decision at the start of this millennium to drastically reduce interest rates, a policy which contributed to the price bubble on the housing market and the financial crisis of 2007-08. How do you intend to rule out something similar repeating itself in Europe?

Draghi: We, the Governing Council of the ECB, are committed to safeguarding price stability and avoiding systemic asset bubbles. So far we have seen some rising prices in a few asset markets at the local level. Such phenomena must be dealt with regionally by the relevant political and supervisory authorities, for example by asking banks to hold more capital against their real estate exposure.

SPIEGEL: What would you say to German taxpayers who fear inflation?

Draghi: At present I do not see any risks to price stability. The ECB remains committed to safeguarding price stability as it has always done in the past. We firmly expect the inflation rate in the euro area to fall next year to below our target of close to 2%.

SPIEGEL: At the start of Monetary Union, Germans were promised that the ECB would behave like a second Bundesbank. Many people here now speak of a new Banca d'Italia, which tolerated double-figure inflation rates in the 1970s.

Draghi: I consider such accusations, to put it mildly, inelegant. For two reasons: in the 1970s, the Banca d'Italia was not independent. Today, the situation is completely different. But there is also a personal reason. Because of inflation, my family lost a large part of its savings at that time. You can therefore rest assured that I am personally and not only professionally committed to delivering price stability.

SPIEGEL: Two German members of the ECB's Governing Council have stepped down in protest, and the head of the Bundesbank Jens Weidmann openly opposes your policy. Does that not make you think?

Draghi: Of course. That reflects concerns which we incorporate into our decisions. You can be assured that, in taking measures, we stick strictly to our mandate.

SPIEGEL: Your former colleague Jürgen Stark, who resigned, sees it differently.

Draghi: His reasoning is not shared by the Governing Council of the ECB.

SPIEGEL: But the fact is, you are doing things that would have previously been inconceivable.

Draghi: We are also currently in a crisis that was previously inconceivable. It is therefore not very helpful to compare our measures with the past. When we speak of the Bundesbank culture, we mean a culture of independence and price stability. I am deeply attached to both principles and can assure you that each member of the Governing Council is just as deeply committed to delivering price stability in total independence and fully in line with the mandate of our founding fathers.

SPIEGEL: In a recent interview with SPIEGEL, Mr Weidmann warned that central bank financing could become addictive, like a drug.

Draghi: That risk exists, and we have it in mind. But central bank financing can also be helpful, like medicine. And that should also be kept in mind.

SPIEGEL: For how long can these controversies between you and Mr Weidmann continue?

Draghi: I would like certain discussions to proceed in a more controlled way. Mr Weidmann and I still have a great deal of understanding for one another. We have the same goal and our differences of opinion over the correct instruments are not insurmountable.

SPIEGEL: You now live in Frankfurt. How often do you travel to Italy?

Draghi: Not very often. I like Frankfurt, in particular its museums, which my wife and I like to visit.

SPIEGEL: Mr Draghi, thank you for this interview.

Opening statement at Deutscher Bundestag

Speech by Mario Draghi, President of the ECB, Discussion on ECB policies with Members of Parliament, Berlin, 24 October 2012

Dear President Lammert,

Honourable Committee Chairs,

Honourable Members of the Bundestag,

I am deeply honoured to be here today.

As President of the European Central Bank (ECB), it is a privilege for me to come to the heart of German democracy to present our policy responses to the challenges facing the euro area economy.

I know that central bank actions are often a topic of debate among politicians, the media and the general public in Germany. So I would like to thank President Lammert and all Committee Chairs most warmly for this kind invitation – and the opportunity it gives me to participate in that discussion.

It is rare for the ECB President to speak in a national parliament. The ECB is accountable to the European Parliament, where we have scheduled hearings every three months and occasional hearings on topical matters. We take these duties of accountability to the citizens of Europe and their elected representatives very seriously.

But I am here today not only to explain the ECB's policies. I am also here to listen. I am here to listen to your views on the ECB, on the euro area economy and on the longer-term vision for Europe.

To lay the ground for our discussion, I would like to explain our view of the current situation and the rationale for our recent monetary policy decisions. I will focus in particular on the Outright Monetary Transactions (OMTs) that we formally announced in September.

Financial markets and the disruptions of monetary policy transmission

Let me begin with the challenges facing the euro area. We expect the economy to remain weak in the near term, also reflecting the adjustment that many countries are undergoing in order to lay the foundations for sustainable future prosperity. For next year, we expect a very gradual recovery. Euro area unemployment remains deplorably high.

In this environment, the ECB has responded by lowering its key interest rates. In normal times, such reductions would be passed on relatively evenly to firms and households across the euro area. But this is not what we have seen.

In some countries, the reductions were fully passed on. In others, the rates charged on bank loans to the real economy declined only a little, if at all. And in a few countries, some lending rates have actually risen.

Why did this divergence happen? Let me explain this in detail because it is so important for understanding our policies. A fundamental concept in central banking is what is known as 'monetary policy transmission'. This is the way that changes in a central bank's main interest rate are passed via the financial system to the real economy.

In a well-functioning financial system, there is a stable relationship between changes to central bank rates and the cost of bank loans to firms and households. This allows central banks to influence overall economic conditions and maintain price stability.

But the euro area financial system has become increasingly disturbed. There has been a severe fragmentation in the single financial market. Bank funding costs have diverged significantly across countries. The euro area interbank market has been effectively closed to a large number of banks and some countries' entire banking systems. Interest rates on government bonds in some countries have risen steeply, hurting the funding costs of domestic banks and limiting their access to funding markets.

This has been a key factor why banks have passed on interest rates very differently to firms and households across the euro area. Interest rates do not have to be identical across the euro area, but it is unacceptable if major differences arise from broken capital markets or the perception of a euro area break-up. The fragmentation of the single financial market has led to a fragmentation of the single monetary policy. And in an economy like the euro area where about three quarters of firms' financing comes from banks, this has very severe consequences for the real economy, investment and employment.

It meant that countries in economic difficulties could not benefit from our low interest rates and return to health. Instead, they were experiencing a vicious circle.

Economic growth was falling. Public finances were deteriorating. Banks and governments were being forced to pay even higher interest rates. And credit and economic growth were falling further, leading to rising unemployment and reduced consumption and investment. A number of economies could have seen risks of deflation.

All of this meant that the outlook for the euro area economy as a whole was increasingly fragile. There were potentially negative consequences for Europe's single market, as access to finance was increasingly influenced by location rather than creditworthiness and the quality of the project.

The disruption of the monetary policy transmission is something deeply profound. It threatens the single monetary policy and the ECB's ability to ensure price stability. This was why the ECB decided that action was essential.

Restoring the proper transmission of monetary policy

So let me now turn directly to our recent policy announcements. To decide what type of action was appropriate, we had to make two key assessments. First, we had to diagnose precisely why the transmission was disrupted. And second, we had to identify the most effective policy tool to repair those disruptions, while remaining within our mandate to preserve price stability.

In our analysis, a main cause of disruptions in the transmission was unfounded fears about the future of the euro area. Some investors had become excessively influenced by imagined scenarios of disaster. They were therefore charging interest rates to countries they perceived to be most vulnerable that went beyond levels warranted by economic fundamentals and justifiable risk premia.

Clearly, it was not by chance that some countries found themselves in a more difficult situation than others. It was mainly those countries that had implemented inappropriate economic policies in the past. This is also why the first responsibility in this situation is for countries to make determined reforms and convince markets that they are credible.

But many were already doing this, only for interest rates to rise even higher. There was an element of fear in markets' assessments that governments, acting alone, could not remove. Markets were not prepared to wait for the positive effects of reforms to emerge.

In our view, to restore the proper transmission of monetary policy, those unfounded fears about the future of the euro area had to be removed. And the only way to do so was to establish a fully credible backstop against disaster scenarios.

We designed the OMTs exactly to fulfil this role and restore monetary policy transmission in two key ways.

First, it provides for *ex ante* unlimited interventions in government bond markets, focusing on bonds with a remaining maturity of up to three years. A lot of comments have been made about this commitment. But we have to understand how markets work. Interventions are designed to send a clear signal to investors that their fears about the euro area are baseless.

Second, as a pre-requisite for OMTs, countries must have negotiated with the other euro area governments a European Stability Mechanism (ESM) programme with strict and effective conditionality. This ensures that governments continue to correct economic weaknesses while the ECB is active. The involvement of the IMF, with its unparalleled track record in monitoring adjustment programmes would be an additional safeguard.

The consequences of the ECB's actions

So what are the likely consequences of the ECB's actions? Before announcing the OMT programme, we considered very carefully the possible risks – and we designed our operations to minimise them. But I am aware that some observers in this country remain concerned about the potential impact of this policy. I would therefore like to use this opportunity to go through those concerns – one by one – and explain our views.

First, OMTs will not lead to disguised financing of governments. We have specifically designed our interventions to avoid this. They will take place solely on secondary markets, where bonds that have already been issued are traded. If interventions take place, they will involve buying government debt from investors, not from governments. All this is fully consistent with the Treaty's prohibition on monetary financing. Moreover, they will focus on shorter maturities and leave room for market discipline.

Second, OMTs will not compromise the independence of the ECB. The ECB will continue to take all decisions related to OMTs in full independence. It will decide whether to intervene based on its own assessment of monetary policy transmission and with the aim of safeguarding price stability. The fact that governments have to comply with conditionality will actually protect our independence. The ECB will not be forced to step in for a lack of policy implementation.

Third, OMTs will not create excessive risks for euro area taxpayers. Such risks would only materialise if a country were to run unsound policies. This is explicitly prevented by the ESM programme. And we have been very clear that each time a programme starts being reviewed, we will routinely suspend operations and resume them only if the review has been concluded positively. This will ensure that the ECB intervenes only in countries where the economy and public finances are on a sustainable path.

Fourth, OMTs will not lead to inflation. We have designed our operations so that their effect on monetary conditions will be neutral. For every euro we inject, we will withdraw a euro. In our assessment, the greater risk to price stability is currently falling prices in some euro area countries. In this sense, OMTs are not in contradiction to our mandate: in fact, they are essential for ensuring we can continue to achieve it.

Moreover, we see no signs that our announcement has affected inflation expectations. They continue to be firmly anchored. This is testament to our track record on price stability over the last decade and our credible commitment to maintaining price stability. The citizens of the euro area can be confident that we will remain permanently alert to risks to price stability. We have all the necessary tools at our disposal to maintain it and to withdraw any excess liquidity in case of upward risks to price stability.

Conclusion

Let me conclude these opening remarks.

Three elements are essential for understanding the policies of the ECB: immutable focus on price stability; acting within our mandate; and being fully independent.

The ECB's new measures help to ensure price stability across the euro area. They also contribute to improving the economic environment. But completing that task of economic renewal demands continuing action by the governments of the euro area.

It is governments that must set right their public finances. It is governments that must reform their economies. And it is governments that must work together effectively to establish an institutional architecture for the euro area that best serves its citizens.

We are already moving in the right direction. Across the euro area, deficits are being cut. Competitiveness is being improved. Imbalances are closing. And governments are working seriously to complete economic and monetary union.

It is important that Europe's leaders stay on course. In doing so, they will be able to unlock fully the enormous potential of the euro to improve living standards and carry forward the project of European integration.

Thank you for your attention – and I look forward to our discussion.

Text of the video message given at the award ceremony for the second Luca Pacioli Award

Speech by Mario Draghi, President of the ECB, Ca' Foscari University of Venice, 13 October 2012

It is a great honour for me to receive this award today from the university where, at the end of the 1970s, I had my first professional experience as a professor.

It is an honour, above all, because of the grounds on which the award is given: innovation, versatility, an interdisciplinary approach, the integration of research and policy. All of these qualities are necessary if we are to find adequate responses to the current challenges posed by the rapid social and economic transformation undergone in the last few decades.

It is with regret that I cannot be there with you today but international obligations keep me far from Venice, a city of which I have many memories and that I regard with much affection.

* * *

"Double-entry bookkeeping … is one of the finest inventions of the human mind and every prudent master of a house should introduce it into his economy" [1], to quote one of Goethe's characters in *Wilhelm Meister's Theatrical Calling*.

Luca Pacioli, whose name the award bears, was an extraordinary man of science, but also took a keen interest in philosophy and art, a typical representative of our Renaissance. The invention of double-entry bookkeeping is generally attributed to him, although historians agree that he never laid claim to it himself. At the very least, Pacioli defended the value of this practice, probably in use for centuries, right here in this city which welcomed him in 1464 shortly before he turned 20, and which published his key works, including "De computis et scripturis", which was consistently used by researchers of accountancy as a reference work for more than 500 years.

Pacioli could see the potential of double-entry bookkeeping as an instrument for scientific and economic progress in a fundamental profession such as that of a merchant in Venice in the 15th and 16th centuries. On this point, I would like to quote a brief passage from "De computis et scripturis", which forms part of his well-known book "Summa de arithmetica, geometria, proportioni et proporzionalità" (Review of arithmetic, geometry, ratio and proportion): *"My method is nothing but an appropriate way of bringing order to the merchant's fantasy, allowing him to gain an overview of all his affairs and to see easily whether they are in good shape or bad."*

It seems to me that these few words underscore the crucial role of knowledge and method in business administration and management. This was an attitude that became standard in the course of the following centuries but which must have been revolutionary at that time, a time characterised by a strong spirit of innovation. And what was certainly new and extremely modern was the approach we know today as "quantitative" in matters such as trade, which had until then

remained far removed from any scientific concept. The sections that make up his “Summa” are evidence of this: arithmetic and algebra, their use in trade, bookkeeping, currency and exchange, pure and applied geometry.

In his biography of Pacioli, Emmett Taylor sums up his work with these words: “ *Pacioli's great contribution to civilization consisted of digging up old material on mathematics and putting it in shape for the use of modern students. He was the first in modern times to make a science out of mathematics. He accumulated the accepted knowledge on the subject and systematized and formulated it with reference to the discovery of general truths and the operation of general laws.*” [2]

His teachings are still valid today, in more ways than one. It is now generally agreed by economists that the key flaw in macroeconomic models prior to the crisis was the omission of the balance sheets of various players in the economy – banks, households, businesses. The models were built on flows, with little or no attention paid to stocks. But it was precisely from stocks that the irregularities and hence the crisis arose. Non linearities arise on a balance sheet when capital falls to zero and the agent goes into default.

But I think Luca Pacioli was also one of the first figures in history to strive to create common standards for use in complex trade operations, requiring various parties to work together and the sharing of a common language, to the full advantage of economic development and therefore of the common good.

* * *

Fast-forwarding several centuries to today, the consensus seems to be that if the crisis that began in 2007 has taught us anything, it is that there was an extraordinary lack of common rules at the global level, in particular in the field of financial stability. In this regard, a concrete outcome has been the collective acknowledgement that the financial markets need rules. And that as a result of the ever increasing globalisation of markets, national practices need to be set aside to make way for new and, to the extent possible, common rules.

Major steps have been taken in recent years to strengthen the financial system, both at the European and the global level, in the interests of and in order to protect savers and investors. Both the G20 and the Financial Stability Board have taken on greater importance and have proven to constitute – together with the International Monetary Fund – a useful mechanism for brokering agreement on the launching of an agenda for necessary reforms.

Allow me to mention, in particular, the work carried out by the Financial Stability Board – the organisation over which I had the honour of presiding between 2006 and 2011 – on the regulation of the financial markets. The Board has put forward proposals on how to reinforce banks’ capital without putting their fundamental role in the real economy at risk; on how to reduce the risk of moral hazard for systemically important financial institutions (those that are “too big to fail”); on how to increase transparency in financial markets (in particular in derivatives). Even matters relating to accounting standards have not been overlooked: significant efforts have been made to increase the comparability of methods and concepts at the international level.

Also with regard to Europe, significant progress has been made but much still remains to be done, particularly in relation to devising a new institutional structure for the euro area aimed at creating the necessary conditions for long-lasting prosperity for all countries in the area.

It is clear, however, that we must move towards greater economic integration among the countries which share the euro. No union can be based on the assumption that a country can cause “externalities” and economic damage to other member countries by pursuing its own national economic policy priorities.

Within the European Monetary Union, progress needs to be made in three areas: budgetary policy, structural reforms and financial market regulation. With regard to budgetary policies and those aimed at strengthening the flexibility and productivity of the weakest economies, it is vital that there be real multilateral surveillance. The necessary solidarity between economies and countries which share the same monetary unit cannot be disassociated from a deep-rooted sense of joint responsibility. Economic policy decisions have in large part become collective decisions.

With regard to financial markets, centralised authorities must be created in order to limit the excessive risks undertaken on the part of banks and increase the efficiency of common rules. Furthermore, a legal framework for managing and resolving banking crises, which safeguards public finances, needs to be put in place, as is happening in other countries.

In this way, the European Commission’s recent proposal for a European Council Regulation which establishes a single banking supervision mechanism for the euro area – in which the ECB will play an important role – is a bold and necessary step towards creating a single financial market which ensures financial stability in the euro area and the European Union

* * *

I would now like to return to the issue of economic structural reform.

When devising new rules for public finances and financial stability, it must not be forgotten that such matters are closely tied to issues of competitiveness and employment. The issue of financial stability in particular cannot be separated from that of competitiveness and of economic development.

As economic theory teaches us, growth is the result of labour and capital dynamics and of their productivity. It is vital to promote innovation, particularly in the European economies in which an ageing population is tending to reduce the size of the working population. An economy's ability to be innovative depends in large part on its human capital. In this sense, improving human capital through high quality education is crucial in increasing productivity and, in this way, creating the necessary conditions for robust and sustainable economic development.

With the rapid advances in technology in recent years and the growing importance of emerging economies in international markets, human capital has played an increasingly important role in guiding the transformation of the productive structure found in advanced countries which, although to varying degrees, have increased their specialisation in activities requiring higher levels of knowledge.

Education improves the quality of the labour force, increasing the efficiency of a fundamental factor in production processes. Moreover, having highly-trained human capital facilitates the assimilation of technological progress and innovative technology, increasing the overall productivity of the economic system.

It is then clear that it is vital for our economies that we exploit the skills and capabilities of our students in order to improve competitiveness and vigour of the firms which offer these students work, or which the students themselves will go on to set up.

Innovation and human capital are all the more important the closer a country is to the technological frontier, and, in order to grow, a country has to know how to innovate. In the 1950s and 1960s, growth meant learning how to use and replicate well-known technology. This is no longer enough. We have to innovate and to do this we need two things: education and competition.

* * *

Allow me to conclude these few brief remarks by reiterating my gratitude for having selected me for this award. I would like to wish the Rector, Professor Carlo Carraro, lecturers and the students at this university a year filled with success; my warmest wishes and all the very best.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, President of the ECB, Brussels, 9 October 2012

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure to be back here in Parliament and in front of your Committee for our regular exchange of views.

- As you know, the European Central Bank (ECB) has recently taken important decisions to address severe distortions in government bond markets. The ECB stands ready to undertake, under appropriate conditions, what we have called outright monetary transactions (OMTs). These provide a fully effective backstop to avoid destructive scenarios that might threaten price stability in the euro area.
- Our OMT announcements have helped to support financial market confidence. The ECB's actions can help to build a bridge. But the bridge must have a clear destination.
- Reaching that destination involves three processes: first, full implementation of fiscal consolidation and structural reforms to enhance competitiveness; second, full implementation of financial sector reform; and third, completion of a genuine economic and monetary union. The establishment of a Single Supervisory Mechanism (SSM) is a key step in these processes.

Today, I will review economic and monetary developments since July. I will then explain in some detail the rationale and modalities of the OMTs. I will end by sharing my views on one of the four building blocks of a genuine economic and monetary union, namely the financial market union.

I. Economic and monetary developments

Let me start with the economy. Since our last meeting, the ECB has left its key interest rates unchanged: the main refinancing rate stands at 0.75%; and the deposit rate at 0%; the marginal lending facility at 1.50%;.

Economic activity contracted in the second quarter of 2012. Looking ahead, we expect weak economic activity in the near term and only a very gradual recovery after that. The risks to this outlook are on the downside, mainly related to the tensions in several euro area financial markets.

Average inflation in the euro area stood at 2.7% in September, reflecting indirect taxes and high energy prices. It should decline to below 2% in the course of 2013. Underlying price pressures should remain moderate given modest economic growth and well-anchored long-term inflation expectations. Risks to the outlook for price developments are broadly balanced.

Our monetary analysis paints a picture consistent with price stability. In particular, the underlying pace of monetary expansion remains subdued. Loan dynamics are also subdued as a result of weak demand for credit but also restrictions on the supply of credit in some euro area countries.

2. Outright monetary transactions (OMTs)

Let me now explain the decision announced by the ECB's Governing Council in September on outright monetary transactions.

The impact on financial and monetary conditions of past reductions in key ECB interest rates differed considerably within the euro area. For example, in some countries, following cuts in key ECB interest rates, the rates charged by the banking system for credit to the real economy have declined only a little, if at all. In other countries, ECB rate cuts have been fully passed through.

One reason for this difference is that the cost of bank credit to firms is inevitably linked to the cost of market funding for the banks themselves. If there are fears about potential destructive scenarios, the cost of funding for banks can be affected asymmetrically across the euro area. This means that two firms that are otherwise identical and have the same creditworthiness have benefited to a different extent from past cuts in key ECB interest rates, merely because they are located in different countries.

It is that distortion in financing costs that hinders the smooth functioning of credit markets and the transmission of monetary policy. It is that distortion which keeps some countries in what I have previously described as a 'bad equilibrium'. And it is that distortion which falls clearly within our mandate to address.

To counter the impairment of monetary policy transmission and to preserve the singleness of the ECB's monetary policy, the Governing Council decided to undertake outright monetary transactions.

OMT interventions in government bond markets provide a fully effective backstop to avoid destructive scenarios that might threaten price stability in the euro area. The aim is to ensure that the ECB's monetary policy stance is transmitted more evenly to the real economy across euro area.

The ECB will conduct OMTs if and as long as countries comply with strict and effective conditions attached to an appropriate programme via the European Financial Stability Facility and the European Stability Mechanism.

Conditionality preserves the primacy of our price stability mandate and ensures that OMTs will not compensate for a lack of fiscal consolidation. Conditionality in particular preserves the incentives for governments to continue with economic and fiscal adjustments. And only if conditionality is fulfilled will the OMTs be successful in moving an economy towards what we might call a 'good equilibrium'.

OMTs are ex-ante unlimited but, as I have just explained, they are not unconditional. Exit from OMTs would take place once their objectives have been achieved or when there is a failure to comply with a programme. OMTs would not take place while a given programme is under review and they would resume after the review period once programme compliance has been assured.

Consistent with the Treaty prohibition of monetary financing, the ECB will only conduct transactions on secondary markets, buying from investors and not from governments. Purchases will focus in particular on government bonds with remaining maturities of between one and three years. This is in line with the traditional focus of central bank monetary operations.

The ECB will accept the same treatment as private or other creditors with respect to bonds purchased in the context of OMTs. And the ECB will be fully transparent on its OMTs. We will report weekly on total portfolio holdings, and monthly on the average duration of our holdings and the breakdown by country.

3. Financial market union

Let me now turn to the other topic you have chosen for today's exchange of views, namely the financial market union.

The ECB welcomes the European Commission's proposal for a Single Supervisory Mechanism, which is very much in line with the statement of the euro area summit of 29 June 2012. We are looking forward to working closely with the European Parliament in this field. I am confident that the excellent cooperation we have established so far will continue with matters of financial supervision.

Let me here focus on three issues that are key to setting the stage for the new supervisory framework in the euro area: first, the principle of separation between monetary policy and financial supervision; second, the possible participation of non-euro area Member States in the SSM; and third, the accountability framework.

On the first issue of the separation of monetary and supervisory functions, we are not entering uncharted territory. Many central banks around the world – including a large majority of the national central banks in the Eurosystem – combine monetary and supervisory functions.

Proper arrangements to prevent monetary policy being inappropriately affected by the supervisory role have been devised in several countries. I am confident that we can establish suitable arrangements in the euro area, drawing in part on their experiences.

The Commission's proposal provides a solid basis for achieving that goal. By having the Supervisory Board carry out all regular supervisory activities performed directly by the ECB, we will go a long way towards avoiding possible conflicts of interest between the two functions. In addition, we are examining internal procedures that would separate the relevant work-streams supporting the two functions.

The second key issue for the supervisory framework is the possibility of non-euro area Member States participating in the SSM. Let us first take a step back and remind ourselves that the key reason why we are building the financial market union is because of what is happening in the euro area. We are building it to break the vicious circle between sovereigns and banks, the manifestations of which are much more acute and disruptive in a monetary union. That is why we need the SSM in the single currency area.

At the same time, it is clear that we have to create the financial market union while sustaining – and even strengthening – the single market. Both the single currency and the single market are key pillars of growth and prosperity in Europe. Both should be maintained – indeed, both should be enhanced.

The ECB welcomes the possibility of involvement of non-euro area Member States in the SSM. The participation of additional Member States would provide an even stronger boost to the completion of the single market.

That being said, for an entity such as the ECB, whose key legal powers and key decision-making fora are limited to the euro area, imposing obligations on – and granting corresponding rights to – non-euro area Member States raises a number of legal issues. Our legal services – together with those of the Commission and the European Council – are examining closely the possible modalities of participation of non-euro area Member States within the legal constraints of our Statute.

The third key issue for the supervisory framework is one that I suspect is particularly close to your hearts: how the ECB will be accountable for its supervisory actions to the citizens of Europe and their elected representatives. While the independence of the supervisory function is important, so is its accountability. They are, after all, two sides of the same coin.

Given the nature of the tasks of supervision and the need for operational cooperation with other authorities – notably where fiscal costs are concerned – separate and robust mechanisms of accountability have to be in place to legitimise the high degree of independence. The Commission proposal foresees, in particular, that the SSM will be accountable to the European Parliament and the European Council.

Questions have been raised about the timeline for when we should begin our supervisory tasks. Irrespective of the precise schedule for the performance of supervisory tasks, I believe that it is very important that the Council Regulation enters into force as envisaged on 1 January 2013. This would allow us to start the preparatory work as swiftly as possible.

I have discussed the main aspects of the SSM. But the financial market union would be incomplete without commensurate progress towards a common resolution regime. The lack of such a regime has increased the cost of bank failures for taxpayers. It has also complicated the handling of bank failures, especially in cross-border cases. A common resolution regime – with an independent European resolution authority at its centre – is crucial for managing crises in a way that is as orderly, effective and efficient as possible.

4. Concluding remarks

Let me conclude my remarks. The euro area is making good progress towards achieving stable and sound foundations. I trust that in October and subsequently in December, the Heads of State or Government will reaffirm their commitment to the irreversibility of the euro by agreeing on a long-term vision for our economic and monetary union.

That process has not yet had a fully visible impact on the everyday life of citizens in the countries suffering most from the crisis. I am well aware of the hardship that the current situation entails for many people, especially those whose job is lost or at risk.

The adjustment process towards sustainable public finances and a competitive economy can be painful in the short term, both politically and economically. Yet, the reforms are necessary corrections which will bring countries back on the path of sustainable growth. And they also contribute to improve social justice, by fostering tax compliance and limiting rent-seeking by vested interests.

I am confident that the euro area and its currently weaker members will emerge from the crisis with stronger and better functioning economies – and that this will be to the benefit of all Europe's citizens.

Thank you very much.

Interview on the EUROPEAN CULTURAL DAYS of the ECB – France 2012

Interview with Mario Draghi, President of the ECB, for the special supplement of Frankfurter Allgemeine Sonntagszeitung

This year the EUROPEAN CULTURAL DAYS of the ECB take place for the first time under your patronage as ECB President. Why is this cultural initiative important?

I was very happy to take over the patronage of the Cultural Days from my predecessors Jean-Claude Trichet and Wim Duisenberg. With this longstanding project, we aim each year to bring some of Europe's cultural diversity to audiences in the Rhine-Main area and beyond.

The process of European integration involves not only economic and political cooperation, but also touches the cultural roots and common values which bind all Europeans together. Culture knows no national boundaries. Particularly in times such as the present, it is more important than ever to be aware of our shared cultural heritage and to strengthen this awareness further. On the path towards a common Europe, cultural exchange between the Member States plays a key role.

I am very pleased that France is the focus of this year's EUROPEAN CULTURAL DAYS, giving us an insight into the diverse cultural life of another EU Member State.

What role do art and culture play in your life?

I can hardly imagine life without art and culture, because they give impulses for new thinking and creativity. Art presupposes both openness and tolerance and opens up new ways of seeing things that we should not ignore and which are essential for defining our quality of life and our future in a positive way. Especially as we have such busy calendars, I think it is important to devote time to art and culture – although, unfortunately, I do not always manage to find time to do that myself.

What do you particularly like about the EUROPEAN CULTURAL DAYS?

The nice thing about the Cultural Days is that, each year, we can enjoy a programme of first-rate cultural events, and they also give emerging talents a chance to perform in front of a wide audience. The opening events are particularly exciting in that they give the upbeat to several weeks of varied performances. The programme is the result of the creativity of artists, the support of many partners and sponsors, and the commitment of staff both at the ECB and the NCB of the theme country.

I very much enjoyed last year's opening concert by the Orchestra Mozart from Bologna, conducted by Claudio Abbado, and I am also very much looking forward to this year's opening concert by one of France's most renowned baroque ensembles, Les Talens Lyriques.

This is the tenth year of the EUROPEAN CULTURAL DAYS. What do you think makes this cultural initiative a success?

Without the support of our longstanding partners and sponsors, not to mention our loyal audiences, such an initiative would be difficult to bring to fruition. Our well-established partnerships with the City of Frankfurt, reliable sponsors, local cultural institutions and our media partner hr2-kultur have enabled us for many years to present a unique insight, each autumn, into the contemporary culture of a different EU Member State.

Two years ago, together with our longstanding partner, the City of Frankfurt, we began a new project: the charity concert of the EUROPEAN CULTURAL DAYS. Under the heading "A concert for you", artists perform for a good cause; this year's concert will be given by musicians from "Le Cercle de l'Harmonie". Entry to the concert is free, but audience members are asked to give donations for a selected Frankfurt-based charity. This year, we will be supporting the work of "DIE FRANKFURTER LESEPATEN", whose volunteers help primary school children from various cultural backgrounds aged 6 to 10 years to learn German. In choosing this charity, we would like to promote language acquisition – one of the most important factors for integration – and tolerance towards other cultures. This is in line with the underlying principle of the EUROPEAN CULTURAL DAYS: "Unity in Diversity".

Building the bridge to a stable European economy

Speech by Mario Draghi, President of the ECB, at the annual event "Day of the German Industries" organised by the Federation of German Industries, Berlin, 25 September 2012

Ladies and gentlemen,

It is a privilege to be invited to address the *Bundesverband der Deutschen Industrie* this afternoon.

The BDI in many ways mirrors the strengths of the German economy. It simultaneously represents global multinationals and family-owned small businesses. It is this combination of small, medium and large firms that gives German industry its uniqueness and resilience. And this has been rewarded in recent years through strong growth and high employment.

The euro area as a whole has been facing challenging times. Financial markets are fragmented. Economic growth has been broadly flat for the first half of 2012. Growth also remains highly uneven, with some parts of the euro area economy expanding at a solid pace, while others are still in a phase of adjustment.

But my central message to you today is that, provided that all policy-makers persevere with the necessary reforms, we have a number of reasons to be positive about where the euro area is heading. We are seeing signs of improved sentiment in financial markets and we expect the economy to return to growth next year. At the same time, considerable progress is being made on all fronts to strengthen the foundations of the euro area.

Above all, the Member States of the euro area are undertaking determined measures to address the root causes of our current challenges. Individually, governments are implementing the fiscal and structural reforms essential for growth. Collectively, they are reforming the governance of the euro area so as to guarantee sound policies for the future.

We at the European Central Bank (ECB) are continuing to maintain price stability, which is the foundation of growth and job creation. We have introduced new measures to ensure price stability by removing unfounded fears about the euro area. These measures are supporting financial market sentiment while deeper reforms are implemented across the euro area.

However, our measures can only build a bridge towards a more stable future. It must be completed with decisive measures by governments to address fundamental challenges and complete the euro area's institutional architecture. They are currently making progress in this direction. The key challenge going forward is to ensure that the immediate upturn strengthens rather than weakens this commitment.

Actions by the Member States to strengthen the euro area's foundations

Let me begin with the actions being taken by the Member States to strengthen the euro area's foundations.

Across the euro area, strong budgetary consolidation is taking place. The International Monetary Fund (IMF) forecasts that the euro area's primary budgetary position will be almost in balance this year. This means that, apart from debt service, all other expenditures are covered by current revenues.

This is quite an achievement in an international context: Japan, for example, will have a 9% of GDP primary deficit this year, the U.S. 6% and U.K. more than 5%. And the euro area is not only performing well on average: each individual country will have a primary budget deficit lower than these three countries. It is those countries most in need that are making the largest adjustments.

Important improvements are also taking place in competitiveness. For example, the countries under full EU-IMF programmes have seen unit labour costs improve by around 10% since 2008, relative to the euro area average. This has translated into current account deficits that are on average more than five percentage points of GDP lower than they were then. And this is not only due to lower imports, but also rising exports induced by higher competitiveness.

At the same time, the Member States are taking significant steps to improve euro area governance. Governance of fiscal policies has been decisively strengthened with the fiscal compact. This agreement is a powerful tool for keeping fiscal policies in balance and reducing debt to sustainable levels.

Governance of financial policies is also now being given proper attention. The European Commission has recently proposed a single supervisor for euro area banks. Single supervision is particularly important in a single currency area where countries are more immediately affected by instability originating from other member countries. Such single supervision should ultimately lead to a more stable financial system.

Taken together, these actions show that clear progress is being made towards addressing the fundamental causes of our current challenges. Deficits *are* being reduced. Rebalancing *is* happening. And governance *is being* reformed.

Actions by the ECB to ensure price stability

Let me turn to the ECB's recent actions. We have played a role in improving overall confidence by removing unfounded fears about the euro area that were affecting our ability to ensure price stability – notably through our recent announcement of Outright Monetary Transactions, or OMTs. Let me briefly explain the rationale for this decision.

The euro area has experienced a very severe fragmentation in its financial markets. In recent months, we have seen highly divergent borrowing costs for the real economy in different parts of the euro area. In our analysis, these differences were larger than justified by individual credit risk. They reflected, to a considerable extent, unfounded fears about the future of the euro area.

For example, a loan to a family in Germany for a house purchase with a five- to-ten-year maturity had an interest rate of 3%; the rate for a comparable borrower in Spain was 7.5%. At the same time, the average firm in Germany paid around 3% for a new loan over five years, while the average firm in Italy paid above 5.5%.

In these circumstances, monetary policy cannot work properly. This is because a key channel through which the ECB ensures price stability is through the cost of credit, in particular bank credit. Bank credit accounts for about 70% of external financing of euro area firms, and that ratio is even higher for smaller enterprises.

But if we are unable to influence borrowing costs in some parts of the euro area, this channel is disrupted. Firms and households have less access to financing, economic growth stalls and these regions are faced with a risk of deflation. In other words, our ability to ensure price stability for the whole euro area is compromised.

The ECB's Governing Council therefore faced a choice: to accept this situation and allow the singleness of its monetary policy to be undermined; or to take actions within its mandate to restore the normal transmission of monetary policy across all parts of the euro area. We decided in favour of the latter.

Our actions aim to repair monetary policy transmission through providing a credible backstop in government bond markets that removes unfounded fears and tail risks from the euro area. Insofar as this supports investor confidence, it will help stabilise conditions in other markets, such as those for corporate and bank bonds. This ultimately feeds into more even borrowing costs for the real economy across the euro area.

Early signs suggest a positive effect. Since the beginning of this month, euro area banks issued about 27 billion euros of new debt – the most since March of this year. Some of these banks had not been able to access the market for almost six months previously. Non-financial corporations have also issued around 43 billion euros of new bonds, the highest figure for five of the last six months.

It is too early to tell the full impact of our measures on borrowing conditions for firms and households. It will take time for the effects of our actions to feed through systematically.

But the fact that we have seen positive signs so quickly is revealing. It shows that investors are fundamentally confident in the overall trajectory of the euro area. They are ready to re-invest at the first signs of stabilisation. This underscores my central message today: the euro area is making progress – and investors are recognising that progress.

The benefits of stability for the euro area as a whole

I have described how the measures taken by both the Member States and the ECB are beginning to improve confidence. This will ultimately lead to greater overall stability. The benefits of this do not accrue only to countries in difficulty. They accrue to the euro area as a whole.

This is particularly true for an open and outward-looking country like Germany. German industry is a sector deeply embedded in the wider European economy. The stability of the euro area is key to its sustained prosperity. For this reason, ECB actions to maintain price stability for the whole euro area are directly in its interests.

As has long been recognised in this country, low inflation and stable exchange rates ensure a level playing field on which German firms can prosper. They can compete based on their sophistication and innovativeness, without unfair distortions. At the same time, being part of a large and stable currency area provides a buffer against external shocks. This will only become more essential in an ever globalising world.

These factors have led to real economic benefits for Germany. Its intra-euro area trade increased from around 25% of GDP in 1999 to almost 40% of GDP in 2010, while its extra-euro area trade increase by more than 20 percentage points in the same period. Almost 65% of foreign direct investment in Germany now comes from the euro area – and more than one and a half million jobs depend on that investment.

In other words, a stable euro area supports a strong German economy. And a stable euro area is the objective of the all the measures that I have just described.

Moreover, measures that support investor confidence also support the proper functioning of the financial system. For instance, TARGET2 data suggests that balances have now fallen slightly from their peak in August. This highlights the fact that if investors are confident that adverse scenarios will not materialise, they will be more prepared to make cross-border loans. This supports demand across the euro area and the smooth functioning of the Single Market.

I understand that some observers in this country have concerns about the medium-term implications of this policy. So let me be clear: we always have a medium-term orientation. We are steadfastly committed to our mandate to maintain price stability. And the measures we have announced fully support this commitment.

First of all, our actions are for the sole purpose of ensuring the proper transmission of monetary policy. They do not aim to finance governments, and nor would they if they were activated. Our operations would only take place in the secondary market, which ensures that money would pass to investors holding sovereign bonds, not to governments.

Moreover, we have been explicit that our measures can be only successful if they are accompanied by reforms from governments that address deep-rooted issues. The Governing Council has made a strong commitment to such reforms a

pre-requisite to be considered for our operations. This ensures that governments will continue to take essential measures.

Euro area citizens can be certain that we remain alert to any risk to price stability. We have always delivered price stability in the past – indeed, the average rate of inflation in Germany since the launch of the euro has been the lowest since the 1950s. And we will continue to deliver price stability in the future.

The credibility of our commitment is clear. Indicators of inflation expectations show that citizens and financial markets expect inflation to remain low in line with our mandate. We take very seriously the trust that citizens put in us to meet their expectations. We will not let them down.

Building a bridge to the long term

I have discussed the actions that the ECB has taken to ensure price stability and the positive early impact they are having. Of course the current improvement in sentiment does not mean that everything is solved. The ECB's actions can only build a bridge to the future. The project must be completed through decisive actions by governments – both individually and collectively – to address the underlying causes of our current challenges.

This requires further efforts by governments to restore fiscal sustainability across the euro area. It requires deep structural reforms to achieve long-term competitiveness and growth. Governments must remain firmly committed to their current reform efforts, and not seek to relax them as economic conditions start to improve.

To secure long-term stability also requires a second level of actions. For citizens and investors to fully regain confidence in the euro area, they need to be convinced that its design flaws have been permanently fixed. A concerted effort from governments to complete our economic and monetary union is therefore essential.

This does not require a choice between extreme options. Some observers have argued that long-term stability requires a return to the original Maastricht framework. Others have suggested that we need a full federation, a United States of Europe. In my view, neither approach is necessary.

We can ensure future stability by elevating to the European level *only* those policies that are essential for our union to function effectively. I have been asked to work on identifying these policies under the lead of the President of the European Council and together with the Presidents of the Commission and the Eurogroup. In our view, a stable and prosperous union must be built on four pillars.

The first pillar is a *financial union* that can maintain a stable and integrated financial market. This implies a single supervisor to control risk-taking by banks and reduce regulatory capture – and a single resolution system to ensure that banks can fail without dragging down their sovereigns.

As regards the Commission proposal for a single supervisor that I mentioned earlier, I am confident that governments will find agreement on the appropriate perimeter of supervisory responsibilities, as well as issues related to democratic accountability. For our part, we will guarantee the firm separation of monetary policy from supervisory tasks. We will also ensure close cooperation with national supervisors who have the competence and resources to implement supervision.

The second pillar is a *fiscal union* that can effectively prevent and correct unsustainable budgets. The consequences of misguided fiscal policies in a monetary union are too severe to remain self-policed. So a stable EMU would ultimately require the establishment of true budgetary oversight at the European level.

The third pillar is an *economic union* that can guarantee the highest standards for competitiveness. Countries must be able to generate growth and high employment without excessive imbalances. This implies that there must be minimum standards for key economic policies and incentives for continued structural reform.

The fourth pillar is a *political union* that can engage euro area citizens more deeply and make the other pillars legitimate. This is essential to ensure that where sovereignty in selected policy fields is pooled, democratic participation is deepened in parallel.

A firm commitment from governments to complete economic and monetary union is the best complement to the ECB's actions.

It ensures that, by supporting immediate confidence, we will build the bridge to a more stable and prosperous euro area. And it sends a clear signal to investors that the euro area has a vision for a sustainable future.

Conclusion

Let me draw to a close.

In exceptional times, regaining stability sometimes requires exceptional measures. We cannot always look to the past for answers. We may need to take new steps to achieve longstanding goals.

That is the situation we have been facing.

For the Member States, new steps have been needed to restore competitiveness. A sustained commitment to reform efforts is required and a rethinking of the institutional architecture of the euro area.

For the ECB, new steps have been needed to maintain price stability in the face of fragmented financial markets. These new steps are not a departure from our mandate. Indeed, they are the only way to ensure that we continue to fulfil our mandate.

All the measures I have described today are fundamentally about ensuring stability. In the current circumstances, the greatest risk to stability is not action, but*inaction*. This is why the ECB has acted.

The euro supports the strong industrial sector on which Germany depends. It supports openness, growth and prosperity. And ultimately, it supports peace and stability.

This is why the euro is irreversible.

Thank you for your attention.

Interview with Süddeutsche Zeitung

Mario Draghi, President of the ECB, conducted by Alexander Hagelüken and Markus Zydra on 11 September 2012, published on 14 September 2012

SZ: After the decision to buy bonds of troubled euro area countries without any limitations, did fellow Italians congratulate you for opening up the wallets of taxpayers in Germany and other countries?

Draghi: No! Actually, the reactions were diverse. In parts of Germany, the echo was negative; in parts of southern Europe, it was not entirely positive either, because of the strict and effective conditionality. The rest of the world complimented us.

SZ: The Secretary General of the conservative CSU has called you a “forger of coins”.

Draghi: I trust that he will change his opinion, when he sees the results. There have already been positive results. The announcement of the facility has contributed to raising confidence in the euro area, and in the euro across the world. Fund managers are bringing their money back to Europe. This is good for the euro area economy.

SZ: Are you really optimistic that the euro area debt crisis will be resolved?

Draghi: We are certainly on a good path. We see extraordinary progress in reforms in Spain and Italy, particularly if you consider what they have done over the last six months in comparison with what they did not do for many years. The direction of policies in many countries was flawed and needed to be corrected. This process is currently under way. But much still needs to be done. And this is also why adherence to strict and effective conditionality is a prerequisite for the Governing Council to consider outright monetary transactions.

SZ: Many Germans fear the risk of a central bank spending money on an unprecedented scale.

Draghi: What was the situation? The risk of self-fulfilling prophecies was increasing: rising sovereign bond yields were seen as aggravating the situation, which was driving yields even higher. There was a risk of a vicious circle that

warranted central bank action because good economic policies alone may not necessarily be enough for countries to free themselves from what we call a “bad equilibrium”.

SZ: To a lot of people, "unlimited bond buying" sounds like unlimited risk that they will have to pay for sooner or later.

Draghi: The obligations that the countries have to meet are the best insurance against risk. The risks are well managed. And, in our assessment, doing nothing poses even greater risks.

SZ: If a country defaults on its bonds, the ECB and thus the tax payers lose a lot of money.

Draghi: This is why conditionality is so important. Moreover, the Outright Monetary Transactions will focus only on the shorter term, in particular on bonds with a maturity of one to three years.

SZ: But 42% of the German population distrust you as the ECB’s President.

Draghi: That is a hindrance for our work. I will have to do more to explain our actions. We will start with this interview. But you always have to weigh the options.

SZ: Which are?

Draghi: Of course, you could say “Nein zu allem”, but that is not constructive. For example, if we had not decided to conduct the longer-term refinancing operations (LTROs), we would have seen a severe credit crunch across large parts of the euro area. Under such conditions, and I have said this time and again, we would not be able to deliver what everybody expects us to deliver: price stability over the medium term. So, we have to help avoid such conditions.

SZ: How serious is your threat? It is hard to believe that you would stop buying bonds and let Spain or Italy plunge into disaster.

Draghi: If a given country does not comply with conditionality, the ECB cannot improve the monetary policy transmission in that country. Any attempt to do so in such a situation would be ineffective because it would be offset by the country’s policy failure.

SZ: Why didn’t you make it mandatory that ESM/EFSF first buy bonds on the primary market before the ECB steps in?

Draghi: The key for us is strict conditionality and effective monitoring. The possibility of primary market purchases by the EFSF/ESM should be sufficient to ensure that.

SZ: Can the euro area now be saved after the ruling of the German constitutional court on the ESM?

Draghi: The ESM is an important measure in the crisis management toolbox. However, coping with the crisis does not depend only on having a stabilisation mechanism in place; in particular, we need determined actions at the level of individual Member States. And, collectively, Member States have to complete Economic and Monetary Union. We at the ECB will conduct monetary policy independently so as to safeguard price stability.

SZ: You keep saying the euro is irreversible. Mr Draghi, you speak like the Chancellor of Europe.

Draghi: I am communicating this message as the President of the ECB to all stakeholders, citizens, businesses and markets. Investors need a long-term vision because they undertake long-term commitments. For them, it is very important that our leaders and governments are determined to keep the euro irreversible. So, if I say this, I am saying what our political leaders are fundamentally saying.

SZ: So you are covering up the failure of politics?

Draghi: Again, I am saying it because it is important to do so. Markets should know that the euro is irreversible. That helps them to properly price euro area assets and it helps us in the conduct of our monetary policy.

SZ: Have you ever wanted to become a politician?

Draghi (laughs): No.

SZ: Why not?

Draghi: Because you do the things you like to do.

SZ: Before us, you had a visit from the Greek Prime Minister, Antonis Samaras. Greece has not met the deficit limit of 3% of GDP even once. How can such a country stay in the euro area?

Draghi: By changing. The country has to fundamentally change its policies. And this is what everybody is telling them to do.

SZ: But Greece is seeking further help, after all the help it has already received. It is said that Samaras wants a cut on the billions of euro due on the Greek bonds the ECB holds.

Draghi: We haven't discussed this, but – anyway – I'm against it.

SZ: Your new bond purchasing programme reminds us of Italy in the 1970s, when the central bank helped the state out in its financing, which only increased the problems.

Draghi: That was something completely different. It took place decades ago, when the Italian central bank wasn't independent from the state. In Italy things have changed completely since then. Banca d'Italia has now been independent for decades, and has not financed any government deficit. We have to move away from clichés of the past if we want to address the future!

SZ: The Bundesbank has a different view: Jens Weidmann fears that the ECB's monetary policy is financing fiscal deficits.

Draghi: No, the Governing Council disagreed with that view. What has been decided is a monetary policy measure. There is a fundamental difference between buying on the primary market, which is forbidden because the money would go to the government, and buying on the secondary market where the money does not go to the government but to bond holders. Article 18 of the Statute states that the ECB may "buy and sell […] marketable instruments" as part of its mandate, if necessary to achieve price stability, of course always respecting the Treaty's Article 123 on the prohibition of monetary financing.

SZ: Where does the German opposition come from?

Draghi: It comes from the history of the country and the fear of inflation. But it has to be clear that in the case of EFSF/ESM support, the parliaments of the euro area countries will be involved.

SZ: But the parliaments do not decide on the amounts that the ECB is going to risk …

Draghi: No, because monetary policy has to remain independent, and it is a prerequisite for the Governing Council to consider the specific monetary policy measures.

SZ: Many Germans were against the euro, because they had doubts about the economic policies of countries like Greece or Italy. Now they feel that they were right.

Draghi: The euro has delivered price stability to an entire continent. It has removed exchange rate risk, fostered economic cohesion, employment and growth. Germany has benefited greatly from all these accomplishments, as well as from price stability that is greater than in the years before the euro.

SZ: The ECB will be getting even more power by supervising the European banking industry. So, will the ECB always bail out ailing banks by printing money?

Draghi: No, we have to organise ourselves and keep banking supervision and monetary policy strictly separate. This has been done in many central banks. We are not mixing anything; fundamentally, there will be a Chinese wall.

SZ: Chinese walls in regular banks have collapsed.

Draghi: Not in central banks.

SZ: How can the ECB do a better job than the German Bafin?

Draghi: It is not about doing a better job; it is about making sure that uniform supervisory practices are applied across the whole single currency area. The more detached you are from national government, the more objective you will be in your decision-making. We don't want to control every small bank directly; we will work together with national supervisors.

SZ: According to the plans, the ECB will have to report on its supervision business to the European Parliament once a year. Is that enough?

Draghi: We surely need substantial democratic accountability here, and it is up to the legislators to establish what they consider necessary.

SZ: Do you personally know people who have suffered from the euro crisis?

Draghi: I have visited many SMEs whose credit was cut in the crisis and who have gone out of business. And I am not talking about only Italian businesses.

SZ: How uncomfortable do you feel in the country of the Bundesbank?

Draghi: I have often said that the Bundesbank is a great institution, and I respect it very much. It would be great if we could always work together. We have done that many times, but at the moment, we have different opinions on the best way to react to the crisis. We all share the same objective of delivering on price stability, but we are not in full agreement about the best way to achieve that.

SZ: And the German people?

Draghi: We need to explain what we do better in Germany, which our intentions are and what precautions we are taking.

SZ: You could speak to the Bundestag.

Draghi: It would be an opportunity to explain what we do in greater detail. If I am invited, I would be very happy to go there.

For a European Public Space

Remarks by Mario Draghi, President of the ECB on receiving the M100 Media Award 2012 Potsdam, 6 September 2012

Dear Minister Schäuble,

Dear Lord Mayor Jakobs,

Dear Mr van Dülmen,

Dear Paul Achleitner,

Dear Luca di Montezemolo,

Distinguished friends,

Ladies and gentleman,

I am enormously grateful to the Board of M100 Sanssouci Colloquium for bestowing this award on me.

It is an honour to be recognised as a contributor to the European project, and to join the company of such illustrious previous recipients. Working for Europe is not only my profession, but also, on a personal level, a driving mission. And in these difficult times – when, unfortunately, we are rarely *sans souci* – striving to build a strong, united and stable Europe is more important than ever.

I would like to thank Minister Schäuble very warmly for his presence tonight and his very moving speech. Wolfgang is among the most important European leaders we have. Over the past 20 years, he has worked relentlessly to advance the cause of European integration, sometimes against strong resistance.

Wolfgang does not grow weary of reminding us of the benefits of the European project. His deeply anchored aspiration "to think Europe further" – *Europa weiterzudenken* – has been rewarded with the renowned Karlspreis in May this year. We are privileged to have such leaders as him today.

I also would like to thank Potsdam Lord Mayor Jakobs and Mr van Dülmen of the M100 Sanssouci Colloquium for their words and their hospitality and the entire M100 board for their trust. And of course, I would like to thank Paul Achleitner and Luca di Montezemolo for their very kind words in support. You all have been very generous to me.

It is no secret that the course of European integration is currently difficult. The global economy is facing serious challenges. These challenges are not all of Europe's making, as some observers would have us believe. But Europe is perhaps experiencing them more acutely than others. The reasons for this are complex. But one part of the explanation is clear: the original institutional design of the euro area did not meet expectations.

In the euro area we have a single monetary policy, but our economic and financial policies are only loosely coordinated. This is because the euro area is a union of nation-states with strong national traditions and preferences. While there was sufficient consensus to share a currency, economic and financial policies remained organised largely at the national level.

The global crisis has revealed the vulnerabilities in this arrangement. Loose coordination of policies neither ensures stability nor does it facilitate effective crisis management. The institutional design of the euro area therefore has to be reviewed to put our economic and monetary union (EMU) on a more secure footing.

But how should this be done? There are two possible paths. The first is to go "back to the past", to make the original design work better. The second is to develop a new architecture that properly reflects lessons of the crisis.

In my view, the first path is not viable. We have seen that the euro area is too interconnected for economic and financial policies to be a purely national responsibility. We must find ways to guarantee that national decisions do not harm other members of the monetary union. In the event of a crisis, there should be effective mechanisms for crisis management. And where necessary, this means going beyond coordination, because this is a matter of *europäische Innenpolitik*.

We have also seen that maintaining stability requires common institutions that can react to events. The euro is the world's second most important currency. It makes up 25% of the world's foreign exchange reserves. 1.5 trillion euros are traded daily on the world's foreign exchange markets. And it is used daily by the 330 million citizens of the euro area. A currency that plays a central role in the lives of so many people has to be managed with effective decision-making.

The second path, designing a new architecture, is therefore the only way forward. The key challenge today is to present a vision to Europe's citizens of what this would entail – which is precisely the theme of this conference.

Together with the Presidents of the European Council, the European Commission and the Eurogroup, I have been given the task of working on such a vision for the next decade. We have aimed to be as pragmatic as possible: to establish what are the minimum requirements to make the euro function to its full potential. And our conclusions are both realistic and attainable.

Member States will have to pool more sovereignty in selected policy areas. This is a clear lesson of the crisis. But we will not need to cede all powers to Brussels. Sovereignty will only be pooled where it is essential to ensure a stable and prosperous monetary union. This will be accompanied by broad democratic participation and legitimation.

Our vision for EMU has four pillars – fiscal union, financial union, economic union and political union. Progress on all four should be made simultaneously. The first three pillars will help to steer fiscal, financial and economic policies in a sustainable way. They will also help to create institutions commensurate with the degree of monetary integration in the euro area.

But today I would like to focus briefly on the fourth pillar, *political union*. This pillar is essential for engaging euro area citizens more deeply and making the other three pillars legitimate.

Some observers argue that because of the common decision-making implied by the other three pillars, political union has to come first. I do not agree. Political integration can and will develop in parallel with economic integration. Over the past 60 years of European integration, this has always been the sequence.

For example, public engagement with euro area issues has naturally deepened through responding to the crisis. To commit money via the European Stability Mechanism, Member States have had to explain the responsibilities of euro membership to their citizens. Parliaments are now taking a sharper interest in European affairs. Closer economic integration has *de facto* strengthened democratic engagement.

But this does not mean that we should not strive to strengthen democratic participation in Europe further. Democratic engagement already takes place through the Council of Ministers – where citizens are represented by elected ministers – and the European Parliament – where citizens elect their MEPs directly. But more has to be done to make the voice of Europe's citizens heard. We need what in Germany is called *demokratische Teilhabe.*

And this is where *you* are needed. I would like to ask all of you – journalists and publishers but also policy makers and academics – to help to develop a genuine European public space, *eine europäische Öffentlichkeit*.

Most of us in Europe are exposed mainly to our national media in our national languages. These media naturally define our perspective: our sense of the "public" tends to stop at national borders. But this no longer describes reality. What is happening in other Member States matters to all of us. Problems that cross borders require citizens to find consensus around common solutions.

Again, the crisis is itself having an effect. For example, newspapers in some countries now take a keen interest in the welfare systems of other countries. Citizens closely follow the elections of ministers they would previously have never heard of.

Certainly, there is an unwelcome side to this related to the potential for reviving outdated national stereotypes. But there is also a positive side insofar as it leads citizens in the euro area to develop a sense of belonging together and to care about decisions in other regions.

One way to strengthen this trend would be to exchange more media between countries. And here I would like to invite your contribution.

Could you consider, for example, publishing what we might call "imported pages" from foreign newspapers? This would allow citizens to get a better sense of how issues are seen in other countries; it would increase cultural sensitivity; and it could generate Europe-wide debates that divide along policy lines rather than national lines. Over time, such debate would help to put European decision-making on a more legitimate footing.

"Imported pages" are but one idea, a starting point. It is with your dedication and creativity that more such ideas can be developed. It is a privilege to be part of the European project, for citizens and journalists alike. But it is also comes with responsibilities, for citizens and journalists alike.

Ultimately, a genuine European public space is essential for supporting the long-term vision of the euro area. Citizens need to be in basic agreement that, within a monetary union, certain economic models are no longer possible. They must understand that there are limits to national discretion in economic policies that affect the area as a whole. In other words, there needs to be a new consensus on economic policies that will reinvigorate the European social model and make it fit for the 21st century.

This is a discussion we must begin today. Setting EMU on a path towards stability is essential so that we can move permanently beyond the crisis. It will send a clear signal to citizens and financial markets that the euro area is committed to staying the course. And it will remove any grounds for doubting the euro's future.

There are many reasons to be optimistic that Europe will find this path. The pattern over recent decades has always been to move forward towards a stronger and more united Europe. When we have faced challenges, we have invariably found solutions. Those who have predicted the worst have turned out to be mistaken.

What's more, the solutions we need do not require extreme approaches or impossible choices. They require a structured and achievable path towards completing EMU. This is fully within our reach today.

I am confident that one day I can return to this beautiful historical setting *sans souci*.

In the meantime, I am most grateful for your support.

Thank you once again for this award and your kind words tonight and thank you very much for your attention.

The future of the euro: stability through change

Contribution from Mario Draghi, President of the ECB, Published in "Die Zeit", 29 August 2012

Across Europe, a fundamental debate is taking place about the future of the euro. Many citizens are concerned about where Europe is heading. Yet the solutions presented appear to them unsatisfactory. This is because these solutions offer binary choices: either we must go back to the past, or we must move to a United States of Europe. My answer to the question is: to have a stable euro we do not need to choose between extremes.

The reason this debate is taking place is not the euro as a currency. The objectives of the single currency remain as relevant today as they were when the single currency was agreed. To spread price stability and sustainable growth to all European citizens. To reap the gains of the world's largest single market and make the historic process of European unification irreversible. To raise Europe's standing – not only economically but also politically – in a globalised world.

The debate is taking place because the euro area has not yet fully succeeded as a polity. Currencies ultimately depend on the institutions that stand behind them. When the euro was first proposed, there were those who said it would have to be preceded by a long process of political integration. This was because sharing a currency would imply a high degree of joint decision-making. Member countries would be a "Schicksalsgemeinschaft" and would need strong common democratic underpinnings.

But a deliberate choice was made in the 1990s not to give the euro such features. The euro was launched as a "currency without a state" to preserve the sovereignty and diversity of member countries. This informed the so-called "Maastricht setup", which laid the euro's institutional foundations. But as recent events have shown, this institutional framework left the euro area insufficiently equipped to ensure sound economic policies and effectively manage crises.

For this reason, the way ahead cannot be a return to the *status quo ante*. The challenges of having a single monetary policy but loosely coordinated fiscal, economic and financial policies have been clearly revealed by the crisis. As Jean Monnet said, coordination " *is a method which promotes discussion, but it does not lead to a decision."* And strong decisions have to be made to manage the world's second most important currency.

A new architecture for the euro area is desirable to create sustained prosperity for all euro area countries, and especially for Germany. The root of Germany's success is its deep integration into the European and world economies. To continue to prosper, Germany needs to remain an anchor of a strong currency, at the centre of a zone of monetary stability and in a dynamic and competitive euro area economy. Only a stronger economic and monetary union can provide this.

Yet this new architecture does not require a political union first. It is clear that monetary union *does* entail a higher degree of joint decision-making. But economic integration and political integration can develop in parallel. Where necessary, sovereignty in selected economic policy fields can and should be pooled and democratic legitimation deepened.

How far should this go? We do not need a centralisation of all economic policies. Instead, we can answer this question pragmatically: by calmly asking ourselves which are the minimum requirements to complete economic and monetary union. And in doing so, we will find that all the necessary measures are firmly within our reach.

For fiscal policies, we need true oversight over national budgets. The consequences of misguided fiscal policies in a monetary union are too severe to remain self-policed. For broader economic policies, we need to guarantee competitiveness. Countries must be able to generate sustainable growth and high employment without excessive imbalances. The euro area is not a nation-state where persistent cross-regional subsidies have sufficient popular support. Therefore, we cannot afford a situation where some regions run permanently large deficits vis-à-vis others.

For financial policies, there need to be powers at the centre to limit excessive risk-taking by banks and regulatory capture by supervisors. This is the best way to protect euro area taxpayers. There also needs to be a framework for bank resolution that safeguards public finances, as we see in other federations. In the U.S., for example, on average about 90, mostly smaller, banks per year have been resolved since 2008 and this had no impact on the solvency of the sovereign.

Political union can, and shall, develop hand-in-hand with fiscal, economic and financial union. The sharing of powers and of accountability can move in parallel. We should not forget that 60 years of European integration have already created a significant degree of political union. Decisions are made by an EU Council filled by national ministers and by a directly elected European Parliament. The challenge is to further increase the legitimacy of these bodies commensurate with increasing their responsibilities and to seek ways to better anchor European processes at the national level.

A more solid political foundation should allow for agreement on a basic principle: that it is neither sustainable nor legitimate for countries to pursue national policies that can cause economic harm for others. This constraint has to be built into how countries design their economic and social models. The only sustainable model is one that is consistent with the terms of a common currency. Countries have to live within their means. Competition and labour markets have to be reinvigorated. Banks have to conform to the highest regulatory standards and focus on serving the real economy. This is not the end, but the renewal of the European social model.

From the ECB's perspective, a strong economic union is an essential complement to the single monetary policy. Building this will require a structured process with correct sequencing. Yet citizens can be certain that three elements will remain constant. The ECB will do what is necessary to ensure price stability. It will remain independent. And it will always act within the limits of its mandate.

Yet it should be understood that fulfilling our mandate sometimes requires us to go beyond standard monetary policy tools. When markets are fragmented or influenced by irrational fears, our monetary policy signals do not reach citizens evenly across the euro area. We have to fix such blockages to ensure a single monetary policy and therefore price stability for all euro area citizens. This may at times require exceptional measures. But this is our responsibility as the central bank of the euro area as a whole.

The ECB is not a political institution. But it is committed to its responsibilities as an institution of the European Union. As such, we never lose sight of our mission to guarantee a strong and stable currency. The banknotes that we issue bear the European flag and are a powerful symbol of European identity.

Those who want to go back to the past misunderstand the significance of the euro. Those who claim only a full federation can be sustainable set the bar too high. What we need is a gradual and structured effort to complete EMU. This would finally give the euro the stable foundations it deserves. It would fully achieve the ultimate goals for which the Union and the euro were founded: stability, prosperity and peace. We know this is what the people in Europe, and in Germany, aspire to.

Verbatim of the remarks made by Mario Draghi

Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London 26 July 2012

(…)

I asked myself what sort of message I want to give to you; I wouldn't use the word "sell", but actually I think the best thing I could do, is to give you a candid assessment of how we view the euro situation from Frankfurt.

And the first thing that came to mind was something that people said many years ago and then stopped saying it: The euro is like a bumblebee. This is a mystery of nature because it shouldn't fly but instead it does. So the euro was a bumblebee that flew very well for several years. And now – and I think people ask "how come?" – probably there was something in the atmosphere, in the air, that made the bumblebee fly. Now something must have changed in the air, and we know what after the financial crisis. The bumblebee would have to graduate to a real bee. And that's what it's doing.

The first message I would like to send, is that the euro is much, much stronger, the euro area is much, much stronger than people acknowledge today. Not only if you look over the last 10 years but also if you look at it now, you see that as far as inflation, employment, productivity, the euro area has done either like or better than US or Japan.

Then the comparison becomes even more dramatic when we come to deficit and debt. The euro area has much lower deficit, much lower debt than these two countries. And also not less important, it has a balanced current account, no deficits, but it also has a degree of social cohesion that you wouldn't find either in the other two countries.

That is a very important ingredient for undertaking all the structural reforms that will actually graduate the bumblebee into a real bee.

The second point, the second message I would like to send today, is that progress has been extraordinary in the last six months. If you compare today the euro area member states with six months ago, you will see that the world is entirely different today, and for the better.

And this progress has taken different shapes. At national level, because of course, while I was saying, while I was glorifying the merits of the euro, you were thinking “but that’s an average!”, and “in fact countries diverge so much within the euro area, that averages are not representative any longer, when the variance is so big”.

But I would say that over the last six months, this average, well the variances tend to decrease and countries tend to converge much more than they have done in many years - both at national level, in countries like Portugal, Ireland and countries that are not in the programme, like Spain and Italy.

The progress in undertaking deficit control, structural reforms has been remarkable. And they will have to continue to do so. But the pace has been set and all the signals that we get is that they don’t relent, stop reforming themselves. It’s a complex process because for many years, very little was done – I will come to this in a moment.

But a lot of progress has been done at supranational level. That’s why I always say that the last summit was a real success. The last summit was a real success because for the first time in many years, all the leaders of the 27 countries of Europe, including UK etc., said that the only way out of this present crisis is to have more Europe, not less Europe.

A Europe that is founded on four building blocks: a fiscal union, a financial union, an economic union and a political union. These blocks, in two words – we can continue discussing this later – mean that much more of what is national sovereignty is going to be exercised at supranational level, that common fiscal rules will bind government actions on the fiscal side.

Then in the banking union or financial markets union, we will have one supervisor for the whole euro area. And to show that there is full determination to move ahead and these are not just empty words, the European Commission will present a proposal for the supervisor in early September. So in a month. And I think I can say that works are quite advanced in this direction.

So more Europe, but also the various firewalls have been given attention and now they are ready to work much better than in the past.

The second message is that there is more progress than it has been acknowledged.

But the third point I want to make is in a sense more political.

When people talk about the fragility of the euro and the increasing fragility of the euro, and perhaps the crisis of the euro, very often non-euro area member states or leaders, underestimate the amount of political capital that is being invested in the euro.

And so we view this, and I do not think we are unbiased observers, we think the euro is irreversible. And it’s not an empty word now, because I preceded saying exactly what actions have been made, are being made to make it irreversible.

But there is another message I want to tell you.

Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.

There are some short-term challenges, to say the least. The short-term challenges in our view relate mostly to the financial fragmentation that has taken place in the euro area. Investors retreated within their national boundaries. The interbank market is not functioning. It is only functioning very little within each country by the way, but it is certainly not functioning across countries.

And I think the key strategy point here is that if we want to get out of this crisis, we have to repair this financial fragmentation.

There are at least two dimensions to this. The interbank market is not functioning, because for any bank in the world the current liquidity regulations make - to lend to other banks or borrow from other banks - a money losing proposition. So the first reason is that regulation has to be recalibrated completely.

The second point is in a sense a collective action problem: because national supervisors, looking at the crisis, have asked their banks, the banks under their supervision, to withdraw their activities within national boundaries. And they ring

fenced liquidity positions so liquidity can't flow, even across the same holding group because the financial sector supervisors are saying "no".

So even though each one of them may be right, collectively they have been wrong. And this situation will have to be overcome of course.

And then there is a risk aversion factor. Risk aversion has to do with counterparty risk. Now to the extent that I think my counterparty is going to default, I am not going to lend to this counterparty. But it can be because it is short of funding. And I think we took care of that with the two big LTROs where we injected half a trillion of net liquidity into the euro area banks. We took care of that.

Then you have the counterparty recess related to the perception that my counterparty can fail because of lack of capital. We can do little about that.

Then there's another dimension to this that has to do with the premia that are being charged on sovereign states borrowings. These premia have to do, as I said, with default, with liquidity, but they also have to do more and more with convertibility, with the risk of convertibility. Now to the extent that these premia do not have to do with factors inherent to my counterparty - they come into our mandate. They come within our remit.

To the extent that the size of these sovereign premia hampers the functioning of the monetary policy transmission channel, they come within our mandate.

So we have to cope with this financial fragmentation addressing these issues.

I think I will stop here; I think my assessment was candid and frank enough.

Thank you.

Interview with Le Monde

Mario Draghi, President of the ECB, conducted by Erik Izraelewicz, Claire Gatinois and Philippe Ricard on 18 July 2012, published 21 July 2012

The International Monetary Fund (IMF) has revised downwards its global growth forecasts because of Europe. Is there a risk of recession?

No. Since the start of the year, the risks of a deterioration in the economy that we had feared have certainly materialised in part. The situation has gradually worsened, but not to the point of plunging the whole of the Monetary Union into recession. We still expect a very gradual improvement in the situation by the end of this year or the beginning of next year.

Thanks to the ECB?

The cuts in interest rates at the end of 2011 and in July should produce their effects, as should the unprecedented LTROs, three-year loans to banks, which we carried out to deal with the risk of a "credit crunch", a restriction or an increase in the costs for loans.

Should the ECB not do more to ease the economy, as the IMF has requested?

We are very open. We do not have any taboos. We decided to reduce interest rates to below 1% in July because we forecast that inflation would be close to or below 2% at the start of 2013. It now seems likely that it will fall sooner than expected, at the end of 2012. Our mandate is to maintain price stability in order to prevent both higher inflation and a generalised, broadly based fall in prices. If we see such risks of deflation, we will act.

The European Council of 28 and 29 June was positively received by the markets which since then have expressed doubts.

The Summit was a success. For the first time, it seems to me, a clear message was given: exit the crisis with more Europe. By putting in place a roadmap to create a Union with four building blocks – financial, fiscal, economic and political – and delivering tangible results: a financial union, one banking supervisor, allowing the rescue funds to recapitalise banks once this supervision is in place. And a calendar for implementation.

These are long-term solutions. Doesn't something need to be done about the urgency of the situation?

Let me tell you about my experience. In 1988 the Delors Committee set out the route towards Monetary Union, with a goal, a timetable and commitments to be respected. This prospect resulted in the Maastricht Treaty in 1992. Italy's borrowing rates were very high at the time. But as a result of its involvement in the project of Monetary Union, Italy saw an abrupt fall in its rates, before there was even a decrease in the deficit, which stood at 11% of GDP! This leads me to believe that if countries make firm commitments, even of a long-term nature, this has an impact in the short term.

The ECB has been criticised for not doing more for the governments. Is the ECB waiting for government efforts to be made before acting?

This idea that there is bargaining between the governments and the ECB is a "quiproquo". Our mandate is not to resolve the financial problems of countries, but to ensure price stability and to contribute to the stability of the financial system in full independence.

What do you think of the growth pact held dear by François Hollande?

It will certainly help, but we need to go further. Each country must also make efforts.

Are you thinking more of structural reforms than of a Keynesian stimulus?

Yes, although, in my view, the focus is too often on labour market reforms, which do not always translate into increased competitiveness because companies sometimes benefit from monopolies or situation rent. So we also need to look at the markets for products and services and liberalise where necessary to increase competitiveness. Politically, these are difficult decisions to take. A European agenda of the reforms to be undertaken would help hugely. We also need to strengthen joint decision-making in these areas at the European level.

So it is a victory for liberal arguments?

No. Putting an end to certain situation rents is a question of fairness, for employees and entrepreneurs, and for all citizens.

What do you think of the policies followed in France?

I welcome the continuation of fiscal consolidation, which remains indispensable, and I also welcome the emphasis on growth potential that will pave the way for recovery. Debt reduction is vital. And the country must respect its commitment to bring its deficit back down to 3% of GDP in 2013 so that it can continue to benefit from low interest rates.

You are one of the most influential men in Europe, yet you are not elected. Does this not pose a problem for democratic legitimacy?

I am cognisant of the importance of being accountable for our actions. I stand before the European Parliament about ten times a year, and we are very active in terms of communication. We stand ready to do more, if our powers were to be strengthened. In the extraordinary conditions that we are experiencing, it is necessary to see the ECB take a stand beyond monetary policy for matters that cannot be addressed by monetary policy, such as high public deficits, a lack of competitiveness or unsustainable imbalances, especially where financial stability may be at risk. Safeguarding the euro is part of our mandate.

When you arrived at the head of the ECB, you were considered the most German of the Italians. Is this still the case?

That's up to you to judge! We have to maintain price stability in both directions, face problems as they present themselves, and act without prejudice.

In some ways you are very German when you support the calls for political union made by Angela Merkel

Any move towards a financial, budgetary and political union is, to my mind, inevitable. This will lead to the creation of new supranational entities. In some countries the transfer of sovereignty – I prefer to say sharing – that this implies is a major stake, in others it is no problem. But one must remember that with globalisation, it is precisely by sharing sovereignty that countries can better preserve it. In the long term, the euro must be based on a greater degree of integration.

Is a Greek exit from the euro area still a leading concern?

Our unequivocal preference is for Greece to remain in the euro area. But that is a matter for the Greek government. It has stated its commitment, now it must deliver results. Regarding the renegotiation of the memorandum [to ease the austerity measures and reforms imposed on the country], I will not take any stance before seeing the Troika's report.

On Friday, 20 July, the finance ministers of the euro area should have completed the aid plan for banks. Have they done so? Will it suffice to prevent the country from defaulting?

One important point is the involvement of senior creditors of banks: the ECB believes that such involvement should be possible in the case of the liquidation of a bank. Savers must be protected, but creditors should be part of the solution of the crisis. It is a matter of limiting the involvement of taxpayers. They have already paid a great deal!

Do you think you can go on holiday this summer in peace?

I never plan my holidays ahead and I only ever go away for a few days. One thing is certain: I will not be going to Polynesia. It's too far.

So is the euro still in danger?

No, absolutely not. From the outside, analysts are seen to be imagining scenarios in which there is an explosion of the euro area. That underestimates the political capital that our leaders have invested in this union, as well as the support of European citizens. The euro is irrevocable!

Having formerly worked for Goldman Sachs, what do you think of the Libor scandal?

It undermines trust in one of the cornerstones of the world financial system. Just think that hundreds of trillions of euro of financial operations are based on the Libor and that in many countries all over the world people buy their homes with mortgages indexed to the Libor. The unspeakable personal behaviour and design flaws have shown once again a faulty governance of the process. Two inquiries are under way in the United Kingdom and in the United States, as well as an inquiry about the Euribor. They must shine a light on these matters.

Does your time at Goldman Sachs make you uncomfortable?

No, indeed, I value this experience of the world of finance and of the private sector. Obviously, there is much to do to rebuild the financial services industry after the crisis. Much has been done by the governments, by the regulators and by the industry itself, but much still remains to be done.

Heads of State and Government want to place the ECB at the heart of bank supervision. Are you in favour of this?

The European Commission is responsible for preparing proposals on this in consultation with the ECB and the European Parliament. The fact that the central bank plays a role in banking supervision has worked well at national level, particularly in France and Italy. If this role fell to the ECB, it would work with national supervisors, counting on their considerable experience and abilities.

Do you not fear a conflict of interest between monetary policy and this supervisory role?

Monetary policy must be kept separate from banking supervision so that the former is not contaminated by the latter. You can build an independent structure, and at the same time benefit usefully from information provided by supervision.

Would such a system have enabled the banking crisis in Spain to be avoided?

A centralised system is preferable to take account of the very high degree of financial integration that a monetary union entails. On the subject of Spain, the ECB has warned the country on several occasions not to let the current account deficit get out of control and has also warned of the excessive growth of credit. But in a monetary union, the fight against property bubbles stems from macro-prudential policies carried out at national level.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory Statement by Mario Draghi, President of the ECB, Brussels, 9 July 2012

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure to be back here in Parliament and in front of your Committee for our regular exchange of views.

Today, I will explain the decisions of the Governing Council of the ECB last week. I will then consider the actions taken by central banks around the world in response to the crisis. I will also discuss the economic adjustment programmes in euro area member countries, and close with some remarks on the longer term vision for EMU.

1. Economic and monetary developments

Last Thursday, the ECB's Governing Council unanimously decided to lower key interest rates by 25 basis points. This has brought the main refinancing rate to 0.75% and the deposit rate to zero. The policy decision took account of further dampening of inflationary pressures, as some of the previously identified downside risks to economic activity materialised.

On non-standard monetary policy measures, the Governing Council decided in June to continue conducting all refinancing operations as fixed-rate tender procedures with full allotment, at least until mid-January 2013. Measures were also taken to improve access of the banking sector to these operations by enhancing collateral availability.

Our measures, both standard and non-standard, support the transmission of monetary policy and the provision of credit to the real economy. They safeguard price stability in the euro area. And they help to reduce financing costs, supporting renewed confidence and sustainable growth.

The ECB remains committed to delivering on its mandate – and retains full capacity to act in a firm and timely manner.

Indicators for the second quarter of 2012 point to a weakening of growth and heightened uncertainty. But looking ahead, we continue to expect the euro area economy to recover gradually, albeit with dampened momentum.

Euro area annual inflation was 2.4% in June 2012, unchanged from May. Inflation should decline in the course of 2012 and be below 2% in 2013. In an environment of modest growth and well-anchored inflation expectations, underlying price pressures should remain moderate. This will restore purchasing power of wages and salaries.

Risks to this outlook are broadly balanced over the medium term: on the downside, they relate to weaker than expected euro area growth; on the upside, risks could stem from further increases in indirect taxes and higher than expected energy prices.

Our monetary analysis gives a picture consistent with price stability over the medium term. In particular, the underlying pace of monetary expansion remains subdued. Weak loan growth largely reflects the current cyclical situation, heightened risk aversion and balance sheet adjustments by households and firms, which weigh on credit demand.

2. Central banks' response to the crisis

Let me now turn to the first topic you asked me to address, the measures taken by central banks around the world in response to the global financial crisis. In a nutshell, I consider those actions to have been bold, forward-looking yet historically informed, drawing appropriate lessons from financial crises of the 20th century.

Central banks have cooperated very closely during the crisis: through an important coordinated interest rate cut in October 2008; provision of swap lines; continuous information exchange; and overall actions that have been mutually consistent. In particular, the overriding objective of medium-term price stability has never been lost from sight.

Both interest rate policy and non-standard measures have taken account of the prevailing specific circumstances: first, the financial and economic structure of each economy; second, the magnitude and specificity of shocks; third, the different operational frameworks of different central banks; and fourth, the different institutional settings in which they operate.

For these four reasons, comparisons across constituencies have their limits. What's more, comparison of the size of central banks' balance sheets may give a distorted picture of the extent of policy action. For example, in the Eurosystem, a significant part of the balance sheet is not related to monetary policy but to gold and foreign exchange reserves.

Therefore, the appropriate way to measure a central bank's actions is to do so in its own institutional and economic setting and against its own objectives.

For the ECB, those actions have been, and will continue to be, geared towards maintaining price stability in the euro area. This is our mandate, and our track record speaks for itself.

3. The ECB's role in adjustment programmes

Effective crisis resolution needs bold actions by central banks but it also needs bold actions by other policy actors, notably governments. This brings me to the other topic that you proposed: economic adjustment programmes and the role of the ECB.

In the aftermath of the crisis, a number of EU and euro area countries have requested financial assistance because of their challenged access to capital markets. At the same time, they have committed to implementing the reforms necessary to secure full market access in the future.

Since financial assistance can only be temporary, the quality of the reforms and their implementation are absolutely essential. It is this quality that ultimately determines the success of a programme.

The design and monitoring of programmes in the euro area is done jointly by the European Commission, the ECB and the IMF. The ECB provides input through its expertise, not least with respect to the financial sector but also with regard to country surveillance. Our experience with this set-up has been very good, and the cooperation with the Commission and the IMF has been excellent.

Today's economic environment obliges all countries to take a very critical look at their past – and it obliges all to take a very objective view of their future.

It is only against the background of the past that the adjustment programmes currently underway in several euro area countries can be understood. It was past economic developments and policies that led to excessive imbalances in a number of countries. And it was those imbalances – fiscal, macroeconomic and external – that were neither healthy nor sustainable.

Unsustainable imbalances provide the objective need for adjustment programmes – and the degree of the adjustment is directly related to the extent to which past policies were misguided.

Policy adjustment in the euro area takes place under market pressures, but less so than for countries outside the euro area because being part of monetary union shelters countries against some pressures, notably on the exchange rate.

But this does not mean that the degree of policy adjustment can be lower. The schedule of regaining full market access within a few years applies here too. Therefore, perseverance in bold and necessary reforms is crucial.

A critical success factor is ownership of the programmes by governments, parliaments and ultimately the citizens of the countries concerned. An essential precondition for ownership is that policy-makers communicate clearly about the economic rationale for adjustment. As I have suggested, this means taking a critical view of the past and an objective view of the future.

This process has started. Increasingly, national policy-makers make the case for reform strongly. They point to past developments in explaining the background of adjustment and now highlight the many beneficial elements of reforms. Some of these reforms improve fairness by combating tax evasion or rent-seeking by vested interests, and they improve the efficiency of the public sector.

National policy-makers are now increasingly making a central part of their objective the overall aim of EMU: to sustain economic well-being in the absence of major imbalances, and to generate sustainable growth in a competitive environment.

In my view, a great deal of progress is underway in this respect.

For example, the Irish authorities have maintained a strong track record for maintaining reform momentum throughout their programme. They have also taken important steps towards restoring the stability of the financial system.

In Portugal, programme implementation remains good and important progress has been made in such areas as the labour market, the housing market, the general competition framework, the judicial system and the transport sector. The Portuguese authorities remain fully committed to achieving this year's fiscal target.

The Spanish authorities too have shown that they remain fully committed to accelerating the structural reform agenda and putting the financial sector on a sound footing. They are also committed to improving external competitiveness to lay the foundations for more sustainable prosperity.

Even without programmes, many policy-makers are bold in reform. In Italy, for example, reforms to increase competition, reduce the administrative burden and increase labour market flexibility have been important measures. The country's spending review will help to achieve the fiscal targets.

Virtually all other countries are undertaking measures to improve fiscal solidity and the basis for sustainable growth without excessive imbalances. So despite the current challenges, countries' progress is strong and the fundamentals of the euro area as a whole are sound.

The euro area's fiscal deficit is declining towards 3% of GDP; price stability is ensured; and the external accounts have remained close to balance. All these are reasons to pursue reforms with a strong degree of confidence.

4. A longer-term vision for EMU

Why then do we still have tensions in a number of market segments? Let me first stress that a lot has been done at country as well as euro area level in terms of economic reforms and governance. But we need full implementation. We have to make clear that EMU is a union based on stability at national and aggregate levels.

Stability at national level means completing reforms to ensure sustainable growth without major imbalances. Stability at aggregate level means implementing the vision recently presented at the summit.

The central message of that vision is this: the euro is here to stay – and the euro area will take the necessary steps to ensure that.

In my view, the core of the report submitted by President Van Rompuy is the identification of four building blocks:

First, a *financial market union* that elevates responsibility for supervision of banks to the euro area level.

Second, a *fiscal union* that reinforces oversight of budgetary policies at the euro area level and also provides some fiscal capacity to support the functioning of the currency area.

Third, an *economic union* with sufficient mechanisms to ensure that countries can achieve sustained prosperity without excessive imbalances.

And finally a *political union* that strengthens the legitimacy of EMU among euro area citizens and deepens its political foundations.

These four building blocks are mutually consistent and coherent, and should be pursued in parallel. I am looking forward to the work on a roadmap that has started. In my view, three issues deserve particular attention:

First, we need to move towards a further sharing of sovereignty in the fiscal, financial and economic domains. There can be no shortcuts in establishing a sound and stable EMU.

Second, EMU is an integral part of the Treaty. This calls on all relevant bodies and actors to engage constructively on improving its functioning, not only at Union but also at national level. To call for an impeccable application of the Treaty and at the same time refuse closer union mentioned in Article 1 of the Treaty is inconsistent, to say the least.

Third, we need to accompany deeper euro area integration with significant progress on democratic legitimacy and accountability. There is no doubt that you and your colleagues – the members of the European Parliament, the directly elected representatives of the citizens of Europe – will continue to play a central role in the steps towards political union.

Thank you for your attention.

President's address at the 14th ECB and its Watchers Conference

Mario Draghi, President of the ECB, Frankfurt am Main, 15 June 2012

Ladies and Gentlemen,

It is a great pleasure to take part in this fourteenth edition of the ECB watchers conference – and the first I am attending as President of the European Central Bank.

As you are all aware, the ECB has the crucial role of providing liquidity to sound bank counterparties in return for adequate collateral. This is what we have done throughout the crisis, faithful to our mandate of maintaining price stability over the medium term – and this is what we will continue to do. The Eurosystem will continue to supply liquidity to solvent banks where needed.

In normal times, "adequate liquidity" may be defined as a volume of refinancing in line with the need for banks to meet the obligatory reserve requirements and the financing of other autonomous factors.

In times of increased financial instability, "adequate liquidity" indicates a volume of central bank money that also counteracts a temporary inability of banks to refinance in the market, which could lead to systemic consequences for the banking sector as a whole.

In my introductory remarks this morning, I will talk in a little more detail about the ECB's monetary policy. I will also discuss Europe's agenda for growth and issues relating to a longer-term vision of our economic and monetary union.

1. Considerations on monetary policy

Let me start with monetary policy.

There are two features I would like to highlight.

The first relates to the effectiveness of the three-year long-term refinancing operations (LTROs) that we launched a few months ago.

As you will recall, these operations were introduced in an environment where money market spreads had surged, liquidity had dried up and banks' access to market-based funding had eroded rapidly.

The uncertainty about market-based funding for banks – especially medium-term funding – was perhaps the most critical issue in that environment. It truly threatened to undermine bank lending and created pressures for a broad-based deleveraging.

A resulting credit crunch would have severely aggravated the slowdown in economic activity, hurt employment and given rise to acute downside risks to price stability.

We must always remember that over two thirds of external financing of firms comes from banks. This ratio is even higher for small and medium-sized enterprises, which account for about three quarters of corporate employment in the euro area.

It is against this background that we decided to launch the three-year LTROs.

Their objectives have been broadly met.

The April bank lending survey points to a marked decline in the net tightening of credit standards and a general improvement in banks' funding conditions. This evidence is supported by a range of market and other indicators. Overall, it confirms that supply side constraints on bank credit have been removed. This has been a very important result.

The full supportive impact of the three-year LTROs needs time to unfold, so it is too early to draw firm conclusions about the behaviour of a single variable – namely, bank credit to the private economy – that is influenced by a multitude of factors. In the current environment of very weak credit demand and heightened risk aversion, a rebound in the volume of credit will be particularly slow.

Yet granular balance sheet data indicate that in February and March, banks domiciled in stressed constituencies could interrupt and partly reverse the sustained decline in loans over the previous months. Indeed, smaller banks in some of those countries could increase their supply of loans.

Inflation expectations remain well anchored and there is no inflation risk in any euro area country. Financial market-based inflation expectations over a ten-year horizon are consistent with our definition of medium-term price stability. And should risks to price stability emerge, the Eurosystem has sufficient tools at its disposal to absorb excess liquidity.

The second point I would like to highlight as a way of understanding the ECB's current conduct of monetary policy is heterogeneity. The situation regarding economic growth is quite different across the euro area.

This is not the first time; we had clearly diverging cycles ten years ago. At that time, growth in Germany was very low and growth in other countries was buoyant. This is part of a normal degree of cyclical heterogeneity that we observe in very large continental economies. It is very similar to what we observe in terms of cyclical heterogeneity within the United States.

What is new in the current episode is the parallel fragmentation of financial markets. This first concerns the interbank market, which works almost exclusively on a national, collateralised and very short-term basis. It is also true for broader capital markets and private capital flows, where home bias is rising.

The prime reason for the current home bias is general risk aversion. In addition, we are very attentive in monitoring whether regulatory initiatives – including anticipation of future liquidity ratios – or initiatives from national supervisors are affecting this market, especially across borders.

We have partly responded to the fact of increased heterogeneity by allowing some national central banks to enlarge the collateral pool. This was essential to ensure sufficient outreach to the real economy in their constituencies in a context of significant heterogeneity. They could accept more direct credit claims, particularly to support credit to the small and medium-sized enterprises that are so important for investment and employment.

This collateral enlargement was crucial for addressing a situation of liquidity abundance in some countries and liquidity scarcity in others. The enlargement has taken place with prudence and its risk management framework is overseen by the Governing Council.

While the process will take time, the restoration of adequate credit flows and the renewed functioning of the interbank market remain our firm objectives.

2. Europe's growth agenda

Let me now turn to the European growth agenda.

Strengthening the growth potential of our economies is crucial.

We have a whole range of pending reforms at the national level: the liberalisation of product markets; the removal of bureaucratic impediments to entrepreneurial activity; greater labour market flexibility, which facilitates the re-entry of the unemployed into the job market; and a growth-friendly composition of fiscal adjustment. Let me elaborate a little.

Product market regulations can be streamlined so as to foster competition, particularly in sheltered professions and the services sector. Extensive administrative reforms should facilitate the start-up of new firms. Moreover, judicial systems can be adjusted so as to resolve and avoid court backlogs, which hamper the conduct of business activities. Once a critical mass for such reforms is achieved, they will considerably strengthen economic dynamism, innovation and employment.

These efforts should be complemented by active labour market policies, targeted at the low-skilled, the elderly and young unemployed people. This would facilitate re-entry into productive activities for those who typically face the most difficult starting position. It would also foster social cohesion despite the burden of economic adjustment facing our economies.

Second, important reforms are pending at the EU level, with the implementation of the Services Directive being a very important initiative to facilitate cross-border trade in services. By reducing the market power of producers, these reforms will put downward pressure on prices and upward pressure on productivity.

Third, I believe that we should oversee national reforms to promote growth in a way that is a parallel to the way in which we oversee fiscal policies. Here we might draw inspiration from the fiscal compact and the idea of avoiding unsustainable policies in the first place and providing incentives for positive reform. In a single currency area, national reforms that affect growth potential and competitiveness are just as important as fiscal policies because they are equally essential for economic sustainability.

Fourth, many items that are considered at the national level could be considered at the EU level. For example, measures to foster labour mobility could be implemented, inter alia by facilitating the cross-border portability of pension rights. European funds could be reallocated to areas most conducive to long-term growth and durable employment opportunities. And the capacity of the European Investment Bank to finance infrastructure projects could be strengthened.

As you can see, there is a long-standing agenda on growth. It is time to implement it with determination and confidence about its longer-term benefits.

Collectively we can compete more effectively in the global economy. Collectively we can better support growth and job creation. And collectively we can preserve our common European values of fairness, social cohesion and social progress.

3. Considerations regarding the longer-term vision for economic and monetary union

Let me turn to the broader question about the evolution of the euro area towards a genuine economic union – one that is commensurate with our monetary union.

As you know, I am in close contact with Presidents Herman Van Rompuy, José-Manuel Barroso and Jean-Claude Juncker to reflect on elements of a longer-term vision for our economic and monetary union. Ultimately, such a vision can be the basis for a process where objectives, progress, conditions and deadlines are specified; and where credibility is substantiated by action in the short run that is in line with long-term objectives.

Since this is a joint effort and our work is still in progress, I cannot provide specifics about this matter as yet.

But I can tell you that my reflections are founded on the central aim of securing stability and sustained prosperity for the euro area.

Price stability will remain a cornerstone of economic and monetary union, as it has been since the beginning. But in order to preserve broader economic stability, we need strengthened foundations in the fields of financial, fiscal and structural policy-making.

The strengthened foundations should secure the past achievements of integration. They should improve the management of the euro area economy. And they should bring economic and monetary union closer to the hearts and minds of Europe's citizens, whose ownership of our collective project of integration has been shaken by the crisis.

A key issue in this context is sovereignty.

In processes of economic integration, we often speak about giving up sovereignty. Yet integration is far from being equivalent to giving up sovereignty. There are many cases in which integration implies a “sharing” or “pooling” of sovereignty. And there are some cases where integration actually leads to more sovereignty and at a higher level.

For example, some smaller euro area countries actually regained sovereignty with the euro by regaining influence over monetary policy at a higher level.

Something similar may hold for countries joining the EU, when they can participate in the shaping of the single market rules rather than having to adjust to them. In a globalised economy, the dwindling of individual influence may actually be reversed through integration.

Of course, this is only true if countries and their citizens are involved in joint decision-making. The degree of participation is therefore much more important than the level of policy assignment to determine whether sovereignty is lost, shared or actually gained.

In the case of Europe, more and more decisions have been elevated to a supranational level because they could only be taken efficiently and effectively by accounting for interlinkages and spillovers. But at some point, when supranational institutions and processes continually gain influence, the need for greater political legitimacy becomes more and more pressing.

In some cases therefore, the first issue to consider with any possible further transfer of competencies would be the transfer of legitimacy through political accountability. If legitimacy is fully ensured at all levels, the policy assignment question can be answered on grounds of policy optimality.

Conclusion

Let me conclude.

As half a decade of crisis has forcefully demonstrated, macroeconomic and financial imbalances entail considerable challenges for the smooth functioning of our economic and monetary union.

Despite these challenges, our monetary policy framework, which is firmly anchored in central bank independence and a clear focus on price stability, has provided a robust basis for the ECB to deliver on its mandate. By preserving an unambiguous commitment to price stability, the ECB has made its best contribution to mitigating the fallout from the crisis. This commitment will continue to guide our policy in the time to come.

Thank you for your attention.

A route for Europe

Address by Mario Draghi, President of the ECB at the day in memory of Federico Caffè organised by the Faculty of Economics and the Department of Economics and Law at the Sapienza University Rome, 24 May 2012

A teacher, says Eco, “ *teaches that everyone must become individual and different*”. [1] Professor Federico Caffè, albeit with a coherent vision and deeply held convictions, was a teacher. He taught his students to think for themselves and did not pass on a binding creed. He helped his students – economists, thinkers, servants of the state and of the institutions, alert citizens – to discover themselves.

I’ll start with the subject which, without a doubt, was the most precious to Caffè, namely welfare. Probably nothing in his intellectual heritage is more topical than this painful protest of his: one cannot, he would say, “ *accept the idea that an entire generation of young people should consider themselves as having being born at the wrong time and having to suffer job insecurity as an inevitable fact*”. [2]

Work: a European matter

" *Full employment is not only a means of increasing production..., it is an end in itself, since it leads to overcoming the servile attitude of those who find it hard to obtain a job opportunity or live in constant fear of being deprived of one. In other words, the benefits of full employment are considered as well, and above all, in terms of human dignity.*" These words of Caffè do not surprise those who knew him and those who have read his works. They express the fundamental inspiration of his professional and public life: it is a duty of economic policy to act so that the economy can get as close as possible to full employment.

In 1975, he formulated it more precisely: " *The goal of dignified work for all, however, is not compatible either with situations of privilege, which have now become destabilising, nor with excessive labour and social security rights, which results in job opportunities evaporating away*" . The issue that Caffè raises here is one of fairness. We find it again today: the international crisis has affected everyone, and young people especially.

In the European Union, between 2007 and 2011 the unemployment rate rose by 5.8 percentage points among the 15-24 year olds, by 3.5 points among the 25-34 year olds and by 1.8 points in the 35-64 age range. Qualitatively, the profile is similar almost everywhere; the clear exception is Germany, where the unemployment rate among 15 to 24 year olds in the first quarter of 2012 was 8%; in Italy it was 34.2%, in Spain 50.7% and the euro area average was 21.9%. These trends reflect a fundamental question: they confirm the particular vulnerability of this essential part of our workforce. The unequal sharing of the "cost of flexibility", only affecting young people, an eternal flexibility with no hope of stabilisation, leads among other things to companies not investing in young people, whose skills and talents often decline in jobs with low added value. The underuse of their resources reduces growth in various ways: it makes the creation of start-ups less likely – and they are on average more innovative than others – it causes a decline in skills in the long run, slowing down the assimilation of new technology and acting as a brake on efficient production processes. In addition to undermining society's sense of fairness, it is a waste that we cannot afford.

I think it's essential to ask how economic policy conducted in various Member States has done its duty in the way desired by Caffè.

Social progress is one of the key objectives of the European integration process: " *The Union shall work for the sustainable development of Europe based on balanced economic growth and price stability, a highly competitive social market economy, aiming at full employment and social progress … It shall combat social exclusion and discrimination, and shall promote social justice and protection, equality between women and men, solidarity between generations and protection of the rights of the child*".

(Article I-3 of the draft European Constitution). Welfare is not only a remedy for the failure of insurance markets, but also a tool to promote inclusion, solidarity and a sense of fairness.

In the three post-war decades (the so-called "Golden Age"), which especially in Europe were marked by high growth rates, use of advanced technologies, high growth employment, stable lifetime employment, welfare started to emerge, at different times and on different scales depending on the country, as an integrated system that protects its citizens from significant risks.

The European model redistributes many more resources for social purposes than the US and Japanese systems: on the eve of the crisis, the total expenditure on pensions, unemployment benefit, for children and families was, in relation to GDP, more than twice that of the US and Japan. This can take different forms as regards the composition of social policies and the degree of labour protection. In Italy, with an overall welfare spending ratio of GDP in line with that of the rest of Europe, spending on support for the unemployed, for households, particularly those at risk of falling into poverty, is at a level less than half that of elsewhere in Europe, while spending on pensions is significantly higher. The weakness of the "social shock absorbers" is that relatively high job protection for those in employment is accompanied by weaker protection for those out of work, contrary to what happens in the Nordic models, where the so-called "flexisecurity" combines an extensive social safety net with less job protection.

In some countries, even if, 40 years on, the assumptions of that model are still valid, reflections on it began some time ago.

Structural factors have changed the context within which the European social model operates: the growing competition from emerging countries, the reorganisation of production processes on a global basis, the speed of innovation, the increasing fragmentation of career paths with ever looser ties to a "permanent position", the greater instability of families, declining fertility, the prospective decrease in the workforce, an ageing population. The set of risks faced by individuals throughout their life has changed significantly.

The social protection systems are therefore constantly evolving; substantial corrections have taken place in recent years in many countries, including France, the United Kingdom and Germany, the country where the reform process began a

decade ago. In Italy, the recent pension reform which approves the full transition to a contribution system completes the necessary correction of the pension spending dynamics which was started years ago. As Germany shows very well, large and effective welfare systems can be made more efficient without compromising social goals.

We are living at a critical juncture in the history of the Union. The sovereign debt crisis has exposed serious weaknesses in the institutional framework; in this context, the difficulties in finding common solutions are having a negative impact on market valuations. The extraordinary measures taken by the ECB have gained us time; they have preserved the functioning of monetary policy.

But we have now reached a point where European integration, in order to survive, needs a bold leap of political imagination. It is in this sense that I have referred to the need for a "growth compact" alongside the well-known "fiscal compact".

A growth compact rests on three pillars and the most important one, from a structural viewpoint, is political: the economic and financial crisis has challenged the myopic belief that monetary union could remain just that, and not evolve into something closer, more binding, into an arrangement whereby national sovereignty on economic policy is replaced by the Community ruling. If the governments of the Member States of the euro define jointly and irrevocably their vision of what the political and economic construct that supports the single currency will be and what the conditions to reach that goal together should be. This is the most effective answer to the question everyone is asking: "Where will the euro be in ten years' time?".

The second pillar is that of structural reforms, especially, but not only, in the product and labour markets. The completion of the single market and the strengthening of competition are crucial for growth and employment. Labour market reforms that combine flexibility and mobility with a sense of fairness and social inclusion are essential.

Growth and fairness are closely connected: without growth, and the events of recent months also reflect this, the temptation to "circle our wagons" gains strength, and solidarity weakens. Without fairness, the economy breaks up into multiple interest groups, no common good emerges as a result of social and economic interaction, and there are negative effects on the capacity to grow. Recent Italian history has no shortage of examples.

These reforms have long been indispensable in a global economy very different to the one which witnessed the creation of the institutions still operating today. In the political structure that will emerge from the crisis it is likely and desirable that for these reforms a system of European rules will be introduced similar to that for the fiscal compact, a discipline leading over time to the European harmonisation of objectives and tools.

The third pillar is the revival of public investment: the use of public resources to push forward investment in infrastructure and human capital, research and innovation at national and European levels. (The proposed strengthening of the EIB and the reprogramming of Union structural funds in favour of less-developed areas go in this direction).

Thus, a growth compact complements the fiscal compact, because there can be no sustainable growth without orderly public finances. In this regard I have noted on other occasions the extraordinary progress made by all governments of the euro area in terms of fiscal consolidation, but, once the emergency is overcome, they need to make improvements by cutting current spending and taxation.

Let me now consider some issues more directly related to the ECB's monetary policy and action.

Objectives and instruments

The first issue involves the relationship between objectives and instruments of economic policy in a macroeconomic reference model that changes over time. For Caffè, one of the first scholars of Frisch and Tinbergen, the optimal allocation of tools and objectives occurred in the reference model prevalent in the 1970s, in which the goal of economic policy was to make best use of the available resources, in particular full employment. In pursuit of this goal, monetary policy was subordinated to fiscal policy, with an ancillary role for the central bank vis-à-vis the Treasury. The reference macro-model was based on a static mechanism of elaborating expectations, which were formed by extrapolating from past observations to the future. This mechanism amplified the immediate effect of public spending on aggregate demand. Monetary policy – in charge of credit conditions – was entrusted with the task of alleviating, through a careful policy of accommodation, the impact that government borrowing would have exerted on the cost of private debt. The central bank was financing the Treasury by creating money. Under these conditions, an increase in public spending could "add demand" – where this would be lacking for the goal of full employment – without taking away resources from other uses.

Since then, the theory of economic policy has followed two paths that have led it to invert the ranking of relative potential of tools and to enhance the definition and measurement of the objective.

As for the instruments, a different theory of the formation of expectations – no longer extrapolative – has highlighted the strong impact of monetary policy and has weakened the expected effects of fiscal policy. In the models that we use today, agents, when formulating their expectations, are attentive to the sustainability conditions of the choices in the long term. Economic policies deemed unsustainable in the long run are ineffective. For example, an active deficit-financed fiscal policy is limited by fears about the government's ability to refinance the debt from which that policy originates. These fears may lead to behaviours that weaken the private sector – or, at worst, completely neutralise – the impact of public spending as a means of controlling demand. Monetary policy, by contrast, is strengthened by this. Acting through the expectations channel, it can have a lasting effect on the expected flows of financial revenue. Affecting the real rate of intertemporal discount, it can deeply affect decisions on savings and consumption.

The definition of the objective is now wider. Price stability has become an essential parameter in defining and measuring prosperity. From taking a relaxed approach to inflation and considering it secondary, nowadays low and predictable inflation is a pre-eminent criterion of economic performance. Why? High inflation hits savings – and therefore investment and future consumption – with a tax on real returns that rewards the risk of uncertain inflation. Low inflation, however, frees up resources that individual choices can allocate to increasing the fixed capital. A policy that neglects inflation gradually destabilises the economy. The costs of uncertainty about the value of the money, initially unimportant, then overlooked, subsequently become evident, and then are judged intolerable. At that point, voters express a strong preference for policies that promise rapid disinflation. But such policies impose high costs in terms of job losses, which have to be included in the dynamic calculation of the costs of inflation. Also, it should not be forgotten that inflation affects the poor more than the rich, and is therefore a tax on the weaker members of society.

Under the influence of the neo-classical synthesis of Samuelson and Solow, the long-term correlation between inflation and growth was perceived as positive in the early 1970s: a slight increase in inflation would have led – within limits – to an increase in employment and growth. [3] But by the end of that decade, studies by Bob Lucas and Tom Sargent were to show that long-term inflation and growth are not correlated. [4] Monetary policy, while very effective in the short term, only affects inflation in the medium and long term. It is, in other words, neutral.

Today, new models and advanced computational techniques allow us to simulate the effects of inflation on incentives to save and to work, on the formation of physical capital, and therefore on the prospects for growth. The correlation has become negative: higher inflation reduces growth and employment. For example, vector autoregressive models with non-constant parameters allow the identification of a range of values that quantify the cost in terms of growth failure for every two percentage point increase in steady-state inflation. This cost implies lower growth of between 3 and 5 percentage points over a period of ten years.

Finally, monetary policy is a powerful tool. When used improperly, it may cause permanent damage. But it can become an effective, stabilising factor and contribute to collective prosperity in an independent and active way. The *sine qua non* for this is to build monetary policy decisions into a systematic and predictable strategy, based on price stability, which drives expectations and guides the economy but doesn't shock it. This is perhaps the most important practical difference to what was studied in the early 1970s.

The ECB's monetary policy strategy

The ECB's monetary policy strategy is based on the new theory of the instruments I have tried to outline, and takes into account the enrichment of the theory of objectives, which emphasises the contributions of price stability to the "general prosperity". It also provides continuity for a monetary tradition in continental Europe that has ensured inflation-free growth for more than 60 years.

The strategy is based on the objective of " *maintaining price stability*" that the Treaty has entrusted to the central bank and the quantitative definition that the Governing Council subsequently gave the objective. The studies I have mentioned helped to define a range within which inflation is no longer a factor that distorts economic choices. The ECB pursues, as an objective of monetary stability in the medium term, an inflation rate below, but close to, 2%, which is the upper limit of this range.

The macroeconomic model on which the ECB's monetary policy strategy rests is imbued with contemporary macroeconomics, based on dynamic optimisation and on the centrality of forward-looking expectations. [5] At the same time, the model is broader and well structured and corrects the simplifications of the pre-crisis neo-Keynesian paradigm with its prescriptive approach to optimal monetary policy.

The weakness of this paradigm was, and is, its inability to recognise the importance of financial frictions and the role of credit and money. This has to do with the fragility of the theoretical foundations that formalise the links between the real economy, financial imbalances and the level of confidence. Ignoring money is tantamount to assuming an absence of risk and uncertainty. Without risk, Keynes would have said, there would be no money. The preference for liquidity is not justified in an economy without uncertainty. But the neo-Keynesian model excludes the possibility of default. In it, risks in the financial sector can be isolated and therefore have no effect on the real economy.

The financial crisis has clearly highlighted the weaknesses of this system. Macroeconomic theory has begun to reflect on the neo-Keynesian system and these studies are now one of the liveliest areas of analysis. These studies – at least their early results – confirm the farsightedness of some of strategic choices of the ECB. Liquidity, money, credit have always been – since 1998, when the Bank received its mandate from the founders of the monetary union – qualifying variables of the ECB's reference model and its strategy. The monetary analysis requires a constant monitoring of banks' assets and liabilities as sources of information on the assessment of risk in the markets and the economy as a whole. This analysis commits the Governing Council to adjust the tenor of monetary policy to ensure the long-term growth of monetary aggregates and credit consistent with the potential for economic expansion.

In this sense, the monetary pillar of the strategy can be interpreted as a strategic reinforcement that helps to prepare correction mechanisms in situations where macroeconomic imbalances are having difficulty in manifesting themselves in inflationary pressures.

The monetary analysis gave important warning signals in the years preceding the crisis regarding the existence of deep macroeconomic and financial imbalances. In the autumn of 2005, in conditions of inflation observed and projected to be "normal", the ECB's monetary analysis began to record a change in the composition of M3 growth: from a model of growth explained by money demand factors – that we would define as irrelevant to the evolution of spending and prices – to a dynamic associated with increased credit creation – that is, to banks' money supply factors. These changes were accepted as indications that the tenor of monetary policy, despite the moderation of inflationary pressures observed and projected, had become too lax. A new cycle of monetary policy tightening was initiated in December of that year, based on considerations inspired by the monetary pillar, where monetary and financial stability is an intermediate objective for attaining a more balanced development of macroeconomic variables and hence price stability over the long term.

In a globalised world, the international financial crisis has not spared the euro area. But today we know that preventive action by the ECB, implemented mainly by considering monetary indicators, has mitigated the impact on incomes and inflation. [6]

The two operations of three-year refinancing (LTROs)

The monetary analysis has also been an essential strategic tool in diagnosing and managing the crisis. In this regard, the analysis that led to the more recent non-standard monetary policy measures can illustrate how the systematic monitoring of banks' liabilities – money in its broadest sense – can provide guidance on the risks faced by the economy as a whole.

Towards the end of 2011, with a decision unprecedented in the history of the euro, the ECB's Governing Council decided to conduct two three-year refinancing operations. At the end of February, or when the second three-year operation was completed, the net increase in loans granted to counterparties was around €520 billion.

The motivation for the two operations can be summarised by the following strategic view. A central bank is mandated with the crucial task of ensuring the sufficient supply of liquidity to sound bank counterparties in return for adequate collateral. In normal times, "sufficient liquidity" means a volume of refinancing in line with the need for banks to meet the obligatory reserve requirements and the financing of other independent factors which explain the growth over time in the demand for money. In times of increased financial instability, "sufficient liquidity" indicates a volume of available central bank money which avoids the risk that – under such market conditions – the temporary inability of banks to provide refinancing leads to insolvency and thus to a situation of widespread default.

In neither of the two cases – normal times or crisis periods – can the central bank be considered responsible for the survival of bank counterparties that are close to bankruptcy.

The two long-term refinancing operations achieved the purpose for which they were intended. In an environment of a near-shutdown of private credit markets, banks were not able to refinance their assets and were unable to maintain their level of exposure to households and businesses. The extensive long-term refinancing allowed for the partial and temporary substitution of private credit with central bank money and thus avoided a disorderly process of credit to the economy running dry.

Nevertheless, these operations were not without their criticism. These can be summarised in three points:

1. The growth in liquidity following the two operations will ultimately lead to inflation;
2. The Eurosystem's balance sheet is exposed to unprecedented and uncontrollable risks;
3. Such operations have reinforced the perverse link between banks and sovereign debtors and may be considered a violation of the prohibition of financing public debt with central bank money, laid down in Article 123 of the Treaty. And, the opposite – but conceptually equivalent – criticism that these operations did not provide the economy with finance.

As regards the first point, it is again pertinent to refer to strategy: in the medium to long term, the inflation dynamic reflects developments in broader monetary aggregates. Conditions that encourage the creation of inflation or speculative bubbles are generated by strong and sustained growth in money and credit, not necessarily as a result of an increase in liquidity granted by the central bank to the banking sector. This liquidity constitutes a precautionary supply for sight liabilities that the banks have towards households, non-financial corporations and other banks. The sight liabilities, i.e. deposits, and not the supply of liquidity, demonstrate a high statistical correlation to the price dynamics of goods and assets.

Today, monetary developments do not allow for the identification of risks of inflation or pressure on asset prices in the medium term.

As regards the second point, the main criticism related principally to the expansion of collateral accepted by the national central banks of the Eurosystem as a guarantee in return for liquidity extended to credit institutions. In particular, doubts were raised regarding credit claims that became eligible with the decisions taken in December 2011.

These doubts are founded on an incorrect understanding of the guarantees that are requested by the national central banks to protect against the risk that central bank liquidity is not repaid. In particular, the discount applied to the nominal value of credit claims provided as security in refinancing operations is very high. This means that, for credit claims deposited as collateral with a nominal value of €100, the national central banks accepting the new collateral provide, on average, the equivalent of around €47 in liquidity. This discounting represents a powerful method for absorbing the credit risk involved in such operations. It is also worth highlighting the fact that the main elements of risk control continue to be shared by the Eurosystem: the criteria for acceptance and measures for controlling risk are approved by the Governing Council, which is also responsible for the continuous monitoring of the effectiveness of all of the measures for mitigating risk.

With regard to the third point, it is undeniable that, in some countries in particular (especially Spain and Italy), banks used some of the liquidity acquired via the three-year long-term refinancing operations for temporary investments in government bonds.

Today, central banks do not have an instrument for the precise and targeted allocation of credit to a sector or in favour of a specific financial use. Those who accuse the ECB of an indirect violation of the prohibition on financing public debt with central bank money are making the same conceptual mistake as those who accuse the ECB of not having forced the banks to the use the funds acquired via the LTROs to supply credit to the private sector. In the first case, banks would have had to have been forced not to purchase government securities, and in the second case, to give credit to the private sector. Both groups of accusers forget that the policy of precise allocation of credit was a norm in various countries until the end of the 1970s. In the 1980s the operational system for monetary policy was radically redefined, principally on account of the heavily distorting effects of such an operational framework on economic activity. Moreover, legal arguments relating to the Treaty and to the current contractual form of repos underlying the LTROs, as well as considerations relating to feasibility, would make it difficult to reinstate such a framework. Finally, the behaviour of credit institutions with respect to households and businesses is not uniform across countries: while some countries saw negative credit developments, others saw growth in credit, in some cases even significant growth.

In Italy, but also in the vast majority of euro area countries, the fall in loans recorded in December has come to a halt, avoiding a much more severe risk of credit restriction which would have had far more serious consequences for growth and monetary stability than the ones we are seeing currently. The Bank Lending Survey registered a gradual normalisation of interest rates set by banks and of the criteria for granting loans to companies. The continued anaemic developments in lending reflect the weakness in demand and the worsening of creditworthiness resulting from an adverse economic cycle. Furthermore, in the countries most adversely affected by the crisis, banks are rationing credit on account of certain prevalent contractual structures.

The large-scale participation in the February operation, in which around 800 banks obtained funding, and the composition of counterparties in terms of their size and type implies that the distribution of liquidity has been widespread and could be even more so in the near future. Furthermore, this widespread distribution of liquidity is also of advantage to small and medium-sized enterprises with which smaller banks have closer relationships. We would wish for the liquidity provided to end up as credit to the private sector. This is the motivation behind the new non-standard monetary policy instrument.

Central bank credit to banks has been a complement to – rather than a substitute for – private credit: in the first quarter of this year, the amount of bonds issued was equal to the total issued in 2011 as a whole, which shows that the operations, at least in the first few months of the year, provided the markets with liquidity, reactivating a number of credit channels. The two LTROs removed one of the obstacles – the only one over which the ECB has any influence – to credit, namely a lack of liquidity. The ECB cannot do anything to make up for a lack of capital, to change intermediaries' risk perceptions, or to remove other structural obstacles present at national level. More generally, the size and complexity of the two LTROs is such that it will take time for all of their positive effects on the euro area economy to be

fully felt. However, it is essential for growth and employment that credit institutions regain their ability to provide refinancing to the economy.

Monetary Policy in unconventional times

Introductory remarks by Mario Draghi, President of the ECB, at the ECB colloquium held in honour of José Manuel González-Páramo, Frankfurt am Main, 16 May 2012

Ladies and Gentlemen, Dear José Manuel,

It is my pleasure to welcome you here today on the occasion of this colloquium on "Monetary Policy in unconventional times". It is held in the honour of José Manuel González-Páramo to mark the end of his eight-year term as Member of the ECB's Executive Board.

The topics of today's colloquium are not only of great relevance, but I believe also very close to your heart, José Manuel, as they reflect two of the main areas which you have dealt with during much of your career:

The first topic concerns the experiences gained with the ECB's non-standard measures and monetary policy during crisis times. José Manuel was closely involved in shaping these measures during his time at the ECB, having been in charge of monetary policy operations for several years, also prior to the financial crisis.

José Manuel joined the ECB in times that seemed very different from today. Financial markets seemed to work rather efficiently in an environment of low volatility and seemingly little risk. Liquidity was distributed by stable and efficient interbank markets at (almost) uniform prices throughout the euro area. The operational framework served well its purpose of transmitting the decisions by the Governing Council on policy rates to market rates. Monetary policy relied on standard monetary policy operations. Money market rates were quite stable and close to the ECB's main refinancing rate, with fluctuations in money market rates being within a few basis points.

How times have changed! Over the past few years, a number of standard and non-standard measures have been implemented as the Eurosystem's response to the dysfunctions in money markets caused by the financial and sovereign debt crises. You have been involved in the design and the implementation of these measures in all phases of the recent crisis: in the early phases, the ECB mainly responded to the crisis by adjusting the timing of its liquidity provision and the lengthening of the maturity of its open market operations, which helped to stabilise short term rates in an environment of high volatility and extreme distrust.

Later on, we dealt with the design and the launch of longer-term refinancing operations, the adjustment of the collateral framework, and the various purchasing programmes that were necessary to maintain an efficient transmission mechanism of monetary policy throughout the euro area.

At the same time, for several years you were overseeing the ECB's research department, which contributed with in-depth analyses on related topics, such as the effects of non-standard measures, or monetary policy around the zero lower bound. All this was achieved with the input, great effort and expertise of you and your staff.

I hope that the interventions in the first half of today's colloquium will provide us with some important insights on the effects of these measures and relationship with standard monetary policy.

The second topic of today's colloquium will look at the interaction of private and public debt, deficits and monetary policy. As Professor of Economics from the Universidad Complutense in Madrid, José Manuel had of course already dedicated a lot of thought and work to these issues prior to the start of his career as a central banker. In fact, José Manuel headed the Public Finance Department of the Universidad Complutense for many years and has published numerous important academic articles in this area and a reference university textbook on the economics of the public sector. He has also played a leading role in many of the most prestigious academic journals on economics and public policy in Spain. He also helped lead the work of the prestigious Centre for Monetary and Financial Studies in Spain better known as the CEMFI Foundation of which he was an Executive Board Member.

José Manuel was able to combine his depth of academic knowledge and experience with a brilliant career as a central banker in Banco de España. This background and wealth of experience proved to be an invaluable asset after he joined the Executive Board and Governing Council of the ECB in June 2004.

One can say that José Manuel had foreseen some of the pressing problems of the euro area today: the need for tax reforms and fiscal consolidation, the issue of sustainability of fiscal reforms and economic growth, to name a few. You have asked the question how to achieve permanent reductions in public deficits in order to achieve fiscal reform, pointing to the reduction of structural public expenditure. You have also asked the question on regional divergences in the euro area, pointing to the need for structural reforms.

Some of these topics are now at the forefront of the questions that European policy makers are confronted with, how to reduce fiscal and macroeconomic imbalances, how to achieve growth, and how to combine these goals with the necessary fiscal discipline that serves to balance the interests among the present and future generations.

Important steps have been taken on the European level as regards the implementation of fiscal rules and consolidation measures. The euro area general government deficit has declined significantly; public debt should stop rising next year and decline thereafter.

The extent of the progress on this front is insufficiently acknowledged and worth noting. Everywhere governments have undertaken significant and difficult reforms and continue to do so. Although more work is certainly needed, we should appreciate how quickly things improve when serious action is taken.

To foster employment and growth policy makers have to address macroeconomic imbalances in the euro area. While monetary policy will continue to ensure price stability in the euro area as a whole and cannot address inflation rates in individual countries, relative competitiveness adjustments can and need to occur at the country level. These adjustments need to be driven by national policies. The countries that experienced unit costs systematically above the euro area average and lost competitiveness will have to regain competitiveness. This can be achieved through a combination of cost moderation – including in some specific cases of past excesses, decisive adjustments – productivity gains and technological change.

In this process, they should experience unit costs below the euro area average – possibly for a sustained period in case of large earlier competitiveness losses. The ECB's focus on price stability in the medium term for the euro area will contribute to an anchoring of longer-term inflation expectations in all countries.

Before concluding, let me comment briefly on the difficult situation in Greece. Since the Treaty does not foresee anything on exit, this is not a matter for the ECB to decide. While the ECB will continue to comply with the mandate of keeping price stability over the medium term in line with Treaty provisions and preserving the integrity of our balance sheet, I want to state that our strong preference is that Greece will continue to stay in the euro area.

Dear José Manuel, you joined the Executive Board of the European Central Bank 8 years ago, in 2004. Since 2006, we were both members of the Governing Council, and I still recall extensive meetings in which José Manuel presented to the Governing Council one item after another on a very wide variety of subjects – ranging from the implementation of monetary policy to the new series of banknotes or to complicated statistical and risk-management issues – with the same degree of commitment and full command of the most technical details.

And of course we became even closer colleagues last fall when I moved to Frankfurt to join the Executive Board. It is with warmth and admiration of your professional skills and congenial nature that I look at our common experiences.

Having now nearly completed your full term as ECB Executive Board member, you have witnessed the financial and sovereign debt crises from the start. Even though we will welcome a new highly experienced member to this team in a few weeks' time, we will greatly miss your personal experience and judgement.

Ladies and Gentlemen, let me close by wishing you a very interesting colloquium. We have highly distinguished speakers from Europe and overseas, and I look forward to some interesting discussions.

Thank you.

Address at the event marking the first signatures to the T2S Framework Agreement

Mario Draghi, President of the ECB, Frankfurt am Main, 8 May 2012

Ladies and gentlemen,

I am very pleased to welcome you to Frankfurt today on the occasion of the signing of the T2S Framework Agreement by a first group of central securities depositories, or CSDs.

T2S is an important project for the Eurosystem and for Europe. It is a key component of the European market infrastructure, and the Governing Council of the ECB remains committed to delivering it.

I fully share this commitment, and I am glad to be here today representing the Eurosystem, together with fellow Governor Visco, and other colleagues from National Central Banks. Allow me to thank them for taking the time to be here with us.

I joined the Governing Council as Governor of Banca d'Italia in early 2006, and it was around that time that we started discussing T2S. It was in July 2006 that we decided to consult and involve European CSDs and market participants, to ensure that T2S would fulfil the needs of the market.

The main reason for the Eurosystem to embark on this project was to address the costly fragmentation of securities settlement market infrastructure, and to achieve greater technical harmonisation in the European securities settlement market. T2S allows for efficient and integrated securities settlement.

The fundamental objective of T2S is to contribute to making Europe a better place to invest, by fostering a single market in post-trade services. It will make financial markets safer and more efficient, and it will increase transparency in the post-trade environment.

Ultimately, investors will benefit from lower cross-border transaction and liquidity costs and from better investment possibilities. Issuers will benefit from deeper and more diversified sources of funding.

T2S is important for Europe. It will be a major contribution to the strengthening of the Single Market.

The Single Market has already brought many benefits, which are, at times, forgotten or taken for granted.

It is during times of crisis that we should not allow our commitment to the cause of further market integration to fade. It is during difficult times that we should remember the importance of cooperation and coordination.

There has been much progress towards further integration in recent years. The most visible example was the adoption of the Single Market Act in April 2011 by the European Commission. A Single Market Act II will follow by the end of this year. But there are many other ongoing initiatives, some of which had been started even before the outbreak of the financial crisis.

Europe's new supervisory structure has been developed in acknowledgement of the fact that the financial system of the EU is now very much interconnected, and the externalities arising from it are no longer confined to the national level. There is also a comprehensive set of new legislation which aims to reform financial market regulation, covering not only the trading level, but also – for the first time – the infrastructure for clearing and settlement.

All these initiatives aim to create a level playing field in Europe, to remove barriers to competition, to facilitate cross-border business, and ultimately to strengthen the process of financial market integration.

However, we should not forget that financial market integration needs to be complemented and supported by the integration of the underlying infrastructure. The Eurosystem's most fundamental contribution to integration in this field is the creation of T2S.

T2S is therefore part of this important integration process. It brings to it an operational dimension. It provides the integrated infrastructure necessary for creating a single market for settlement services in Europe.

For this reason, the European authorities, and in particular the ECOFIN Council, have expressed their support for this project on more than one occasion.

Today's event is therefore not only important for the market participants involved, but also for Europe.

I would like to warmly congratulate the CSDs that are here with us today and have signed the T2S Framework Agreement. Without your valued support and active participation, T2S would simply not have been possible.

I would also like to congratulate all those involved in the governance of T2S. It is thanks to the combined efforts of all the T2S governing bodies that we have been able to reach this milestone in the project.

Today's signing of the T2S Framework Agreement will mark the start of an entirely new phase of the project. From now on, the Eurosystem and the CSDs will be even more closely united in this mutual enterprise. The staff of our respective organisations will increasingly need to work together – like a single team – for the success of T2S.

The time between now and the launch of T2S will pass by quickly. Much has already been achieved, but much of the hard work still lies ahead.

I am confident that our common T2S endeavours will continue to be a success, and I look forward to continuing our cooperation with the CSDs and with market participants.

Thank you very much for your attention.

Welcome remarks at the ECB-EC conference on financial integration and stability

Speech by Mario Draghi, President of the ECB, at the ECB-EC conference "Financial integration and stability: towards a more resilient single financial market" Frankfurt am Main, 26 April 2012

Ladies and Gentlemen,

On behalf of both the ECB and our co-host, the Commission, I am delighted to welcome you to today's conference "Financial integration and stability: towards a more resilient single financial market". In particular, it is my pleasure to welcome our distinguished speakers and panellists.

As you all know, the Eurosystem has a keen interest in financial integration and in the efficient functioning of the financial system. Financial integration helps to maintain balanced monetary and financial conditions and thereby fosters a smooth transmission of monetary policy throughout the euro area.

Financial integration also plays an important role for financial stability, as financial integration and financial stability can be mutually reinforcing. As evidenced by the years prior to the financial crisis, the stability of the financial system contributes to financial integration. At the same time, a more integrated financial sector typically improves the resilience of the financial system through more competition, better diversification and risk-sharing, as well as through more liquid markets.

The advantages of stable and integrated financial markets are manifold. They allow us to reap the benefits of the single EU market for capital and financial services. A better allocation of capital translates into lower prices, more choices for individuals, better business opportunities for firms and ultimately leads to higher economic growth.

Hence, for the last quarter of a century, the creation of a single market for capital and financial services has been a central goal of the European Union. Pursuit of this goal has generated many policy initiatives over the years. Most recently, the launch of the euro was a landmark achievement in this regard, and the Financial Services Action Plan has removed major obstacles to financial integration that stemmed mainly from legal and regulatory segmentation.

As a result of these policy initiatives, financial integration increased steadily in the years leading up to the crisis. However, the process was not homogeneous across all sectors. In some market segments such as the money and financial markets, financial integration increased significantly and rapidly. In others, however, the process was slower and, in fact, never completed. The case in point is retail banking.

Despite differences in speed in different sectors, it was widely assumed that financial integration was a continuous process, that financial integration was a one-way street once all legal barriers were removed. However, the financial crisis has demonstrated that financial integration cannot be taken for granted: the process of financial integration was brought to a halt and even reversed in some market segments.

I see two main reasons for this development. First, some market developments before the crisis were not really signs of increasing integration. What I am referring to is the complete compression of cross-country yield differentials before 2007. While the compression had been interpreted as an indicator of financial integration, it was, in fact, a sign of a systematic underpricing of credit risk.

And second, the pre-crisis institutional set-up had shortcomings and proved unable to support the single market in times of crisis. Regulation, supervision and crisis management had been organised along national lines, with some elements of cross-border cooperation. This approach was incapable of adequately preventing the build-up of risks. Moreover, when the risks finally materialised, the fragmented crisis management arrangements led to policy responses that were rational from a national perspective, but suboptimal from a European point of view. The fragmented arrangements also induced banks to withdraw behind national borders.

The resulting halt of financial integration, and even reversal in some segments, was the first setback in the European Union's quest to achieve a single market for capital and financial services. To preserve the benefits of a single market and to reverse these trends, decisive action has since been taken in different directions.

Where economic governance is concerned, new crisis resolution instruments have been created: the European Financial Stability Facility has been established, and the European Stability Mechanism will enter into force shortly. A key milestone in this respect is also the adoption of the "six-pack". Let me take this opportunity to warmly thank the Commission for the work that has been done in these areas through difficult times in the last years.

Regarding the financial sector, financial supervision underwent a comprehensive reform: three European Supervisory Authorities were established, and the European Systemic Risk Board now adds an EU-wide macro-prudential perspective that was missing before the crisis.

In addition, the regulatory framework is being overhauled with a view to strengthening the resilience of financial market participants and the financial infrastructure.

And finally, the EU framework for crisis management and resolution is currently being revised so as to address deficiencies highlighted by the crisis.

All these ongoing reform efforts are important steps towards closer integration. Looking forward, it will be crucial that the current initiatives are completed. Undoubtedly, these reforms are significant and would even have been unlikely without the crisis. However, it is also indisputable that financial integration is a process. Future financial developments will constantly put the institutional framework to the test. The current reform efforts are therefore part of the journey, and not the end of the road.

Let me close by wishing you all the best for an interesting and productive conference today. I am sure that the lessons of the crisis, the current institutional reforms and the future prospect of financial integration give us plenty of food for discussion.

Thank you.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Mario Draghi, President of the ECB
Brussels, 25 April 2012

Madam Chair,

Honourable members of the Committee on Economic and Monetary Affairs,

It is a pleasure to be back here in Parliament and in front of your Committee for our regular exchange of views.

Accolgo con soddisfazione l'esito delle riunioni di primavera di aumentare le risorse del Fondo monetario internazionale (FMI) di 430 miliardi di dollari. L'area dell'euro ha fatto la sua parte accrescendo le proprie protezioni e impegnandosi a fornire al FMI un importo aggiuntivo di 150 miliardi di euro. Sono lieto che ora altri azionisti del Fondo si siano offerti di prestare il proprio contributo per incrementarne le risorse.

Il est maintenant d'une importance cruciale que le Mécanisme de Stabilité européen soit entièrement opérationnel. La BCE peut fournir son soutien à cet égard. Naturellement, même avec un pare-feu important en place, les pays de la zone euro doivent continuer à mettre en œuvre les ajustements budgétaires et structurels qui s'imposent.

Wie üblich, werde ich zuerst auf die aktuelle wirtschaftliche Lage im Eurogebiet eingehen. Danach werde ich mich den Themen zuwenden, die Sie vorgeschlagen haben: Bewertung der Sondermaßnahmen der EZB und Bewertung der wirtschaftlichen Ungleichgewichte in der Währungsunion.

Economic and Monetary Developments

Let me first focus on economic and monetary developments in the euro area since our previous meeting on 19 December last year.

Available indicators for the first quarter of 2012 broadly confirm a stabilisation in economic activity at a low level. Latest developments in survey data are mixed, highlighting prevailing uncertainty. Looking ahead, growth should be supported by foreign demand, the very low short-term interest rates as well as our non-standard measures. At the same time, downside risks relate in particular to a renewed intensification of tensions in euro area sovereign debt markets and their potential spillover to the real economy. Further increases in commodity prices may also hamper economic activity.

Euro area annual **inflation** was 2.7% in March, unchanged from the previous three months. Inflation is likely to stay above 2% in the course of this year, because of recent increases in energy prices and indirect taxes. The Governing Council continues to expect annual inflation rates to fall below 2% in early 2013.

Looking forward, in an environment of modest growth in the euro area and well-anchored inflation expectations, underlying price pressures should remain modest. Risks to the outlook for price developments are broadly balanced. Upside risks could stem from higher than expected oil prices and further indirect tax increases; downside risks could arise from weaker than expected economic activity.

Let me stress that the Governing Council will pay particular attention to any signs of pass-through from higher energy prices to wages, profits and general price-setting. It is essential that medium-term inflation expectations for the euro area economy continue to be firmly anchored in line with the Governing Council's aim of maintaining inflation rates below, but close to, 2% over the medium term.

The **monetary analysis**, in particular the subdued pace of underlying money growth, confirms the prospect of price developments remaining in line with price stability over the policy-relevant horizon. Money and credit data up to February point to a stabilisation of financial conditions. At the same time, the demand for credit remains weak in the light of still subdued economic activity and the continuing process of balance sheet adjustment in non-financial sectors.

I consider it of crucial importance that banks strengthen their resilience further, including by retaining earnings and by retaining bonus payments. The soundness of banks' balance sheets will be a key factor in facilitating both an appropriate provision of credit to the economy and the normalisation of their funding channels.

The effectiveness of the ECB's recent non-standard measures

I would now like to turn to the effectiveness of the latest Eurosystem **non-standard monetary policy measures**, in particular the long-term refinancing operations (LTROs).

Let me first of all be clear about why we implemented the three-year LTROs.

As you will remember, the second half of 2011 was marked by an intensification of stress in sovereign debt markets and an environment of high uncertainty. This increasingly hampered the access of euro area banks to market-based funding. If no action had been taken, this could have resulted in severe strains on bank lending to firms and households and a generalised selling of assets.

The LTROs contributed to alleviate these very difficult funding conditions. Banks could satisfy their additional liquidity needs, which is reflected by a net liquidity injection of around €520 billion, taking into account the shifting of liquidity out of other operations. Moreover, banks have benefited from more certainty about their medium-term funding due to the longer maturity of the new operations.

I understand that you are particularly interested in the transmission of the LTROs to the real economy. This is indeed a crucial point: ensuring that the ECB's monetary policy continues to be transmitted effectively to the real economy was a key motivation of the Governing Council decision. It is encouraging to observe that a very large number of small banks have participated in the two LTROs. Small banks are best placed to refinance the real economy, in particular small- and medium-sized firms which are the biggest generator of employment in the economy.

We are confident that central bank liquidity has come very close to the real economy. Of course, this does not mean that this will *by itself* boost lending to firms and households. First, the central bank cannot interfere with the banks' use of the liquidity since that is their business decision. But we trust that they will use it to refinance the real economy because that is the role of a banking system. Second, the future evolution of credit growth will depend essentially on demand. In the current environment, this is likely to remain subdued. Thus, money and credit growth may stay weak for some time before the overall economic situation improves. The Bank Lending Survey, with some new information about financing conditions will be published at 10 am this morning.

Some of you may worry about the possible inflationary risks arising from these non-standard measures. Let me emphasize that our non-standard measures are not a constraint on setting interest rates in line with what is required to ensure price stability in the medium term. In particular, the interest rate on the 3-year LTROs is not fixed, but linked to the prevailing main policy interest rate. Furthermore, for measuring monetary liquidity, it is not the balance sheet of the Eurosystem that is relevant, but the balance sheet of the banking sector itself. Only the latter shows the interaction with the real economy. And this is captured by monetary data and credit data which, as I have mentioned, are still very subdued. You can rest assured that the Governing Council will use all the instruments at its disposal to counter possible upside risks to price stability should they materialise.

We also hear concerns that the Eurosystem is exposing itself to excessive risks. I would like to underscore that the expansion of our balance sheet is being managed with extreme prudence. We continually review collateral eligibility and our risk control framework. Furthermore, the application of conservative risk control measures, such as haircuts, in all monetary policy operations protects the soundness of the Eurosystem's financial position.

Let me conclude this point by recalling that all non-standard measures are temporary in nature. Moreover, liquidity support cannot substitute for capital or for sound fiscal and structural policies that bring about sustainable growth and stability in the European economy.

Dealing with macroeconomic imbalances in a currency union

Now, I would like to discuss the second topic selected for our exchange of views, namely **macroeconomic imbalances** in the euro area.

Of course, divergences of economic developments are a normal feature within a monetary union. Such divergences can also be observed on the other side of the Atlantic. But they should not become of a persistent and structural nature.

Unfortunately, very large imbalances were allowed to accumulate over recent years in several European countries. These imbalances stemmed from different sources: insufficient fiscal discipline, financial excesses, failure to implement structural reforms especially, but not exclusively, in the labour and product markets and significant competitiveness losses. All of this necessitates urgent and resolute adjustment.

Clearly, it cannot be the responsibility of the ECB to address these imbalances. From the perspective of monetary policy, our primary objective is to maintain price stability in the euro area as a whole. For that purpose, the ECB continuously monitors all relevant information from the countries and various business sectors of the euro area. But the monetary

policy stance of the ECB has to be focused on the entire euro area. It cannot address divergences among individual euro area countries.

That is the task of governments: they must undertake determined policy actions to address major weaknesses in the fiscal, financial and structural domains. We note that progress is being made in many countries. These measures need to be complemented by growth-enhancing structural reforms to facilitate entrepreneurial activities, the start-up of new firms and job creation. Here, governments should be more ambitious.

At the European level, there has been substantial progress towards reinforcing the economic governance framework. We have seen a strengthening of the fiscal rules of the Stability and Growth Pact and the introduction of the Fiscal Compact, about which we spoke in the Parliament last December. And we are implementing the new focus on correcting macroeconomic imbalances.

The recent crisis has shown that a well-functioning EMU needs not only a strong institutional set-up for monetary policy at the centre, but also one for economic policies.

Ensuring competitiveness of all euro area countries should be seen as a common responsibility. I am sure many of you here in the European Parliament will agree that we need a change in the mindset of how national policy-making is conducted and perceived.

The economic policies of euro area countries are, ultimately, domestic policies for the euro area. Precisely because of spill-over effects, they must be subject to mutual surveillance, and corrected if required in the collective interest of the euro area as a whole. This should apply both to fiscal and macroeconomic policies.

But surveillance alone is not sufficient. Citizens also expect from Europe common answers to the common challenges which all euro area countries are facing. In a context of global competition and ongoing fiscal consolidation, euro area countries should join their forces. Given that they share a single currency, they have even stronger reasons than other countries to work together. This can be in the field of research and development, education or infrastructure, they should strive for cooperation as much as possible.

Let me add that, just like competitiveness, I see financial stability clearly as a common responsibly in a monetary union. During the crisis, we have observed strong negative spill-over effects across euro area countries and between the banking sector and its respective sovereign. National supervisors and Treasuries are also confronted with the well-known problem that during good times, large banks work as European institutions but in bad times fall on national shoulders. Ensuring a well-functioning EMU implies strengthening banking supervision and resolution at European level.

European integration has brought peace and prosperity. While I hesitate to sketch out the long-term end point of the integration process, I am convinced that we need to actively step up our reflections about the longer term vision for Europe as we have done in the past at other defining moments in the history of our union.

Thank you for your attention.

Statistics to deliver price stability and mitigate systemic risk

Speech by Mario Draghi, President of the ECB at the Sixth ECB Statistics Conference, Frankfurt am Main, 17 April 2012

Ladies and gentlemen,

on behalf of the Executive Board I would like to welcome you to our sixth biennial European Central Bank (ECB) statistics conference. I am very pleased to see that the event has once more attracted many distinguished participants.

Let me take the opportunity to share with you some thoughts on the topics on the agenda.

As policy-makers in the fields of monetary policy and financial stability, we are deeply dependent on the work being done to maintain a stream of timely, relevant and reliable data.

Today and tomorrow you will have the opportunity to discuss ways of further strengthening the information basis for the fulfilment of the mandates given to the ECB and the European Systemic Risk Board (ESRB).

Key challenges

The financial crisis has dramatically increased the need for very timely granular data. And it has led to a rethinking of a number of organisational and conceptual aspects in statistics.

To give just one example, the traditional monetary statistics derived from individual banks' balance sheets are insufficient to gather information on financial groups that operate across borders and through non-bank subsidiaries. This is because the monetary statistics cover only the euro area and do not focus on the various kinds of risk to which banks are exposed and the adequacy of their capital in view of these risks. This means that it is vital to collect data consolidated at the level of banking groups or insurance groups.

Some of these data are already available at the national level for micro-supervisory purposes, but they are not always comparable across countries. The ECB, the ESRB and the three new European supervisory authorities (ESAs) are all working to fill remaining data gaps and to meet the challenge of timely, frequent and high-quality data for their macro-prudential functions.

Moreover, there is an increasing need to consider measures of dispersion not just averages, and to consider micro data as well as macro aggregates. For financial stability purposes, in particular, a wider variety of granular data and indicators are needed, and more emphasis needs to be put on data "outliers" and so-called "tail risks".

As we have learned, systemic risk may stem from any part of the financial system, including the shadow banking sector. That is why we also need more data to monitor unregulated financial institutions and markets.

In recent years, significant steps have been taken to identify the data gaps and to fill them by gathering more and more detailed quantitative information. But we are just at the beginning of this process, and I know that statisticians are all too well aware of the fact that the data perimeter may change again in the future.

It is vital that the work done at the European Union level is consistent with the worldwide dimension. In 2009, the G20 endorsed a report on "The Financial Crisis and Information Gaps". That report contains 20 high-level recommendations on the measurement of risks in the financial sector, international financial linkages and the communication of official statistics.

Quite some progress has been made in the implementation of these recommendations. For example, accounts for economic sectors, statistics on securities, and the Principal Global Indicators website supported by seven international organisations, including the ECB. But it is still necessary to continue with these efforts, in particular on quarterly government finance statistics and on the FSB common template for systemically important global financial institutions. And the transposition of the new rules into all national legal systems needs to proceed swiftly.

The role of statisticians

Going beyond the pure data challenges, the statistical community is still coming to grips with the fact that their work is now more than ever in the spotlight of public debate. "Statistical errors" were once something in which only specialists were really interested. Now, they can receive headline coverage, sometimes even more so than everything else coming out of both official and non-official statistical sources.

Public scrutiny is good for statistics but it also brings new challenges for statisticians. Alongside their more traditional role of collecting data and assisting in the correct interpretation of data, statisticians also need now to be more involved in the communication of results – to the markets, to the media and to the wider public. The role of dashboards and the narrative use of data are examples of tools where the input of statisticians is clearly essential.

Selected ECB statistical initiatives to fill data gaps

Together with the rest of the Eurosystem, the ECB is undertaking a number of important statistical initiatives to support fulfilment of the ECB's mandate to deliver price stability and the ESRB's mandate to mitigate systemic risk. The initiatives will also help other policy-makers and decision-makers.

Let me briefly mention three of these initiatives:

First, the Eurosystem is developing a Securities Holdings Statistics database. The financial crisis has highlighted the lack of transparency in a number of financial markets as well as difficulties in assessing financial exposures and linkages between institutions. Securities holdings represent a field where exposures are often concentrated, and a lack of sufficiently comprehensive, consistent and granular information has been identified.

The aim of developing a detailed dataset on securities holdings is to combine holdings of large players in the euro area with information on the individual issuers across the world. This will provide a potentially very useful tool for both monetary policy and macro-prudential analysis.

Second, the Eurosystem has been extending its database to provide more detailed information on the activities of financial institutions and instruments. This covers more detailed balance sheet information on banks but also on investment funds, insurance corporations and pension funds. Complex securitisation operations, which played a major role in the financial crisis, are reflected in new data on the activity of financial vehicles resident in the euro area.

Information on who is lending to whom in the euro area economy can help us to understand the process of financial intermediation better. It is now published on a quarterly basis in the matrix of the integrated sector accounts. The provision of quarterly information on cross-border holdings of financial assets and liabilities by euro area residents allows users to detect cross-border exposures.

Third, the Eurosystem is amending its statistical legal acts to align its economic and financial statistics with the recently revised international statistical standards. These revised standards aim at achieving consistency between domestic sector accounts and statistics for the rest of the world. This consistency will give users a much more complete view of inter-linkages between the rest of the world and the domestic sectors of the economy.

Reporting burdens

The ECB is well aware that closing information gaps requires significant efforts by all parties involved – the statisticians, the reporting agents and the data users. It is also clear now more than ever that a lack of good quality information on which to base decisions can be far more costly to society than the collection of new, additional data.

In any case, all data collections by the Eurosystem are subject to a prior, strict “merits and cost” procedure. Importantly too, there is a strong emphasis on ensuring that there are no double collections of the same information by different statistical authorities and that, as far as possible, existing information serves multiple purposes.

These data collections must be detailed and comprehensive enough to meet various current and potentially future statistical needs. When banks or other agents report the raw data, the compilation of aggregates and distribution measures for monetary policy, macro-prudential and other statistical purposes can be done by the respective statisticians and be used for several purposes. The reporting agents thus can be spared these compilation exercises – saving them resources and cost.

Of course, this requires effective coordination between the various statistical authorities to ensure their data needs are matched. As an example, the ECB is working with the ESRB and the ESAs aiming to achieve the highest possible coordination and synergies with regard to data for supervisory purposes, macro-prudential analysis and monetary policy.

A good example of this is the recent collaboration of the European System of Central Banks and the European Banking Authority (EBA) through the Joint Expert Group on Reconciliation of credit institutions’ statistical and supervisory reporting requirements. The second edition of the group’s report has just been published on the websites of the ECB and the EBA.

The problems faced in such initiatives are often very complex, and progress takes time. For example, as supervisory data on consolidated group structures are currently not fully harmonised within the European Union, efforts are needed to make these data comparable across countries and time. The quality and timeliness of such data requires efficient data transmission and processing between different organisations.

Confidentiality

One of the thorniest issues in such coordinated activities concerns the confidentiality of individual data, and supervisory data in particular.

The protection of confidentiality is sacrosanct for all statistical activities. It is enshrined in the relevant legal texts of the ECB and it is central in standard practices for all official statistics. Where “Chinese walls” need to exist, they are strictly respected. Reporting agents should know and should have the right to know where the confidential information they are providing is to be used.

But a big effort is needed to ensure the harmonisation of divergent practices in the protection of data and sometimes conflicting legal texts in the different fields of competence and in different countries.

Restrictive “blanket” confidentiality rules that cover all types of information, irrespective of whether there are real risks of a breach of confidentiality, are often counterproductive. They end up not only being damaging to information sharing and disclosure, but also to the real protection of confidentiality where and when this is needed. These rules confuse what is truly confidential and what needs strong protection with what is possibly market sensitive or what is simply inconvenient.

So here is yet another area of activity on which statisticians and legal experts need to focus. They need to ensure that legal frameworks and existing practices find the right balance between the need for confidentiality and the possibility of data sharing.

Conclusion

Let me conclude. As I hope all of my remarks have illustrated, statistics is a core activity of policy-making, and central banking in particular. Right now, it is also a highly dynamic activity.

I personally attach great importance to progress in the areas I have mentioned. I am convinced that your discussions today and tomorrow will offer valuable contributions on how best to face the challenges and how to take advantage of the opportunities.

Producing high-quality statistics on the financial sector remains a core task of a central bank. It is a central input not only for decision-making processes but also for the communication of our decisions, and thus, for the credibility of our actions.

In light of these challenges, the central bank statisticians of the future will have to serve both areas – the pursuit of price stability as well as the support of financial stability.

I wish you a very fruitful conference and very much look forward to the results of your deliberations.

Thank you for your attention.

Remarks at the Annual Reception of the Association of German Banks

Speech by Mario Draghi, President of the ECB, Berlin, 26 March 2012

Sehr geehrter Herr Schmitz,

vielen Dank für Ihre freundliche Einführung und vielen Dank für Ihre Einladung nach Berlin. Ich freue mich, heute hier zu sein.

Ladies and Gentlemen,

I would like to take this opportunity to provide you with my assessment of the current situation in the euro area and shed light on recent signs of improvements in the overall outlook. I would particularly like to draw your attention to the effectiveness of the policy measures implemented by the Eurosystem, the EU institutions and national authorities. And to remind you of the measures that we all must continue to pursue over the coming months and years with great diligence in order to continue on this path of stabilisation.

The current economic situation

As this audience knows very well, in November last year, the prospects for the euro area financial sector were very bleak.

Banks were experiencing a period of heightened stress. The inter-bank market was closed except to the strongest institutions in the safest countries, and funding markets were impaired. Unable to raise funds beyond short maturities, many banks were reducing medium-term lending to the real economy.

At the same time came the requirement to increase capital ratios to 9%. This increased the risks of substantial deleveraging, including the risk of banks cutting back on loans, notably those to small and medium-sized enterprises.

We could see the intensity of the deleveraging pressures in bank lending surveys and other data. In the fourth quarter of 2011, there was a significant tightening of credit standards on loans to both companies and households. There was no doubt that the euro area was on the brink of a major credit crunch, with potentially adverse consequences for the economy and employment.

At that time, many observers had little confidence in the capacity of the euro area to reverse the situation.

Yet today, only four months on, the picture looks different. There are signs of stabilisation in both financial markets and overall economic activity – albeit still at low levels.

Conditions in bank funding markets have improved. For example, euro area banks have already issued about 70 billion euro in senior unsecured debt so far this year, which is well above the amount they issued in the whole second half of 2011.

Banks are meeting their new capital requirements. The capital plans submitted to the European Banking Authority (EBA) indicate an intention to exceed the benchmarks by more than 20%. EBA has also confirmed that there will be no stress test this year.

Bank lending is also stabilising. Banks are starting to assess their financial situation more positively and in many cases their willingness to make loans is increasing.

How has the picture changed so clearly in only four months? There are two parts to the answer.

First, the doomsday predictions were always exaggerated. Not because the situation last November was not very serious. But because the willingness of euro area authorities to take the measures necessary to restore stability was greater than many commentators realised.

Second, euro area authorities have proved their commitment to safeguarding financial stability through a number of important policy measures. The Eurosystem, the EU institutions and national authorities have all played a role in constructing a comprehensive and coherent response to the economic, financial and fiscal challenges that we face.

Let me now explain the key elements of this response in more detail.

The policy response of the Eurosystem

The primary explanation for the improvement in sentiment over the last few months has been the measures taken by the Eurosystem – that is, we at the European Central Bank (ECB) and our colleagues at the national central banks of the 17 countries that share the euro.

As you know, since December last year the Eurosystem has launched two long-term refinancing operations – LTROs – with a maturity of three years. While the total liquidity requested by banks in these operations amounted to around 1 trillion euro, the net liquidity injection by the Eurosystem has been around half a trillion euro because the other half has been shifted over from other operations.

Let me be clear about why we implemented the three-year LTROs. It was not to support sovereign debt markets. It was also not to bolster bank profits.

The LTROs were specifically designed to prevent a credit crunch that could compromise the maintenance of price stability in the euro area. With funding markets closed, banks needed liquidity assurance over the medium term to avoid pre-emptive deleveraging and to continue lending.

To understand why these operations were necessary requires a euro area wide perspective. It would be misleading to judge the urgency for action – or the necessary responses – based on the situation in any one country or groups of countries. The Eurosystem acts in the interests of the euro area as a whole with 330 million citizens. This is the perspective that always informs our decisions.

Some observers have raised questions about these operations. The questions tend to fall into three categories and since they touch on fundamental issues, I would like to spend a moment responding to them.

First, some wonder whether there is really any transmission from the LTROs to the real economy. The argument goes that banks are simply taking cheap liquidity and setting up carry trades or putting the liquidity back into our deposit facility.

The facts show that this is an incomplete view. Over 800 banks participated in the February LTRO, compared with around 500 in December. This number included 460 banks from Germany, most of them – literally hundreds – being smaller banks.

I cannot tell you names of the towns and villages in which these banks are located because often they are the only bank in town and could be easily identified. But I can tell you this: that the money is now closer to small and medium-sized enterprises than it was before.

We cannot say that this money will necessarily go to these smaller enterprises but it is certainly very close to them. We have this in mind because nearly three quarters of corporate employment in the euro area is in the small and medium-sized business sector. The banks I am talking about are ones whose main business is lending to the *Mittelstand* and thereby supporting the real economy.

It is also not accurate to claim that banks are returning the liquidity straight back to the Eurosystem. We know that banks using the deposit facility are not identical to those borrowing from the Eurosystem. This implies that even though the bulk of the liquidity is returned eventually, it is being directed within the banking system as intended.

The second category of question involves concerns that some have expressed that the Eurosystem is exposing itself to excessive risks. Critics point in particular to the differentiated collateral framework adopted by some national central banks to allow banks to participate in the three-year LTROs.

Let me underscore that high haircuts are applied to the additional credit claims so as to ensure risk equivalence between this collateral and the regular framework. Moreover, the main elements of the risk management framework applied are common: the eligibility criteria and risk control measures were approved by the Governing Council, and the Council will monitor the effectiveness of the risk control framework on an ongoing basis. Hence, there is only limited national discretion. I should also emphasise that the Eurosystem has a long experience in the acceptance of credit claims in its collateral framework.

Moreover, the Eurosystem is being very careful to manage any risks that may ensue from our current operations. We employ a conservative risk management framework. On the additional collateral presented so far, the average haircut is 53%. This means that on a nominal value of 100 euro we provide 47 euro of liquidity. This shows you how prudently such collateral is accepted.

If over time the market value or quality of the collateral posted were to decline, counterparties would have to provide additional collateral or return part of the liquidity. This too serves to protect the financial soundness of the Eurosystem as a whole.

The third kind of question comes from some observers who worry that the liquidity created by the LTRO will lead to inflation or asset price distortions.

Here it is important to distinguish between different concepts of liquidity. We would expect an impact on inflation and asset prices only following a sustained and strong increase in money and credit – not following an increase in *central bank* liquidity *per se*. The tentative signs we are seeing of a stabilisation in money and credit growth do not signal increasing inflationary pressures over the medium term.

For example, growth in monetary aggregates remains at low levels, with M3 increasing by 2.5% in January 2012, well below the average growth rate of M3 in monetary union so far, which was 5.9%. The same is true of the counterparts of M3 – loans to the euro area private sector increased by only 1.5% in January, compared with an average of 6.8% since the start of the euro.

Market indicators of inflation expectations overall show no signs of inflation above our medium-term objective. Investors overall assume a break-even inflation rate in five years of around 1.7%. Looking further out at the inflation expectations between five years and ten years also shows that, adjusted for the usual risk premia, market expectations of long-term inflation are fully consistent with our definition of medium-term price stability.

Moreover, the Eurosystem has a range of tools at its disposal to absorb excess liquidity if that is deemed necessary in the future. Available tools include increases in reserve requirements and the conduct of liquidity absorbing operations including not only short-term but also longer-term deposits. Hence, there are tools and the Governing Council can use them as needed. Moreover, our balance sheet has grown and shrunk in the past without creating inflation – for example, this was evident over the course of both 2009 and 2010.

In other words, we are constantly alert to threats to medium-term price stability. Euro area citizens can be certain that our objective is delivering price stability over the medium term – and that we have all the necessary tools to achieve it. The consistent strong anchoring of inflation expectations confirms that our commitment is credible.

Let me address one final issue, and this concerns the debate in this country about Target2 balances. It is important that this debate is framed correctly – in particular, by distinguishing between symptoms and causes.

Target2 is a payment system that reflects the flow of funds within the euro area. Imbalances within Target2 are a symptom of real and financial imbalances between euro area countries. Restoring normality within Target2 requires not that we address the symptom – the payment system – but that we address the cause: the underlying imbalances.

This is not the task of monetary policy. It is the task of the national authorities and EU institutions that are responsible for fiscal, economic and financial policies.

Important progress has been made in recent months to strengthen the credibility of these policies – and this has been recognised by financial markets.

This is the second explanation for the overall stabilisation we have witnessed since November – and it is something to which I will now turn briefly.

Policy responses at the national and EU level

The signature at the last European Council of the International Treaty, including the fiscal compact, is an important signal of commitment to reducing deficit and debt levels. Enshrining balanced budget rules in national legislation creates a new "first line of defence" against fiscal imbalances. Like the *Schuldenbremse* in this country, this legislation shifts the onus for enforcement away from Brussels and onto national institutions. Prevention is better than cure – and that is the spirit of the compact.

Member States have also taken important steps to strengthen euro area and global firewalls. The entry into force of the European Stability Mechanism has been advanced and the paying-in of capital will be accelerated to reach full lending capacity sooner than originally planned. On top of this, euro area countries have committed to providing an additional 150 billion euro to the IMF.

Seen together, these measures represent a coherent strategy to strengthen euro area economic governance. The focus is not, as some commentators claim, skewed towards fiscal consolidation. Stronger fiscal rules are one – albeit essential – element in a larger package that addresses real and financial imbalances and provides a safety net for countries in financial difficulties.

But stronger governance cannot be effective without individual Member States also fulfilling their responsibilities. Here too we have witnessed a number of positive developments in recent months.

The new governments in Spain and Italy have shown determination to address their twin challenges of fiscal and macroeconomic imbalances. The government of Spain remains committed to bringing its deficit below 3% by 2013 and taking the necessary measures to ensure a rapid and secure transition to this target from the high deficit in 2011.

The latest review missions confirm that the Irish and Portuguese programmes are on track – with authorities in both countries strongly committed to meeting their targets and with a solid track record.

It is important that observers recognise that these reforms at the national level will take time. They are addressing deep-rooted obstacles to competitiveness and growth, and the positive effects may not be visible immediately. But once realised, they will put employment and growth on a new and more sustainable track.

The example of Germany shows the need for patience. The structural reforms passed many years ago did not immediately feed through into higher growth and employment. But now they have, and Germany is reaping the benefits and leading the way in Europe.

With a new governance framework in place and strong commitments from national governments, there are solid grounds for trusting that reforms will be implemented across the euro area as a whole.

Conclusion

Let me conclude. The turnaround we have witnessed since November is the result of every institution of the euro area fulfilling its responsibilities. No single institution can carry the burden of addressing a set of challenges that are simultaneously economic, financial and fiscal. Everyone has played their part.

But let me emphasise that the current stabilisation should not make us pause in our responses to these challenges. Indeed, this is a time for continued action.

The present situation provides a window of opportunity for governments to accelerate efforts to consolidate budgets, to boost employment and to enhance competitiveness – and to do so with confidence.

It also creates a benign environment for banks to strengthen their resilience further – including by retaining earnings and cutting dividends and bonuses.

Decisive policy measures brought about the stabilisation since last November. Now, further decisive policy measures are required to strengthen fiscal positions and competitiveness.

These measures will lay the foundations for future sustainable and balanced growth in the euro area.

Thank you.

Interview with Bild Zeitung

BILD interview with Mario Draghi, President of the European Central Bank, conducted by Kai Diekmann, Editor in Chief, and Nikolaus Blome, Deputy Editor in Chief on 19 March 2012, 23 March 2012

Part I

BILD: President Draghi, when it was clear that you were to become head of the European Central Bank, BILD made a photomontage of you wearing a Prussian spiked helmet and called you a “true German”. What did you think of that?

Mario Draghi: I really liked it. The Prussian element is a good symbol of the ECB’s key task: to maintain price stability and to protect European savers.

BILD: For Germans, a central bank chief must take a strict line on inflation, be politically independent and favour a strong euro. In that light, how German are you?

Draghi: These are indeed German virtues. But every central banker in the euro area should have them.

BILD: The French President said that Europe should learn from the German model…

Draghi: …he’s right. Long before him I said that Germany is a model. The old European welfare state model is in fact dead, because it had to make debts far too often. The Germans have re-invented it – with no excessive debts.

BILD: Do you have a message for the people of Germany?

Draghi: Keep it up!

BILD: The ever-present fear of devaluation, of inflation, is typically German. Can you understand that?

Draghi: In the twentieth century the people of this country suffered terribly because of inflation. It destroys wealth and makes planning impossible. What’s more, it can really destroy the fabric of a society.

BILD: Why then, as ECB President, are you allowing euro area inflation to currently stand at 2.7%, significantly more than the ECB’s objective?

Draghi: Hold on. If you exclude the price of oil and recent tax increases by many governments, the inflation rate has been stable for months at 1.5%. Should the inflation outlook get worse, we will immediately take preventive steps. And look at the facts, they speak for themselves. Since the founding of the ECB the yearly average inflation rate has been better than in any comparable period prior to the euro.

BILD: In two moves, the ECB has put almost €1 trillion into circulation. That's inflationary, surely?

Draghi: The banks to which the ECB has lent the money have, by and large, not fed this into the economic cycle but have used it to meet old liabilities. So the money in terms of inflation has, so to speak, been neutralised. This action is not inflationary. And we will watch very carefully if and how the money is fed into the economic cycle.

BILD: But the head of Germany's Bundesbank, Jens Weidmann, has issued a sharp warning about this flood of money.

Draghi: I get on very well with Jens Weidmann both professionally and personally. Our difference of opinion has been blown up.

BILD: Was he exaggerating?

Draghi: He is a typical central banker, like all of us. We like to worry about things that nobody else worries about. And of course there are risks and side effects if you use such a strong drug, such as the almost €1 trillion of central bank money. It was right of Jens Weidmann to point that out and I agree with him.

BILD: Is there a rift between north and south in the Governing Council?

Draghi: No, there is no divide between north and south. All members of the Governing Council have taken to heart Germany's stability culture. The time of conflicts is over. But let me also say that the situation in the autumn was really critical. It could have led to a dangerous credit crunch at the banks and thus to bankruptcies; companies would have suddenly been left sitting high and dry financially. We had to prevent that.

BILD: And the banks are doing nicely out of it, right?

Draghi: The ECB's money has got to the right places. In Germany alone, 460 banks participated in the action, many more than usual. So it wasn't just the acutely suffering banks, but also many others, many of them small. That particularly helps the small and medium-sized companies that account for 70% of all jobs in Europe.

BILD: This all sounds very optimistic. Is the euro then a safe currency?

Draghi: Yes, it is.

BILD: Is the crisis over?

Draghi: The worst is over, but there are also still risks. The situation is stabilising. The key data for the euro area, such as inflation, the balances of payments and in particular budget deficits, are better than in the United States, for example. Investors are regaining their trust and the ECB has not had to provide support by buying government bonds for several weeks now. It is now up to the governments. They must make the euro area crisis-proof in a sustainable manner

BILD: If it were your birthday today, what would you want from the German government and the Chancellor?

Draghi: Trust the ECB. Trust Europe.

Part II

BILD: There is no end to the crisis in Greece. Yet again, more than €100 billion of credit is to be given to them. But isn't the country a bottomless pit?

Draghi: The Greeks have passed very many important reforms in parliament. If they also implement these, the country has a chance to get itself out of the current downward spiral.

BILD: But the parties that reject the reforms will be the ones that win in the upcoming elections.

Draghi: To overcome the crisis, Greece needs a stable political situation.

BILD: Why should taxpayers in Germany and other euro area countries be liable if it goes wrong?

Draghi: The fact is that European taxpayers have taken on a lot for Greece. Their money must be protected. This is also why the ECB did not take part in the debt relief – because the cost would have been borne by taxpayers.

BILD: How much time does Greece have left?

Draghi: Some reforms can take effect very quickly. For example, a tax reform and better tax collection would spread the tax burden more fairly. That is a strong incentive to work more – and this will get the economy quickly back on its feet.

BILD: Many experts now think that the only way for Greece to become competitive again is if it leaves the euro area.

Draghi: As a matter of principle, the ECB does not give any thought to a country leaving the euro area.

BILD: Nevertheless…

Draghi: Leaving the euro area and having the possibility to devalue their own currency would not improve anything. It would not remove the need for reform. In fact, the consequences of leaving the euro area would be high inflation and instability – and, for the foreseeable future, nobody would lend Greece the money it needed.

BILD: Will the Greeks in any case have to give up their prosperity?

Draghi: Yes, they are renouncing exactly that as a result of wage cuts across all sectors. But this is still easier to do inside the euro area rather than outside it.

BILD: Is there a limit to the support? Or will it just continue like this?

Draghi: I can't answer that. We will have to see how things develop in the country. Generally speaking, the fact remains that if we want to protect taxpayers' money, the euro area cannot be turned into a transfer union, where one or two countries provide the money, the rest spend, and the whole thing is financed by joint Eurobonds. That cannot happen.

BILD: Many parties, also in Germany, are calling for that.

Draghi: A community must be founded on trust – trust that shared rules will be adhered to, for example, with regard to budgetary discipline. That is why the new fiscal pact among euro area states is the right thing and why Eurobonds would be premature.

BILD: Is the German Chancellor's stance winning through?

Draghi: Let me put it this way: without pressure from the markets and from the Germans, much of the progress we have made in the various euro area countries would not have been possible.

BILD: How often do you speak on the telephone with the Chancellor?

Draghi: Not very often. The ECB is very mindful of its independence. And the Chancellor fully respects this.

Competitiveness of the euro area and within the euro area

Speech by Mario Draghi, President of the ECB, at the colloquium "Les défis de la compétitivité", organised by Le Monde and l'Association Française des Entreprises Privées (AFEP), Paris, 13 March 2012

Ladies and gentlemen,

I am delighted to have the opportunity to participate in this debate.

Competitiveness is a key issue of economic policy in each and every country of the euro area. It is a key issue for the euro area as a whole. And it is of fundamental importance to the lives and long-term prosperity of all of our citizens.

We at the European Central Bank (ECB) have a steadfast commitment to price stability. This in turn provides support for economic growth and job creation across Europe. But for any individual member of the euro area to prosper in a globalised world, our contribution needs to be complemented by the work of national policy-makers.

Future prosperity requires us all to establish and maintain a competitive position, both inside and outside the euro area. These external and internal dimensions of competitiveness will be the main focus of my remarks. But first let me say a few words about how we see the current economic situation.

The state of the euro area economy

Overall, we see continued signs of stabilisation in the euro area economy, albeit still at a low level. The situation in financial markets has clearly improved in response to the ECB's measures. The improvement is also due to the progress made by euro area governments towards accepting more binding common fiscal rules and by the progress on fiscal consolidation and economic reform in many countries.

Countries should use this phase of financial stabilisation to make further progress on their programmes of economic reform – to strengthen their potential growth, to boost employment and to enhance competitiveness.

Banks too should use this currently more benign environment to strengthen their resilience further, including by retaining earnings, cutting dividends and bonuses. The soundness of banks' balance sheets will be a key factor in facilitating an appropriate provision of credit to the economy, which is their main task. The financial system should serve the real economy, not the other way around.

As far as monetary policy is concerned, growth will be supported by the very low short-term interest rates and by all the measures adopted by the ECB to foster the proper functioning of the euro area's financial sector.

Taking the context of deeply malfunctioning credit markets, our recent decision on medium-term liquidity has been central in banks returning to play their vital role in the real economy. Banks account for over two thirds of external financing of firms in the euro area. Banks are especially important for small and medium-sized enterprises, which account for nearly three quarters of employment in the private sector.

As many as 800 banks participated in our last operation. They cover virtually the entire euro area. Many of the banks are small, regional institutions. I cannot even mention their location, the towns, the villages where these banks are, because often they would be the only bank in town so they could be identified. This tells us one thing – that the money is now closer to households and the small and medium-sized enterprises than it was before.

We are continuously alert to the risk of inflation, but this risk is not materialising at the present time. Moreover, inflation expectations remain firmly anchored in line with price stability. All the necessary tools to address potential upside risks to medium-term price stability are fully available.

Over the past 13 years, the ECB has achieved one of the best records of price stability in European history. We are committed to maintaining that record.

The recent signs of stabilisation allow us all to face the medium-term challenges for the euro area with a degree of confidence. All policy-makers should take advantage of this position to continue their reforms with confidence.

Competitiveness: the external and internal dimensions

Let me turn now to the theme of this conference and explain the term competitiveness.

Competitiveness, broadly defined, is firmly grounded in a notion of relative productivity: a competitive economy is one that provides the institutional environment necessary to foster the development of highly productive firms.

Such firms have the capacity to sell their goods and services abroad easily and profitably, contributing to longer-term economic growth and employment and, ultimately, to the welfare of citizens.

But competitiveness is not only international price competitiveness. Competitiveness is also related more broadly to a country's external performance. Analysis of this broader concept of competitiveness includes indicators of export growth, market shares and current account balances.

Prices, costs and wages are important factors in determining the ability of firms to compete in international markets. But for firms – and thus countries – to adjust successfully to the big changes implied by globalisation, other factors have become increasingly important.

These include the range and quality of the products a country exports. In this regard, countries in the euro area can take advantage of their high technological advancement and well-educated labour forces. They should be producing higher quality and more sophisticated goods, and redirecting their exports towards strongly growing markets.

Against this background, the domestic environment in which firms operate is central to fostering competitiveness. Countries whose firms compete successfully in international markets are in general those with better technology, a higher degree of openness and greater domestic market competition.

A growing body of cross-country evidence confirms that policies to promote competition in Europe's markets for goods and services clearly raise the potential for growth and job creation at little or no cost to the public purse. Continued efforts to promote stronger competition and further market integration within Europe are important tools for enhancing the global competitiveness of European firms.

In this vein, supportive national economic environments – including well-conceived physical and social infrastructures, sound public finances and, I should emphasise, stable financial systems – will all contribute to the competitiveness of the euro area.

Let me go a little deeper into the challenges of competitiveness for Europe's economy. For the euro area, we have to distinguish between two distinct concepts: the external competitiveness of the euro area as a whole in the global economy; and the internal competitiveness of the various countries within the euro area.

External competitiveness

Let me start with external competitiveness.

The euro area has actively contributed to the rise in international trade that is one of the defining features of globalisation. In the last two decades, the openness of the euro area has increased markedly.

In the mid-1990s, exports of goods and services from the euro area as a whole to the rest of the world were equivalent to 15% or less than one sixth of GDP; now they amount to 23% or nearly a quarter of GDP. Even though we are roughly comparable in size to the United States, the euro area is about ten percentage points more open, and we are much more open than Japan despite our larger size.

This also means that we have ample evidence that any fears of a 'Fortress Europe' were completely unfounded. On the contrary, we are the most open of the largest economies.

External performance in terms of the current account shows that the euro area as a whole has performed well, and that external imbalances have been kept in check. The euro area's current account has traditionally been close to balance, compared with sustained deficits in the US and sustained surpluses in Japan.

Of course, remaining competitive is a continuous challenge. Over the past two decades, as low-cost competitors have emerged elsewhere in the world, the euro area – like other advanced economies – has recorded some decline in export market shares. These losses partly reflect the mechanical effect of the new entrants. Nevertheless, the euro area does need to adjust the range of goods, services, sectors and industries in which it specialises.

Euro area countries have changed their specialisation over the last two decades, but not all did so to the same extent. As a consequence, the specialisation of the euro area as a whole has not changed much. We could have expected that the euro area would have shifted more towards higher quality products and products that are more skill-intensive and capital-intensive.

The fact that there has not been more progress overall might reflect structural rigidities that constrain firms' ability to adjust rapidly and to make substantial changes in their specialisation – particularly towards high-technology products.

In particular, rigidities in the product and labour markets make it difficult for firms to adjust costs and prices to changing conditions. The ability of countries to adopt the appropriate specialisation may also be limited by structural issues related to the quality of education and the incentives for innovation.

Internal competitiveness

The general picture for the external competitiveness of the euro area is positive.

But this general picture does not necessarily hold for each member of the euro area.

Overall, looking at competitiveness within the euro area, there have been substantial differences across countries.

Indeed, the strains in some sovereign debt markets have been compounded by the severe competitiveness differentials that have emerged within the euro area.

A convenient way to identify competitiveness differentials is simply to look at the current account balances of each country.

Current account imbalances could be justified for any country, including those participating in a monetary union, and they do not necessarily reflect a loss of competitiveness. But increasingly, larger current account deficits have resulted from significant losses of national competitiveness, signalling domestic macroeconomic imbalances and deeper structural problems. These losses of competitiveness limit the country's growth potential and hinder its participation in the global trade integration.

Against this background, rather than financing productive investment in the tradable sector and fostering export performance, capital inflows in some countries with excessive current account deficits have fuelled asset price rises and private indebtedness. Hence, current account imbalances within the euro area should be a source of concern for policy-makers when they relate to losses of competitiveness.

A useful way to measure excessive imbalances is to look at unit labour costs, as these reflect developments in both productivity and labour costs. If we compare countries with an external surplus and countries with an external deficit, we see that, since the introduction of the euro, unit labour costs have increased by 28% in deficit countries, 2.5 times as much as in surplus countries.

For sure, some of this differential might reflect sustainable increases in income per capita or other "catch-up" effects. But to a much larger extent, this differential relates to structural problems and reflects growing misalignments between developments in wages and productivity.

These misalignments have also become visible in terms of deviations from price stability. Indeed, we can observe that most countries with strong current account deficits prior to the crisis had also experienced substantial increases in prices.

Ensuring price stability is key for competitiveness.

It provides the nominal anchor for future price developments. It is key for the euro area as a whole as much as it is key for all countries.

Significant and persistent deviations from price stability translate into losses of competitiveness and should be corrected.

Restoring competitiveness is vital for a number of countries within the euro area. Policies to ensure sufficient responsiveness in wages and prices, as well as to boost productivity, are crucial ingredients in the rebalancing.

The policy challenge

Let me conclude. The euro area's performance in the global economy is good, but continuous adjustment is needed to keep up in a highly dynamic international environment.

Within the euro area, a number of countries need to repair and strengthen their competitiveness for the sake of their own continued prosperity and the overall stability of our economic and monetary union. This process requires going to the root of the loss of competitiveness, tackling its sources and enhancing the opportunities for growth.

The time frame of this correction will differ according to the degree of the imbalances and countries' overall economic conditions. But in times of severe financial constraints, there is no other choice than to address the structural losses in competitiveness in an urgent and decisive manner.

What monetary policy can do for competitiveness is to ensure price stability in the euro area, reducing risk premia and making sure that all the transmission channels of the monetary impulse do work.

I would add that the markets clearly understand that. Thus, continued price stability, unencumbered credit markets, fiscal consolidation and structural reforms that decisively address the issue of insufficient growth stemming from loss of competitiveness would bring about an increase in confidence. And, as I am sure we all understand, increased confidence will further contribute to Europe's recovery and to our longer-term potential for growth, jobs and continued prosperity.

Thank you.

Interview with Frankfurter Allgemeine Zeitung

Interview with Mario Draghi, President of the ECB, conducted by Holger Steltzner and Stefan Ruhkamp, published 24 February 2012

For two years, Europe's politicians have been promising to save the euro, whatever the cost. But the problems have kept on growing. Do you believe the second aid programme for Greece will be successful?

Yes, I do. But the work has only just begun. With the adoption of this comprehensive financial package, we are sending a clear signal: Europe is helping Greece, and important international institutions, such as the IMF, are assisting as well.

What is different this time?

Of course the ball is now in Greece's court. The country has started to take action: for example, to cut the minimum wage. Above all, however, political debate in Greece has changed. The Greek people and Greece's politicians now have a completely different attitude towards their country's responsibilities. The key to controlling risks lies with the implementation of the programme, which has to be flawless. The upcoming elections will be very important. It is essential that the new government supports the programme, just as the old one has. Since everything depends on the implementation of the programme, monitoring is very important. And that is being taken care of.

Is that also what the "escrow" account is for, which has been set up for Greek debt servicing?

In organising such a large financial aid programme, we need effective assurances to minimise the risk as much as possible. That is why there is such an account for the first time.

The haircut requested of Greece's private creditors has been raised again. Do you expect voluntary agreement?

Yes, all parties involved have signalled their agreement.

Then there is no need for clauses to enable a binding haircut for all creditors, the so-called Collective Action Clauses?

No, they may need them to achieve a sufficient level of participation among creditors.

That doesn't sound quite so "voluntary" any more. Won't it then come to what the ratings agencies call a default? Will the ECB then accept Greek bonds as collateral?

It is not a rating default yet. But, of course, that could happen, if Greece introduces the clauses by law. Then we will have to stand by our principles. The alternative is: we could ignore it and continue to accept bonds as collateral, which we don't intend to do.

Or you obtain collateral from the other Member States.

That is the solution it boils down to. Via the EFSF, additional safeguards to the value of €35 billion are to be provided for a transitional period, so that the Eurosystem could then accept Greek bonds as collateral, even if they were to be downgraded to "selective default". We are not the IMF of Europe. Our primary task is to ensure price stability in the euro area as a whole, irrespective of what is happening in an individual country such as Greece.

By removing the Greek bonds held by the central banks from the debt restructuring, the ECB has gained a privileged position as creditor. How is that justified?

The bonds were bought for monetary policy reasons. There is therefore a public interest. But even more important is the fact that, in the end, it is taxpayers' money. It is our duty to protect the taxpayers' assets. Moreover, we are not there to contribute to government financing by dispensing with claims.

But the ECB has always said that the purchases were part of its monetary policy. If it was an independent decision, why shouldn't the central banks bear the losses, which they would take over, without hesitation, if the financing of a bank proved to be unprofitable? What is the difference between losses on government bonds and losses from a bank failure?

Look at the United States and the United Kingdom. In both cases, the central banks have bought up large amounts of securities and the State has secured it with guarantees.

But for the markets, this means that the risk for private creditors has become greater. They have to count on the fact that, if the worst comes to the worst, the central bank will be serviced first. How great is the damage for the European government bond market?

Not very great, because the amount of our bond purchases, compared with the entire market, is small. For that reason, we do not see any effect on risk premia either. Moreover, Greece is a special and unique case of private sector involvement.

The call for Greece's creditors to accept a haircut makes it clear that there is no such thing as a risk-free investment any more. Is that a problem?

That issue was processed by the markets a long time ago. The decisions of autumn 2010 (at the Deauville summit) put an end to all public debtors borrowing at the same conditions, irrespective of their creditworthiness.

Does the disappointment that there is no absolute security any more actually, in the end, have a stabilising effect on the financial system?

Of course there is an excess of risk aversion and fluctuations, and that may cause great difficulties for monetary policy. But in the long run, the different perception of risks makes the system more stable. And what's more, it forces governments to keep their finances under control. Before the introduction of the euro, corrective signals came from exchange rates. After this corrective mechanism ceased to exist, some governments thought they could do and allow what they wanted, without having to pay. Now market prices are being corrected and that is a good thing. However, we must of course be careful that the markets do not overdo it and send false signals. Markets can be stabilising up to a point, but destabilising beyond it.

How can you tell whether a market price is right or wrong?

One indication is extremely high volatility. Strong fluctuations can shake confidence so badly that nobody dares to lend out money any more. Interbank lending then becomes virtually impossible and the banks can no longer issue any bonds either, even when these – like covered bonds – are well secured. In such a situation one knows that something is wrong.

And then the central bank must intervene?

If the operation of monetary policy is no longer certain because of the distrust, if monetary policy is no longer reaching the economy which negatively affects credit, overall demand and ultimately price stability. Yes, then the central bank must act and work out a strategy for dealing with the disruptions. Of course it depends on the reason for the risk aversion. If it is because of a lack of liquidity, or even just the assumption that the counterparty might be short of funds, then the central bank could help. But if banks have a capital shortfall, then it is not the task of the central bank.

Many Germans are concerned about the majority composition of the ECB Governing Council, which in numerical terms is dominated by central bankers from fiscally weak countries. They fear inflation. What would you say to these people?

The ECB acts according to two maxims: that it should ensure price stability and should not provide monetary financing to governments. We operate independently of our nationality. In the early phase of the currency union, the former president of the Bundesbank, Hans Tietmeyer, whose picture hangs on the wall here, once refused to sit at a table on which name cards specifying the participants' respective institutions had been laid out. He said: "Clear them away, we are here in a personal capacity and not as envoys of our institution or country." This is the spirit of the ECB.

Even after the debt forgiveness, Greece's government debt will amount to 120% of annual overall economic output. That is barely sustainable for a country with a sound economy, but much less so for a country in a poor competitive position. What is so terrible about the idea that Greece might give up the euro?

Firstly there is no provision in the treaty for a country to leave or to be excluded from the euro. But even apart from that: do you think that by leaving the euro, printing a new currency and undergoing the subsequent adjustment, Greece could avoid the structural reforms that are necessary?

No, they remain necessary. But it would be easier to find agreement for the adjustment and, above all, the sheer possibility of an exit would improve the basis for the negotiations with Greece. Without this option, the rest of Europe is signalling: whatever you do, whatever happens, we will fund you.

That is not true, because Member States and the IMF would not finance a programme that lacked credibility.

But if the Greeks remain in the euro area, they must reduce their costs and, for example, cut the wage level by at least a third. Will that succeed?

There is no alternative, because even if a country has flexible exchange rates and devalues but make no other changes, it has not gained anything. It depends on the real lowering of wage costs. In the currency union, this occurs when nominal wage costs fall or remain contained, while prices remain stable. Experiences in the 1970s show that this is the more sustainable method to regain competitiveness. Otherwise we get inflation with high social costs over the long term.

If Greece keeps the euro, the adjustment will take many years. During that time, the country will import more than it exports. As this current account deficit will no longer be financed by private lenders, this task will fall to the central bank.

That is correct, there will be deficits for a while. But Greece is making progress. A part of the adjustment in wage costs that is required to restore competitiveness has already been achieved. Some of the agreed structural reforms will only make themselves felt in the long term, but others, such as efforts to make the labour market more flexible, can immediately strengthen confidence.

The funding of such deficits of fiscally weak euro countries are visible in the huge balances of the TARGET payment system. Would the Eurosystem have already collapsed without this rescue system, this bailout?

I cannot see any bailout there. We have a currency union and a payment system which is organised by the ECB as a single platform. And there are payment flows from one country to another. The fact that these balances arise at all is because of the disturbed conditions in the money market, in which banks distrust each other. Rather than lending money to each other, they borrow it from the central bank and deposit it there too.

Does that not entail enormous risks for central banks, at which TARGET claims are mounting up because of the imbalances? For the Bundesbank alone, they amount to almost €500 billion.

There are no risks in a cohesive monetary union. There are certainly grounds to monitor the imbalances, because in a currency union with a well-functioning interbank market, the TARGET claims would not become so large in the first place.

Do you expect the TARGET balances to disappear again one day?

Yes, of course. We have seen in the past that imbalances recede whenever the situation improves.

In December the ECB provided financing of almost €500 billion for the unusually long period of three years. The second operation of this kind, which will be conducted at the end of February, could be of a similar magnitude. Can you understand that these large sums make many people feel uneasy, and lead them to wonder if they will one day have to foot the bill?

It is important to explain things well. That's why the media are so important.

Only we are worried too, unfortunately.

The net inflow from the first three-year tender, at a good €200 billion, was not that high. There is no sign of inflationary tendencies in the euro area, quite the opposite. And if there should be any sign of future inflation, we have the instruments with which to absorb the liquidity again within a short space of time.

But with the longer-term refinancing operations, the ECB also relaxed the collateral framework.

We have made it possible for individual loans to be lent on. This mainly benefits the smaller banks, which do not have the capacity to securitise such credit claims and then use them as collateral with the central bank. This extension involves additional collateral of around €600 billion, which, as a result of the large haircuts, can permit additional lending of €200 billion. In relation to the size of the euro area, that is not such a big sum. In addition, the national central banks bear the risk stemming from these loans.

There were rumours that the ECB asked the banks to borrow a lot of money and then to use it to buy government bonds.

Who said that? I'd like to have a word with that person. No, we made it very clear that the banks take their own decisions. We would prefer it if they would lend the money to companies and households. Incidentally, the impact of the three-year tender was underestimated when I announced it in December, because many people expected the ECB to expand its government bond purchases, the famous "bazooka". Maybe I should have called the tender "Big Bertha" when I announced it, then everyone would have listened.

The ECB is hardly buying any bonds of fiscally weak euro area countries at the moment. Wouldn't this be a good opportunity to put an end to this programme that is so controversial, particularly in Germany?

The markets are still vulnerable, and so we have to be very careful about announcing the end of such an instrument. The Securities Markets Programme has served a purpose since it was introduced.

If the situation were to worsen again, would you be ready to expand the collateral framework again?

That would be for the Governing Council of the ECB to decide, but I personally am not in favour of it. We have done enough. The collateral rules should not be relaxed further. In future, based on the current outlook, it will rather be a question of tightening the requirements again.

You said recently that the ECB's financing measures had prevented a credit crunch in December. What has changed since then?

Banks were tightening their credit conditions. This applied more to countries such as Portugal and Spain and less so to Germany. But following the very weak fourth quarter of 2011, both hard indicators and confidence indicators have gradually improved. The situation varies considerably across the individual euro area countries, but it has stabilised overall.

Have the positive signs increased over the past two weeks?

Yes, I would say so, although uncertainty remains high.

Is there still a risk of a "lost decade" of very low growth, as experienced in Japan?

No. What makes me confident are the reforms that have been started in Europe in the past four or five months.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement Mario Draghi, President of the ECB, Brussels, 19 December 2011

Dear Madam Chair,

Dear Honourable Members,

E' per me un estremo piacere partecipare per la prima volta come Presidente della Banca Centrale Europea a questa riunione. Il dialogo monetario trimestrale con l'ECON rappresenta un' opportunità fondamentale e la pietra angolare per un rapporto costruttivo tra le nostre due istituzioni.

Cet échange a lieu quelques semaines seulement après que d'importantes décisions ont été prises à la fois par le Conseil des Gouverneurs de la BCE et par les Chefs d'Etats et de Gouvernements. Dans ce contexte, notre discussion promet d'être particulièrement riche et fructueuse.

Zur Einführung werde ich zunächst auf die aktuellen wirtschaftlichen Entwicklungen im Eurogebiet eingehen. Anschließend werde ich mich den von Ihnen gewünschten Themen zuwenden, nämlich dem Instrumentarium zur Krisenbewältigung einerseits, sowie den Rating-Agenturen andererseits.

I. Economic and Monetary Developments

Since the last regular hearing in October with former President Trichet, the ECB has taken a number of steps to ensure that it will continue to deliver price stability in the medium term in an environment that remains challenging. These steps relate both to changes in our interest rates and to non-standard measures.

As you know, regarding interest rates, the Governing Council early December decided to lower the key ECB interest rates by 25 basis points, following a 25 basis point decrease on 3 November 2011.

As regards the short-term growth outlook for the euro area, the intensified financial market tensions are continuing to dampen economic activity in the euro area and the outlook remains subject to high uncertainty. Euro area economic activity should recover, albeit very gradually, in the course of 2012, as also projected by Eurosystem staff in early December. Substantial downside risks to this economic outlook nevertheless remain.

With regard to price developments, inflation was 3.0% in November. Inflation is likely to stay above 2% for several months to come, before declining to below 2%, which view is also broadly confirmed in the December staff projections. Given the environment of weaker growth in the euro area and globally, underlying cost, wage and price pressures in the euro area should also remain modest. Risks to the medium-term outlook for price developments remain broadly balanced.

The latest monetary data reflect the heightened uncertainty in financial markets. Looking beyond short-term volatility, the monetary analysis indicates that the underlying pace of monetary expansion remains moderate.

The Governing Council of the ECB is determined to ensure that inflation expectations continue to be firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

Let me now turn to the latest non-standard measures. Such measures should prevent adverse effects on the monetary policy transmission mechanism stemming from the ongoing tensions in parts of the euro area financial markets. They should in particular mitigate the effects of strains in financial markets on the supply of credit to firms and households.

First, several measures have been enacted to ensure that banks maintain access to funding markets.

- We have decided on three-year refinancing operations to support the supply of credit to the euro area economy. These measures address the risk that persistent financial markets tensions could affect the capacity of euro area banks to obtain refinancing over longer horizons.
- Earlier, in October, the Governing Council had already decided to have two more refinancing operations with a maturity of around one year.

- Also, it was announced then that in all refinancing operations until at least the first half of 2012 all liquidity demand by banks would be fully allotted at fixed rate.
- Funding via the covered bonds market was also facilitated by the ECB deciding in October to introduce a new Covered Bond Purchase Programme of €40 billion.
- Funding in US dollar is facilitated by lowering the pricing on the temporary US dollar liquidity swap arrangements.

These measures should ensure that banks continue to have access to stable funding, also at longer maturities, which gives them the opportunity to continue lending to firms and households.

Second, some banks' access to refinancing operations may be restricted by lack of eligible collateral. To overcome this, a temporary expansion of the list of collateral has been decided. Furthermore, the ECB intends to enhance the use of bank loans as collateral in Eurosystem operations. These measures should support bank lending, by increasing the amount of assets on euro area banks' balance sheets that can be used to obtain central bank refinancing.

Third, the Governing Council decided on measures aimed at fostering money market activity. Amongst others, the reserve ratio will be temporarily reduced, from 2% now to 1%. This increases the incentives for market participants to engage in money market transactions. Also, it increases the collateral available to banks, as it reduces their liquidity needs vis-à-vis the Eurosystem and thereby the amount of collateral that needs to be posted.

Overall, all measures mentioned aim to ensure enhanced access of the banking sector to liquidity and facilitate the functioning of the euro area money market, thereby avoiding severe limitations to the real economy from a lack of financing possibilities. This also helps ensure that the official interest rates set by the ECB are transmitted in an appropriate way to the economy, and in that way help maintaining price stability in the medium term.

II. Foundations for a stable economic and monetary union

Let me now turn to the outcome of the last European Council.

This Council has really brought about a breakthrough in terms of commitment to sound and transparent fiscal rules. The foundations for a fiscal compact have been laid – a suggestion presented before the plenary of the European Parliament at the ECB hearing on our annual report at the beginning of this month.

It has been agreed that the annual structural deficit should not exceed 0.5% of nominal GDP. Euro area Member States will implement such a rule in their national legal frameworks at a constitutional level. The objective is to avoid excessive deficits before they arise, rather than trying to control them after they have emerged. An automatic correction mechanism is also foreseen in case of deviation. Moreover, the leaders agreed on a numerical benchmark for annual debt reduction to bring down debt levels. Sanctions will also apply automatically to euro area Member States in breach of the 3% reference value for deficits. The European Court of Justice may be asked to verify the implementation of these rules at national level.

The new fiscal compact is an essential signal, showing a clear trajectory for the future evolution of the euro area. It frames expectations of both citizens and financial markets. Enshrining strict rules in primary legislation, making them enforceable by the European Court of Justice: all of this should contribute to making public finances in the euro area credibly robust. The ECB welcomes this outcome.

As regards the euro area crisis management instruments, we welcome the decisions of the Heads of State or Government of the euro area to strengthen the EFSF and the ESM in a number of areas.

First, there is now greater flexibility in the euro area crisis mechanisms to act as backstops, thanks to the decision to accelerate the entry into force of the European Stability Mechanism, ESM, to July 2012 and for the European Financial Stability Facility, EFSF, to remain active in financing programmes that have started until mid-2013.

Second, the clarification that as regards private sector involvement, the euro area will adhere to established IMF practice is also helpful in reassuring investors.

Third, the decision to include an emergency procedure into the voting rules of the ESM [1] is essential for effective decision making procedure, especially in crisis situations.

As regards the EFSF, the Governing Council of the ECB has decided that the ECB will be able to act as agent for the EFSF in its market operations. The ECB – probably supported by a number of National Central Banks – will make its

technical infrastructure and know-how available to the EFSF. The technical and legal preparations have started and we hope to complete them in January.

III. Credit rating agencies

The activities of credit rating agencies, notably in relation to sovereigns as well as the EFSF, have lately occupied centre stage in the debate in Europe. Calls for better regulation have become louder. Against this background, the Commission's recent legislative proposals on Credit Rating Agencies, which the ECB broadly supports, is also discussed by this Committee.

Credit ratings have a direct impact on the market functioning and the wider economy. A sound and robust framework must thus be created. This framework should be geared towards the following objectives: to reduce market volatility; to enhance the quality of rating process; and to restore market confidence.

The two issues that are of particular importance are, first, the assurance of appropriate underlying methodologies and the transparency of ratings; and second, the reduction of hardwiring of ratings in legislation and market practices. Ratings simplify complex risk assessments. But they should only be one of several inputs for investors. In particular, they should be no substitute for financial institutions and other investors to carry out their own assessment. This is the main step towards avoiding mechanistic reliance on external credit ratings.

Let me say a few words on how the ECB itself uses ratings. In practice, for the large majority of marketable securities (such as sovereign bonds) the Eurosystem Credit Assessment Framework mainly uses the ratings issued by eligible credit rating agencies. At the same time, the Eurosystem does not mechanically rely on these assessments, as it is aware of the limitations of methodologies. It reserves the right to reject or limit the use of an asset on the basis of any information on its credit quality that it may consider relevant. The Eurosystem has applied such discretion to temporarily suspend the application of the minimum rating requirement to debt instruments issued or guaranteed by some euro area governments following EU/IMF adjustment programmes.

Thank you for your attention.

Interview with the Financial Times

Interview with Mario Draghi, President of the ECB, conducted by Lionel Barber and Ralph Atkins on 14 December 2011 in Frankfurt

Financial Times: We are now more than four years into the financial crisis. What lessons would you draw so far? What has gone right and what has gone wrong?

Mario Draghi: We have to distinguish two stages. First was the financial crisis, with its repercussions for the real economy. I think we learnt the lessons that we need a more resilient financial system, a system where we would have less debt and more capital. There has been substantial progress in designing new regulatory policies and some progress in implementing this new design.

The second stage of the crisis is really a combination of, I would say, a challenging political phase, where euro area leaders are reshaping what I called the fiscal "compact," and a situation where banks and countries, face serious funding constraints. These challenging funding conditions are now producing a credit tightening and have certainly increased the downside risks for the euro area economy.

Action is proceeding on two fronts. At last week's European Union summit you saw a first step towards fiscal rules that are not only more binding, but actually are of a different nature. They would be binding ex ante, which is an entirely new quality, and written into the primary legislations of the member states.

The second line of action is a set of meaningful, significant decisions taken by the ECB last week. We cut the main interest rate by 25 basis points. We announced two long-term refinancing operations, which for the first time will last three years. We halved the minimum reserve ratio from 2 per cent to 1 per cent. We broadened collateral eligibility rules.

Finally, the ECB governing council agreed that the ECB would act as an agent for the European Financial Stability Facility (EFSF).

Will the three-year refinancing operations give banks an incentive to buy "periphery" eurozone bonds?

Not necessarily. Of course banks also have capital difficulties, and these measures don't necessarily help them on that side. The objective is to ease the funding pressures that banks are experiencing. They will then decide what the best use of these funds is. One aspiration is to have them financing the real economy, especially small and medium sized enterprises (SMEs). What we are observing is that small and medium sized banks are the ones having the biggest funding difficulties, and they are generally the ones who provide most of the financing for the SMEs. And SMEs account for about 70 per cent of employment in the euro area's corporate sector.

Is this Europe's version of "quantitative easing"?

Each jurisdiction has not only its own rules, but also its own vocabulary. We call them non-standard measures. They are certainly unprecedented. But the reliance on the banking channel falls squarely in our mandate, which is geared towards price stability in the medium term and bound by the prohibition of monetary financing [central bank funding of governments].

Coming back to what banks are going to do with this money: we don't know exactly. The important thing was to relax the funding pressures. Banks will decide in total independence what they want to do, depending on what is the best risk / return combination for their businesses. One of the things that they may do is to buy sovereign bonds. But it is just one. And it is obviously not at all an equivalent to the ECB stepping-up bond buying.

Do you expect, in the next six months, another round of bank recapitalisations and, in some cases, nationalisation?

Last week, we had the results of the European Banking Authority (EBA) "stress tests" exercise. But ideally, the sequence ought to have been different: We should have had the EFSF in place first. This would have had certainly a positive impact on sovereign bonds, and therefore a positive impact on the capital positions of the banks with sovereign bonds in their balance sheet. So the ideal sequencing would have been to have the recapitalisation of the banks after EFSF had been in place and had been tested.

In fact, it was done the other way round, so the capital needs identified by the EBA exercise reflect stressed bond market conditions. That may exert pressure on banks to achieve better capital ratios by simply de-leveraging.

De-leveraging means two things; selling assets and/or reducing lending. In the present business cycle conditions, I think the second option is by far the worst. I understand regulators have recommended to their banks that they shouldn't go this way, so let's hope they follow this advice.

Couldn't somebody just say to the EBA, look, just hold off now, this is completely unhelpful?

I think the press statement by EBA somehow hints at that, because they say that there wouldn't be another exercise next year.

To be fair to EBA, the shape of the exercise was decided at a time when the biggest economic threat seemed to be the banking system's lack of credibility. People feared banks' balance sheets concealed fragilities that in the end would strain the economies. So they started this exercise thinking that, being transparent, and marking-to-market sovereign bonds, would strengthen the credibility of the banking system and reduce risk premia. At the end, it did not work that way because of the sequencing. But I wouldn't say it's EBA's fault.

The big point here though is, at least the world in 2011, has fundamentally changed, if not for the last two years, where a position where equities would be seen as more risky than government bonds is now in reverse….

The big change is that assets which were considered absolutely safe are now viewed as potentially unsafe. We have to ask what can be done to restore confidence. I would say there are at least four answers.

The first lies with national economic policies, because this crisis and this loss of confidence started from budgets that had got completely out of control.

The second answer is that we have to restore fiscal discipline in the euro area, and this is in a sense what last week's EU summit started, with the redesign of the fiscal compact.

However, we are in a situation where premia for these risks are overshot. When you have this high volatility – like we had after Lehman – you have an increase in the counterparty risk. In the worst case, you can have accidents and even if you don't have accidents, you have a much reduced economic activity because people become exceedingly risk averse.

So the third answer to this is to have a firewall in place which is fully equipped and operational. And that was meant to be provided by the EFSF.

The fourth answer is to again ask: why are we in this situation. Part of this had to do with fiscal discipline, but the other part was the lack of growth. Countries have to undergo significant structural reforms that would revamp growth.

And the fifth answer is that the idea of introducing private sector involvement (PSI) in eurozone bail-outs was, in retrospect, a mistake?

The ideal sequencing would have been to first have a firewall in place, then do the recapitalisation of the banks, and only afterwards decide whether you need to have PSI. This would have allowed managing stressed sovereign conditions in an orderly way. This was not done. Neither the EFSF was in place, nor were banks recapitalised, before people started suggesting PSI. It was like letting a bank fail without having a proper mechanism for managing this failure, as it had happened with Lehman.

Now, to be fair again, one has to address another side of this. The lack of fiscal discipline by certain countries was perceived by other countries as a breach of the trust that should underlie the euro. And so PSI was a political answer given with a view to regaining the trust of these countries' citizens.

Coming to the fiscal pact, what is your answer to those who say there is excessive concentration on budgetary rigour at the expense of competitiveness and growth and that actually what is being created is a "stagnation and austerity union"?

The answer is that they are right and wrong at the same time. They are right because there can't be any sustainable economy without growth and competitiveness and job creation. They are wrong if they think that there is a trade-off between the two. There's no trade-off between fiscal austerity, and growth and competitiveness. I would not dispute that fiscal consolidation leads to a contraction in the short run, but then you have to ask yourself: what can you do to mitigate this.

Improvement in budgetary positions should elicit some positive market response, lower spreads and lower cost of credit. But two further conditions have to be satisfied: Implementation at national level of the structural reforms needed to enhance growth and jobs creation. And finally, it is necessary to have the right euro area design, implementing the fiscal compact, so that the confidence is fully restored. Austerity by one single country and nothing else is not enough to regain confidence of the markets – as we are seeing today.

Consolidation must also go hand in hand with structural reforms. Each country has its own path that they should undertake. For some, the situation would not be sustainable even if they were outside the euro and were to devalue their currency. That would give only a temporary respite - and higher inflation, of course.

But that was part of the answer in the early 1990s in Italy – it did have an exchange rate adjustment.

If you take that as an example, remember there was no IMF around, there was no EFSF and gross [government bond] issuance in 1992 was a multiple of the figures that we see today. It's true that Italy moved the exchange rate, but this cuts both ways. It brought a temporary respite to the economy, so that exports could grow, but it also widened sovereign bond spreads because exchange rate risk came on top of sovereign risk. Three or four years down the road Italy still had something like 600 basis point spread with respect to the German bund. Furthermore, the effect of the devaluation would have been only temporary without the structural reforms (abolition of indexation among others) that followed.

But these austerity programmes are very harsh. Don't think that some countries are really in effect in a debtor's prison?

Do you see any alternative?

They could leave the eurozone?

But as I said before, this wouldn't help. Leaving the euro area, devaluing your currency, you create a big inflation, and at the end of that road, the country would have to undertake the same reforms that were due to begin with, but in a much weaker position.

But maybe it would be the best thing for the rest of the eurozone?

Well, then you would have a substantial breach of the existing treaty. And when one starts with this you never know how it ends really.

You said earlier that it would have been far better if the EFSF had have been in place. So where are we on creating this firewall - what size of bazooka are we talking about?

One first observation is that the delay in making the EFSF operational has increased the resources necessary to stabilising markets. Why? Because anything that affects credibility has an immediate effect on the markets. A process that is fast, credible and robust needs less resources.

It sounds like you're a bit disappointed then with the outcome of last week's summit then?

Actually no, because there was confirmation of previous figures on the EFSF's resources – and of an additional €200bn that could be provided by the International Monetary Fund. What was also overlooked by many is that the date for a first assessment of the adequacy of resources has been brought forward to March 2012 – in just three months' time, when the leaders ask themselves whether the resources for the firewall will be adequate. In the meantime, the ECB acting as an agent will make the EFSF operational. Important was also the commitment to clearly restrict the PSI to IMF practices, which should reassure the investors.

When do you think the EFSF will be operational?

Our aim is to be ready to provide agency functions in January next year.

But can we assume that the idea floated in October of leveraging the EFSF is not actually going to happen? And that bringing in other sovereign wealth funds, Chinese, all this was overpriced.

No, I think it is premature and probably wrong to proclaim the EFSF dead. Furthermore I think that if one can show its usefulness in its present size, the argument for its enlargement would be much stronger.

What do you say to those who say the solution is to have a very big fire wall and ultimately put the ECB behind it, because that is the only thing which will tame the markets?

People have to accept that we have to and always will act in accordance with our mandate and within our legal foundations.

But if you look at the wording of the treaty, there is nothing that sets a limit on how many government bonds you buy….

We have to act within the Treaty. In general, there must be a system where the citizens will go back to trusting each other and where governments are trusted on fiscal discipline and structural reforms.

Once the firewall is in place with the EFSF, perhaps as soon as the beginning of next year, might you actually stop the SMP (securities market programme)?

We have not discussed a precise scenario for the SMP. As I often said, the SMP is neither eternal nor infinite.

Let's not also forget that the SMP was initiated with the view to reactivating monetary policy transmission channels. So as long as we see that these channels are seriously impaired, then the SMP is justified.

Arguably, the monetary transmission channels are more impaired than ever before, if you look at interest rates in Greece or Italy compared with Germany?

The cost of credit is bound to differ because it's geared to some extent not on our short-term policy rate but on sovereign spreads.

Would the ECB consider putting a limit on yields or spreads, or would that violate the treaty in your view?

Sovereign spreads have mostly to do with the sovereigns and with the nature of the compact between them. It is in this area that progress is ongoing. Monetary policy cannot do everything.

But if the economic situation deteriorated, would you be prepared to embark on "quantitative easing" in the style of the US Federal Reserve or Bank of England, in terms of large-scale government bond purchases to support economic growth?

The important thing is to restore the trust of the people – citizens as well as investors – in our continent. We won't achieve that by destroying the credibility of the ECB. This is really, in a sense, the undertone of all our conversation today.

What will be the effect of the British staying out of Europe's fiscal compact, and is there in your view a risk to the City of London?

The UK certainly has shown a capacity to undertake a fiscal correction of an extraordinary size. My more general reaction to all this is that it's sad. I think the UK needs Europe and Europe needs the UK. There's a lot that can be learnt from both sides.

The UK has taken legal action against the ECB [over the location of financial market clearing houses]…

I can't comment on that.

What are you expectations for global growth next year?

You could have a significant slowdown in several parts of the world. Global growth is decelerating, and uncertainty has risen. At the same time, we have laid a lot of groundwork for a better functioning of economic union in the future and we should draw confidence from that.

The euro, monetary policy and the design of a fiscal compact

Speech by Mario Draghi, President of the ECB, Ludwig Erhard Lecture, Berlin, 15 December 2011

Ladies and Gentlemen,

I am honoured to have received the invitation from Professor Hans Tietmeyer to deliver this year's Ludwig Erhard lecture.

When I was working at the Italian Treasury in the 1990s, Professor Tietmeyer and I had many opportunities to work together. I vividly remember many of our exchanges over the course of the two decades since the Maastricht Treaty. And I am very grateful that he remains in close contact with the European Central Bank (ECB) as adviser to our audit committee.

Ludwig Erhard's legacy in shaping Germany's post-war recovery stretches far beyond his own country and far beyond his own times. His conception of the social market economy was visionary. And he even held cherished views about central bankers, stressing the importance of price stability: "Die soziale Marktwirtschaft ist ohne eine konsequente Politik der Preisstabilität nicht denkbar." I think we cannot formulate this idea any better today.

Ludwig Erhard also helped to enshrine the principle of central bank independence. When in the early 1950s the independence of the German central bank system was not yet settled, he as minister of the economy argued that the government should not issue instructions to the central bank. You all know that the statutes of the ECB inherited this important principle and that central bank independence and the credible pursuit of price stability go hand in hand.

Current circumstances remain demanding, with economic, financial and fiscal issues deeply intertwined with challenges at the political level in many countries and in the supra-national European sphere.

Last week two sets of important decisions have been taken, which are going to be the focus of my remarks today. First, I will elaborate on the motivation for the monetary policy measures that the ECB announced last Thursday and what we expect from them. Second, I would also like to share with you some views on last week's European Council summit's decisions, which brought some very important new elements to our economic and monetary union.

Monetary policy decisions for the euro area

To explain our recent monetary policy measures, let me recall the particular role of banks in the euro area economy. The flow of credit to firms and households in the euro area works largely through banks. During recent years, about three quarters of firms' external financing have come from that source.

This means that any impairment in the bank lending channel will have stronger consequences in the euro area than in other economies where firms' external financing comes largely from corporate bond markets.

Banks in the euro area have recently come under pressure both as regards their capital bases and their funding conditions.

The plan to strengthen their capital bases is an attempt to reinforce their standing in financial markets, but this is not an easy process. There are essentially three options for banks to pursue to raise their capital ratios as demanded by the European Banking Authority: they can raise their capital levels, sell assets or reduce their provision of credit to the real economy.

The first option is much better than the second, and the second option is much better than the third. But raising capital levels is expensive in a depressed market and faces resistance from shareholders. Selling assets is less preferable and curtailing credit to the real economy is even worse. Therefore, public authorities ought to cushion the impact on the real economy and banks should consider restraining dividends and ad hoc compensation to strengthen buffers.

Banks are also facing problems in raising longer-term funding in financial markets. The resulting shortening of their funding leads in turn to maturity mismatches on balance sheets of the kind that caused the financial crisis. At the same time, shortages of collateral are beginning to emerge in some segments of the financial system especially for the small and medium sized banks.

In addition to identifying these particular strains in the banking sector, our regular economic and monetary analysis has indicated that the intensified financial market tensions continue to dampen economic activity in the euro area and the outlook remains subject to high uncertainty and substantial downside risks. In such an environment, cost, wage and price pressures in the euro area should remain modest over the policy-relevant horizon. At the same time, the underlying pace of monetary expansion remains subdued.

In these conditions, and faithful to our mandate to maintain price stability over the medium term, the ECB's Governing Council has taken a number of far-reaching decisions.

The Council decided to reduce its key interest rates by another 25 basis points to 1%. In normal financial market conditions, a policy rate reduction is a potent instrument of inflation control and demand support. The rate cut works its way through a long chain of downward adjustments in financial returns. At the end of the process, the yield on large spectrum of securities declines and promotes broad-based policy accommodation.

In the present conditions, this process turns out to be hampered, so that the impact of a rate cut by itself is weakened. Banks limit their lending to other banks and potentially to the broader economy, and they hold on to precautionary balances of cash as self-insurance.

Therefore, the Governing Council last week decided on three other measures, each of which provides additional support in order to bring the necessary monetary policy impulse to the real economy.

The current package should be felt tangibly in the financial sector and the real economy over the coming weeks and months. Of course, it comes against strong headwinds generated by deleveraging.

We established very long-term refinancing operations with a maturity of three years. This duration is a novelty in ECB monetary policy operations.

The extension of central bank credit provision to very long maturities is meant to give banks a longer horizon in their liquidity planning. It helps them to avoid rebalancing the maturities of their assets and liabilities through a downscaling of longer-term lending. Incidentally, we want to make it absolutely clear that in the present conditions where systemic risk is seriously hampering the functioning of the economy, we see no stigma attached to the use of central banking credit provisions: our facilities are there to be used.

Banks will be able to refinance term lending with the Eurosystem and thus preserve their long-term exposures to the real economy. After the first year, banks will have the option to terminate the operation. So they can flexibly adapt to changing liquidity conditions and a normalising market environment.

Our second measure will allow banks to use loans as collateral with the Eurosystem, thereby unfreezing a large portion of bank assets. It should also provide banks with an incentive to abstain from curtailing credit to the economy and to avoid fire-sales of other assets on their balance sheets.

The goal of these measures is to ensure that households and firms – and especially small and medium-sized enterprises – will receive credit as effectively as possible under the current circumstances. Of course, we have to screen the collateral carefully so as to protect our balance sheet.

The third measure we announced last week is to reduce the required reserves ratio from 2% to 1%. This measure frees up liquidity of the banking sector by about 100 billion euro. Along with other measures, this reduction in the reserve requirements should, too, help revive money market activity and lending.

You will notice that I referred repeatedly to small and medium-sized enterprises. The reason for drawing your attention to these businesses is that they are a significant part of our economy, accounting for about 70% of employment in the euro area and 60% of the turnover of all firms. We believe that the measures introduced last Thursday will provide support for this sector and indirectly also support much-needed investment, growth and employment.

Foundations for a stable economic and monetary union

Let me now shift my attention to last week's European Council summit. For more than 12 years, Europe's economic and monetary union has been haunted by concerns about national budgets. Within a common currency area during normal times, the fiscal policies of individual countries typically face less pressure from financial markets. It was for this reason that at the very beginning of Europe's single currency, the Stability and Growth Pact was established to provide a control mechanism for fiscal policy.

Next year, the euro area as a whole will have a government primary budget deficit close to zero. This compares with primary deficits projected at around 5% of GDP in Japan, the UK and the US.

Yet the implementation of the Stability and Growth Pact has not been good enough. As the Federal Chancellor of Germany recently remarked, the Pact has been broken 60 times over the past 12 years. So we clearly have work to do to prevent this happening again.

The new set of rules for economic and fiscal surveillance known as the six-pack – which was approved by the European Parliament earlier this year – will certainly strengthen the implementation of the rules. But while these changes were being planned, the entire fiscal cohesion and credibility of the euro area was weakened.

We have now begun the process of re-designing Europe's fiscal framework on three fronts.

The first lies with the countries concerned: they have to put their policies back on a sound footing. I believe that they are now on the right track and they are right in implementing budgetary consolidation resolutely. The unavoidable short-term contraction may be mitigated by the return of confidence. But in the medium term, sustainable growth can be achieved only by undertaking deep structural reforms that have been procrastinated for too long.

The second pillar of a response to the crisis consists of a re-design of the fiscal governance in the euro area, what I called the fiscal compact. The fiscal compact is a fundamental restatement of the rules to which national budgetary policies ought to be subject so as to gain credibility beyond doubt.

Last week's summit committed to enshrine these rules in the primary legislation. They will foresee that the annual structural deficit should not exceed 0.5% of nominal GDP. Euro area Member States will implement such a rule in their national legal frameworks at a constitutional level, so that it is possible to avoid excessive deficits before they arise, rather than trying to control them after they have emerged. Prevention is better than cure.

Rules will also foresee an automatic correction mechanism in case of deviation. Moreover, the leaders agreed on a numerical benchmark for annual debt reduction to bring down debt levels. They also agreed to sanctions that will apply automatically to euro area Member States in breach of the 3% reference value for deficits.

The European Court of Justice may be asked to verify the implementation of these rules at national level.

Taken together, I believe that these decisions are capable of making public finances in the euro area credibly robust.

But restoring financial markets' confidence also requires that investors be reassured that government debt will always be repaid and timely serviced. Greece will remain a unique case, and a credible stabilisation mechanism, a firewall, will be in place and can be activated when needed subject to proper conditionality. The leaders unambiguously agreed to

assess the adequacy of the firewall by next March. Its objective is to address the threats to financial stability, and especially the risk of contagion between different sovereign debt markets.

The leaders decided to deploy the leveraging of the European Financial Stability Facility (EFSF) at the earliest opportunity. At the same time they agreed that the EFSF's successor, the European Stability Mechanism, should come into force by July 2012.

It is crucial that the EFSF be fully equipped and be made operational as soon as possible. With this goal in mind, last Thursday, the Governing Council decided that the ECB would stand ready to act with its technical infrastructure and know-how as an agent for the EFSF in carrying out its market operations.

Conclusion

Let me conclude. The decisions of the European Council summit, together with the six-pack approved recently by the European Parliament, are a breakthrough for clear fiscal rules in our monetary union.

However, the crisis has not ended yet. It is now important not to lose momentum and to swiftly implement all those decisions that have been taken to put the euro area economy back on course.

The monetary policy measures taken last week by the ECB's Governing Council will support the flow of credit to firms and households in the euro area economy.

Ludwig Erhard faced a situation that was much more difficult than what we face today. Still, he was able to look through the challenging present and to work hard to build a future that he never doubted would be brighter. The European policy makers might well be inspired by his style: "Den Strom der Zeit können wir zwar nicht lenken, aber wir werden unser Schiff sicher steuern."

Thank you very much for your attention.

Hearing before the Plenary of the European Parliament on the occasion of the adoption of the Resolution on the ECB's 2010 Annual Report

Introductory statement by Mario Draghi, President of the ECB, Brussels, 1 December 2011

President,

Honourable members of the European Parliament,

I am delighted to be making my first appearance here as President of the European Central Bank (ECB) and I am honoured to present to you the ECB Annual Report for 2010.

Je souhaite tout d'abord rendre ici hommage à mon prédécesseur. Tout au long de son mandat, Jean-Claude Trichet a su entretenir un dialogue fructueux et constructif avec le Parlement européen. Dialogue que j'entends poursuivre avec tout autant de vigueur.

Die EZB ist sich ihrer großen Verantwortung als Hüterin der Geldwertstabilität bewusst. Die Unabhängigkeit der EZB ist und bleibt unverhandelbar.

Impegno, forte senso di responsabilità e corretta attuazione delle politiche sono condizioni essenziali della partecipazione all'Unione Economica e Monetaria.

Monetary policy decisions in 2010 and 2011

Today's session is an opportunity for us to take a wider perspective on ECB policies. In that way, I will also touch on a number of the broader themes of the Resolution of the European Parliament.

Let me begin with a few words on the main monetary policy decisions we have taken and the challenges we have faced during 2010 and 2011.

As you know, the ECB's monetary policy is constantly guided by the goal of maintaining price stability in the euro area over the medium term. And when I say this, I mean price stability in either direction. This applies to both the setting of official interest rates and the implementation of non-standard measures.

This autumn, tensions in financial markets have intensified again with very adverse effects on financing conditions and confidence. Downside risks to the economic outlook have increased. The weaker degree of activity is moderating price, cost and wage pressures. It is in this context that the ECB decided to reduce its key interest rates by 25 basis points in early November 2011.

Dysfunctional government bond markets in several euro area countries hamper the single monetary policy because the way this policy is transmitted to the real economy depends also on the conditions of the bond markets in the various countries. An impaired transmission mechanism for monetary policy has a damaging impact on the availability and price of credit to firms and households.

This is the very important monetary policy reason for the ECB's non-standard measures. But of course, such interventions can only be limited. Governments must – individually and collectively – restore their credibility vis-à-vis financial markets.

Tensions in sovereign bond markets have been accompanied by stress in the banking sector given the financial interlinkages between governments and banks. The ECB has taken several measures in 2010 and 2011 to ensure that banks continue to have access to funding sources. This has enabled them to continue lending to firms and households.

Most importantly, the ECB has extended its policy of fully allotting liquidity demanded by banks at fixed rates against collateral. The maximum maturity of these liquidity-providing operations was first extended to six months and later to 12 and 13 months. A new Covered Bond Purchase Programme has recently been initiated, with a size of 40 billion euros.

In addition, liquidity in US dollars has been offered to banks for three-month periods. Yesterday, in a globally coordinated action with the Federal Reserve, the Bank of Japan, the Bank of England, the Bank of Canada and the Swiss National Bank, we have agreed to lower the price on US dollar provision in other constituencies including the euro area. We have furthermore agreed, as a contingency measure, to establish temporary bilateral liquidity swap arrangements so that liquidity can be provided in each jurisdiction in any of the currencies, should market conditions so warrant.

As the ECB's Governing Council meets on Thursday next week, we are now in the pre-decision period, and nothing that I say should in any way be interpreted in terms of future monetary policy decisions. But as far as the current situation is concerned, there is not much more to say beyond what I have said in recent statements.

We are aware of the continuing difficulties for banks due to the stress on sovereign bonds, the tightness of funding markets and scarcity of eligible collateral in some financial segments. We are also aware of the problems of maturity mismatches on balance sheets, the challenges of raising levels of capital and the cyclical risks related to the downturn.

Challenges for Europe's Economic and Monetary Union

Let me now turn to the overall functioning of Europe's Economic and Monetary Union. Looking back at 2010 and 2011, notable progress has been achieved in reinforcing economic governance – though I recognise that this may not be evident in times of crisis.

The European Parliament has contributed decisively to that progress, and the ECB commends that work. The "six pack", the European Semester, the Euro Plus Pact: all these initiatives have set the stage for closer coordination and more intensive scrutiny of economic policies in the EU, particularly in the euro area.

Yet we are at a difficult stage at present. We have set up these new mechanisms, but their positive effects on the credibility of government fiscal policies are not yet visible. And the government changes that have taken place in some of the more exposed countries have not yet had much of an effect on the continuing fragility of financial markets.

Fundamental questions are being raised and they call for an answer. At the heart of these questions are not only the credibility of governments' policies and the actual delivery of the promised reforms, but also the overall design of our common fiscal governance.

I am confident the new surveillance framework will restore confidence over time. I am also quite sure that countries overall are on the right track. But a credible signal is needed to give ultimate assurance over the short term.

What I believe our economic and monetary union needs is a new fiscal compact – a fundamental restatement of the fiscal rules together with the mutual fiscal commitments that euro area governments have made.

Just as we effectively have a compact that describes the essence of monetary policy – an independent central bank with a single objective of maintaining price stability – so a fiscal compact would enshrine the essence of fiscal rules and the government commitments taken so far, and ensure that the latter become fully credible, individually and collectively.

We might be asked whether a new fiscal compact would be enough to stabilise markets and how a credible longer-term vision can be helpful in the short term. Our answer is that it is definitely the most important element to start restoring credibility.

Other elements might follow, but the sequencing matters. And it is first and foremost important to get a commonly shared fiscal compact right. Confidence works backwards: if there is an anchor in the long term, it is easier to maintain trust in the short term. After all, investors are themselves often taking decisions with a long time horizon, especially with regard to government bonds.

A new fiscal compact would be the most important signal from euro area governments for embarking on a path of comprehensive deepening of economic integration. It would also present a clear trajectory for the future evolution of the euro area, thus framing expectations.

On the precise legal process that brings about a move towards a genuine economic union, we should keep our options open. Far-reaching Treaty changes should not be discarded, but faster processes are also conceivable.

Whatever the approach, companies, markets and the citizens of Europe expect policy-makers to act decisively to resolve the crisis. It is time to adapt the euro area design with a set of institutions, rules and processes that is commensurate with the requirements of monetary union.

Thank you for your attention.

Continuity, consistency and credibility

Introductory remarks by Mario Draghi, President of the ECB, at the 21st Frankfurt European Banking Congress “The Big Shift”, Frankfurt am Main, 18 November 2011

Ladies and gentlemen,

It is a privilege and a pleasure for me to be here today.

As you know, this is the first time I’m speaking publicly as President of the European Central Bank outside the ECB. I could not think of a more appropriate occasion than the European Banking Congress in the ECB’s home town.

I understand that this congress was established about 20 years ago to strengthen the position of Frankfurt as a European financial centre, and thereby make the city attractive as a location – first for the European Monetary Institute and now for the ECB. Well, I am pleased to see how successful it has been!

Before discussing the shift towards a much greater role of emerging economies, which is the theme of today’s congress, let me elaborate on the current situation in the euro area.

I. The euro area situation and ECB monetary policy

Activity is expected to weaken in most of the advanced economies. This is the result of a weakening of various components of aggregate demand, both domestic and foreign. And it is evident in ‘hard’ data as well as survey data.

In the euro area, downside risks to the economic outlook have increased, and the weaker degree of activity will moderate price, cost and wage pressures.

This is why the ECB decided to reduce its key interest rates by 25 basis points on 3 November, acting in full compliance with its mandate to maintain price stability in the medium term.

We are aware of the current difficulties for banks due to the stress on sovereign bonds, the tightness of funding markets and the scarcity of eligible collateral. We are also aware of the problems of maturity mismatches on balance sheets, the challenges to raise levels of capital and the cyclical risks related to the downturn.

In the money market, we see rising spreads between secured and unsecured segments, and a widening of repo prices between different types of collateral. Interbank activity remains subdued and concentrated in the very short-term maturities. This limited activity is reflected in increased recourse to our liquidity-providing operations, as well as to our deposit facility.

So far, the ECB has taken several non-standard measures to ensure that short-term funding does not represent a problem for euro area banks. The most important non-standard measures are the fixed rate full allotment procedures and the longer-term refinancing operations. We have also implemented three additional US dollar operations, which cover the end of the year, and we have launched a second covered bond purchasing programme.

Let me use this occasion to dwell a bit further on monetary policy in the current environment. Three principles are of the essence: continuity, consistency and credibility.

Continuity first and foremost refers to our primary objective of maintaining price stability over the medium term.

Consistency means to act in line with our primary objective and with our strategy both in time and over time.

Credibility implies that our monetary policy is successful in anchoring inflation expectations over the medium and longer term. This is the major contribution we can make in support of sustainable growth, employment creation and financial stability. And we are making this contribution in full independence.

Gaining credibility is a long and laborious process. Maintaining it is a permanent challenge. But losing credibility can happen quickly – and history shows that regaining it has huge economic and social costs.

These three principles – continuity, consistency and credibility – are at the root of the Governing Council's outstanding record during the past 13 years in terms of price stability and anchoring inflation expectations.

National economic policies are equally responsible for restoring and maintaining financial stability. Solid public finances and structural reforms – which lay the basis for competitiveness, sustainable growth and job creation – are two of the essential elements.

But in the euro area there is a third essential element for financial stability and that must be rooted in a much more robust economic governance of the union going forward. In the first place now, it implies the urgent implementation of the European Council and Summit decisions. We are more than one and a half years after the summit that launched the EFSF as part of a financial support package amounting to 750 billion euros or one trillion dollars; we are four months after the summit that decided to make the full EFSF guarantee volume available; and we are four weeks after the summit that agreed on leveraging of the resources by a factor of up to four or five and that declared the EFSF would be fully operational and that all its tools will be used in an effective way to ensure financial stability in the euro area. Where is the implementation of these long-standing decisions?

II. The shift towards a much greater role of emerging economies

Let me now turn to the "big shift" in the global economy that is the theme of today's congress: the much greater role of emerging economies.

Their performance in the aftermath of the crisis has been impressive. Diverging economic performance between the emerging economies and the advanced economies had been evident for at least a decade. But after the crisis, there was a dramatic widening in the divergence.

Initially after the 'Lehman shock' of September 2008, economic activity contracted sharply in both advanced and emerging economies. But a two-speed recovery quickly became evident. The emerging economies have returned to their pre-crisis economic dynamism very rapidly, while the advanced economies have experienced the slow pace of growth that is typical for recoveries following profound financial crises.

To this day, most of the advanced economies are only close to, or have just recovered, their production levels pre-Lehman. In contrast, output in the main emerging economies is now already 20% higher than it was before.

In the past, shocks in advanced economies often caused enduring drags on emerging economies. The Latin American debt crisis of the 1980s was a prominent example. But now, economic reform and strengthened institutions in the emerging world have changed this pattern. Generally, these economies have built enough financial, fiscal and external buffers to dampen international spillovers.

The second feature I would like to highlight is the asymmetry between the rising role of the emerging economies in trade and their still lagging role in finance. They are giants in trade, but their financial linkages to the rest of the world are still developing. Indeed, they are much more open in terms of trade: trade openness is close to 60% of GDP, whereas the same measure based on financial flows is less than 15% of GDP.

The third feature is the relevance of emerging economies for the euro area. They account for roughly one third of our external trade, up from a quarter ten years ago. Interestingly, this increase in the weight of emerging economies has improved the price competitiveness of the euro area, because on average they have had higher inflation than us. At the same time, their higher inflation has not fed into higher euro area prices, because their goods were much cheaper to begin with and because of an increasing share of imports from these countries.

The euro area also benefits from trade with emerging economies in terms of product specialisation. We have a comparative advantage in mid-technology exports, while the most dynamic emerging economies focus on either high-tech or low-tech good. Thus, those economies compete more directly with exports from the United States and Japan or other emerging economies.

The euro area is also helped by the composition of demand in emerging economies. This is tilted more towards goods than services, matching the composition of euro area exports better than that of other large advanced economies.

Therefore, in macroeconomic terms, the euro area's trade relationship with emerging economies has been generally positive.

Conclusion

In spite of the decoupling experienced in recent years, the fortunes of advanced and emerging economies are intimately linked. The growth of emerging economies has brought a much higher level of economic prosperity to hundreds of millions of their people. And their rising role means that today they share responsibility for global economic performance in half with the rest of the world. They account for almost 50% of global GDP measured in purchasing power parity terms (or just over one third of global GDP measured in market exchange rates).

In today's global economy, advanced economies can face some of the same distress that was earlier associated with emerging economies: profound fiscal challenges, sudden stops in capital flows, macroeconomic retrenchment and forced reform. At the same time, and going forward, the emerging economies will be confronted with the challenges that have long concerned advanced economies: population ageing and, perhaps, reform fatigue.

In spite of the current challenges faced by the global economy, we must resist temptation to resort to unilateral policies, and we must work together to ensure that the gains achieved are firmly secured for future generations.

Thank you for your attention.

Interview with Bild am Sonntag

Interview with Jean-Claude Trichet, President of the ECB, conducted by Walter Mayer and Michael Backhaus on 27 October 2011

Mr President, your term of office comes to an end on Monday. The euro is in stormy waters and the captain is leaving the ship. How hard is that for you?

It has been an immense honour and responsibility to be President of the ECB for the last eight years, and to have been able to maintain price stability since the inception of the euro. The last four years have been a very challenging period for all the staff of this institution. This global crisis has presented all of us – both governments and central banks – with considerable and thoroughly unexpected challenges. In any case, this eight-year mandate, which is not renewable, is an essential feature of the independence of the ECB.

In recent weeks and months you've spoken forcefully about this being the most severe crisis since the Second World War. Can you now give the all-clear, following the decisions taken by the Heads of State or Government this week?

The global crisis began in the United States, before spreading throughout the industrialised world. The crisis is not over. It has laid bare the weaknesses of advanced economies. We are now seeing the weaknesses of the US and Japanese economies – but also, of course, Europe's weaknesses. Europe's governments have made serious mistakes, such as failing to comply with the Stability and Growth Pact. And they did so despite the fact that the ECB was emphatic in warning them of the importance of complying with the requirements of the Pact. In addition, some countries failed to pay sufficient attention to their own competitiveness. The critical issue now is for the rules of the Pact to be comprehensively tightened up and implemented. The European Council was in full agreement on this point.

What would be the worst case scenario were all of the Member States' precautionary measures to fail?

The decisions taken at the summit meeting need to be implemented with great precision and speed. The euro area's Heads of State or Government have a plan, and national governments and the European Commission now have some hard work ahead of them. Swift and full implementation of those decisions is now absolutely critical. We will monitor this process very carefully. Now is the time for action.

What kind of future would Europe have without the euro?

We have to be very careful to distinguish between the euro as a currency and the problem of financial stability in the euro area. The first 13 years of the euro have seen the currency retain its value, both domestically and externally. Annual inflation currently averages 2.0% – and just 1.56% in Germany. That is lower than in the previous 50 years. Inflation will, in all probability, remain very low for the next ten years – at around 1.8% according to current expectations. So, we have price stability in the euro area. We are rightly proud of that fact, as we have achieved what was expected of us: we have secured price stability and ensured that the euro is a credible and trusted currency. The financial stability of the euro area is a different story. This has been undermined by mismanagement on the part of certain governments. However, following the decisions taken this week, I am confident that governments can succeed in restoring financial stability. A critical issue in this respect will be the will of the people. I was very impressed by the decisiveness displayed by the German parliament this week.

The euro's rescue fund is being significantly strengthened, with its total firepower set to reach €1,000 billion. Does this mean that the ECB will, in future, be able to do without its controversial purchases of stressed countries' government bonds?

We have adopted special measures during the crisis because they were necessary in order to correctly transmit our interest rate decisions to the economy. In August 2007 we supplied banks with liquidity at fixed rates of interest in order to stabilise the markets. Second, we took the decision to buy covered bonds. And third, we intervened in some government bond markets to help improve the transmission of our monetary policy. Such actions are only justified in the exceptional circumstances of a major global crisis. Once national governments' new tools to restore financial stability are up and running, we will have no reason to continue with these special measures.

Does the ECB really have complete freedom as regards government bonds, or is it under political pressure?

The ECB takes its decisions in full independence. We have consistently demonstrated this, taking controversial decisions on interest rates and other matters. Under the Treaties, members of the ECB's Governing Council are not permitted to take instructions from anybody – neither from governments nor from interest groups. Indeed, they are not even allowed to ask for instructions. It was for monetary policy reasons that the Governing Council, in full independence, adopted all the non-standard measures.

The crisis is being caused by excessive debt in euro area countries. Do we need a political union, or is a return to the Stability and Growth Pact of Maastricht sufficient in order to prevent such events from recurring in the future?

What is important at the moment is to monitor compliance with the now considerably stricter stability requirements. We had initially called for these to go further – calling, for example, for more automatic sanctions against "deficit sinners". Significant progress has been made, and that now needs to be rigorously implemented. That includes strengthening the presidency of the Eurogroup and the body of staff which is to monitor economic developments. In the medium and long term we need to strengthen Europe's political structures, which will not be possible without amendments to the Treaty. I would say – as a citizen of Europe, not as President of the ECB – that we could proceed in the direction of significantly stronger European governance with well-defined responsibilities. With that new governance, it would be possible, in countries that consistently fail to comply with stability requirements and thereby threaten the financial stability of the euro

area, to directly implement appropriate measures. In the long term, therefore, we will need to go further in the direction of political union. But the decision on that will lie with the people of Europe.

What was your most important decision, your greatest success?

As a central banker, you are constantly taking important decisions – for example on interest rates. All of these decisions are taken with the aim of ensuring price stability, which is a prerequisite for sustainable growth and job creation. As a result, it is difficult to say that a particular decision was the most important. But the greatest challenge for the ECB's Executive Board was to recognise in 2007, in real time, that something very significant – something very dangerous – was happening. We were the first central bank in the world to recognise the reality of the situation and quickly implement comprehensive measures in response.

Horst Köhler, with whom you negotiated the Maastricht Treaty, describes the markets as "monsters". Is he right?

I would not necessarily go as far as Horst, for whom I have great respect, but I can see what he could have meant by that. Supervisory authorities need stronger means of monitoring the rapid development of new technology and need to ensure that all innovation in the financial markets continues to serve the real economy and is not to its detriment. Realisation as to what was happening in the markets came somewhat late. We are currently seeking to correct that. Authorities the world over agree that we need to discipline the markets and the financial system as a whole and make them much more resilient in all circumstances.

Jesus drove the money-changers – i.e. the bankers – out of the temple. How do you, as a man of money, feel about this parable?

Central bankers are guardians of monetary stability, which is a public good. So, when the markets run riot, whether on the upside or on the downside, we ensure that there is a return to discipline. Wisdom needs to discipline "animal spirits" – excessive greed or fear. On the other hand, I would certainly warn against making it difficult for banks to carry out their functions. In Europe, banks finance 75% of all economic activity. The real economy needs banks to finance investment, and we should not mistreat or ignore them. We would be shooting ourselves in the foot if we did that.

You experienced the occasionally violent protests of the 1968 movement at close quarters – from ministries in Paris with people demonstrating in front of them. How seriously do you take the "Occupy" movement, which has spread from Wall Street to cities around the world?

I think we should always be very attentive to the signals coming from society. They are manifold and complex. People are asking themselves how it was that first the financial markets and then the real economy turned out to be so vulnerable. We now need to make our market economies much more robust, as only they are capable of creating wealth and employment. And banks need to strengthen their resilience and avoid behaviour – including excessive bonuses – that is not compatible with the values of our societies. These are the messages that I would take from public opinion. We are all working hard to strengthen the financial system, both at the European and at the global level.

To what extent has the greed of the financial markets damaged the notion of the market economy and freedom in Europe and beyond?

We should be very conscious of the fact that certain behaviour in the markets has caused considerable irritation. That includes the size of certain bonus payments. This has shocked the public on both sides of the Atlantic. We therefore need a change in values and a change in behaviour in this respect. We are all living in democracies, and for that reason it is very important that society accepts the values and behaviour observed in the economy.

You've spent the last 40 years working in the public sector in the area of monetary policy – first in Paris for France, and now in Frankfurt for the euro area. Can you tell us something: what is money, the nature of money?

Money has an essential function. It acts as a store of value, it is a means of exchange and it allows people to calculate the price of everything. Money is an inseparable element of civilisation, as it allows the division of labour. It is only thanks to money that we have cities at all. I would compare money to a poem, since a poem always retains its structure, just as a gold coin always retains the image stamped on it. Once formed – whether written or minted – these two things should not and cannot be altered. Goethe gave considerable thought to this issue, as you can see from reading Faust.

To what extent are you personally fascinated by money?

I, personally, am not fascinated by wealth.

In Germany we say that money rules the world. Would you, as a man of money, confirm that?

No, I would not say that at all. Ideas rule the world – hopefully. Money is a means, not an end; an instrument, not the ultimate goal; *un moyen, pas une fin*.

Your wife recently said on German television that the question of whether she was pleased that her husband's work was coming to an end was a "delicate and difficult question". She also said that she hopes you find something to occupy yourself with as soon as possible. What does Madame Trichet mean by that?

Did she really say that? She knows me well. I will certainly remain active. But I will wait until I have left the ECB before deciding what exactly I will do.

Does she perhaps mean that Jean-Claude Trichet cannot be happy without work?

You can trust my wife on that!

Mr Trichet, why is your signature on the euro banknotes?

The euro banknotes are issued by the ECB. I therefore sign the euro banknotes as President of the ECB, on behalf of the Governing Council. Currently there are around 14 billion euro banknotes in circulation.

Interview with Le Monde

Interview with Jean-Claude Trichet, President of the ECB, conducted by Erik Izraelewicz, Clément Lacombe and Cécile Prudhomme, on 27 October 2011 and published in Le Monde dated 30-31 October 2011

New agreements were reached on the night of Wednesday 26 October to Thursday 27 October by the heads of state and government of the euro area, three months after the summit of 21 July. Is this, at long last, the end point of the crisis?

This agreement must be applied rigorously and quickly in all its dimensions, including the improvement of governance. Decision-makers must strive to be ahead of events, even if the speed of decisions in our democracies is not necessarily that of the markets.

A key challenge for the euro area is to communicate with investors and savers in the rest of the world, who have difficulty in deciphering European decision-making. Provided that their decisions are implemented quickly, the euro area countries have the means to improve the perception that the rest of the world has of Europe.

Nevertheless, there are still uncertainties… Which element needs the greatest vigilance?

Progress has to be made on all points in a resolute way.

In respect of governance, in the past, at the ECB, we have found ourselves preaching in the wilderness, when negligence by governments, markets and by many economists was the rule. We knew a time when markets did not distinguish between the signature of Greece and that of Germany, when a majority of observers felt that the Stability and Growth Pact was a too tight corset which prevented Europe from breathing, and when the whole world believed that IMF loans had become useless. That was still the case in early 2007!

Your successor, Mario Draghi, has indicated the ECB is going to continue its purchases of government bonds. Does this mean he has given in to political pressure?

Mario has repeated what the Council had communicated previously.

Hasn't the independence of the ECB been affected nonetheless?

The question doesn't arise. The treaty requires us neither to receive nor to seek instructions from anyone. We did not ask for permission to take exceptional measures on 9 August 2007 to confront the first waves of financial turbulence! We were criticised by Germany and France when we refused to lower rates in 2004, and by ten out of 12 countries when we increased them in December 2005. All our non-standard decisions have been taken in complete independence. That independence is essential.

You are the captain of a ship passing through a terrible storm. Isn't it dangerous for the euro to have to change its captain right now, because of mandate issues?

In the storm the direction is clear: the mandate given by Europe's democracies. One has to be permanently alert. The weather has been particularly rough for four years. The crew of the ECB is on deck. The crew does not change. The future president has been on the ship for years. He has shared in all the decisions in a collegial way. He has considerable experience.

Emerging countries like China could come to the aid of Europe via the EFSF…

In the summit statement there is an increase in the intervention capability of the EFSF, thanks to a leveraging effect. In practice, this means that, in addition to European capital, private capital – and possibly public capital – from around the world could invest jointly with the Stability Fund. They will do it because it will be in their interest of course.

Do you understand the criticism coming from Germany, namely that the ECB had gone too far in its support for states?

In our democracies, criticism is natural and necessary. Some people in Germany and other countries regard our policy as too bold. While other people think of us as being too cautious...

We keep the currency for 17 countries, for 332 million fellow citizens, for citizens of all persuasions. We have a course to follow, price stability, and our non-standard decisions since 9 August 2007 - the first global decision in the crisis - have been taken to help us restore a proper implementation of our policy in a crisis without precedent for 65 years.

Price stability has been ensured since the creation of the euro, but Europe's economy has weakened, unemployment has grown...

Since 1999, prices have increased by 2,0% per year. We have done what was demanded of us by Europe's democracies. I will add that our fellow citizens, the 332 million people in the euro area, are extremely attached to price stability, particularly the most vulnerable among them. Opinion polls show this.

With regard to employment, we have created around 14 million jobs in the euro area since the launch of the single currency, compared with around 7 million in the United States. These job creation efforts must be resolutely pursued. The European countries which have paid most attention to their competitiveness and those most committed to structural reforms are in a better situation than the others.

Some of your decisions continue to cause discussion, such as the increase in your rates in 2008, a few weeks before the collapse of Lehman Brothers...

At the time, there was a real threat of inflation expectations becoming destabilised by the increase in oil prices. Of course nobody could foresee that Lehman Brothers would file for bankruptcy in mid-September. The fact that we showed ourselves to be very firm about price stability, fully in line with our definition – less than 2% ***but close to 2%*** over the medium term – helped us in the crisis. Because we avoided not only a materialisation of the inflation risk but also of the deflation risk which, after Lehman bankruptcy, was becoming the main danger. A comparison of inflation expectations shows that we have had one of the best "anti-deflation" protections of comparable advanced countries.

The movement of the 'indignant ones' is on the rise around the world. Do you understand these feelings of helplessness in the face of globalisation?

We are seeing at the moment multiple and complex messages that highlight that the fragility of the global economic and financial system is not acceptable. These messages are important. Indeed, all the efforts of the international community, particularly those of the G20, aim to improve the soundness of the global economy.

These messages are fed by many factors beyond the financial fragility observed since 2007. There is an outcry against the level of some bonuses in the financial sector, which are not accepted by our democracies. The financial sector must change its values. It is also an area of work opened by the G20. There is also another message which is more complex, namely that the changes are too fast. First of all, science and technology are advancing at an unprecedented rate: it's a

great success but it requires constant adaptation. Second, the emerging markets, all of the former "Third World" countries, are growing at a pace which has no historical precedent: it's a great success but leading to swift significant economic transformations. Third, longer life expectancy is also a remarkable success but is raising major funding problems.

Three distinct successes but very difficult to control. To put them fully at the service of our citizens, our societies and economies must make an ongoing effort to adapt much faster than in the past.

You would welcome the creation of a European Ministry of Finance. Do you think that attitudes are ready for that?

Not as President of the ECB, but as a citizen, I can imagine a development for "tomorrow" and "the day after tomorrow". Tomorrow, it would be necessary that we could impose on a country the essential decisions after several refusals to apply the recommendations formulated by European governance. Thus, one could prevent a particular economy from adversely affecting the financial stability of the rest of the area. This requires a change in the Treaty, now being specifically envisaged by governments in the euro area, which I welcome.

As for "the day after tomorrow", one can consider a deeper institutional change, with a genuine European executive. In any case, Europe's historical development depends entirely on the lessons our democracies will draw from the crisis, on the conclusions the people of Europe will draw from the events experienced since 2007.

What are you going to do now ?

First of all, I'm going to read a lot and think a lot. Then, knowing me as I do, I know that I'm going to stay active.

Tomorrow and the day after tomorrow: a vision for Europe

Speech by Jean-Claude Trichet, President of the ECB, at the Humboldt University, Berlin, 24 October 2011

Ladies and gentlemen,

It is a great pleasure to be invited to speak here at the Humboldt University this evening. One can only be honoured to be in the university of Hegel, Heinrich Heine and the Nobel prize-winning physicists Albert Einstein and Max Planck – not to mention 27 other laureates. But it is with the ideas of the university's founder – Wilhelm von Humboldt – that I would like to begin my remarks.

As a Frenchman who has lived in Germany for the past eight years, I note with interest that the mother of the university's founder – Marie-Elisabeth Colomb – came from a French Huguenot family who also made that eastwards move. Her family had emigrated to Berlin following the Revocation of the Edict of Nantes, a reminder that European integration is a process that has been with us for centuries.

Wilhelm von Humboldt himself was deeply engaged with the question of how to create the conditions for individuals to flourish within a society. His answer involved removing the conditions for mutual harm.

In some ways, this speaks to the challenges of European integration.

The individual Member States of the European Union (EU) also seek to flourish. Their actions are interdependent and can both benefit and damage each other. Removing the potential for mutual harm is essential for collective prosperity.

This dialectic between the individual and the community is at the core of the European project. It is the dialectic between the individual nation states and the community of nations. And it presents some of Europe's most fundamental challenges.

I would like to reflect today on how to address these challenges – to look forward and offer a perspective of where Europe could go.

In particular, I would like to develop three propositions.

First, while the reasons for European unity have often been presented as deriving from past conflicts and past divisions, forward-looking motivations are in my view decisive.

The unique construction of Europe – with strong local identities and large, integrated markets – is a source of great strength in the new, globalised world we face. It allows Europeans to plant deep roots and build strong communities. At the same time, we can fully benefit from economies of scale and the free flow of trade and investment.

For this reason, European integration is profoundly in the interests of all Member States and deeply connected to their *future* prosperity.

Second, for Europe to realise fully its future potential, it needs the right rules and the right institutions.

Europe requires a solid form of governance to ensure that the actions of individual countries are oriented towards the common good. Our current arrangements have not yet fully met this standard. They are now being improved. It is a continuous process which will call for Treaty changes if necessary.

As this process will take time, we need to start planning today for the Europe of tomorrow and the Europe of the day after tomorrow.

Third, the underpinning of a more integrated Europe is the emergence of a true European public debate.

As one would say in German, die Schaffung einer europäischen Öffentlichkeit.

Europeans today are highly interconnected via economic and social linkages. Yet our fragmented national public discourse does not necessarily permit citizens to understand fully these connections.

A true European public debate would help us deepen our interest in each other, bridge our linguistic differences and care more about what is happening across our borders.

These are the three main themes on which I will focus tonight.

But before I talk about the Europe of the future, I would like to talk about the Europe of today. To reflect on the relationship between member countries and Europe. And to touch on the challenges we collectively face in tackling the crisis.

1. Europe and Germany

Building deeper union between France and Germany in the service of Europe has been an important theme of my own working life. In this time, I have been profoundly influenced by the German commitment to a stability culture.

In the 1980s, I was seen in my own country as the strongest advocate of the ‘franc fort’ policy. This policy was designed to be part of the modernisation of the French economy through a “competitive disinflation” policy.

In the 1990s, I worked side-by-side with Hans Tietmeyer and Horst Köhler to contribute to the foundations of the euro in the Maastricht Treaty. This work was to ensure that, among other things, the European Central Bank (ECB) would be based on the principles of independence and the pursuit of price stability.

Then in 2003, I had the honour of moving to Frankfurt to become President of this institution.

It was a great personal satisfaction to join an institution that embodied my deep-seated beliefs in central bank independence, price stability and economic discipline.

Over this period I have developed a strong admiration for Germany and its people, and also for the way that Germany conducts its economic policies.

The German economy has often been thought of as the engine of the European economy. But less than 10 years ago, Germany was seen by some observers as the “sick man of Europe”.

Let me cite some books and newspaper articles from that time:

"Can Germany be saved?", asked one of this country's most well-known economists in 2003, noting that *"Germany provides something of a case study of what not to do in designing a prosperous future"*.

"How the mighty are fallen", said a major international magazine also in 2003, well representing the mainstream economic analysis. *"After the German economy was seen as an exemplary model of successful capitalism for decades*," the magazine went on, *" today it is Germany that economists point to with a mixture of contempt and alarm."*

"Vom Meister zum Mittelmaß", wrote a major German newspaper in 2005, speaking of *"absteigende Staaten wie Deutschland, die in ihrer Bedeutung schrumpften und ihren Haushalt nicht in den Griff bekämen*. *"*

Thankfully, these gloomy forecasts proved mistaken, and today, Germany is in the lead in rebounding from the crisis.

Since the trough of mid-2009, German real GDP has grown by 6.9% compared with the euro area as a whole by 3.8%. Employment in Germany has increased by 2.1%. Exports have grown by 25.6%. This performance is no accident. Neither is it based on cyclical, unsustainable factors. It is the result of sound fiscal policies, permanent attention to unit labour costs, and bold reforms that have been rigorously implemented over a prolonged period. And it sets an example that is very important for the current situation.

First, it demonstrates how sound policies can lead to prosperity within economic and monetary union.

By encouraging industries to embrace the opportunities of globalisation. By maintaining technological excellence. By prioritising cost and price competitiveness. And by ensuring flexibility in the labour market.

Second, it proves that it is possible to regain competitiveness within monetary union.

Germany after the post-unification boom had a very serious competitiveness problem itself. It took a sustained effort to become competitive again.

This gives encouragement to euro area countries that have lost competitiveness and now must regain it. It also underscores the fact that the adjustment effort must begin immediately.

But there is also a third lesson from the German example.

Would the German recovery have been possible without the euro and Germany being in the euro area? Without Germany benefiting from a vast single market of the size of the United States with a highly stable currency?

The German recovery has taken place in the context of the best inflation record achieved by a major central bank for over 50 years. The ECB has delivered an average rate of inflation of 2.0% since beginning operations in 1999. In Germany it is even lower with an average yearly inflation rate of 1.57%.

Such a low rate of inflation over a comparable time period is actually the lowest in Germany for over 50 years. Moreover, expectations of future inflation remain firmly anchored in line with our definition of price stability.

Financial markets and euro area citizens expect the ECB to deliver on its mandate. The German public can rely on our steadfast commitment to do so.

The euro has extended the zone of monetary stability to Germany's main trading partners in the euro area. As more than 40% of Germany's exports go to other euro area countries, this is very important for German prosperity. The stability of the euro has also helped German companies remain competitive vis-à-vis the rest of the world.

2. Europe and the crisis

Let me now turn directly to our current challenges. As you are all well aware, we continue to face the most serious economic and financial crisis since World War II. Tackling the crisis has required unprecedented action from public authorities to maintain economic and financial stability.

Inevitably this has produced diverging views. This is not surprising. The euro area is responding to events of historical importance and it naturally takes time to forge consensus on the right way ahead.

But it is very important that people do not misconstrue these debates. They are about policies, not about principles, because in the euro area our principles do not change.

Our principles are the foundations on which we rest. Stability. Responsibility. Independence.

But our policies must adapt. No two crises are the same. It is precisely because we want to defend and reinforce the principles we cherish, that we have to shape our policies appropriately.

I am fully aware that in this country people have genuine concerns about the single currency. They seek assurance that it remains a community of stability. That it is founded on rules and responsibilities. And that the rules are respected and the responsibilities are taken seriously.

I would like to use this occasion to explain the way the Governing Council of the ECB is deciding on monetary policy.

Our standard measure for fulfilling our mandate of maintaining price stability – avoiding both inflation and deflation – is interest rate policy. But effective interest rate policy requires that our policy decisions are transmitted to the real economy. If that is not the case, our monetary policy cannot achieve its objective.

In this transmission, both banks and financial markets play an important role. They are crucial for the financing of the real economy – of firms and households. Yet the crisis has damaged banks and at times severely disrupted the functioning of financial markets.

Addressing these problems needed to be done through non-standard measures. The ECB has decided such measures, for monetary policy reasons, since the very start of the global crisis. It has been offering liquidity to financial institutions at a fixed rate and with full allotment. It has also provided this liquidity over an extended period of time, up to 12 months, so that the euro area banking sector, Germany's banks included, could continue to be as correct as possible a vehicle for the transmission of our monetary policy.

With additional liquidity demanded by the euro area banks, our balance sheet has expanded during the crisis. But we have been prudent. Our balance sheet has expanded by about 80% since the beginning of the crisis. Only for the sake of comparison the balance sheet of the Federal Reserve increased by about 230%, that of the Bank of England by 205%, and that of the Swiss National Bank by 235%. The crisis hit all of the economies concerned, but you can see that all our non-standard policies have been measured.

Of all our non-standard measures, the policy of full liquidity allotment at fixed rates has been the most important one in my view. Yet it is the bond market interventions that have received the greatest attention, and the most scrutiny.

But just as our measures of enhanced credit support have been necessary to ensure that banks continue to extend credit to the real economy, our bond market interventions have been necessary to help foster a more appropriate transmission of our policies to the real economy. The government bond markets are crucial for our monetary policy transmission. They largely determine the prices of loans and mortgages and thus affect, indirectly, the transmission of monetary policy to all firms and households.

The ECB's government bond market interventions are not inflationary. Unlike the bond purchase programmes of other major central banks our aim is not to inject additional liquidity. We actually absorb all liquidity injected by these purchases on a regular basis – euro for euro, week by week.

There is no fuelling of money growth in the euro area. M3 growth is less than 3% currently and inflation expectations have remained firmly anchored by all standards.

So let me emphasise this point. It is very important to understand that all the ECB's policy decisions during the crisis have been made fully in line with our mandate to maintain price stability.

They have been taken in full independence and we have established a solid track record for our independent decisions. Both inflation and inflation expectations in the euro area demonstrate the value of independent deeds, not just words.

Last week in Frankfurt, at the occasion of my official farewell as President of the ECB, Prime Minster Juncker, the longest-serving prime minister in Europe and chair of the Eurogroup, said that discussions of government pressure on the ECB lacked any basis in fact, that such pressure would have been completely futile and that the ECB always acts completely independently.

3. Europe and the future

I have talked about where Europe has come from. Let me turn now to where Europe is going.

When people seek a justification for European integration, there is a tendency to look backwards.

European integration has banished the spectre of war from our continent, is always stressed. European integration has delivered the longest period of peace and prosperity in European history.

This perspective is entirely correct. But it is also incomplete.

There are many more reasons for striving towards “ever closer union” in Europe today than there were in 1945. And these are entirely forward-looking.

65 years ago the distribution of global GDP was such that Europe had only one role model for its single market: the United States of America.

Today, Europe is faced with a new global economy, reconfigured by globalisation and by the emerging economies of Asia and Latin America.

It is a world where economies of scale and networks of innovation matter more than ever. By 2016 – that is, very soon – we can expect the euro area in terms of purchasing power parity to be below the GDP of China and over and above the GDP of India. Together, these two countries would represent around twice the GDP of the euro area.

Over a longer horizon, the entire GDP of the G7 countries will be dwarfed by the rapid development of the systemic emerging economies.

Europe has to cope with a new geo-political landscape very profoundly reshaped by these emerging economies.

And Europe is also faced with new global challenges, such as climate change and migration, where effective solutions are possible only at the European and international levels.

In this new global constellation, European integration – both economic and political – is central to achieving prosperity and influence. For an outward-looking, export-oriented country like Germany, this is profoundly in its interests.

The challenge is to set the correct path for European integration. Getting this right is essential to realise fully our continent’s tremendous potential. Let me therefore lay out a vision for the Europe of tomorrow.

The Europe of tomorrow

The creation of Europe’s economic and monetary union is unique in the history of sovereign states. The euro area constitutes a “society of states” of a completely new type.

Like individuals in a society, euro area countries are both independent and interdependent. They can affect each other both positively and negatively.

Good governance requires that both individual Member States and the institutions of the EU fulfil their responsibilities.

First and foremost, every country in the euro area needs to keep its own house in order.

This means responsible economic policies on behalf of governments and rigorous mutual surveillance of those policies by the Commission and Member States – going beyond the indispensable surveillance of fiscal policies to encompass all aspects of the economy.

In a society, the institutions of law enforcement can ultimately compel a citizen to abide by the rules. In the euro area, our framework based on surveillance and sanctions depends on the willingness of offending states to comply.

I am aware that many observers wonder what can be done if a Member State simply cannot deliver on its promises.

That is why, when I had the deep honour of receiving the Karlspreis, I suggested a new approach to the policing of economic governance.

For countries that lose market access, the current approach of providing aid against strong conditionality is justified. Countries deserve an opportunity to put the situation right themselves and to restore stability.

But as I suggested in Aachen, this approach should have clearly defined limits. A second stage should be envisaged for a country that persistently fails to meet its programme targets.

Under this second stage, euro area authorities would gain a much deeper and more authoritative role in the formulation of that country's economic policies.

This would move us away from the present concept where all decisions remain in the hands of the country concerned. Instead, it would be not only possible, but in some cases compulsory, for the European authorities to take direct decisions.

Implementing this idea of the second stage would evidently require a Treaty change. It would also imply a new concept of sovereignty. This is necessary given the complex interdependence that exists between euro area countries. And it is ultimately in the interests of all citizens of the euro area.

In my view, it was important to launch such reflections as soon as possible. I am very happy that the European Council, at its meeting yesterday in Brussels, has indicated in its conclusions: "The European Council notes the intention of the Heads of State or Government of the euro area to reflect on further strengthening of economic convergence within the euro area, on improving fiscal discipline and deepening economic union, including exploring the possibility of limited Treaty changes."

The Europe of the day after tomorrow

Let me now look even further into the future. A vision that can stabilise expectations needs to address not just tomorrow, but also the day after tomorrow. And as it takes time to implement such a vision, we must start thinking about it today.

It is my firm conviction that the Europe of the day after tomorrow will be of an original type – a new type of institutional framework.

In Aachen, on a personal basis, I began to reflect on some elements of this new possible framework.

I asked the question: with a single market, a single currency and a single central bank, would it be too bold to envisage a ministry of finance of the Union?

This European finance ministry would, first, oversee the surveillance of both fiscal policies and competitiveness policies, and when necessary, have responsibility for imposing the "second stage" I just described.

Second, the ministry would perform the typical responsibilities of the executive branches regarding the supervision and regulation of the EU financial sector.

And third, the ministry would represent the euro area in international financial institutions.

Since my Karlspreis address, it seems to me that the case for such an approach has strengthened.

I now hear leaders calling for a Treaty change to create stronger economic governance at the EU level. I hear euro area citizens calling for better supervision of the financial sector. And I know that our partners in the G20 look to Europe as a whole for solutions, not to individual Member States.

Increasingly, it seems that it is not too bold to consider a European finance ministry, but rather too bold not to consider creating such an institution.

This finance ministry would be only one element of the European future institutional framework. Exactly how these new institutions would eventually evolve one cannot say. As Jean Monnet once wrote: *« Personne ne peut encore dire aujourd'hui la forme qu'aura l'Europe que nous vivrons demain, car le changement qui naîtra du changement est imprévisible »*. [1]

We have several federal or confederal institutional frameworks in today's world. To name only a few, the United States of America, the Federal Republic of Germany and the Swiss Confederation. The European Union is unique in its past history, in its present nature, in its future ambition. It will have to invent its own concept.

But one could imagine that in the future European institutional framework, the Council might evolve into the Senate of the Union, the European Parliament into the lower house, the Commission into the executive and the European Court of Justice into the judiciary – each time for the part of sovereignty that is shared.

And I have no doubt, taking into account the long and proud history of the European countries, that “subsidiarity” will play a major role in the future Europe – very significantly more than in the present models of federation.

As I said, these are personal remarks of a European citizen. The future of Europe is in the hands of its democracies, in the hands of the people of Europe. Our fellow citizens will decide. They are the masters.

In any case, whatever the future institutions of Europe will be, an essential element would be the emergence of a truly pan European public debate. As Europeans we connect deeply with our nations, traditions and histories. These are Europe’s roots. But we also need to extend our branches more widely.

To do this, the Euro area needs media, in the broadest sense of that word, that allow citizens to take a deeper interest in each other. Media that provide regular information on events beyond national borders. Media that permit citizens to debate and exchange. And media that are not constrained by language barriers. All we need is a pan European public debate, a *gemeinsamer öffentlicher Raum,* a *débat publique pan-Européen* that allows Europeans to appreciate the wider community of which they are part – a community where their interests are increasingly shared and their lives more interdependent than ever before.

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Let me draw to a close.

Twenty years ago, in 1991, my friend Hans Tietmeyer, the former President of the Bundesbank, said that “monetary union is not just a technical matter. It is in itself, to some extent, a political union”.

This condition creates mutual responsibilities.

We see that a challenge in one country can become a challenge for the euro area as a whole. Addressing it requires strong responses from all Member States, including Germany, and from EU institutions.

The global crisis has called into question the overall economic and financial strategy of major advanced economies. All have weaknesses in their economic systems. Not surprisingly, the main weakness for Europe was the nature of its institutional framework – in particular, that its economic and fiscal governance was not commensurate with the interconnectedness of economies sharing a single market and a single currency.

The question is how to confront those obstacles. We should not look back. We must look forward – to the opportunities of Europe for our collective betterment; and to the potential for every country to be stronger and more prosperous in a well-functioning union.

As far as the ECB is concerned, its Governing Council will continue to anchor solidly price stability and confidence in Europe – stability and confidence for 17 countries and 332 million fellow citizens who have decided to unite closely with a single market and a single currency. As Konrad Adenauer said in Aachen 57 years ago: “Gerade wird man die Mahnung verstehen, dass Europa uns heute Schicksalsgemeinschaft ist. Dieses Schicksal zu gestalten ist uns übergeben”. “Above all, people will understand the call: that Europe, for us today, is a community with a common destiny. It’s up to us to shape that destiny”.

Thank you for your attention.

Towards a more integrated Europe: Challenges ahead for the euro area and Central and Eastern Europe

Address by Jean-Claude Trichet, President of the ECB, at the National Bank of Poland's conference, Warsaw, 21 October 2011

President of the Republic of Poland,

President of the European Parliament,

President of the National Bank of Poland,

Ministers,

Governors,

Commissioner Rehn

Distinguished guests,

Ladies and gentlemen,

Let me start by thanking my dear friend and colleague, President Belka, for inviting me to address such a distinguished audience today.

Twenty years ago, the dissolution of the Soviet Union marked one of the most important events in European history – the final stage of the revolutions that began two years earlier in 1989; the end of communism in the countries of Central and Eastern Europe; and the beginning of their transition to democracy and market economies.

It is also almost 20 years since the European Council met in the city of Maastricht in the Netherlands to agree on strengthening the pillars of the European Union (EU) and laying the foundations for the transition to Europe's Economic and Monetary Union (EMU).

The changes that Europe has seen over the last two decades have been enormous.

Right from the start, the countries of Central and Eastern Europe embarked on a hugely ambitious path of reform. Leaving aside differences across countries, a long and challenging process of economic transformation brought countries in the region significant improvements in incomes and living standards. Full membership of the EU – or the prospects of accession – provided an important stimulus for the process of transformation as well as an anchor of stability.

In Western Europe, completion of the three stages of EMU led to the establishment of the European Central Bank (ECB) and the introduction of the euro in January 1999. Having started originally with 11 participating countries, the euro area has since expanded to include 17 EU Member States including some previous transition economies, namely Estonia, Slovenia and Slovakia.

The *changes* Europe has seen over these past 20 years are enormous. Equally enormous have been the *challenges* along the way, not least of course due to the global financial crisis. But there have also been enormous *achievements*. In my remarks today, I would like to take stock of some of those achievements and focus on three main aspects of the process of economic convergence in Central and Eastern Europe.

Three main aspects of the process of economic convergence

1. Nominal and real convergence: What has been achieved?

The *first* aspect of convergence relates to developments in terms of nominal and real convergence between the countries of Central and Eastern Europe and the euro area. Looking at the region as a whole, after some very difficult years,

inflation has come down dramatically from very high levels at the beginning of transition to single-digit levels today. Long-term interest rates have also fallen substantially, reflecting the gradual anchoring of inflation expectations.

The countries of the region have also made remarkable progress in terms of institutional and structural convergence. In particular, we have witnessed the building of appropriate institutions, increased trade integration with the euro area and improvements in the business environment.

Naturally, this progress has been reflected in per capita income convergence. Over the last 20 years, per capita income has risen to an average of 63% of the EU average if adjusted in terms of Purchasing Power Parity (PPP).

But combining low inflation with real convergence has posed a serious challenge in many countries. Let me elaborate on this.

The very process of real convergence entails upward pressures on prices, which can be hard to avoid in terms of both relative prices and the overall price level. Among other things, these pressures stem from high productivity growth as well as the processes of price liberalization and tax harmonization.

Price increases related to productivity growth are usually referred to as the Balassa-Samuelson effect. But most studies have found this effect to be relatively limited.[1] Convergence in price levels, which stood on average at two thirds of the EU average in 2010, seems to have surpassed convergence in income levels in all countries of the region. This means that growth in prices has generally been higher than growth in productivity.

Potential rigidities in labour and product markets and, in some cases, an excessively loose macroeconomic stance may have complicated the delivery of low inflation rates. Indeed, while all countries have reduced inflation to moderate levels, the entrenchment of a low inflation environment still constitutes a challenge in many economies.

2. Importance of ensuring polices that support fast *and* sustainable output growth

The *second* aspect of convergence that I would like to highlight relates to the growth model followed by some new EU Member States. Given its lower starting point in terms of real income, it could be expected that, in a world with full financial integration, large capital inflows would flow into the region.

Moreover, as people expect to be richer tomorrow than today, they may choose to smooth consumption over time by borrowing today, the more so the higher the expected gains in disposable income. A process of gradual real exchange rate appreciation, supported by strong, domestically driven output growth and temporarily accompanied by relatively large current account deficits, would seem fully in line with what the theory of convergence suggests.

But in several countries, the process of real convergence proved itself difficultly sustainable. During the period before the global crisis, expectations were overly optimistic, and investors and consumers engaged in economic behaviour that generated excess domestic demand, strong credit growth and inflationary pressures.

As in many other markets, risk premia were squeezed, leading to asset price misalignments (particularly in the housing market) and over-indebtedness in a context of abundant global liquidity and a strong appetite for risk. Foreign direct investment flows often focused on the non-tradable sector, for example, construction and financial sector intermediation. Furthermore, foreign currency lending grew rapidly, leading to increasing balance-sheet mismatches.

As a result a number of countries experienced notable departures from price stability and wide external imbalances that eroded competitiveness – developments that went over and above what could be justified by ‘equilibrium’ catching-up.

Macroeconomic policies added to the risks. In countries with a fixed exchange rate, independent monetary policy was not available, resulting in monetary policy conditions that became too expansionary. In principle, this could have been compensated by very tight fiscal policy. But with the benefit of hindsight, fiscal policies were often insufficiently restrictive or even loose.

The global crisis revealed these weaknesses with particular virulence. When capital flows dried up in late 2008 and trade collapsed, real output declined sharply, in some cases leading to severe recessions. With the main and remarkable exception of Poland, the region was severely hit by the crisis. Many observers feared then that, if the crisis were allowed to run its course, it could be near catastrophic for the region and extremely dangerous for the European banking system.

But I am pleased to say that this potential ‘catastrophe’ was avoided and I would like to devote my remaining time to the question of how this was done – the *third aspect* of the convergence process I previously mentioned. I believe answering this question may provide lessons for countries that are currently facing similar challenges in the euro area.

3. The reaction of CEE countries to the global financial crisis: what can be learnt?

In my view, the return to the convergence path is being achieved thanks to a combination of four main elements.

First and foremost, there are domestic policy actions to address macroeconomic imbalances at the national level. The precise policy actions differ across countries, reflecting the different country-specific challenges and policy frameworks in place. But the actions generally require a strong fiscal adjustment and/or measures to maintain confidence in the soundness of the financial sector.

Second, the reaction of the international community has been essential. Where funding challenges became more acute, international financial assistance led by the IMF – jointly with the EU in EU Member States,– has been crucial in supporting market confidence and avoiding financial crises. The balance of payments support facility available for EU Member States has been reactivated, while the World Bank, the European Bank for Reconstruction and Development and the European Investment Bank have supported several countries. Some European countries have also provided bilateral financial support.

Third, the private sector, represented by the foreign banks active in the region, has by and large maintained its exposure to the region, helped by the informal forum known as the "Vienna Initiative". By avoiding a large-scale uncoordinated withdrawal of cross-border banking groups from Central and Eastern Europe, a systemic crisis in the region could be avoided.

Finally, the ECB is also making a key contribution. For example, by providing extensive liquidity provision to parent banks established in the euro area, the subsidiaries of those banks in Central and Eastern Europe are indirectly benefiting from this ample liquidity.

Ladies and gentlemen, let me draw to a close. I am sure that the three aspects of convergence that I have mentioned will be better understood thanks to the discussions, which will take place during this impressive conference.

Achieving sustainable convergence requires the conduct of sound economic policies, both before and after adoption of the euro. The present global crisis is demonstrating, once again, to which extent continuous resolute sound macro policies are the best way to improve economic and financial resilience in times of unexpected challenges and shocks.

Thank you very much for your attention.

Remarks at the farewell event

Speech by Jean-Claude Trichet, President of the ECB, Frankfurt am Main, 19 October 2011

Sehr geehrte Frau Bundeskanzlerin,

President of the European Parliament,

President of the European Council,

President of the European Commission,

President of the Eurogroup,

Dear President Giscard d'Estaing,

Dear Chancellor Helmut Schmidt,

Ministers, Excellencies, fellow Governors,

Dear Members of the ECB staff,

Ladies and gentlemen,

It is more than thirteen years since the European Central Bank was founded, and almost thirteen years since the Euro was launched. As my mandate as President of the ECB draws to a close – and throughout my eight years of office – I profoundly feel the high level of trust and confidence the European democracies have decided to bestow on the ECB. Our primary mandate of preserving price stability, as well as our independence in fulfilling this mandate, were given by the people of Europe on a multinational and multipartisan basis.

In being fully faithful to our mandate, we are faithful to the democratic will of the Member States.

With my five colleagues of the Executive Board, my twenty-two colleagues of the Governing Council, as well as with the dedicated staff of the ECB, we have been called upon to realise a long-standing and ambitious idea of the people of Europe.

The single currency is an ancient idea, which has deep roots in history. Without going back to the Roman Empire or the Carolingian Empire, six centuries ago Georges Podiebrad, the king of Bohemia, was calling for a common European currency.

Well before the Werner report, published forty years ago, great thinkers of all European nationalities have called for unity with a single market, a single economy and a single currency. These historical roots put in perspective the accomplishments of the Euro as a new currency, the present challenges of the euro area and the future of the Economic and Monetary Union.

The achievements of the Euro as a currency have to be judged against its primary mandate. Over nearly thirteen years, and in spite of a series of major global economic and financial shocks, average yearly inflation has remained at 2.0% for 332 million fellow citizens. Despite the successive rises of the price of oil and commodities, it is the best result, over such a period of time, of the 50 last years in any large country in Europe. In Germany, with average yearly inflation of 1.6% over 13 years, it is a better result than before the Euro.

Equally important is the low level of the inflation expectations. The ECB Governing Council is providing a very solid anchoring of price stability over the next ten years, fully in line with our definition: less than 2%, but close to 2%.

The Euro is a credible currency that has proved to be a very good store of value, backed by solid fundamentals.

These last eight years can be divided into two periods of equal duration.

The first four years were challenging, but no more or less than usual for a central banker. The ECB had to preserve stability after the bursting of the dotcom bubble and in the face of high and volatile oil and energy prices. We fought hard to preserve the fiscal governance of the Euro area, at a time when the three major countries wanted to weaken the Stability and Growth Pact. And, as always, we had to take our responsibilities for our own decisions; also when increasing interest rates, which at times did not please many governments, market participants, or the international financial institutions. The ECB has been fiercely independent and will remain so.

After four years came the financial and economic crisis.

Not a crisis like many we have known over the last 50 years. Not like the first oil shock of 1973 or the second oil shock of 1980. Not an event like the sovereign debt crisis of the 1980s and beginning of the 1990s. Not like the Asian crisis or the dotcom bubble bursting in the early 2000s.

Since August 2007, we have experienced a crisis of a new kind. A global phenomenon that has no equivalent since World War II, in its nature and dimension. For the first time since 66 years, the epicentre of the global crisis was the financial system of the advanced economies.

The impact of the crisis on the real economy could have been of the magnitude of a great depression, had central banks and other public authorities not reacted with rapidity and resolve.

For its part, since the financial turbulence began, on 9 August 2007, the ECB Governing Council has applied a “separation principle”. It has separated the “standard” measures – namely the interest rates designed to deliver price stability over the medium term – from the “non-standard” measures – designed to help restore a better transmission of our standard measures at times of market disruptions.

The credibility of the Euro and the solid anchoring of inflation expectations over the next 10 years have been well preserved throughout the crisis. This is because we have kept an unwavering sense of our direction – price stability – thanks to our interest rate policy, whilst at the same time being alert in taking appropriate non-standard measures – full

allotment of liquidity at fixed rates, purchase of covered bonds, and the Securities Market Programme. And again, all decisions of the Governing Council have been taken in full independence.

Since the crisis began, I have thought of the qualities expected from central banks as being analogous with the two ethical virtues famously suggested by Max Weber nearly a century ago: the ethic of conviction and the ethic of responsibility.

I proposed an analogy, to associate the "standard" measures with the ethic of conviction and the "non-standard" measures with the ethic of responsibility. It is equally important to preserve integrity between intention and action, and between action and consequences. Our "separation principle" proposes a way to preserve both.

Max Weber said himself: "Das bedeutet nicht, dass eine Gesinnungsethik gleichzusetzen ist mit Verantwortungslosigkeit oder dass eine Verantwortungsethik gleichzusetzen ist mit prinzipienlosem Opportunismus […]. Die Gesinnungs- und die Verantwortungsethik sind keine Gegensätze, sondern ergänzen einander." "This is not to say that an ethic of ultimate ends is identical with irresponsibility or that an ethic of responsibility is identical with unprincipled opportunism (…). The ethic of conviction and the ethic of responsibility are not opposites. They are complementary to one another".

The crisis has revealed fault lines in all major advanced economies of the world. The sustainability of their medium to long term strategies has been put into question. Europe – and the Euro area in particular – has shown positive fundamentals, on a consolidated basis, in particular, as regards its overall fiscal situation and domestic and external equilibrium. But on a country-to-country basis the major weakness of the Economic and Monetary Union lies in its insufficient governance of the economic union, while the monetary union has delivered according to expectations.

The need to strengthen economic governance is the first lesson from the crisis. On behalf of the Governing Council, I have continuously called for a "quantum leap" in governance. The "six packs" just approved represent a significant step. Implementation will show if they constitute a quantum leap. I appreciate, President Buzek, the resolve of the European Parliament in the discussions which took place with the Council.

What is now necessary is to clarify crisis management in three dimensions: reinforcing the EFSF's capacity to ensure financial stability, based on convincing national fiscal and structural policies; strengthening the balance sheets of the European banks; and working out an appropriate solution for Greece's medium term adjustment.

This clarification is urgent. I think the famous saying of Jean Monnet – « Les hommes n'acceptent le changement que dans la nécessité et ils ne voient la nécessité que dans la crise » "people may accept change when they are faced with necessity, and only recognise necessity when a crisis is upon them" – captures the situation well: a global crisis is, indeed, upon us. A farewell is a time for reflection on the past and the present, but it is also an opportunity to reflect about the future.

We just had the privilege to listen to the two founding fathers of the European Monetary System, the precursor of the single currency of the Europeans. I thank them very much for having been extremely generous in giving us the benefit of their experience and their great wisdom.

I will take the risk of expressing personal views and not necessarily views of the Governing Council of the ECB. In the long-term historical perspective, Europe is called upon to complete the design of what it calls "Economic and Monetary Union". As I already said, would it be too bold, in this future Economic and Monetary Union, with a single market, a single currency and a single central bank to envisage also an executive branch? Not necessarily a ministry of finance that administers a large federal budget. But one that would exert direct responsibilities in at least three domains: first, the rigorous surveillance of both fiscal policies and competitiveness policies with the capacity, in exceptional cases, to take decisions immediately applicable in a particular economy that puts the euro area financial stability in danger; second, all the typical responsibilities of the executive branches as regards the union's integrated financial sector, so as to accompany the full integration of financial services; and third, the representation of the union in international financial institutions.

Jean Monnet again once wrote: « Personne ne peut encore dire aujourd'hui la forme qu'aura l'Europe que nous vivrons demain, car le changement qui naîtra du changement est imprévisible ». "Nobody can say today what will be the institutional framework of Europe tomorrow because the future changes, which will be fostered by today's changes, are unpredictable."

I trust that today's changes, triggered by the global crisis, are precisely one of those changes that Jean Monnet expected able to foster a new institutional framework.

In any case, these are decisions which can be taken only by our democracies, by the people of Europe to which we are accountable.

Whatever the future holds, you can be sure that the ECB Governing Council will continue to be faithful to its primary mandate and that the ECB, together with the Eurosystem, will continue to be an anchor of stability and of confidence.

I present my best and warmest wishes to Mario Draghi, my successor, who has given the Governing Council the benefit of his wisdom and experience during these last years. He has taken with all of us our collegial decisions. His eminent qualities will make his future captainship of the European monetary team, together with the Executive Board and the Governing Council, a great success.

Let me draw to a close on a personal note and express my thanks to all the people I have worked with over the years on the project of Europe's Economic and Monetary Union. In particular today, I would like to pay tribute to my colleagues here at the ECB, the current and former Executive Board, Governing Council and General Council members. I would like to pay tribute to all ECB staff. All members of staff have been decisive in the achievement of our primary goal. They deserve full appreciation and gratitude for all their dedication, commitment, professionalism and very hard work.

The present calls for immediate action. The future calls for a vision of where we are going, a sense of direction.

Immediate action. Goethe famously said: „Wissen ist nicht genug; wir müssen es anwenden. Wollen ist nicht genug; wir müssen es tun!"

"Knowing is not enough; we must apply. Willing is not enough; we must do." I think this applies admirably to the sense of action which should inspire Europe in the coming days.

And sense of direction. Jean Monnet had for us, for our future, this exclamation: « Continuez, continuez, il n'y a pas pour les peuples d'Europe d'autre avenir que dans l'union ». "Continue, continue. There is no future for the people of Europe other than in union". And Alcide De Gasperi: "è la volontà politica di realizzare l'Unione che deve essere il fattore determinante, la forza di propulsione". "The most important factor, which must prevail on others, is the political will to build the Union."

I thank you for your attention.

Interview with the Financial Times

Interview with Jean-Claude Trichet, President of the European Central Bank, and the Financial Times, conducted by Lionel Barber and Ralph Atkins, on 12 October 2011 in London

Financial Times: What needs to be done to contain and bring the eurozone crisis to a close?

Jean-Claude Trichet: We have to be lucid, recognising the acuteness of the situation. Noting that there is an interplay between the sovereign risk crisis and the banking sector, and that we have to act both at a global level and at a European level. In such situations being ahead of the curve is of the essence. We have to take the right decisions in reinforcing the balance sheets of the banking sector on the one hand and, on the other hand, doing what is necessary to restore as completely as possible the credibility of the sovereign signature. Europeans have a special responsibility because they are the epicentre of these tensions which are of a global nature.

What do European leaders need to do to restore the credibility of sovereign debt, or government bonds?

European governments need to be crystal clear they are doing all they can, individually and collectively, to honour their signature. It is what the Heads said on 21 July 2011 in their communiqué: "All other euro area countries solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature and all their commitments to sustainable fiscal conditions and structural reforms. The euro area Heads of State or Government fully support this determination, as the credibility of all their sovereign signatures is a decisive element for financial stability in the euro area as a whole." This declaration is, in my view, extremely important.

What are the risks in the discussions over Greece?

The ECB has a clear position. Governments should avoid a credit event and avoid a compulsory solution [on involving the private sector]. We ourselves, in the July 21 [eurozone leaders'] agreement, called for the appropriate enhancement of our own collateral.

So it is absolutely essential to prevent contagion from Greece?

Yes.

David Cameron in his Financial Times interview talked of having a firewall. How do governments make sure that firewall is credible and that contagion can be prevented?

They have an instrument, which is the EFSF. The appropriate way of having an appropriate firewall would be to leverage the EFSF capital, which is what is being discussed now by Treasuries.

Some believe that preventing contagion from Greece also requires a clear statement from governments that bond holders of other countries will not suffer haircuts or debt write-downs?

The Heads of State or Government have said very clearly that Greece is a special case and that, as I just quoted, as regards all other countries they reaffirm their inflexible determination to honour fully their own individual sovereign signature. I would say it was important to avoid any ambiguity in this respect.

Can you explain how you would leverage the EFSF?

There are various means to do that and I don't want to embark into technicalities because it's really the responsibility of the treasuries. But there are several ways to leverage the EFSF.

Do you think the ECB's role in providing unlimited liquidity prevented an intensification of the global financial crisis and a depression in Europe?

I think the governing council of the ECB has demonstrated a capacity to be lucid in diagnosing the gravity of the situation since the start of the crisis in August 2007. So I would certainly echo what you say.

We have had two categories of monetary policy measures in this crisis. One has been the decisions on interest rates - what I would call the standard measures - which are designed to deliver price stability over the medium term and be sure that inflation expectations are solidly anchored.

On the other hand, in periods of abnormal tensions in financial markets, we have helped restored a better transmission of our monetary policy - of our interest rates - by other, non-standard measures.

The most important of our non-standard measures is full allotment at fixed rates, which we used as early as August 2007 and which is now a generalised concept. Other non-standard measures have included intervention in the covered bond market and in treasuries.

After almost 13 years of the euro we have delivered for 332 million fellow citizens 2.0 per cent average annual inflation. This is better than over the past 50 years for the main euro area countries, and we can see from information we extract from financial markets that we are credible to deliver price stability for the next 10 years, in line with our definition.

So this is a level of credibility, after four years of crisis, which demonstrates the effectiveness of our so-called separation principle between the standard measures and the non-standard measures.

As it is obvious, the euro as a currency is credible and solid. The challenges in the euro area are related to fiscal credibility and financial stability.

What needs to be done today, tomorrow and perhaps in the more distant future to make sure that the governance systems for the eurozone are actually credible and work properly?

The crisis revealed – like an X-ray picture - the weaknesses of many advanced economies - weaknesses in the US and in Japan as well as in Europe. In Europe it has revealed a big weakness in terms of governance – abnormal behaviour of individual countries and absence of effective surveillance of the policies pursued by the various countries. The ECB called a long time ago not only for a strict respect of the Stability and Growth Pact but also for a surveillance of competitive indicators and imbalances inside the euro area. This new pillar of surveillance is now part of the enhanced governance just decided by the European Parliament and Council.

Because of the hard lessons various countries have learnt during this crisis, I assume they will stick not only to the letter but also to the spirit of this new governance structure. It is of the essence.

Beyond this I think we have to reflect on a treaty change that would permit more than surveillance, with recommendations and appropriate sanctions. When recommendations are not followed and sanctions prove ineffective, European institutions should have the capacity to impose the necessary decisions on a particular country.

…and this is where your idea of a minister of finance comes in….

I said in my (Charlemagne award) speech in Aachen that, for the "day after tomorrow", within the framework of an effective European executive branch, we could have a minister of finance with, in particular, three major responsibilities. He or she would have responsibility for surveillance of fiscal and macro-economic policies - including the capacity to impose decisions when necessary. And as far as the executive branch responsibility is concerned, the minister would be responsible for the financial sector of Europe, so that the financial sector could be decoupled from the various sovereign signatures in order to have an achieved single market of financial services, including in crisis periods. And the minister would have also the responsibility of representing Europe in international institutions, vis-à-vis the rest of the world.

Would this just be for the eurozone or for the 27 European Union countries?

The working assumption of European treaty is that at a certain moment in time, all 27 would be in the euro. But of course the possibility of imposing decisions would not apply outside the euro area - that goes without saying.

Do you think the appetite for that amount of economic integration is there now in Europe, among the new generation of leaders?

There are more reasons today for the Europeans to unite in economic, financial and monetary fields than there were at the beginning of the 1950s, at the time of the first speech of Robert Schuman. I really think that the structural transformation of the world, the formidable economic success of the emerging countries, of China, of India, of all emerging Asia, of Latin America, calls for the Europeans to unite very significantly. One of the main lessons of the crisis is precisely that Europe needs more unity. In my opinion, this is not necessarily perceived spontaneously or communicated appropriately to the public, but I think these are truths that are there. This necessity for Europe to unite is recognised more and more in the business sector, by all those who have a direct connection with the rest of the world.

I think we had, recently, several examples of European democracies where it was said it was impossible to take some difficult decisions. But after discussions and due reflection, the decision was finally taken in the direction of reinforcing European unity. We are presently experiencing history in the making in Europe. All what I know makes me think that no leader, no individual and no country will take the responsibility of going backwards. That's the reason why I'm confident in the future of Europe. But it calls for a strong sense of direction and for hard work.

Even those countries where there are deep political reservations, deep political doubts?

I'm confident for all countries without any exception.

How do you respond to those leaders who say 'we're elected, we're not going to be pushed around by markets'?

I think we are proud to live in market economies because they have proved the right way of producing wealth, and all other experiments have proved catastrophic. That said, market economies have to be disciplined. You must have rules. You cannot rely too naively on the spontaneous functioning of markets. Central banks were created when it became apparent that it was necessary from time to time to exert some discipline in the market.

Was not part of the problem leading up to the current crisis that there was almost an irrational belief in the perfect nature of markets and in, for example, efficient market theory?

Yes. In this respect I have to say that the immediate lessons drawn from the crash of the dotcom bubble were unfortunate. The idea was that financial markets were extraordinarily resilient - which was plain wrong. I must say, I never shared the view that we were in a world where there was no risk.

That being said, when the first diagnosis was made at a global level with China, India, Brazil, Russia around the table, as well as of course Japan, the US and the Europeans, we didn't challenge the fact that a market economy was the best recipe for producing growth.

In Germany there's a very strong belief in the market, which is why German conservatives opposed crisis measures taken by the ECB. We've had two resignations by Germans – Axel Weber and Jürgen Stark – from the governing council. If you're talking about further steps towards European integration, are you in danger of losing the Germans?

First of all, I don't know what 'The Germans' means, I don't know what 'The English' means, I don't know what 'The French' means. We are living in cultures that are very deep, very profound and very complex, obviously, and where fortunately you have a lot of different opinions.

We have a legitimate debate – in Europe as well as in the US and in Japan – about whether the central bank is doing well on this, well on that. The Governing Council of the ECB did all what was necessary to be faithful to its primary mandate and to take into account, in transmitting our decisions on interest rates, that we were in the worst crisis since 66 years, a crisis which was disrupting some markets.

Jürgen Stark has been a very close friend for 18 years. He has worked for Europe for the past 18 years. I have great esteem for Jürgen and all that he has done and is doing.

If you look back on all the years that you've been involved in European construction, is this the most serious crisis that you've had to deal with?

I was involved in many crises: the real economy crisis after the first oil shock, the sovereign risk crises of the 1980s, the crisis of the exchange rate mechanism in 1992 and 1993, the Asian crisis in particular. But what we are experiencing presently is bigger and has hit directly in at the heart of the advanced economies. So it is undoubtedly an historical event of the first magnitude, the worst financial crisis since the Second World War. It could have produced a great depression had appropriate decisions not been taken at the appropriate.

This is also the moment of maximum peril for Europe's most important political and economic project and if this were to fail, it would have the gravest consequences for Europe, never mind the rest of the world?

All advanced economies are being X-rayed by the present crisis and revealing their skeletons and the weaknesses in their skeletons. It's true for all of us - for Japan, for the US, for Europeans. Europe's skeleton of Europe is weak because the institutional framework is weak.

I would confirm that is a major challenge and that it puts into question the strategy of all major advanced economies, including Europe and its institutional framework. At the same time, I could say, that it has positive aspects, now what are our major weaknesses. We had a period of benign neglect, at the global and European levels which was shared by financial markets, by the mainstream of economic analysis and by executive branches. As regards financial markets, before the crisis, for instance, Greece's government was borrowing at the same interest rate as the German treasury!

Can we carry on with a situation where every country has to sign up to the slightest change and we can be held hostage, if you like, by a country like Slovakia?

I think that the complexity of the European decision-making process in a crisis situation that requires for major decisions 17 democratic decisions is obviously one of the weaknesses of the present institutional framework.

Are you confident that in the end will get a suitable rescue package agreed by European leaders at their meetings over the next two to three weeks?

All that I know makes me think that it is the clear will of the European governments. I would add that I see nobody taking the responsibility of a failure.

A lot of people think the ECB should be acting as lender of last resort to governments and that ultimately this crisis could only be resolved when the ECB says 'we are the ultimate backstop' Why is the ECB not prepared to be that ultimate backstop?

I think that the ECB has done all it could to be up to its responsibilities in exceptional circumstances. I explain tirelessly what we have been doing to those who are uneasy with some of the decisions we have taken. Keeping inflexibly our sense of direction – price stability – and being up to the challenges of the worst crisis since 66 years.

The ultimate backstop is, of course, the governments. To do anything that would let government off their own responsibilities would be a recipe for failure.

Are banks still being irresponsible when it comes to pay and bonuses?

I think we have a real problem here. It is a question of values. Our democracies do not understand some behaviour. It's a very grave issue for all the democracies in the advanced economies.

You will be succeeded by a very experienced technocrat and somebody who's also spent years on Europe's construction. But he's Italian and in some quarters, in the press and the media, this is seen as a potential problem. What is your response to that?

First, nationalities do not count. He is a very knowledgeable true European. And do not forget, he took all the decisions of the Governing Council as member of the college. Our decisions are collegiate decisions. So I have absolutely full confidence in what he will do, together with all our colleagues.

What do you plan to do after you leave the ECB on October 31?

I have not reflected yet on what I will do afterwards because I have to say that, even in the three weeks which I still have, there are a lot of things to do - 24 hours a day. I'm sure that I will read much more than I do today. I will certainly continue to meditate on the historical future of Europe and I will give more time to my four granddaughters

Interview with L'Express

Jean-Claude Trichet, President of the ECB, interview for L'Express, conducted by Corinne Lhaïk and Benjamin Masse Stamberger, on Wednesday, 5 October 2011 and published on Tuesday, 11 October 2011

You have been head of the European Central Bank (ECB) for eight years; what are you most proud of?

First, to have delivered price stability to 332 million Europeans as we were required to do by the European democracies and as has been continually confirmed by the peoples of Europe in all opinion polls, and particularly by the poorest and most vulnerable of our fellow citizens. That is our primary mandate according to the Treaty: We have fulfilled our contract over the first 13 years and our credibility ensures price stability for the next ten years. Second, to have held the course of European unity in extremely difficult circumstances created by the economic and financial crisis – the worst since the Second World War. At the ECB and throughout the Eurosystem, including the Banque de France, we have a remarkable European team spirit. The same spirit prevails at the European Parliament, which requires me to regularly explain our monetary policy and with which we have close relations based on trust. I said at my first hearing before the European Parliament eight years ago that the Stability and Growth Pact was absolutely essential. Now, of course, it is no longer necessary to belabour the point because it is clear where fiscal laxity in some cases and a lack of surveillance in all cases has led us. Lastly, the Governing Council of the ECB has always strived to be as clear as possible. It recommended the utmost prudence in the management of financial risks even before the start of the financial turbulence.

So you are right, but no one listens to you?

We give our advice. Sometimes it is followed and sometimes it isn't. In any case, we cannot step in for governments any more than we can for the private sector. We are each called upon to be up to the challenges that face us, particularly in such difficult times.

What are you least satisfied with?

The greatest challenge of this period is of course the crisis, which is the worst since the Second World War. It could have been the worst crisis since 1929 if major and often bold decisions had not been swiftly taken, first by the central banks, who are in the front line but whose resources are necessarily limited, and by the governments of the advanced countries throughout the world.

Don't you regret, for example, the increase in interest rates in July 2008 or the increase at the start of 2011, which were regarded by some as premature?

We take our decisions on interest rates to deliver price stability for our fellow citizens in the medium term. In the 13 years since the euro was introduced, we have had an average annual inflation rate of 2.0% When the euro was launched, we were given our definition of price stability: an increase of below, but close to, 2%. In spite of the oil shocks and the increase in the prices of energy and raw materials, that is the best result for 50 years in the large European countries. Such a result is not achieved by chance, particularly when observers point to the same stability for the next ten years. Of course, price stability is a necessary condition for sustainable growth and job creation. But it does not suffice in itself. In each country, fiscal responsibility, the level of competitiveness, developments in production costs and structural reforms are further essential conditions. But overall in the euro area a total of around 14 million jobs have been created over 13 years, compared with 8 million jobs in the United States. A great deal still remains to be done in order to achieve full employment, and it requires the strengthening of European competitiveness.

What is the status of the euro area today?

It is affected by a crisis which is clearly global in scale. While the United States was the epicentre of the financial crisis in 2008, Europe is now more deeply affected by the sovereign debt crisis. However, looking at the euro area as a whole, our position is objectively better than that of Japan and the United States: at the end of the year we will probably have an average government deficit of 4.5% of gross domestic product (GDP) compared with 10% in those two countries. But some euro area countries are particularly vulnerable. Everything possible must be done to correct these situations: governance must be strengthened substantially in the euro area, particularly regarding fiscal policy and the monitoring of competitiveness indicators and of internal imbalances within the euro area. The current crisis must also be tackled in the best possible way. We call for all undertakings on the part of the various governments – not just Greece – to be rigorously complied with.

Can Greece avoid a default?

A very large adjustment is necessary in Greece to correct the errors of the past in the greater interests of the country and in the interests of growth and sustainable job creation. The commitments made by Greece and those made by all the European countries on 21 July should enable the scenario you mention to be avoided, and we have always warned the governments against it.

Should Greece have been allowed to join the euro area?

The past is over and done with. What matters today is the rigorous and rapid implementation of the decisions taken by the Greek government and by the other governments.

What should the governments have done to prevent the crisis from developing so dramatically?

They should have strictly complied with the rules of the euro area. Without a political federation or a federal budget, it was essential to have a very careful, continual and rigorous surveillance, particularly of fiscal policies. The countries did not respect the rules of the Stability and Growth Pact that they had laid down themselves. At the ECB, we have always been extremely firm on this point. In particular, I'm thinking of the positions taken by France, Germany and Italy in 2004 and 2005. To avoid being subjected to rigorous surveillance, they came up with the idea of weakening the Stability and Growth Pact. They not only weakened the letter of the Pact, they also considerably weakened the "spirit" of its application. That is why I welcome the very important change that has just been decided by the European Parliament and Council regarding European governance, whereby the Pact has been considerably strengthened, and there will be careful monitoring of imbalances and competitiveness indicators. I would add that observers and the markets themselves proved short-sighted: for a long time, before the crisis of 2008-09, Greece borrowed at the same rate as Germany!

Should the resources available to the European Financial Stability Facility (EFSF) be increased? Should that be done with the aid of the ECB?

First, it is necessary for the 17 countries of the euro area to ratify the agreement of 21 July, which provides for an extension of the fund's scope of action. As we speak, this is not yet the case. Then, all of the States must stand ready to react and apply fully the flexibility that is laid down in their agreements of 21 July. They need to be able to increase the effectiveness of the stability fund through recourse to a "leveraging" effect.

And what of the possible role of the ECB?

We are doing a great deal. But we cannot and must not act in place of the Member States themselves. Everyone knows that ultimately it is the Member States which have the capacity to convince all the market participants and to maintain or restore financial stability.

This summer you uncharacteristically became angry when the Germans accused you of being too lax. Do you regret it?

No! I never get angry. I explain, untiringly, what the Governing Council decides and what is applied by all the Eurosystem central banks. And the concept "the Germans" does not exist any more than the concept "the French", fortunately. All Europeans live in great democracies, which are also democracies of opinion with an ongoing and perfectly legitimate public debate. The ECB itself is a completely independent institution which, in accordance with the Treaty, can neither take nor seek instructions from anybody. At the press conferences, I have always emphasised our faithfulness to the primary mandate assigned to us by our political democracies: to ensure price stability for 332 million Europeans. I would also point out that since the beginning of the financial crisis, our interest rate decisions have not been transmitted properly throughout the euro area. This is a very unpleasant reality which it would be irresponsible to deny. This is why we have taken so-called non-standard measures. One example is the fact that we offer banks the opportunity to refinance themselves – to the level that they think necessary provided that they have the appropriate collateral – at a fixed rate, which is by far the most important initiative. Everything we do is aimed at improving the transmission of our monetary policy to the economy, including in the exceptional circumstances which we are experiencing today. I have also said that while the size of our balance sheet has increased by 77% since the beginning of the global crisis, which is admittedly not negligible, - the Fed's [the US central bank] has increased by 226%.

The fact that in Germany you are accused of being lax makes us smile in France, where Edouard Carmignac (1), an investment manager, has made you a final plea: reduce the rates to zero and state that you are prepared to acquire, without any limit, the debt of struggling European countries! German public opinion does not call me "lax"! That would be difficult when the euro has maintained its value better than the previous national currencies in the last fifty years. And I do not think that French public opinion, after the hard lessons of the crisis, today considers me to be "ultra orthodox". There are of course dissenting voices in all democracies of opinion, in France just as in Germany, and in the 15 other countries in the euro area. As the ECB is an institution with considerable responsibilities in Europe and as it is one of the two most important monetary institutions in the world, among the industrialised countries, it is normal that there is criticism as well as support.

As a result of your career, do you think that you have played a special role in French and European economic policy? I have been very fortunate to be linked with a historic task, that is the modernisation of the French economy and of all the other European economies in the context of furthering European unity. I have been associated with this strengthening of European integration for over 30 years. I was adviser to President Valéry Giscard d'Estaing when he launched, along with Chancellor Helmut Schmidt, the European Monetary System and the exchange rate mechanism. Then I had the responsibility of negotiating the Maastricht Treaty, which led to the creation of the euro, and then the task of leading the Banque de France, when it was independent, and then the European Central Bank since 2003. These successive responsibilities have left me deeply convinced that the peace, prosperity and stability of our continent are very firmly based on the strengthening of European unity. It would be a serious mistake to take them for granted.

Don't you feel that you have "trichetised" the French ruling class?

European integration has always been a historic undertaking, simultaneously multinational and multi-partisan. In all countries, moderate opinions as well as socialist or socio-democratic opinions, on the left and the right, have embraced European integration. This has been the case in France, as in the other European countries, since Robert Schumann's speech 60 years ago. This does not mean that there has not been a debate in all our democracies, but the debate largely took place within each of the main strands of opinion.

In the second part of his memoires, *Le temps présidentiel,* (published by NiL), Jacques Chirac says the following about you: "Jean-Claude Trichet is a hesitant, cautious man. He is afraid of his German counterpart, Hans Tietmeyer. For him, the President of the Republic doesn't matter." What would you reply to that?

I have not yet read President Chirac's memoires. Rest assured that I will read them very carefully. In any event, after the change to our Constitution and after the new law on the Banque de France, it could neither take nor seek instructions from the government - no more than can the European Central Bank and all the other national central banks today.

Do you think that France has not introduced enough reforms, or that the reforms are poorly designed?

All the European countries without exception have an insufficient growth potential compared with that of the emerging economies and the best- performing advanced countries in the absence of structural reforms.

So you do not see anything specific in the slow progress in France?

It is unfortunately a general phenomenon in Europe. But I can give you an example, among many others, which I think is meaningful. It is the problem of the single market for services in Europe. We are having great difficulty in achieving the initial ambition of Europe's founding fathers, that of a large common economic market. At first, services were only a small

part of the economy. Today they are the major part. And we are very, very far from having a common market for services. The resistance is very strong. This explains the maintenance of the status quo. But it is to the detriment of growth in the economy as a whole.

In the light of your experience, what friendly advice could you give to your successor?

I don't have any advice for him. He has been a member of the Governing Council for a long time; he has taken part in all our collegiate decisions. I am sure that he will assume his responsibilities very well, which are at the same time very important and very demanding.

François Baroin, the French Minister for the Economy, would like to give you a new job, a mission within the euro area.

I do not know what you are talking about. I have not taken any decisions on what I will do after my mandate ends. My duties are extraordinarily time-consuming and I will devote myself entirely to them over the next four weeks.

What would you like to do on 1 November that you do not have time to do at the moment?

Read a lot, reflect on the current path of European history and spend more time with my grand-daughters, Eléonore, Diane, Anna and Marie.

Interview with Die Welt

Jean-Claude Trichet, President of the ECB, Interview for Die Welt, conducted by Jan Dams and Martin Greive, on Friday, 7 October 2011

WELT: Mr Trichet, at the time you took up office, did you think it conceivable that you would be dealing with such a serious crisis in the currency union?

Jean-Claude Trichet: Even before the outbreak of the financial crisis, the ECB warned that it was highly likely that there would be major corrections in the financial markets. However, the fact that the crisis would call into question the whole economic and financial strategy of all developed economies was not quite so foreseeable.

You have had to take harsh criticism of your crisis management from Germany. How disappointing is that for you?

That reminds me of a Goethe quote: "*Against criticism a man can neither protest nor defend himself; he must act in spite of it, and then it will gradually yield to him.*" The ECB must accept the criticism. The only thing that matters is that we are faithful to our primary mandate and take our decisions fully independently.

It is about precisely that that increasing doubts are being expressed. Under your leadership, the ECB has lost its independence because it has financed hard-up euro area countries by printing money.

This criticism is completely inaccurate. We are fiercely independent of governments and pressure groups. All our decisions are made fully independently by the 23 members of the ECB's Governing Council. And we are totally devoted to our primary Treaty mandate of price stability. We have delivered price stability over 13 years with an annual inflation rate of 2.0% for the euro area as a whole and 1.55% for Germany. This is better than any time over the previous 50 years. For the last four years we have been experiencing the worst global crisis since World War II, and not surprisingly it is hampering our monetary policy transmission. That is why we have had to take some non-standard measures but with caution and prudence. With our decisions since the outbreak of the crisis, we have reacted appropriately to the market failures in the financial markets. We have lived up to our responsibilities.

The two German members of the ECB's Governing Council, Axel Weber and Jürgen Stark, both resigned because they could no longer support the buying up of government bonds.

Jürgen is a very good European and a very close friend. Over the last 18 years he has been closely involved in the European construction and European unity. He has been an outstanding ECB Chief Economist. He is one of the greatest champions of the European Union that I know. When, after serving the euro for many years, such a person, who has been totally loyal to the institution, announces his resignation for personal reasons, one has to fully respect his decision.

According to opinion polls, a majority of Germans now want the Deutsche Mark back. Is the euro at risk of losing its backing in Europe's largest economy?

There are different opinion polls! In early September Die Welt published the results of a survey in which two thirds of respondents in Germany called for "more common policies in Europe". The citizens of Germany know how important European unification is for their country; the fall of the iron curtain would not have been possible without a united western Europe.

In that case, how do you explain the growing mistrust?

I believe there is a problem of communication. Contrary to how things are often portrayed, we do not have a crisis of the euro as a currency. The euro is a credible, stable currency. In spite of the global crisis, its external value today is significantly higher than when it began. For 13 years the ECB has provided for stable prices. And observers and markets are anticipating the same stable prices for the next ten years. This achievement in particular is not valued highly enough by some commentators in Germany, and I do not understand why that is. Of course, there are shortcomings in the financial sector, in fiscal policies, and as regards financial stability: the financial markets are too unstable, some euro area countries are uncompetitive, and reliable fiscal policy is lacking in several countries. However, none of these problems have to do with the currency. They are the responsibility of the governments of the euro area.

Do you have the impression that the Heads of Government have understood what is at stake?

I believe they are conscious of their extraordinary responsibility. They all have to make decisions in the context of democracies which, in the advanced economies, are very inward-looking, which is a real problem at the time of the worst global crisis for the last 66 years.

What will happen if the European Heads of Government do not get the crisis under control?

My working assumption is that the Heads of State and Government will overcome the crisis. Europe must realign its fiscal policy, as other large developed economies must also do. This year, at 10%, the deficits in the United States and Japan will be around twice as high as in the euro area on a consolidated basis. In spite of this, Europe is the epicentre of the government debt crisis. The reason for this is the mutual dependence of the 17 euro area countries. This is why it is so important that every euro area country plays by the rules. A few days ago in the European Parliament, I quoted what I told the Members of the Parliament in my first hearings, eight years ago, four years before the crisis, concerning the absolute necessity to stick to the Stability and Growth Pact.

At your Governing Council meeting last week you reactivated all the crisis instruments. Is the euro in serious danger?

The euro as a currency is evidently not in danger. It is the financial stability of the euro area as a whole which is at stake, and this creates difficulties for our monetary policy transmission. Taking into account the reality of the situation we have reactivated a number of non-standard measures.

Many people nonetheless fear that the continuous flooding of the markets with new money will lead to inflation in the medium term.

This fear is totally unfounded. First the Securities Market Programme (SMP), namely the purchase of Treasuries on the secondary market, is not at all a quantitative easing programme. We are rigorously withdrawing all the liquidity which is provided. As regards all our non-standard measures, the balance sheet of the ECB has expanded by 77% since the beginning of the crisis; that of the US Federal Reserve System by 226%. This gives a measure of our relative prudence in this very grave crisis. And we are fully credible to deliver price stability over the next 10 years, according to observers and market participants.

In the spring, the ECB spoke out against the restructuring of Greek debt which was being discussed at that time. Now there is again discussion of a debt restructuring. Does your opposition still stand?

In the spring, the Governing Council of the ECB unanimously made the following points. We cannot accept the securities of a state in default, even for a short period of time, as collateral for the refinancing of banks without an appropriate credit

enhancement. Similarly, we said that a credit event should be avoided. Our position has not changed. In any case, we call for the full implementation of the decisions taken by the Heads of State and Government on 21 July.

Then providing funding to Greece remains the only option. How many years will Europe have to support Athens?

Greece must pursue an adjustment which must be very strong and credible under the permanent surveillance of the IMF and of the European institutions. A key element, in my opinion, is the technical assistance of Europe, now being organised in Athens by Mr Reichenbach.

Can the European safety net protect the euro area from a conflagration?

We welcome the decisions of the Heads of State and Government of 21 July through which the flexibility of the safety net was enhanced. It is now their responsibility to make the safety net operational as soon as possible.

Do you believe that the ECB will then be able, as planned, to cease its controversial buying up of government bonds?

In the future, the EFSF will be able to intervene in the secondary market. The stability of the European financial system will in the future be guaranteed by the governments via the EFSF.

How large should the capacity of the EFSF be?

The governments must first implement all the decisions of the EU summit of 21 July and provide appropriate leveraging of the fund.

Should the EFSF be granted a banking licence in order to be able to obtain money directly from the ECB?

The ECB's Governing Council does not consider that appropriate. The governments themselves have several means to leverage the EFSF.

Yet again the banks are deeply in crisis and clearly need to be recapitalised. Can the euro area afford another banking crisis?

We have to deal with the sovereign risk tensions and we have to deal with the banking tensions. It is crucial that the banks put their balance sheets in order as quickly as possible. They need to build up a stronger equity position by retaining profits and being less generous with bonus payments. In so far as is possible, they must recapitalise in the market. If a financial institution has no access to the capital markets, the Government must stand ready to recapitalise solvent banks. In addition, where it would be necessary, the Heads of Government have decided that the EFSF can be mobilised to recapitalise banks.

How can it be prevented in future that taxpayers have to continuously save the banks?

The global financial system must be much more resilient. That is the reason why we have to apply rigorously and fully the new Basel III rules, to be sure that systemically important financial institutions do not put the sector in danger. In this regard we have to be inflexible and oppose any pressure group.

Under your leadership, the ECB has risen to become Europe's secret government. Is it not deeply undemocratic when representatives of an unelected institution like the ECB can dictate austerity plans to an elected government like Italy's?

We do not dictate anything to anyone. We do not replace any government. We do not take any political decisions. We are only giving messages to Governments individually, and to the Eurogroup as a whole. This has always been our task since the setting-up of the ECB. Do you not think it was appropriate for us to tell the big countries in 2004 that they should not weaken the Stability and Growth Pact?

Almost all experts agree that Europe must come closer together. How do you imagine the Europe of the future?

I would make a distinction between the immediate future, and – after a change in the Treaty – what I would call "tomorrow" and the "day after tomorrow". Immediately we must apply completely and rigorously the new governance which has just been approved by the Parliament and the Council. "Tomorrow" we must have the possibility to impose decisions on a country that is not applying the recommendations and, in so doing, is putting the system as a whole in

danger. And “the day after tomorrow” we should have a significantly stronger political union with an executive branch and, in this executive branch, a European Finance Minister. He would be responsible for surveillance of fiscal and economic policies, for the monitoring of the financial sector and for the representation of the European economy in international institutions.

At the end of the month, your term of office comes to an end and you will step down after years as President of the ECB. What headline would you like to read over your period in office?

Despite successive oil shocks and the global crisis, the ECB Governing Council has delivered greater price stability than in the previous 50 years to 332 million fellow citizens.

Do you already know what you are going to do with your spare time in future?

I have not made any specific plans, because I am concentrating fully on my last weeks in office. My greatest privilege will surely be that I will have more time for reading, for meditating on the present history of Europe and to spend with my four granddaughters: Eléonore, Diane, Anna and Marie.

Interview on the Cultural Days of the ECB – Italy 2011

Interview with Jean-Claude Trichet, President of the ECB, for the special supplement of Frankfurter Allgemeine Zeitung

1. Mr Trichet, as patron, do you feel that the Cultural Days of ECB have been a success?

Yes, definitely. Within Frankfurt and the Rhine-Main region, the level of public interest and support for the Cultural Days of the ECB has grown over the years. Thanks to the participation of extremely talented and enthusiastic artists – so far from Portugal, Poland, Hungary, Austria, Greece, Romania and the Netherlands – and to our collaboration with the respective national central banks, we have been able to bring a part of Europe’s cultural riches to Frankfurt every year since 2003. This year, the focus of the programme of events will turn to Italy, a country which, throughout the ages, has made a significant contribution to the development of the arts in Europe. Over the years, the Cultural Days have therefore become a firm cultural “rendez-vous”.

Furthermore, we now have a number of excellent partners and sponsors who, for many years, have lent their support to this event that takes place over several weeks. Particular mention at this point goes to the City of Frankfurt, which, from the outset, has provided committed support for the Cultural Days.

2. What is special about the Cultural Days?

The Cultural Days always offer the opportunity to discover something new and unexpected, even to those who have already visited a number of the European Union’s Member States and are well versed in European culture. When putting together the programme of events, it is therefore our aim to stage up-and-coming artists as well as those already of international renown, to present the experimental arts, and thereby build a bridge that spans the arts from the modern to the traditional. The cultural diversity on offer in Europe is unbelievable. Every year, we try to give the public greater insight into this cultural kaleidoscope through the Cultural Days.

3. Does a commitment to culture also pay off during times of crisis?

Yes, it certainly does, as culture brings people together and fosters mutual understanding. Over the last few years, we have seen that culture acts more as a unifying than a divisive force. The cultural wealth of Europe is unique in the world. We should always bear in mind that it is a reflection of our common heritage, which we need to preserve and develop further.

Especially in difficult times like these, it is very important that we continue our commitment to culture. We are therefore happy that numerous partners and sponsors, in both Germany and the showcase country, help us so effectively in organising the Cultural Days.

4. Which showcase countries can the public look forward to in the coming years?

After Italy, there will be France in 2012 and Latvia in 2013. I would also like to take this opportunity to thank all my colleagues, as well as the teams from the respective national central banks, who have supported, and will continue to support, this project here at the headquarters of the ECB, with great commitment and an extremely exciting programme of events. We are proud that we have succeeded together in putting on a series of events in Frankfurt that is, as always, ambitious, varied and appealing.

5. What would you like to see for the Cultural Days in the future?

Continued enthusiasm, lots of curiosity, experimentation, and that, for a period of three to four weeks a year, it continues to bring together people from all nations and of all ages to celebrate the cultural identity and diversity of Europe.

Finally, we should never forget that our extremely rich and diverse cultural heritage is based on the constant exchange between the countries of Europe, placing us all under a humanistic obligation to continue to foster and expand this heritage in the future.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Jean-Claude Trichet, President of the ECB Brussels, 4 October 2011

Dear Madam Chair,

Dear Honourable Members,

It is always a great pleasure to be here as President of the European Central Bank (ECB), before the directly elected representatives of the European people. This interaction is a cornerstone of our Economic and Monetary Union.

Today, I appear before your committee with particular emotion. This is the last of my 35 immensely fruitful dialogues with you.

Members of the European Parliament, you are the heart of the living democracy in Europe. We at the ECB are the guardians of the currency of our fellow citizens. And we are fully independent in our actions to protect the currency whilst you ask us to report to you.

Indépendance et responsabilité sont indissociables. Afin de conserver sa légitimité, une banque centrale indépendante doit être prête à rendre des comptes au Parlement et au public. Tout au long de mon mandat, j'ai attaché autant d'importance à l'une qu'à l'autre. La BCE est farouchement indépendante. En même temps, elle ne peut pas se passer d'une interaction régulière et étroite avec le Parlement européen: c'est cela même qui lui permet d'accomplir ses missions en toute transparence et responsabilité. C'est pourquoi j'ai toujours répondu présent lorsque vous m'avez convié à venir échanger ici, que ce soit en session plénière ou en Commission, et plus fréquemment que d'habitude lorsque des circonstances exceptionnelles l'exigeaient.

Ich möchte in meiner Einleitung mit dem vereinbarten Thema beginnen, nämlich den Prinzipien der Geldpolitik der EZB seit ihrer Gründung. Danach werde ich eingehen auf die Beziehungen zwischen der EZB und dem Europäischen Parlament in den letzten acht Jahren, und den Beitrag unserer beiden Institutionen zur europäischen Integration. Mit einigen Überlegungen zur Zukunft der EU, und insbesondere der Wirtschafts- und Währungsunion, werde ich dann schließen.

1) The ECB's actions since its creation: Permanent alertness, resolute action and fierce independence

Let me first reflect on the ECB's actions since its creation. With current discussions sharply focused on how to deal with the financial and sovereign debt crisis, it is sometimes forgotten that our primary objective is to maintain price stability in the euro area.

More precisely, we aim to maintain inflation rates in the euro area below, but close to, 2% over the medium term.

This is what the Treaty demands from us. This is what the citizens of the euro area expect from us. And this is what we have delivered.

Price stability is a necessary condition to foster sustainable economic growth, job creation and to ensure the well-being of Europe's citizens.

One fundamental indicator is medium and long term inflation expectations. Inflation expectations that are in line with our definition of price stability help employers and employees in the euro area to agree fair wages. They help businesses small and large to make longer-term investments. They ensure, all things being equal, a more favourable financial environment because market medium and long term interest rates incorporate stable price expectations. And they help governments to play their role in macroeconomic stabilisation.

Preserving inflation expectations in line with price stability has been far from easy. Let me remind you of a few of the many shocks to the economy since 1999.

The early 2000s saw the bursting of the "dot-com" bubble. Medium and long term inflation expectations remained stable. Then came the terrorist attacks of 9/11. Inflation expectations remained stable. We saw dramatic surges in oil prices. Once again, medium and long term inflation expectations remained stable.

Then, in 2007, there were the first signs of an unprecedented financial crisis, the repercussions of which continue to this day. What happened in late 2008 in particular could have resulted in an economic catastrophe not seen since 1929. Authorities across the world took action to avoid another Great Depression. We at the ECB responded by lowering interest rates and introducing our non-standard measures. We experienced a very short period of negative inflation, with some commentators expecting a long period of deflation. Yet medium and long term inflation expectations remained stable.

As you know, 2010 and 2011 have been extraordinary years for the economy, with parts of the euro area confronting serious problems in sovereign debt markets. But I can say once again: inflation expectations remain stable.

Dealing with these diverse shocks has required constant alertness, resolute action and fierce independence.

Permanent and credible alertness in 2004, when the ECB kept interest rates at 2% while governments and international institutions were calling for more cuts.

Fierce independence in 2005 when the ECB started increasing its policy rates despite, again, the strong opposition of many governments and against the advice of international financial organisations. The ECB was criticised for that decision; with hindsight, that criticism turned into respect.

Alertness in August 2007, at the very start of global money market turbulences, when the ECB was the first central bank to take non standard measures to ensure the smooth transmission of monetary policy.

At the very beginning of the financial crisis the ECB decided to stick to a strict *separation principle* between the "standard measures" and the "non-standard measures". The "standard measures" are designed to deliver price stability in the medium term: they are the interest rate decisions. The "non-standard measures" are designed to help restore a better transmission of our "standard" monetary policy decisions at times when the crisis is disrupting markets or segments of markets: the "non-standard measures" include the supply of liquidity at full allotment and fixed rates and the interventions in private and public securities markets.

This *separation principle* permits us to preserve, including in the present deep crisis, a strong sense of our direction in the medium term – price stability – whilst taking into account the reality of the disruption of markets due to the crisis.

Like actions, numbers speak louder than words. Let me mention one number: 2.01%, the average inflation rate in the euro area since 1999 until today, over a period of almost 13 years during which oil prices have soared.

This number has become so deeply embedded in our society that people have almost forgotten it.

But this number reflects the lowest annual average change in prices that any large euro area country has experienced since the beginning of the European project, over 50 years ago. Price stability is now so self-evident to the citizens of Europe, and so much expected from their central bank, that achieving it is taken for granted.

Even our regular exchanges of views have sometimes dealt less with the “M” than with the “E” of EMU!

2) Economic and Monetary Developments

Achieving price stability through alertness and fierce independence sets the framework for our day-to-day actions. In this context, let me report on recent economic and monetary developments. Note that as we have entered the Purdah-period, nothing I say has any bearing on upcoming monetary policy decisions.

We expect real GDP growth in the euro area to be very moderate in the second half of this year. Growth is dampened by a slowing pace of global growth, by declines in equity prices and business confidence, and by continuing tensions in segments of financial markets as well as in some sovereign debt markets. The more moderate economic outlook is confirmed in the ECB’s September projections. The risks to the economic outlook, which previously were balanced, are now on the downside, mainly relating to tensions in some financial markets.

Turning to prices, inflation was 2.5% in August, and rose to 3% in September according to the Eurostat flash estimate, almost exclusively as a result of oil price developments. We expect inflation to stay above 2% over the coming months. Next year, it should fall below that level, depending on commodity price and wage developments. This pattern is also reflected in the latest ECB projections of inflation ranging between 1.2% and 2.2% next year. The risks to the medium-term outlook for inflation were broadly balanced in the eyes of the Governing Council in its last meeting, whereas before they were seen as being on the upside.

Our monetary analysis indicates that the underlying pace of monetary expansion remains moderate. Liquidity accumulated prior to the period of financial market tensions continues to be ample but recent data indicate that part of it may be held more for precautionary reasons than for spending.

Finally, in the context of our continuing analysis of the euro area economy, let me draw your attention to today’s release of the 2011 Structural Issues Report. This deals with structural features of distributive wholesale and retail trade and their impact on prices in the euro area. The distributive trade sectors are not only economically important in their own right, but also relevant to monetary policy. Ultimately, it is retailers who set the prices of most consumer goods and they are a key interface between producers and consumers. I very much ask you to take note of the report. It suggests ample scope for further improving effective competition and removal of unwarranted barriers to cross-border trade.

3) The European Parliament and the ECB – a constructive relationship to the benefit of Europe

Let me turn to the relationship between our two institutions. The ECB’s fierce independence and its accountability to the Parliament are two sides of the same coin. In this endeavour, and especially throughout the recent turbulent times, our two institutions have interacted very constructively. The quality of our relations has been instrumental to the exercise of our tasks and, I believe, more generally to the process of European integration.

The hearings in your Committee are naturally the cornerstone of the ECB’s Treaty-based accountability obligations. But they are more than that: beyond monetary policy *stricto sensu*, they have allowed two genuine European institutions – two institutions that only have the whole in mind and not just the parts – to have a continuous dialogue on a number of issues of great relevance for the smooth functioning of the single market of the European Union and of EMU.

This holds in particular for legislative dossiers on which you decide, together with the Council, and to which the ECB has contributed. I feel reassured when I see the numerous occasions when you have used your powers to bring Europe forward rather than settling for the lowest common denominator. I am confident that this will continue.

The latest example is of course the economic governance package. Long before the crisis, our two institutions had sent similar messages to governments, in our own ways and through different fora.

In November 2003, three weeks into my mandate, the ECB lambasted the fateful decision of the Council that effectively watered down the Stability and Growth Pact. Let me quote what I said eight years ago during my first regular hearing before your Committee: *“The failure to respect the rules and procedures foreseen in the Stability and Growth Pact risks, in our view, undermining the credibility of the institutional framework and confidence in the sustainability of public finances across the euro area.”*

In 2005, six years ago, in the name of the Governing Council I both expressed our “grave concerns” as regards the conclusion of the negotiations on the new text of the Stability and Growth Pact, and I raised alarm bells as regards the evolution of the competitive indicators of the various countries member of the Euro area.

Well before some sovereigns run into trouble in 2008, the Parliament also *“requested that Member States in the euro area strengthen the effective coordination of economic and financial policy”* [1].

When the time came to transform these messages into ambitious legislation, the Parliament immediately seized the opportunity. You were fully supported by the ECB.

A second telling example of the fruitful interaction of our institutions is the new architecture of financial supervision. Throughout the 2000s, the Parliament regularly called for the reinforcement of a true level playing field at the European level, while pointing out significant failures in the supervision of ever more integrated financial markets. [2] When the Commission put forward the financial supervisory package, the Parliament did its utmost to strengthen the powers of the new supervisory authorities. Here again, you could also count on the support of the ECB.

4) Visions for Europe from 2011

Honourable Members,

In the middle of the deepest financial crisis since World War II, it is important to remind ourselves that Europeans can take pride in what our continent has achieved over the last 66 years. The unprecedented level of prosperity, peace and stability that the European Union and the Economic and Monetary Union have provided for their citizens is something we need to cherish.

An important debate is underway on *how* to ensure that Europe continues to deliver well into the future. Important and much needed reforms have been adopted over the past few months. But this is not the end of the road. On the contrary: further steps must be taken on our way to an ever closer economic union. In the short to medium term, it is essential to implement and enhance the newly agreed legislation as far as possible. Here, this Parliament has a pivotal role.

On economic governance, there is no doubt that you will make extensive use of tools such as the ‘economic dialogue’ to support economic integration with the required legitimacy. This will open up the process of fiscal and macroeconomic surveillance and, by enhancing transparency, it should encourage Member States to abide by the new rules as strictly as possible.

I am also confident that, both in the financial supervisory and governance package, you will seize the opportunity of the review clause to go one step further. In 2013 and 2014, you will have a *rendez-vous* with the Council to take stock and explore possible improvements. This will once again be an occasion to bring forward European integration in key policy areas.

You have always pushed the frontiers of what is impossible by putting forward new ideas which have eventually become political reality. As a citizen of Europe, I very much hope that the Parliament will maintain this track record.

When I received the Karlspreis a few months ago, I was reflecting on the future of the European Union and of the Economic and Monetary Union “tomorrow” and the “day after tomorrow”. As a citizen of Europe I see the necessity of deepening the institutional framework of the European Union. In my personal view, Europe will need to make significant progress towards political unity with an executive branch and a Parliament, both with extended responsibilities as in any democracy. Part of this executive branch would be a European finance ministry which will be responsible, not necessarily for a large federal budget, but certainly for a strong economic and fiscal surveillance and governance, for the handling of the financial sector and for the external representation of the Economic and Monetary Union.

Such a strengthening of the EU executive will not be possible without one absolutely necessary condition: democratic legitimacy. This Parliament is the only institution that can ensure this for Europe as a whole. Collective responsibility for the destiny of EU and EMU and strong democratic control by the Parliament are two complementary and necessary dimensions. The future belongs largely to this Chamber; the future depends very much on this Chamber.

Mrs Chair, honourable members of the Economic and Monetary Affairs Committee of the European Parliament: let me convey to all of you my most sincere thanks for our very fruitful cooperation over the past eight years. I have very much enjoyed working with you in such a constructive spirit. I wish you, as well as my successor, Mario Draghi, the Executive Board and the Governing Council of the ECB great success with the challenges, as well as the opportunities, that lie ahead.

I can assure you that from its side, the ECB will continue to guard our currency, the euro, and deliver price stability to Europe's citizens.

Interview with Corriere della Sera

Interview with Jean-Claude Trichet, President of the European Central Bank, conducted by Marika De Feo, Corriere della Sera

1. Mr President, are you satisfied with the outcome of the meetings in Washington?

It is always extremely important for world leaders in the areas of economy and finance to exchange views, compare notes and work out a diagnosis of the situation which is lucid and without any complacency. We are in the fourth year of a very demanding global crisis. The epicentre of the crisis is in Europe, but it is a global crisis. On behalf of the ECB's Governing Council, I called on all European authorities to be up to the very demanding challenges of the times and to demonstrate their sense of direction. And I told our partners in the rest of the world that we needed support and strong encouragement for European affairs, but not public lectures.

2. The G20 pledged on Thursday to "take all necessary actions to preserve the stability of banking systems and financial markets". Which strong and collective action do you suggest?

First, the full, comprehensive and speedy implementation of all decisions already taken individually and collectively in Europe and in the world. As regards the Europeans, full and swift implementation of the decisions taken on 21 July.

Second, as has been underlined by the European Systemic Risk Board, coordinated efforts to strengthen bank capital, including recourse to backstop facilities.

Third, we need to stand ready to respond to new challenges that can arise at any time. Permanent and credible alertness is more important than ever in the present circumstances.

3. Are governments responsible for the dangerous development of the crisis?

I am on record as having stressed, on behalf of the Governing Council, since the inception of the euro, that fiscal soundness was of the essence, that the Stability and Growth Pact was fundamental in a single currency area without a federal budget, and that the surveillance of competitive indicators by peers was absolutely necessary. All this is clearly documented.

Now, in the present very demanding circumstances, what counts is that all authorities are up to their responsibilities. Now is the time for effective action, implementation, verbal discipline and a stronger team spirit on the part of the European executive branches.

4. European countries were urged to boost the rescue fund (EFSF) to contain contagion and avoid recession. What do you think of that? Could the EFSF be leveraged, for example, through the European Central Bank, or receive a bank licence? Or is it better to anticipate the creation of the ESM, as Germans suggest?

I call for the full and swift implementation of the decisions of 21 July taken by the 17 Heads of State or Government. And for them to stand ready to face up to acute new challenges in a period which is so demanding.

5. Mr President, growth seems to have deteriorated quickly, downside risks to growth are augmenting. Are these reasons strong enough for the ECB to become more aggressive in the fight against the crisis, involving also monetary policy?

As you know, we consider that being a very solid anchor of stability and confidence in the turbulent times we are experiencing is a fundamental contribution to growth and job creation. The remarkable anchoring of inflation expectations, which is due to our credible monetary policy, protects us against the risk of inflation and the risk of deflation. You know our well-established concept: we are never pre-committed, and our interest rates are always designed to deliver price stability in line with our definition and the anchoring of expectations.

6. Would the ECB go as far as introducing also other liquidity operations, for example 12-month liquidity operations, as was suggested in Washington?

Do not forget that we are presently refinancing all our banks on the basis of full allotment at a fixed rate at one-week, one-month and three-month maturities. This is the most important of our non-standard measures, designed to help restore a better monetary policy transmission mechanism. These non-standard measures have to be exactly commensurate to the degree of abnormal functioning of markets in the assessment of the Governing Council.

7. Do you think that the downgrading of Italy recently decided by Standard & Poor's is justified?

I do not comment on decisions by rating agencies. Investors and savers know that what counts is their own judgement. What counts are fundamentals and actions taken by governments and parliaments to enhance and consolidate confidence.

8. And are you satisfied with these actions until now?

As you know, we sent messages to Italy that were followed by action and, after some hesitation, the decisions were confirmed rapidly by the parliament. Of course, this is work in progress, all this has to be implemented as soon as possible, and there are other measures upon which the authorities are reflecting.

9. Which measures are still missing?

We would encourage everything that goes in the direction of structural reforms to unleash the capacity of Italy to grow faster, to have a better growth potential. The potential of Italy is immense, and the present growth potential is not in line with the overall capacity of Italy. I think there is a general consensus among economists on this, and everything that goes in the direction of unleashing productive forces is welcome.

10. Which other strengths do you see in the potential of the Italian economy?

One of the major strengths of Italy is its entrepreneurial spirit. The capacity of individuals and families to start a business, take risks and be devoted to their enterprises is exceptional. But this entrepreneurial spirit, which is shared by society as a whole, needs to be allowed to develop fully through structural reforms aimed at increasing the flexibility of the economy.

11. What more should be done to increase growth? For instance, reducing protection in non-tradable sectors and monopolies, approving the liberalisation of closed professions, higher pension age, making labour markets more flexible and an overall increase in productivity?

A lot of things can be done, in particular but not exclusively the liberalisation of closed professions, improved flexibility of the labour markets, improved education and training, and measures to boost innovation.

12. How do you evaluate the fact that Italy is going to have a primary surplus as a percentage of GDP from next year onwards?

It is of course something which is important, and maybe not sufficiently well-known by external observers. We encourage Italy to follow this path and to do all that is necessary in order to consolidate this primary surplus and reach the goal of having balanced overall public finances in 2013.

13. Do you think that this objective can be reached with the measures taken until now?

What counts is the goal. The decisions which were taken recently make it possible to advance significantly in the direction of that goal. Whether new decisions will have to be taken, taking into account the overall situation and the evolution of the real economy, is an open question. But the goal is the goal; it has been affirmed, and it is very important.

14. Would it have been better to publish the messages you sent to Italy?

As you know, we have sent messages and we do that on a permanent basis, through various means, addressed to individual governments. We do not make them public. But we are calling for all governments without exception to permanently ensure sound fiscal and macroeconomic policies. We do this every month in the Eurogroup and in ECOFIN, so this is not something extraordinary.

15. The SMP is temporary, how long will you go on with the programme?

We are implementing this programme – like all non-standard measures – for monetary policy reasons, to restore a better transmission of our monetary policy, because some markets or segments are disrupted and not functioning properly.

These disruptions, in the case of the Securities Markets Programme (SMP), are due to the fact that governments, individually, still have to ensure their full credibility in the markets, and that the peer surveillance called for by the Stability and Growth Pact was not exercised correctly. It was on the basis of the commitments of 21 July made by the EU Heads of State or Government that the Governing Council of the ECB decided to activate the SMP, taking into account the commitment of governments to give the EFSF the capacity to intervene on the secondary market.

16. Are you buying sovereign bonds to help Italy in particular?

No. We are embarking on the SMP to help restore a better transmission mechanism for monetary policy at a time when governments have not yet implemented their decision of 21 July.

17. What will happen when you stop this programme?

I already explained how we see this programme and the commitment of the governments to step in individually and collectively.

18. Many are calling for Greece to default, also from the Governing Council…

We have decisions which were taken with the signature of 17 Heads of State or Government on 21 July, and the Governing Council considers that it is extremely important that all the decisions be implemented. Moreover, the key to everything are the decisions of the Greek government, which has to adjust in a decisive way, in the interests of the Greek people.

19. But some observers from outside have the impression that you are also losing patience with Greece.

Our message is crystal clear.

20. Are you satisfied with this first agreement of the Troika?

When we have a report, we shall see.

21. Will the role of the EFSF be enough to substitute for the ECB?

The decisions which have been taken by the European governments have to be fully implemented, and they explicitly include the possibility of intervening on the secondary bond market.

22. People say that we are at a crossroads for Monetary Union, where the euro may break apart, remain only 10-12 countries, or have a more integrated governance.

Since 9 August 2007 we have been experiencing the worst crisis since the Second World War. This global crisis is challenging the strategies of all the big advanced economies, Japan, the United States and Europe. So it is not surprising that we are all in very demanding times. As regards Europe, it is absolutely crucial to make a distinction between the currency itself and the tensions that we have observed in some countries. The euro has kept its value remarkably over 13 years, has preserved price stability, is backed by strong fundamentals and is considered by markets to be solid and stable for the next ten years, when we look at inflation expectations. On a consolidated basis, public finances in the euro area are sounder than in the United States or in Japan, with a public finance deficit of 4.5% of GDP, whereas it is around 10% in the other two countries. That being said, we have a number of countries that undoubtedly have to correct their policies. And that calls for a strong enforcement of their national policies in the domain of public finances and structural reforms. We must have a “quantum leap” in the governance of the 17 members of the euro area.

23. Mr President, did the role of the ECB change during the crisis, and if so, how?

The ECB is an anchor of stability and confidence in Europe. Its track record in terms of price stability is remarkable and better than what any of the euro area countries experienced over the last 50 years. The crisis did not change anything in this respect. On the contrary, in times of difficulty, turbulence and crisis, the role of the ECB as an anchor is even more important.

24. Is there still a vision for a united Europe?

I profoundly believe that the people of Europe feel that, in the present world, a united Europe is more important than ever. The rise of the big emerging economies, the structural changes at the global level, and the rapid advances of science and technology call for Europeans to unite, with a profoundly improved governance structure.

25. How many hours do you work every day, how many days a week? Do you still have room for private interests and family?

I would say 10 to 11 hours a day and probably, as an average, 6 to 6½ days a week, depending on the European and international working weekends. It is demanding,

particularly in times of turbulence. I thank profoundly my wife and family for their understanding.

Preventing spillovers on the global economy

Speech by Jean-Claude Trichet, President of the ECB at the Bretton Woods Committee, International Council Meeting 2011 Washington, 23 September 2011

Ladies and Gentlemen,

It is now four years after the outbreak of the global financial crisis, and three years after the collapse of Lehman Brothers, which were stark reminders of how much financial integration and globalisation made all economies interdependent.

This interdependence creates benefits but also adverse spillovers which may arise in all domains, from inadequate macro policy choices to private market imperfections. I will focus today on two key areas of policy interest to address spillovers in the global economy: (1) reforming global finance, and (2) strengthening policy discipline at the domestic and global level, before turning to how the euro area can contribute to global stability.

1. Reforming global finance

At the Pittsburgh Summit in 2009, G20 leaders agreed 'to do everything needed to repair our financial system and to maintain the global flow of capital'. The November 2011 G20 Cannes summit will take stock of where we stand in terms of implementation of this important reform agenda.

In a number of areas, important decision have already been taken, notably as regards the improvement of bank capital with the agreement on Basel III, and the development of macro-prudential frameworks. In other areas, we are close to concluding our work, in particular as regards a new global framework on systemically important financial institutions (SIFIs).

In those areas where decisions have already been taken by the international community, implementation is now key. The G20 yesterday committed to full implementation of Basel III along the agreed timelines. The EU has already started this process early with the European Commission putting its proposals on the table for the so-called Capital Requirements Directive IV, which will translate Basel III into the legal framework of the EU Member States.

In terms of macro-prudential framework, the European Systemic Risk Board has started its operation this year. All jurisdictions must ensure timely implementation so that we can ensure that we have done everything to make a difference as regards the resilience of the global, regional and national financial systems.

Let me briefly highlight three key areas on which we need to stay committed and where swift progress is of the essence.

The first challenge may come from the shadow banking sector. The introduction of more stringent capital requirements may provide incentives for banks to shift part of their activities outside the regulatory realm. It is therefore decisive that we continue our work to improve our capacity to identify and assess the potential risks stemming from the shadow banking system. This includes regulatory reform of money market funds, securitisation and the interaction with the banking sector.

The second challenge is how to keep pace with financial innovation. Improving the OTC and commodity derivatives markets is a key part of this agenda, It is a complex matter and one in which alignment of details is essential to avoid regulatory arbitrage.

The third challenge is to enhance transparency across the board: with regards to markets, institutions, and products. Insufficient information contributes to mispricing of risks, mistrust among market participants, which can result into downturns and crises. At our October meeting of G20 Finance Ministers and Central Banks Governors we will be

discussing IOSCO “recommendations to promote markets’ integrity and efficiency to mitigate the risks posed to the financial system by the latest technological developments”.

2. Improving policy discipline globally

Aside from a more resilient global financial system, we need to have more disciplined macro policies as the lack of discipline in macroeconomic policies in several countries led to the build-up of unsustainable external imbalances before the financial crisis.

There is still a gap between the degree of economic integration and the willingness of policy makers to take into account interdependence and spillovers.

Keeping one’s house in order is no longer sufficient in an integrated world. Spillovers from the rest of the world can influence economies considerably. Multilateral surveillance is now being enhanced along two tracks. The informal G20 track and the formal IMF track.

The G20 Framework for Strong, Sustainable and Balanced Growth, incorporates a first systematic multilateral assessment of global imbalances. It comes at an appropriate time because four years after the crisis, global imbalances remain unsustainably high. The sum of the current account balance (in absolute terms) of the major economies are projected to remain close to 2.5% of world GDP in the next few years. This is less than their pre-crisis peak (over 3% of world GDP), but still twice as high as in the early 1990s, before the acceleration in financial and real globalization.

It is now of foremost importance to implement the Framework effectively, and to fully live up to the expectations that the G20 process raised internationally. The G20 Cannes Summit will provide a litmus test.

Multilateral surveillance of domestic policies of systemic countries to ensure their orientation towards medium term stability and sustainability is being strengthened in the IMF as well.

The recently conducted first round of IMF spillover reports, the Consolidated Multilateral Surveillance Report to the IMFC and the current triennial review of IMF surveillance can be seen as useful steps towards a broader and more comprehensive framework.

3. Strengthening governance in the euro area

The need to strengthen discipline is understood strongly on our side of the Atlantic, so that the euro area can do its part in contributing to global stability.

The earlier economic governance framework has proved to be insufficiently binding while lacking appropriate comprehensiveness.

The requirements for a very significant reinforcement of the fiscal surveillance of the Stability and Growth Pact and for the creation of a new surveillance of competitive indicators and macroeconomic policy have been discussed widely and in much detail by euro area authorities. We have embarked on a deep and comprehensive reform of its economic governance to reinforce economic policy coordination.

The Governing Council of the ECB has called for a “quantum leap” in the economic governance of the euro area. This includes in particular (i) greater automaticity of sanctioning mechanisms, particularly in the Stability and Growth Pact (ii) as well as truly independent fiscal and economic analyses of macroeconomic imbalances.

The recent conclusion of the negotiations between the European Parliament and the EU Council on the economic governance reform package are welcome. Fiscal surveillance will become stronger and more coherent with the reinforcement of the Stability and Growth Pact. While falling short of the quantum leap that the ECB was advocating, this agreement strengthens the initial Commission proposals in many ways and is thus a step in the right direction.

The EU budgetary frameworks will also be strengthened, including through the introduction of fiscal rules at the national level. The so-called “European Semester” can be expected to provide ex-ante and integrated guidance to the Member States for the formulation of national budgets and structural reforms for the following year.

This will be complemented by the introduction of a macroeconomic surveillance procedure, which closes an important gap in the economic governance framework. It is key for this framework to be rigorously applied, including in terms of the indicators used, in order to consolidate the effectiveness of this new procedure to assess in particular euro area Member States experiencing sustained losses of competitiveness and large current account deficits. The focus needs to be on the

prevention of situations creating risks to economic, budgetary and financial stability in the euro area. In addition, this macroeconomic surveillance procedure should rely on transparent and effective trigger mechanisms.

Conclusions

Let me conclude with three key messages to policy makers – in advanced and emerging market economies alike – who all have a role to play to address the challenges that are ahead of us.

First, what has already been decided has to be implemented expeditiously, comprehensively and fully. This requires resolve and fortitude on the part of the public authorities, but also lucidity on the part of the private sector.

Second, there can be no complacency as regards the unfinished part of our reform agenda for a stronger international financial architecture. And I cannot help saying that on top of what is clearly identified by the international community as the urgent issues under discussion in the Financial Stability Board and the G20, we are far from understanding the potential global systemic instability that is associated today with the sheer size of the non-banking sector which experienced an exponential growth over the last 20 years.

Third, as regards the euro area and the sovereign debt crisis, of which the euro area is currently the epicentre, the euro area central banks, and the ECB in particular, have been permanently calling for sound economic policy management, in particular in the fiscal domain, for structural reforms and for reinforced economic governance. As independent institutions that are devoted to stability and that are medium- to long-term oriented, we are an anchor of stability and confidence. This is especially valuable in the turbulent market environment that we are witnessing and that is characterised by acute tensions of some sovereign signatures which are causing negative spillovers on others.

Only a few weeks ago, the central bankers were all meeting in the BIS headquarters in Basel in our Global Economy Meeting. Reporting to the press afterwards, I stressed that we were all very closely “united in purpose”: each of us in our own economy, with its different features and challenges, striving to solidly anchor inflation expectations, preserve stability and consolidate confidence. Meeting here in Washington, authorities have the opportunity to display the same unity in purpose to address their economic challenges at home, prevent negative spillovers for the global economy and consolidate confidence in the world recovery.

Now, at the end of this exposition, it might be useful for me to tell you what is the assessment that the European Systemic Risk Board has expressed after its last meeting only two days ago:

Since its previous meeting on 22 June 2011, risks to the stability of the EU financial system have increased considerably. Key risks stem from potential further adverse feedback effects between sovereign risks, funding vulnerabilities with the EU banking sector, and a weakening growth outlook both at the global and the EU level. Over the past few months, sovereign stress had moved from smaller economies to some of the larger EU countries. Signs of stress are evident in many European government bond markets, while the high volatility in equity markets indicates that tensions have spread across capital markets around the world. The situation has been aggravated by the progressive drying-up of bank funding markets, and availability of US dollar funding to EU banks had also decreased significantly. In that context, central banks have decided on coordinated US dollar liquidity-providing operations with longer maturities. The high interconnectedness in the EU financial system has led to a rapidly rising risk of significant contagion. This is threatening financial stability in the EU as a whole and adversely impacts the real economy in Europe and beyond.

Looking ahead, decisive and swift action is required from all authorities. In the immediate future this includes: (1) implementing, fully and rapidly, the measures agreed upon at the 21 July meeting of the Heads of State or Government of the euro area; (2) adopting sustainable fiscal policies and growth-enhancing structural measures so as to achieve or maintain credibility of sovereign signatures in global markets; and (3) enhancing the coordination and consistency of communication.

Authorities must act in unison with a total commitment to safeguard financial stability. Supervisors should coordinate efforts to strengthen bank capital, including having recourse to backstop facilities, taking benefit from the possibility of the European Financial Stability Facility to lend to governments in order to recapitalise banks, including in non-programme countries.

I thank you for your attention.

Interview with Expansión

Jean-Claude Trichet, President of the ECB, interview given to Daniel Badía González, Expansión on 14 September 2011, published 20 September 2011

1. At the last meeting you said that the risks to inflation are balanced and you noted downside risks to growth. However, the ECB raised interest rates in April and July. Does this new scenario leave room for possible rate cuts in the medium term? In 2008, following the bankruptcy of Lehman Brothers, there was a major shift in your monetary policy.

At the last meeting of the Governing Council we delivered two main messages. In our assessment the outlook for the real economy has deteriorated and we think that there are downside risks to growth. This is a significant change compared with the assessment three months ago, when we thought that the risks were balanced. On the other hand, in July there were upside risks to inflation, but now they are balanced. We will continue to keep price expectations solidly anchored. This is a major asset for Europe: it protects us from the materialisation of the risk of inflation as well as the materialisation of the risk of deflation.

2. Investors are very concerned by the departure of Jürgen Stark, just a few months after Axel Weber stepped down. What are the consequences of his departure for the ECB and do you have any reassurance to offer in this regard?

The Governing Council has been totally faithful to the primary mandate of the ECB which is price stability. The track record for the first 12 years is impressive: price stability is the best it has been for the last 50 years for 332 million fellow European citizens. We will continue to fulfil our mandate with dedication. Jürgen has been a marvellous partner and colleague for me for the past 18 years. He has always demonstrated a very strong commitment to the consolidation of European unity. We have worked together for five years at the ECB and I must stress his constant loyalty to our institution. I have a deep esteem for him.

3. These two resignations were related to opposition to the purchase of sovereign bonds. What is the limit of the Securities Markets Programme?

The Securities Markets Programme (SMP) is a non-standard measure that the Governing Council decided on in order to help restore a more correct monetary policy transmission mechanism at a time when we are observing major disruptions to markets or segments of markets. Since the start of the crisis in 2007 we have applied a strict “separation of principles” between the two categories of measures. On one side are the standard measures – the interest rates – that are designed to deliver price stability, and on the other are the non-standard measures designed to be commensurate with the degree of disruption to markets. This is the case for all our non-standard measures: the supply of liquidity with a full allotment at fixed rate, the purchase of covered bonds and the SMP. In the case of the SMP, we consider that governments have the responsibility to ensure, individually and collectively, financial stability, which will re-establish a more correct functioning of markets. It is their responsibility and it is the commitment they took on 21 July.

4. Has the current crisis exceeded all your expectations?

I said myself, on behalf of the central bankers participating in the Global Economy meeting in 2006 and at the beginning of 2007, that a significant market correction was likely because risks were underestimated, insurance premia too low and volatility abnormally low. Since August 2007 we have experienced several episodes of a global crisis that is extremely demanding and calls for all authorities and entities, public and private, to live up to their responsibilities.

5. But what is the real source of the problem?

The current episode of the crisis is a crisis of the sovereign signatures, due to fiscal imbalances. The Governing Council of the ECB constantly advised governments that they should strictly respect the Stability and Growth Pact, individually and collectively. I was on record, on behalf of the Governing Council, in stating, many many times, that we have a single currency and no federal budget, meaning that the Stability and Growth Pact was fundamental for the stability of the Economic and Monetary Union (EMU). We fiercely defended the Stability and Growth Pact against the major countries of Europe when they wanted to dismantle it in 2004 and 2005. Let me also stress that it is a global crisis, hitting all major advanced economies, with its epicentre in Europe.

6. Angela Merkel sent us a very optimistic message about Greece this week. Do you think that, at present, there is a real risk that Greece will become insolvent?

Greece has to strictly implement its adjustment programme and reach all its targets. This is absolutely fundamental. All governments have to fully implement their decisions which were adopted on 21 July in Brussels.

7. Nouriel Roubini, Bill Gross of PIMCO and George Soros, among other renowned economists, have been issuing catastrophic messages about the future of the euro since the start of the crisis. Don't you think they should be more cautious, given that their views often have an impact on the market?

One should not confuse the issue of financial stability in the euro area and the necessity to adjust fiscal policies, which are an important and pressing problem, with the euro as a currency. Since its inception, the euro has kept its value remarkably. Price stability has been ensured in a better fashion than with the previous national currencies. It is the currency for the euro area as a whole. And the euro area as a whole has a balanced current account and a public finance deficit much lower than many big advanced economies. Such a currency, with such strong underlying fundamentals, is solid and credible.

8. Do you think that Spain is implementing sufficient reforms? What else can it do to restore investor confidence?

Spain should resolutely continue to place particular emphasis on further structural reforms in order to have the highest possible level of growth potential, to improve its productivity and to restore investor confidence.

9. Most European governments have completed the process of restructuring their financial sectors, but the Spanish government will still have to inject a large sum into several financial institutions at the end of September. What is your view of the situation of Spain's financial sector?

The situation has improved considerably, but one should remain permanently alert. Every month the Governing Council of the ECB calls upon all the banks in Europe to do all that is necessary to reinforce their balance sheets, to retain earnings, to be cautious and moderate as regards remuneration and to have recourse to a public backstop, where necessary.

10. What are the challenges facing the new President, Mario Draghi?

Every central banker faces the challenge of being the guardian of the currency, and therefore an anchor of stability and confidence in a very demanding period. Mario Draghi needs no particular advice from me. He is a long-standing member of the ECB's Governing Council and has been closely involved in all the decisions we have taken over the years.

11. Could you give us your view of your eight years in office? Do you have any regrets or is there anything that you wish you had done differently?

I have not gone yet and I have a very demanding task ahead of me in the remaining month and a half. In any case, I can assure you that it has been very inspiring to be President of a monetary institution that is responsible for issuing the common currency for 332 million people in 17 countries, including Spain. This is a great responsibility. As you know, in the Governing Council of 23 members, we are a team, together with Miguel Ángel Fernández Ordóñez and José Manuel González Páramo. We are all very close and this is something that is very inspiring. The team's spirit means so much to me.

12. What is it that has gone wrong in this crisis? What recommendations would you give?

Emerging economies have shown remarkable overall behaviour in the face of this crisis, unlike the advanced economies. I think the main lesson to be learnt is that we have to make a difference as regards the resilience of the advanced economies. And this requires the implementation of a very robust fiscal policy, a very strong monitoring of competitive indicators in all economies and in particular in the euro area, and bold structural reforms.

13. The markets fear liquidity problems in the European banking sector. Do you think this is an understandable concern? The ECB has just announced a joint action with the Federal Reserve System to lend dollars to the European banks. What has brought us to this situation? Could the ECB embark upon other measures, for example more twelve-month tenders? In addition, the liquidity crisis is reducing the banks' capital. In this context, will they be able to strengthen their positions themselves or will they require external support, perhaps through the European Financial Stability Facility or some other means?

As I already said, the European banking sector has to reinforce its balance sheet and improve its resilience. As regards its access to liquidity, I think it is important for observers and market participants to know that the ECB is supplying liquidity in euro on an unlimited basis at fixed rates for durations of one week, one month and three months. And the eligible collateral in the hands of the banking sector is a multiple of the amount of liquidity we are presently supplying

(around €530 billion). As regards the liquidity in dollars, we just announced last Thursday the agreement between five central banks, which has been well understood by the observers and illustrates the very close cooperation which exists, in particular between the Federal Reserve System and the ECB.

Intervention at the Eurofi Financial Forum 2011

Speech by Jean-Claude Trichet, President of the ECB, Wroclaw, 15 September 2011

Ladies and gentlemen,

It is a great pleasure for me to be back here at the Eurofi Financial Forum.

These events always provide a very good opportunity to exchange views on issues that are central to the effective functioning of the financial sector and its key task of supporting sustainable growth in the real economy.

As we are all well aware, this is a very challenging time for the advanced economies. We avoided a dramatic economic depression in the autumn of 2008 – following the collapse of Lehman Brothers three years ago to this very day. But we still have a long way to go to move beyond this crisis.

At the Pittsburgh Summit two years ago, the G20 leaders reiterated their promise to do 'everything necessary to ensure recovery, to repair our financial systems and to maintain the global flow of capital'. Now, more than ever, we need to make significant progress in delivering on those promises.

Today, I would like to focus on what has been achieved so far by our collective efforts to repair our financial systems – in particular, the establishment of the new European supervisory structure, the agreement on Basel III and the global framework for systemically important financial institutions (SIFIs).

But I also want to look at the road ahead: we must not stop here and leave our task half-finished.

There is still very important work to be done on a number of regulatory challenges.

And with all our reforms and with all our new institutions of economic and financial governance, we must ensure timely implementation so that we can ensure that we have done everything to make a difference as regards the resilience of the global, regional and national financial systems.

THE ESRB

Let me start with some of our accomplishments before moving on to highlight some key areas where we need to make progress. The first accomplishment is the establishment of the European Systemic Risk Board (ESRB) earlier this year. As you know, the ESRB brings together the policy makers such as central banks, supervisors and the Commission, thus fostering a broad-based review of risks and vulnerabilities and a deeper understanding of interlinkages and spillovers between different parts of the financial system. This wide-ranging perspective, which encompasses both micro and macro elements, is an essential feature of the new European supervisory framework and it fills a gap identified at the global level. Although the ESRB does not have direct binding powers, the effectiveness of its "comply or explain" mechanism builds upon the high reputation of the ESRB's members and the quality of its analysis.

In its last meeting in June, the ESRB underlined the threat to financial stability stemming from the interplay between the vulnerabilities of public finances in certain EU Member States and the banking system, with potential contagion effects across the Union and beyond. To ensure the resilience of the EU financial system and limit the potential for adverse spillovers, the ESRB at the time also stated that backstop plans should exist, starting with resources from private markets and, if necessary, with public funds.

As we also said at the time, we are furthermore working on specific issues such as FX lending, complex financial products and mismatches in the funding structure between various currencies. Let me mention that we have our next ESRB General Board meeting next Wednesday.

Basel III implementation

As regards Basel III, compared with Basel II, the new framework envisages higher minimum capital requirements, better risk capture, stricter definition of eligible capital elements and more transparency. These elements should substantially improve banks' capital position and loss absorbing capacity, thus enhancing the resilience of the financial sector.

The new Basel framework also introduces entirely new concepts, such as a non-risk-based leverage ratio and mandatory liquidity requirements. It has been agreed that these measures will be introduced gradually during a transition period. It is essential that prior to their introduction the potential impacts of these new elements on financial markets are carefully assessed to ensure that these measures do not hinder banks providing funding to the real economy.

A major challenge ahead is the consistent and timely implementation of the Basel III framework. It is of the essence that we all adhere to the agreed timeline, ensuring that our banks have a strong capital base. Only when implemented in a consistent manner across jurisdictions will the expected significant net social benefits, including reduced volatility of credit and GDP growth as well as the lower probability of occurrence of systemic crises, be achieved. To reap the benefits of the new framework, a consistent implementation of Basel III is essential.

In this context, I welcome the European Commission's proposal on the implementation of Basel III in the EU, issued in July in the form of a fully-fledged capital requirements regulation.

With this step, the EU has demonstrated its strong commitment to the rapid implementation of the Basel III agreement. As it was already said earlier in this Eurofi colloquium, great attention is presently given to this very important piece of legislation, to verify and make sure that it is fully in line with the agreements reached at global level through the Basel Committee, the FSB and the G20. I am confident that this work will be satisfactorily concluded.

SIFIS

Another important step taken to strengthen the resilience of the financial markets is the agreement reached on global systemically important financial institutions. A key lesson from the crisis is that incentives need to be put in place for banks to reduce their 'systemic footprint'.

So I am very pleased that at end-June this year the Group of Governors and Heads of Supervision, which I had the privilege to chair, adopted the consultative document regarding global systemically important banks. The envisaged measures have several objectives. These objectives include reducing the probability of an adverse event occurring, reducing the extent or impact of the failure of a systemically important bank and reducing the cost to the public sector.

The framework is built on two building blocks that increase the loss absorbency of global systemically important banks. The first building block is a gradual capital surcharge based on the degree of systemic importance, ranging from 1% to 2.5 % of risk weighted assets.

The second building block is that the additional capital requirements have to be met with common equity. The unambiguous choice of common equity as the unique instrument to meet the capital surcharge should ensure robustness. These measures complemented with supervisory judgement should capture structural and cyclical changes in the banking system.

Shadow banking

The introduction of more stringent capital requirements for credit institutions under Basel III as well as the requirements for global systemically important banks, may provide incentives for banks to shift part of their activities outside the regulatory perimeter. It is therefore decisive that we continue our work to improve our capacity to identify and assess the potential risks stemming from the shadow banking system.

We need to develop a better understanding of the interconnections between regulated and non-regulated entities. We also need to explore the possible channels of contagion that may result in adverse market dynamics. Gaining a better understanding of the functioning of the shadow banking system is a key element of and a precondition for improving the efficiency of financial regulation and supervision across markets and jurisdiction.

I strongly encourage the FSB to continue to work very actively on all of its work streams regarding the regulation of the non-banking sector. This includes regulatory reform of money market funds, securitisation and the interaction with the banking sector. I am looking forward to the progress report to be delivered for the G20 meeting in October.

Further regulatory challenges

In a number of key domains, decisions have been taken by the international community. It is no time to challenge them. It is time to implement.

In a crisis period where confidence is of the essence, it would be extremely damaging if the authorities were to hesitate, demonstrate an absence of resolve and of the fortitude that is required by the circumstances. I see resistance of some in the financial sector against Basel III. I see similar messages on the SIFIs. For me, it is crystal clear: what has been decided is decided.

But there are other areas of regulatory reform where work is still underway. Let me briefly highlight two key areas on which we need to stay committed and where swift progress is of the essence.

First, there is the review of the Markets in Financial Instrument Directive (MiFID), on which a proposal is expected to be released by the European Commission this autumn, will represent a key step in the right direction. Amending the MiFID should enable the EU regulatory framework to keep pace with financial innovation while responding to the G20 commitments to deal with less regulated and more opaque parts of the financial system.

Second, it is key that transparency is enhanced across the board: with regard to markets, institutions and products. Lack of information contributes to the mispricing of risks, mistrust among market participants can turn situations into downturns. In order to build confidence and contribute towards the stability of markets it is important that financial innovation and technological advances contribute to the ability of financial markets to sustainably provide financial services to the real economy. We need to establish a harmonised framework that enables coordinated action, increases transparency and reduces the risks posed by these market practices. Moreover, we need to better identify, monitor and assess the potential threat to market stability posed by High Frequency Trading.

The IOSCO consultation on Regulatory Issues Raised by the Impact of Technological Changes on Market Integrity, carried out in response to a G20 Leaders request during the Seoul Summit in 2010, recalls that “the benefits from technological advances should not overshadow the risks that these innovations pose to the efficiency and integrity of markets. These changes raise issues that should be addressed by regulators in order to maintain the integrity of financial markets.” IOSCO is currently assessing the responses to this Consultation and steps that could be taken to help mitigate these possible risks. I look forward to the report for the G20 Finance Ministers in October.

CONCLUSION

In conclusion I would like to send these messages and make a comment on the central banks role in present time:

My first message is to underline once again that all what has been decided has to be implemented strictly, comprehensively, and fully. As the continuous challenges demonstrate clearly, we are not back to “business as usual” as some thought some months ago. We need resolve and fortitude of the public authorities and lucidity on the part of the private sector.

Secondly, a lot remains to be done. No complacency should be tolerated in any field. And I cannot help saying that on top of what is clearly identified by the international community as the urgent issues in discussion in the Financial Stability Board, we are far from understanding the potential global systemic instability that is associated today with the sheer size of the non-banking sector which experienced an exponential growth over the last 20 years. I would call all of us to better understand this aspect of the global financial dynamics.

Thirdly, more directly linked to the present tensions in the European sovereign debt, I would only remind all of us that the central banks – and the ECB in particular but with all others – have called permanently for sound fiscal management, sound economic policies and structural reforms, strict implementation and reinforcement of the European economic and fiscal governance—tirelessly, not only in stress times, but also in times of generalised benign neglect of both governments and markets. We call all authorities to implement swiftly all decisions and to be constantly ahead of the curve. As institutions that are independent, that are devoted to stability and that are medium- to long-term oriented, central banks are more than ever an anchor of stability and confidence. This is especially the case in an environment which is turbulent since 4 years, in open crisis of the financial sector since 3 years – shall I say exactly 3 years – and in a market environment characterised by acute tensions of some sovereign signatures in the advanced economies since one year and a half. It is exactly what is inspiring the Governing Council and the General Council of the ECB: to offer the most solid anchor of stability possible to all economic agents and, overall, to our own people. For in very difficult times, all depends on the confidence of our fellow citizens. It is what is inspiring the 27 central banks of the European Union. It is what is inspiring the sister central banks in all the world.

We are just coming from Basel, the BIS headquarters. Reporting to the press on the Global Economy Meeting, I stressed that we were all very closely “united in purpose”: each of us in our own economy, with their different features and challenges, striving to solidly anchor inflation expectations, preserve stability and consolidate confidence.

The globally co-ordinated decision we published this afternoon on US dollar liquidity-providing operations is a clear illustration of our very close cooperation at the global level and of the “unity in purpose” that I was mentioning last Monday.

I thank you very much for your attention.

Interview with Il Sole 24 Ore

Interview with Jean-Claude Trichet, President of the ECB, and Il Sole 24 Ore, conducted by Beda Romano, on 31 August 2011, published 2 September 2011

1. A compatriot of yours, Jacques Delors, the former president of the European Commission, has said in recent days that the euro area is "on the brink of the abyss". It's a very pessimistic view, undoubtedly coloured by a sense of disappointment. Do you share it?

I have great admiration for Jacques Delors. But let me sum up some of my present observations. First, we have a credible single currency which over the last 12 years has kept its value in terms of price stability in a remarkable way in comparison with the previous national currencies in the last 50 years. The solidity of the currency itself is not disputed and our fellow citizens all over Europe are calling on us to continue preserving price stability. Second, the euro area, taken as a whole, is in a better position from a fiscal standpoint than other economies. In 2011, the public finance deficit of the euro area should be around 4.5% of GDP, while in the United States or Japan it will be about 10% of GDP. But we had a very serious weakness in terms of economic and fiscal governance inside the euro area which has been revealed by the global crisis.

2. Well-informed politicians are not hesitating to talk about a possible break-up of the euro area. The weaknesses cannot be denied.

The weaknesses have to be corrected. Loose fiscal policies and insufficient attention to competitive indicators have not been surveyed rigorously and corrected in time. Individually and collectively the European countries have to correct the present situation. Individually by adjusting their domestic policies – as all the advanced economies, including the US and Japan are called on to do – and collectively by considerably reinforcing their mutual surveillance and their governance.

3. On the subject of governance, there's a discussion in various quarters about the possibility of creating European bonds. Former Italian Prime Minister Romano Prodi has proposed the creation of a fund guaranteed by the gold reserves of countries that would issue bonds to buy back national debt and make new investments.

At this stage, we have the EFSF bonds, which are bonds with a European signature. The main message of the ECB Governing Council to governments is to implement rapidly, fully, comprehensively the decisions taken by the European heads of state and government on 21 July.

4. Are you talking about the decisions taken by the European Council in July, the ratification of which in some countries, such as Germany, is proceeding very slowly?

I will not mention any particular country. All 17 countries are called upon to implement all the decisions taken by the heads of state and government. This comprehensive and quick implementation is important, including for the confidence of our fellow citizens.

5. So the idea of European bonds doesn't attract you? Some people are convinced that in the current circumstances we need to consider the most innovative and ambitious solutions.

As I already said, it's important to note that the EFSF is financed through the issuance of bonds guaranteed by the European states. The Governing Council of the ECB considers that it is important that individual countries feel responsible for their own fiscal policies. At the same time, the Council judges it as essential that peer surveillance is conducted in the most rigorous way. Since the inception of the euro, we have called for a major strengthening of collegial governance. And long before the crisis, in 2004 and 2005, we defended the Stability and Growth Pact when it was attacked by the big countries of the euro area. The European Council, Commission and Parliament are working on the development of six draft secondary legislation texts to reinforce supervision of economic, fiscal and competitiveness policies. We are in the final stages of negotiations and I urge the parties to reach an agreement as quickly as possible.

6. A few weeks ago, in Aachen on the occasion of the Charlemagne Prize, you launched the idea of a finance minister for Europe. How realistic is this proposal? When do you think Europe can become a fully fledged federation?

I said that not for tomorrow but perhaps for the day after tomorrow the European Union could be a confederation of a new type, not like the United States of America, but with a government of the confederation, including a finance minister. But this depends on our people. The people of Europe will decide what will be the future of their history.

7. Over the past ten years, the ECB has succeeded in maintaining price stability in the euro area. But low inflation has not been enough to avoid the turbulence of these years. In your view, is it enough to monitor inflation? Doesn't the crisis perhaps show that, in addition to looking at the euro area as a whole, the ECB should also take greater account than it did in the recent past of economic developments in individual countries?

First of all, as you know, the Treaty requires us to maintain price stability in the euro area as a whole, not to monitor the economic policies of different countries. This is the task of the Eurogroup and of the Commission according to the Treaty. And we have delivered price stability, which was our Treaty responsibility. But since the inception of the euro we have constantly asked the governments individually and collectively to live up to their responsibilities. As I said, we fought to defend the Stability and Growth Pact in 2005 when three main euro area countries wanted to water it down. And since then we have been giving the Eurogroup detailed information on the evolution of the competitiveness of member states and we are calling for rigorous monitoring of fiscal and economic policies.

8. In your opinion then, national governments are to blame for the current situation. Let's talk about Italy. From your perspective, how do you judge the country's efforts in the eight years of your presidency?

The Italian economy has tremendous potential given the quality of its human resources and its corporate culture. And yet economic growth has been disappointing. For this reason, I believe in particular that structural reforms are necessary to increase the growth potential of an economy held back by too many obstacles – and they prevent it from achieving its full potential.

9. Italy has been the subject of intense market turmoil this summer. In this regard, how do you view the recent package of austerity measures proposed by the Italian government?

These measures decided by the government in its announcement on 5 August are of extreme importance to rapidly reduce public finance deficits and enhance the flexibility of the Italian economy. It is therefore of the essence that the overall goal in terms of the public finance improvement that was announced be fully confirmed and substantiated. This is decisive to consolidate and reinforce the quality and the credibility of the Italian strategy and of the Italian signature.

10. And what about structural reforms? The serious situation in Italy, like the dramatic drifting in Greece, might it not be linked to an obsolete economic structure, not only to the high public debt?

My message is clear: it is essential that all those measures that allow full exploitation of Italy's medium and long-term economic potential are introduced. Today there is a huge potential that is not tapped as it should be.

11. The message that you sent to the Italian government in early August to urge it to take further restructuring measures has sparked controversy in Italy. Why this unusual decision?

The view of the Governing Council was that the market turmoil at the beginning of the month required a message to be sent to the Italian government. We were seeing a progressive weakening of investor confidence and we felt it would be useful to share with the Italian authorities our thoughts on the most appropriate measures to help restore market confidence.

12. Some commentators have claimed that there was a quid pro quo: new consolidation measures in exchange for a launch of bond purchases in order to lower Italian bond yields.

No. There was no negotiation. We sent our message based upon our analysis of the reasons for the market disruption. We analysed the decision taken by the government. Our decision to activate our Securities Markets Programme (SMP) is designed to help restore a better transmission of our monetary policy.

13. And yet, the purchase of government bonds was probably your most painful and controversial decision in recent years at the helm of the ECB ...

Even in normal times all our decisions are very difficult. It is not by chance that you preserve price stability for 332 million fellow citizens over almost 13 years as we have done. Now we are experiencing a global crisis – the worst since the Second World War. And in these exceptionally demanding circumstances we had to take non-standard measures for monetary policy reasons. In particular, the decision to supply liquidity in full allotment mode and to purchase securities.

14. But the decision to buy bonds was particularly delicate because of criticism in Germany, worried by any form of debt monetisation, and because it exposed divisions in the Governing Council. Your detractors level an unfair accusation against you: they claim that you will be remembered as the President who caused the bank to lose its independence.

I have just returned from the European Parliament and I can tell you that our decisions were commented on favourably by the members of Parliament, as all journalists could see. Having said that, the Governing Council acts very prudently, also in the use of non-standard measures, so as not to endanger the credibility and solidity of the ECB and of the Eurosystem. Bear in mind that since the crisis erupted in August 2007, our balance sheet has increased by around 77%, while the Federal Reserve's has risen by 226%, and that of the Bank of England by 200%. In other words, the crisis has caused us to take a number of non-standard steps, but we took them cautiously and always with a view to ensuring a better transmission of monetary policy. Everybody knows as well that we are fiercely independent. The Governing Council has proved its independence through all its decisions and also through its firm and explicit messages to governments on all occasions.

15. President Trichet, you will leave at the end of October after eight years as the head of the ECB. Mario Draghi, the governor of the Banca d'Italia, will replace you. How has the bank that you will pass on to him changed in recent years? Do you have any tips to give him?

Mario Draghi has been a wise and strong member of the Governing Council for many years. He knows the institution extremely well and, of course, was a party to all the decisions we have taken. What matters is the permanence of the institution. I am certain that Mario Draghi will ensure the institution's continuity and credibility over the long term.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Jean-Claude Trichet, President of the ECB Brussels, 29 August 2011

Dear Madam Chair,

Dear Honourable Members,

Thank you very much for the invitation to the exchange of views today. You asked me to begin with a brief overview of the main recent economic and monetary developments in the euro area and recent monetary policy decisions.

I. Economic and Monetary Developments

Incoming information since our last regular hearing in June continue to point towards ongoing growth in the euro area, although – as expected – at a slower pace. After a strong increase of 0.8% quarter-on-quarter in the first quarter of 2011, partly due to special factors, real GDP growth decelerated to 0.2% quarter-on-quarter in the second quarter. Looking ahead, we continue to see the euro area economy growing at a modest pace in a context of overall relatively sound economic fundamentals for the euro area as a whole. At the same time, not least because of the recently re-emerged tensions in financial markets, uncertainty remains particularly high. This mainly relates to ongoing fiscal and economic adjustment in a number of euro area countries and most other advanced economies, as well as the overall outlook for the global economy. In particular, the United States has been facing both fiscal and structural headwinds amidst weakened economic prospects.

Inflation in the euro area has remained elevated for some months, mainly driven by commodity prices. We expect to see inflation still above 2% over the months ahead. Risks to the medium-term outlook for price developments are under study in the context of the ECB staff projections that will be released early September.

Our monetary analysis indicates that the underlying pace of monetary expansion remains moderate but monetary liquidity remains ample, with the potential to accommodate price pressures. At the same time, monetary liquidity is likely to be held more for precautionary reasons rather than for spending purposes.

The Governing Council of the ECB is determined to ensure that inflation expectations continue to be firmly anchored in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

II. Recent measures taken in response to the intensification of the crisis early August

Let me turn to our response to the deterioration in financial markets in the second half of July and early August in the euro area and elsewhere. Notably, in the euro area the renewed intensification of financial market turbulence led to very high interest rates, potentially damaging volatility and very low trading volumes in some government bond markets that at times ceased to function appropriately. The tensions to some extent resembled those observed in May 2010, but in some aspects they were more broad-based than what we had seen at that time.

In view of these developments, the ECB decided earlier this month to continue conducting its refinancing operations as fixed-rate tender procedures with full allotment, at least until mid-January 2012. 'Full allotment' means that the Eurosystem fulfils, against collateral, in full the liquidity demands by any participating bank in our refinancing operations. Currently, the outstanding Eurosystem credit in our refinancing operations amounts to about € 530 billion, which is provided in operations ranging from 1 week to 6 months. We decided in early August to conduct one refinancing operation with a maturity of approximately six months to help banks in their liquidity planning, and enhance support for their lending to households and corporations. Currently about 470 banks participate as counterparts in our refinancing operations; and over 6,000 banks are potentially eligible. The total value of marketable securities eligible for Eurosystem credit operations is about € 14,000 billion (as of 31 December 2010; source: ECB Annual Report). Therefore, there is no liquidity or collateral shortage for the European banking system.

The ECB resumed government bond market interventions within its Securities Markets Programme (SMP) in August. Via its securities interventions, the ECB Governing Council aims at helping to restore a more appropriate transmission of its monetary policy stance in an environment in which some market segments are dysfunctional. The interventions do not influence our monetary policy stance. In order to sterilise the impact of these interventions on the liquidity conditions in the banking system, we re-absorb the liquidity injected.

On the broader context of this programme, let me quote what I said in May 2010 [1]: "Our actions are in full compliance with the prohibition of monetary financing and thus with our financial independence. The Treaty prohibits the direct purchase by the ECB of debt instruments from governments. We are buying bonds on the secondary market only, and we stick to the principles of the Treaty, which are price stability, our primary mandate, and central bank independence. We expect from governments strict respect for the principle of budgetary discipline and effective mutual surveillance.

The purchases made on the secondary market cannot be used to circumvent the fundamental principle of budgetary discipline. The Securities Markets Programme strictly aims at correcting malfunctioning of markets.

The prohibition of monetary financing underlines precisely the fact that budgetary discipline is of the utmost importance. We have taken note of the precise additional commitments taken by some euro area governments to accelerate fiscal consolidation and to ensure the sustainability of their public finances." I have nothing to withdraw from these remarks of May 2010. They remain fully valid.

We expect from governments strict respect for the principle of budgetary discipline and effective mutual surveillance. It is of utmost importance that these commitments are now implemented strictly and timely. They need to be backed by concrete measures. This applies to both the IMF/EU adjustment programmes and the renewed commitment of all euro area governments to the agreed fiscal targets. The full and timely implementation of the 21 July agreement between Heads of State or Government is of essence in this respect.

While a special arrangement for Greece has been launched, the inflexible determination of all other euro area governments to fully honour their own individual sovereign signature is key in returning to sustainable and healthy public finances and contribute to stable market conditions.

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Achieving maximum long-term growth

Speech by Jean-Claude Trichet, President of the ECB at the Jackson Hole Economic Symposium Panel: Setting priorities for long-term growth Jackson Hole, U.S.A., 27 August 2011

The title of our panel today is *Setting Priorities for Long-Term Growth*. Given all of our recent struggles to regain our reference growth paths, it may strike some as something of a luxury to think about the long run; central bankers and policy makers have had to devote unprecedented attention to higher-frequency economic developments. Many new lessons have been learned; many policy and institutional innovations have been introduced.

The recent financial crisis has produced a large and persistent downturn in our economies; a downturn, moreover, that threatens our long-run growth potential. It is therefore entirely natural that policy makers do not lose sight of the prerequisites for stable sustainable growth.

This is especially so for most of the advanced economies, including the euro area, characterized (as it has been in recent decades) by declining potential growth rates. In the face of any economic predicament, one should ask oneself two questions – what got us here, and what can get us out? In the wider case of sustainable growth for the euro area, what matters is a commitment to structural reforms and sound macroeconomic policies. In the case of the financial matters, a robust macro prudential and supervisory framework is key. I will address both these issues in my coming remarks.

Likewise, some may consider it unusual to solicit views on matters of long-run growth from the President of a central bank. After all, pick up just about any growth-theory textbook and you'll find few references to inflation and fewer still to monetary policy. Monetary policy is fundamentally viewed as neutral over the long run.

And indeed, inflation *is* ultimately a monetary phenomenon. Growth, in turn, *is* ultimately a real one reflecting, in particular, technology, education and training, capital accumulation, institutional quality.

Nonetheless, monetary-policy institutions can play and have played a fundamental role in supporting long-run, sustainable growth. In many ways, I see a parallel between the theory and practise of monetary-policy making and the shaping of modern growth analysis which emphasises the role of sound/proper institutions.

That achieving high and sustainable growth matters, however, is easy to motivate. On the subject of growth differences across countries, Lucas (1988) memorably wrote: *The consequences for human welfare involved in questions like these are simply staggering: Once one starts to think about them, it is hard to think about anything else.*

I. WHAT DRIVES GROWTH IN THE LONG RUN?

So let's start to think: what *does* drive growth in the long run? In fact, growth theory – much like central banking – has come a long way. As everyone knows, Solow's work in the late '50s produced two startling insights. [1] First, that smooth factor substitutability could rid us of the Harrod-Domar boom-bust cycle. This, in fact, paved the way for a proper analysis of sustainable growth. [2] His second insight was that growth was driven not only by factor accumulation but also by technological progress.

Fundamentally, technological progress and innovation are, over the long run, the prime drivers of economic growth and also important reasons for differences in international economic performance, even though demographic differences are also very relevant. Higher growth rates of technical innovation raise output and can lower the non-inflationary rate of unemployment.

But what is technical change? Cracking open the Solovian black box of technical progress has taken us from theories of learning-by-doing, to the impact of R&D on product variety and quality. The latter theories being underpinned by Paul Romer's reflection on the fact that ideas are fundamentally non rival. [3] This concept, by the way, was not really new. The famous letter of Thomas Jefferson to Isaac McPherson expressed it very clearly in 1813. [4] The bottom line in all of this is that knowledge spillover between open, dynamic economies could benefit everyone. Not surprisingly, these new developments in growth theory came replete with policy prescriptions.

A more recent but allied literature suggested the following: how close an economy is to the technological frontier and whether its institutions facilitate convergence to that frontier are vital considerations. [5] In effect, a laggard country gains by implementing (or jumping to) frontier technologies. [6] But an economy *near* the frontier – or with an appetite to define that frontier – should increasingly favour innovation over imitation.

Like many close to European policy [7], I find this an attractive framework. Indeed, following World War II, the European economies were remarkably catching up in productivity and technological terms and today are leaders in many fields, in particular as concerns the embedding of technological innovation in manufacturing processes. [8] Yet, there is still an enormous potential to tap, to reform our economies and boost their growth potential and job creation. [9]

II. GROWTH PATTERNS IN THE EURO AREA AND US

Debates about the US versus the euro area have become common place in recent years. To my mind, though, such debates often fall short of a careful, nuanced analysis required. Some international comparisons *are* indeed informative and yield important insights. Others – given lack of harmonized data, data concept or data unit – are more suspect. The crisis, though, has taught us that growth is only meaningful if it is sustainable and balanced. Growth that is not sustainable but follows boom-bust cycles, carries enormous costs in terms of economic well-being. These costs go far beyond pure GDP numbers; the deepest of these costs is that they, in some cases, put a strain on the fabric of our societies. For that reason alone, sustainability is a key qualification to associate to growth. The second key term is the

balance of growth, both in domestic and external terms. Domestically balanced growth implies a broadly acceptable distribution of economic well-being within societies in terms of income and wealth as well as the avoidance of misalignments especially of asset prices; and externally balanced implies the need to avoid excessive international disequilibria.

Since the introduction of the single currency in 1999, the euro area has experienced a per-capita growth rate that, at around 1% a year, is comparable to that in the United States (1.1%). This is the first fact that is often overlooked in international comparisons. In such comparisons, we often look at headline growth numbers; yet, demographics are very different. Adjusted for population growth, there has been virtually no difference between US and euro area growth over the first decade since the introduction of the single currency. The euro area, though, has created more jobs: 14 million compared with 8 million in the US. Further, over recent decades differences in country and state dispersion rates of growth and inflation in the euro area and US are remarkably similar. On employment, moreover, it will be interesting to compare our different evolutions in the coming years. What we all want to avoid is excessively volatile employment where human capital is all too easily lost and inequality deepens.

Table 1 shows a detailed comparison of the euro area with the US over recent decades. This makes the standard growth accounting of contributions into employment and labour productivity. Labour productivity itself can be further decomposed into changes in labour composition, Information and Communication technologies (ICT) and non-ICT usage per hour and (residual) TFP growth. The interest in the distinction between ICT and non-ICT reflects recent evidence that the ICT sector has been strongest where most growth has emerged across the world economy.

Looking over the contributions, we note a significant difference in labour productivity (1.7 for EU13 vs. 2.9 for US). The main drivers in this comparison of labour productivity are ICT capital services per hour (0.4 vs. 1.0) and, perhaps more significantly from our standpoint, economy-wide TFP (0.5 vs. 1.1). Although having said that, there turns out to be quite some heterogeneity among countries,

Moreover, **see Table 2** analysing the sectoral decomposition of TFP growth. TFP in the production of goods is slightly larger in the euro area than in the US. Rather, the higher overall TFP growth in the US is driven by stronger TFP growth in services, in particular in distributive trade (0.2 vs 0.5). [10] Although, in passing, we should remember that productivity and technical improvements in Services are plagued by measurement difficulties.

But of course TFP numbers always represent a rough metric. [11] The TFP residual will be contaminated by measurement errors, erroneous assumptions about market structure, or the nature and existence of the aggregative production function. The residual will also be a catch-all of neglected factor utilization, factor quality improvements over time, statistical complications associated in calculating factor rewards (appropriate tax and depreciation allowance for capital income etc).

But the wider perspective is: (1) the services and distributive sector is now a dominant and growing part of the euro area economy's output (around 60%) and employment share; (2) the Service sector typically more regulated and thus less flexible to changes and open to innovation [12] although certainly recently there has been progress in the deregulation of network industries and progress through the new Services directive; (3) evidence is mixed but the Service sector in general is often thought to have inherently lower productivity and employment generation mechanisms relative to the more open manufacturing sector.

III. Diversity within the United States and the euro area

Allow me, next, to take a closer look at the developments both across US states and euro area Member States.

For the euro area it is very common to look at the level of its constituent countries and focus on the diversity among individual states, because a number of economic policy choices that affect productivity are national.

For the US, this exercise is rarely done. It is often conjectured that relevant policies are federal, and therefore by definition uniform at the level of the federation; and that, as a consequence, differences at the state level play much less a role. In essence, it is therefore often assumed that the US economy would be significantly more homogeneous than the economy of the euro area.

Looking more closely at the regional dispersion across US regions and euro area economies does not confirm this. In fact, the dispersion of many of the key indicators is surprisingly similar.

Let me share with you some findings from our analysis that we started some months ago and begin with inflation. [13] Before the crisis, the dispersion of HICP inflation in euro area countries had remained broadly stable since the late 1990s, at a level similar to the 14 US Metropolitan Statistical Areas. [14] During the crisis we saw a temporary increase in inflation dispersion in the euro area but this has been reversed over the past 12 months. **(Chart 1.)**

The picture is similar for the dispersion of GDP growth. Before the crisis the dispersion of growth rates was around 2%, in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns overall. [15] **(Chart 2.)**

Going one step further, investigation of the sources of this growth dispersion in the US and euro area economies reveals parallels even in the root causes of dispersion in economic performance and productivity. On the one hand, both currency areas comprise regions that experienced a significant boom and bust cycle over the past decade. On the other hand, both also contain regions that are facing significant structural challenges of a more long-term nature.

In the United States, for example, Nevada, Arizona, Florida and California experienced increases in house prices that outpaced the national average by a wide margin. The steep house price increases accompanied above average growth in these states. This could probably be explained, at least in part, by the impulse that these states received from the housing-related sectors such as construction, which saw its share in terms of value added increase at the national level during the years of the housing boom. In the crisis, the sharp fall in house prices in Florida and the south-western US states turned boom into bust. These states experienced the harshest recession among the US states. [16]

Similarly, in the euro area some countries experienced asymmetric boom-and-bust cycles. Several euro area countries had higher than average growth in the pre-crisis years. In Ireland and Spain particularly, strong growth was accompanied by strong increases in housing prices.

At the same time, other US states, particularly the former manufacturing powerhouses in the “Great Lakes” region, have seen a long episode of below average growth. Below average performance of the region – and particularly weaker growth rates in the states of Michigan and Ohio – are related to strong reliance on manufacturing. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP, with implications for areas with a high concentration of companies in manufacturing industries other than information and communications technology. During the crisis, GDP growth in the "Great Lakes" region, which was below average before the crisis, remained below average.

Similarly, other countries in Europe – Portugal, for example – have experienced growth persistently below the euro area average for the past decade due to structural rigidities that are now being addressed.

Just a few years ago, the low-growth group of countries included Germany – labelled the “sick man of Europe” at that time. Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

The effect of the crisis on the different euro area economies follows a similar pattern to those of comparable US states. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis. These relatively low growth rates are linked to a deterioration of competitiveness, driven, for example, by persistent above average unit labour costs.

Precisely as regards the evolution of unit labour costs, that are so important for growth, dispersion both ahead of the crisis and during the crisis was quite similar in the euro area and the United States. **(Chart 3.)**

At the same time, it is worth noting that both currency areas include regions with persistently above or below average unit labour cost growth. Again leaving aside the countries to join the euro area most recently, here, Greece, Portugal and Ireland, in particular, had progressively lost competitiveness vis-à-vis their main trading partners in the euro area. They are now engaging in catching-up, adjustment strategies. Germany, which had lost competitiveness in the reunification process, by contrast, has been able to restore this competitiveness over the same period of time. **(Chart 4.)**

Similar persistent losses and gains in unit labour costs are also observed in the United States. Taking a look at the upper and lower bound of the spectrum of US states over the same period as the euro area reveals that some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states have been improving their labour cost competitiveness vis-à-vis the national average over the past decade.**(Charts 5,6 and 7.)** In summary, there are strong indications that economic diversity in the euro area and the United States has not been significantly very different over the past 12 years.

The observation that very large, continental economies of the size of the US or of Europe are probably necessarily diverse should not be reason for complacency. The fact that advanced economies of the size of more than 300 million people have a tendency to be significantly diverse calls for a solid economic governance framework and explains why the ECB Governing Council has been so vocal in this ground since the inception of the euro area.

And this inherent diversity of advanced economies of large size is an additional reason to resolutely engage in the structural reforms that would permit to accelerate the completion of the European single market in all sectors, and to enhance the growth potential of each individual European economy and of the euro area as a whole.

IV. Setting Priorities for Long-Run Growth

Let us get back to our central theme - *Setting Priorities for Long-Run Growth*. Let me make some suggestions – three to be precise. A first, and overwhelming, priority – notably for the euro area – is the vigorous implementation of ***structural reforms*** . A second, but by no means unrelated priority, is the continued attention to *external and internal* ***imbalances*** . A final priority is greater ***flexibility*** on the part of policy institutions. Let's take them one by one, with a particular emphasis on the euro area.

First, ***structural reforms***. We earlier noted the primacy of *institutions* in modern growth theory. Sound institutions are essential to encourage a flexible, cutting-edge, knowledge-based economy. There is substantial evidence from industry-level studies on regulation as well from firm-level studies on the dynamics of firm performance that confirm the need for such a conducive environment to generate productivity growth. [17]

Douglas North defined institutions as … *the rules of the game in a society … the humanly devised constraints that shape human interaction*. [18] And being "humanly devised constraints" (rather than exogenous geographical or climactic constraints), their major impact was through the setting of incentives. [19]

And one can see the remaining challenges for many advanced economies as follows:

- Employment regulation needs to help more proactively outsiders, low-skilled, young and older workers.
- In Europe, the single market needs to be advanced especially in the area of services. [20]
- Tax, benefit and pensions systems should not discourage labour participation and create weak incentives for investment and innovation.
- The distribution of wealth and general economic well-being needs to ensure some acceptable social balance.

Several remedial policy proposals have been suggested and implemented in the recent past. The most well known is the European Council's Lisbon Strategy for Growth and Jobs, followed by the Europe 2020 Strategy. [21] The latter is the Agenda that the European Union and its Member States have decided to help Europe recover from the crisis and come out stronger, both internally and at the international level. [22] The Agenda sets targets for the European Union in 2020 in terms of employment, research and development, energy and education.

The Agenda puts particular emphasis on structural reforms in the labour and services markets. These two markets are still over-regulated and not directly subject, given their largely non-tradable dimension, to the competitive forces originating from within and outside the single markets. [23] At the EU-level, the necessity and shape of structural reforms is acknowledged, but the gap between awareness and implementation is far from closed.

That said, we would do well to understand why political systems abide distortionary, inefficient structures and resist more efficient alternatives. Do structural reforms imply a J-curve of long-run gain but short run pain that sits ill with the decision making process in our democracies? Do vested interests strategically and systematically block change?

A second priority is ***vigilance against imbalances***. I spoke at the last Jackson Hole symposium of the risks of chronic global *imbalances* and costs involved in unravelling the excessive private leverage, unsustainable fiscal and trade positions. Establishing more reasonable borrowing, restructuring and strengthening the balance sheets of firms, households and governments in an orderly manner remain key to smooth and continuous global growth. In all this, central banks are not immune. Tensions in financial markets and severe global imbalances deepen uncertainty and, therefore, profoundly challenge monetary-policy setting.

Precisely these dangers underpin the Mutual Assessment Process of the G20 framework. The indicative indicators – agreed in February this year – identify imbalances in public, private and external positions as the key culprits preventing balanced global growth, and a key input in shaping corrective policies. Seen in that light, a country's economic success should be judged also on these indicators and not only on its last few years' growth figures.

However, another imbalance – which has gained currency following the financial turbulence – is *income imbalances*. Naturally, extremes of income inequality and restricted opportunity challenge our values and strain the fabric of our societies.

In short, growth skewed towards the few (or absent for a large minority) risks social tensions, undermines institutions and encourages policy failures of one kind or another. Structural reforms, particularly in the form of re-training, improving job

matching, providing flexibility and incentive for job creation and innovation remain the best policy options for encouraging well-balanced growth, and an environment of low and credible inflation the best environment to encourage matters from a central-banking perspective.

Finally, a priority for medium and long-run growth is that ***our policy institutions remain attuned to an ever-changing landscape***. We have seen in recent years the near-Knightian uncertainty policy makers endured and how boldly they responded. The ECB was among the first central banks to react to the outbreak of the financial turmoil in August 2007 in providing liquidity to distressed institutions. Another example of flexibility by ourselves and in the wider central banking community is in the swap agreements with other central banks as an example of internationally co-ordinated means of swiftly responding to the crisis.

Since then, we acted with what I have previously (here in Jackson Hole) called 'credible alertness'. [24] This includes implementing both non-standard monetary policies and our interest rate policy. Interest rate policy depends on the outlook for price stability. The use of non-standard measures depends on the functioning of the monetary policy transmission and must be commensurate with the level of malfunctioning or disruption of money and financial markets and segments of markets. Our non-standard measures do not in any way impinge upon our capacity to design our monetary policy stance to deliver price stability in the medium term.

Despite all the ups and down of recent years, our key challenge remains as it has always been: to create strong, sustainable, balanced, non-inflationary growth. Credibility and the medium-term orientation in monetary policy allows, where needed, scope and flexibility to address various types of severe shocks. Over the long-term a commitment to price stability anchors expectations, improves the workings of the price mechanism, reduces transaction costs, protects savers and reduces uncertainty. This is what I meant at the outset when I said that the theory and practice of monetary policy making paralleled developments in growth theory – namely, both are now seen to hinge on institutional quality.

V. CONCLUSIONS

Let me conclude. Ultimately growth is driven by technical progress. This is especially important where there are limiting demographic factors. In the euro area, there is ample of scope to realize efficiency gains from existing and prospective technological changes given structural reforms and more vigilant implementation of the existing policy agenda. The remarkable resilience of the German labour market in the last few years [25], where wage moderation and flexible time accounting shielded the economy from excessive job destruction, illustrates admirably the promise of well-structured reforms.

Although there have been improvements in the euro area in recent years, there is still evidence of regulatory and market-based barriers to entry in selected professions which have to be actively corrected.

Structural reforms – re-training, improving job matching, providing flexibility and incentives for job creation and innovation – remain the best policy options for encouraging well-balanced growth, and an environment of low and credible inflation the best environment to encourage matters from a central-banking perspective.

Likewise, alertness against savings and trade imbalances across the global economy is a fundamental concern. Such imbalances – if unchecked or conveniently rationalized away – make our entire, inter-connected economies more fragile and more risk prone. We have seen how rapidly negative financial impulses can transmit through the global economy and pull down economic activity. Alertness means alertness. I have learned whilst discussing global imbalances and financial transmission channels – much of it done here at Jackson Hole – that appropriate improvements in regulation and multilateral surveillance frameworks can yield large gains. We should work hard to maintain momentum.

Interview with Le Point

Jean-Claude Trichet, President of the ECB,
English translation of the full interview given to Patrick Bonazza, Le Point, on 22 July 2011,
published 27 July 2011

Has the euro been saved, then, after last week's summit in Brussels?

The euro itself, that is the currency, has never been under threat. The risk was not to the stability of the single currency, but rather to the financial stability of the euro area owing to the fiscal problems in Greece. The euro is not in question: it is solid, strong and credible. The euro has kept its value for over 12 years. The European Central Bank (ECB) is an anchor of stability and confidence, which is very important, particularly in turbulent and difficult periods.

Yes, but aren't the struggling countries in the euro area putting the single currency at risk?

The pressure observed on sovereign risks is not solely a European problem, it is also a global problem. The United States and Japan also have major fiscal problems, as you well know. The paradox is that, from a global perspective, the euro area is in a far better situation, with a consolidated fiscal deficit of around 4.5% of GDP this year, compared with approximately 10% of GDP for these other two countries. On the other hand, individual countries in Europe, in particular Greece, are in a much more difficult situation. All the decisions taken in Brussels by the Heads of State or Government are important for the financial stability of the euro area.

What part did the ECB play in the decisions taken in Brussels on 21 July?

In such circumstances, it is necessary to take a close look at the role of the central bank. We are responsible for ensuring that the currency, savings and purchasing power of 331 million citizens across 17 countries remain sound and stable. As you know, inflation hits hard on the poorest and most vulnerable among us. Our democracies entrusted us with this responsibility and we are living up it! Since the launch of the euro 12 years ago, we have achieved an average annual inflation rate of 1.97%, which is in line with our definition of price stability, i.e. below, but close to, 2%. Moreover, by being in charge of a single currency for 17 countries and 331 million citizens, the Central Bank has an overall view that enables it to convey messages to those taking government decisions, knowing of course, that they are in full control of their own decisions.

Was your participation in the meeting between Sarkozy and Merkel on 20 July in Berlin planned?

Angela Merkel and Nicolas Sarkozy invited me to join them at the Chancellery in Berlin. The Governing Council of the ECB advised me, in real time, that it would be useful if I accepted this invitation so that I could put across the views of the ECB.

Another €109 billion for Greece, after €110 billion last year. Do you believe that Europe is going to be able to raise such large sums of money for a single country just like that?

What matters above everything else – and it is absolutely essential – is that Greece regains control of its economic balances, that Greece itself implements the measures for restoring its budget, government accounts and competitiveness as quickly and as rigorously as possible. What matters is that it implements rigorous structural reforms and resolves to embark on a privatisation programme.

Last year, France raised €4 billion and after the summit in Brussels it is going to borrow an additional €15 billion between now and 2014 to the benefit of Greece. Are you sure that the French, who have their own problems, will accept this indefinitely?

Greece is committed to doing everything, and will do everything – under the strict surveillance of Europe, which is something we have always called for – to restore confidence, regain stability and pay back its loans from Europe. The Europeans are not subsidising Greece to never see their money again. They are investing in its recovery. Of course, they need to monitor their investment closely.

The 17 euro area countries have bought Greece some time, but that's no guarantee that the country is going to accept the austerity measures being imposed on it.

We are not imposing "austerity" on Greece. Greece itself is correcting its years of mismanagement. Throughout the years in the run-up to the crisis, Greece continued to spend more than was coming in. Sound governance is the only way to once again achieve growth and job creation based on a newfound competitiveness.

Do you think that Greece's membership of the euro area is partly to blame for its downfall? Despite the level of inflation in the country, Greece has been able to borrow at very low rates, thanks to the ECB. This gave rise to a credit bubble.

No, I don't think so, because the euro area has only been in existence for just under 13 years, and prior to that, other countries, everywhere in the world, had experienced similar problems to those that Greece is experiencing today. Moreover, we are seeing today, unfortunately, that the issue of poor fiscal discipline is arising more often in developed

countries, whereas before it was only an issue in developing countries – in Asia, Latin America or the Near East. Greece is a symbolic example of this turnaround.

And what is the reason for this turnaround?

The fact is that the monitoring of economic and fiscal policies in the euro area was not as good as it should have been. The ECB and the Banque de France – Christian Noyer and myself – have always said with regard to Europe that the Stability and Growth Pact was not an artificial creation conveying an ultra-orthodox view of the economy coming from across the Rhine. It was a fiscal framework that was absolutely necessary for a monetary union that had neither a federal government nor a federal budget. On behalf of the Governing Council, I publicly denounced the liberties that in 2004-05 Germany, France and other major countries wanted to take, and indeed took, in the form of a Stability and Growth Pact that was weakened both in letter and in spirit. We have constantly called for closer monitoring, not only of fiscal policies, but also of indicators of competitiveness and internal imbalances.

Today, in the light of the crisis, everyone can see that we were right.

And that you have a better chance of being listened to…

I sincerely hope so.

Over the last few weeks, you have fought against the idea of asking the private sector (banks, insurance companies, funds, etc.) to incur losses to help Greece. It would seem that the Heads of State did not listen to you?

Once again, we have always said publicly that it is not the Central Bank that takes the decisions, but the governments themselves. With regard to private sector involvement and Greece, we have had three very clear messages. First, we said that any participation had to be voluntary. As far as this is concerned, our advice has been followed. Second, we said that it was necessary to avoid a “credit event”, and at the moment, it looks as though we have done so. Lastly, our third message was that a “selective default” should be avoided. However, in the event of such a default, governments would have to recapitalise the banks and provide credit enhancement for the collateral accepted by the ECB for its refinancing operations. We secured this guarantee which was essential to protecting the integrity of the ECB in the event of a “selective default”. It was essential for the ECB, and all the Eurosystem central banks in order to maintain stability and confidence in Europe. The protection of the integrity of the central bank is non-negotiable.

Following the summit in Brussels, the European Financial Stability Facility (EFSF) is to provide cheaper loans to programme countries and will also be able to purchase bonds and recapitalise struggling banks. With this, are we not getting sucked into in a costly and vicious circle?

We have advised governments to incorporate more leeway and flexibility into the EFSF – taking into account that we are experiencing exceptional circumstances since the onset of the worst crisis since the Second World War. A more versatile and flexible EFSF will be a more efficient tool for helping to ensure the financial stability of the euro area as a whole.

With regard to private sector involvement, the Heads of State have affirmed that these solutions would only be applied to Greece. Why the special treatment?

The creditworthiness of a country is absolutely essential. Whether you are a household, a company or a country, you will be granted loans on good terms if the lender is confident that he will be paid back. That’s why confidence is so important. The Heads of State or Government wanted to remove all ambiguity, and in their own words they said: “All other euro countries solemnly reaffirm their inflexible determination to honour fully their own individual sovereign signature. The euro area Heads of State or Government fully support this determination, as the credibility of all their sovereign signatures is a decisive element for ensuring financial stability in the euro area as a whole”. I could not have put it better myself.

Did you look into the possibility of Greece leaving the euro?

Not for a minute did anyone consider that option.

But what do you have to say to the many people who don’t believe that Greece will pull through unless its debt is drastically reduced?

The problem that Greece has is that it needs to return to a path of sound governance as quickly as possible, i.e. it needs to restore its budget to health, implement a rigorous privatisation programme and carry out essential structural reforms. The proposals from the private sector and the decisions of the European governments, i.e. lowering interest rates and

extending the duration of the loans, will ease Greece's debt service burden considerably. Furthermore, the outstanding debt will decrease through bond swaps and debt buybacks. But what is important is that Greece carries out the adjustment itself, helped by this very important decrease of the yearly service of the debt.

After Brussels, will countries like Spain or Italy avoid the Greek contagion?

Without exception, every country is aware that it is experiencing an exceptional crisis. For example, the Italian government has just adopted a fiscal programme that will reduce its deficit to less than 3% from 2012. How many major developed countries, outside Europe, can say that? Spain has started to carry out ambitious reforms, as noted at the meeting on 21 July. The European Central Bank has called for all countries to strictly adhere to the letter and spirit of the Stability and Growth Pact, to strengthen competitiveness and, in particular, to monitor production costs and carry out the necessary structural reforms. That is the path to sustainable growth and job creation.

The crisis has been enlightening. Within the euro area, those countries that have been very attentive to their budget and their competitiveness, such as Germany or Austria, have succeeded in creating jobs and reducing unemployment, even during the crisis. The same applies to countries outside the euro area, for example Sweden, which has had much better results than any other country outside the euro area.

With each crisis, the usual suspects call for greater federalism in order to prevent the next crisis. This time, they want euro bonds and greater sharing of the debt burden. Is this a responsible and helpful response? And can we take steps towards federalism without asking the people for their opinion?

As you know, the summit in Brussels was not convened at all with the aim of causing institutional upheaval. That said, the view that Europeans need to reflect on their long-term vision of how they want European institutions to evolve is, for me, a valid one. The construction of Europe really started 60 years ago. Evidently, it has not yet been completed, and it is also very clear that it is up to our democracies to take the decisions and thus, ultimately, to the people of Europe to say what they want. Speaking as a European citizen, and not as the President of the ECB, I think that the Europeans will go on to invent in a long term prospective an entirely new type of confederation of sovereign states, which would not be a carbon copy of the United States of America.

We were sold the euro area as an area of prosperity and stability and instead we get austerity. Go figure!

Since the introduction of the single currency, the euro area has seen a growth rate per capita that, at around 1% a year, is comparable to that in the United States, and has created even more jobs: 14 million compared with 8 million in the USA. Not enough people know these facts and they do not receive sufficient attention. In addition, it was never claimed that the euro would do away with the need for good public finance management; indeed, we said precisely the opposite. The euro area is redressing its public finances, just as the United States and Japan must do, and as the United Kingdom has also started to do. Two things are certain. First, everywhere in the world, whenever budgets are managed carefully, the costs of production are controlled and the social partners act with prudence, the reward is growth and job creation, even after the worse crisis since 1945. Second, the euro area as a whole is faced with fewer problems than the United States or Japan, but it must take tremendous steps to strengthen its governance.

Is speculation the big bad wolf that will devour the euro?

The euro itself is not in question. The euro is a very credible currency that has done a remarkable job of ensuring price stability. Also, it is issued in an economic area for which the overall results are sound compared with other ones. As far as government or corporate bonds are concerned, the financial markets are complex and very sophisticated. Some investors have confidence (or not) and invest (or not), and others can forward buy or sell and speculate up or down. Market participants are thus motivated by varying degrees of confidence, as well as by fear and greed. When serious crises arise, such as the one that we have been in since 2007-08, they expose weaknesses as sure as x-rays show up the skeleton inside the body. A good way of not letting speculation take hold is to identify ones own weaknesses upfront and to correct them. In the years that preceded the crisis, countries in particular, had a false sense of security. Unfortunately, this sentiment was not only shared by some Europeans, but also by the whole of the international community, not to mention many economists. Once again, the lesson that we Europeans must draw from this is to strengthen the governance and monitoring of economic and fiscal policies. That does not mean to say that the functioning of the financial markets does not need to be substantially improved. At the moment, the key word for all industrialised countries is "confidence".

Yes, but it is possible to speculate on whether Greece will default.

Such a speculation would be a sure-fire way of losing money given the decisions taken last Thursday. And let me say again, the euro, as a currency, is sound and credible, and is not affected by the pressures on sovereign risks.

Don't the rating agencies play the speculation game?

I think that this is an important issue for financial stability at the global level. Here we see a very small number of institutions having an enormous international influence. The patently oligopolistic way in which the rating agencies work is certainly not optimal in terms of market organisation. This configuration is structurally "pro-cyclical", in other words it fuels the creation of bubbles during cyclical upturns and exacerbates the busts during cyclical downturns. These failings must be addressed. This is easily said, and more difficult to do…

You will be relinquishing your duties this coming November. What does this mean for you?

My professional life has been shaped by both the pursuit of long-term or very long-term strategies such as the construction of Europe and by a series of crises. When I started my career as a civil servant I had to deal with the first oil price shock in 1973-74, which was an enormous blow to the whole of the industrialised world. Unfortunately, because we responded poorly, particularly in Europe, this shock was the start of mass unemployment. I have also lived through the sovereign debt crises in Latin America, Africa, the crisis in the Soviet Union, the crises of the Exchange Rate Mechanism of the European Monetary System in 1992 and 1993, and of course the Asian crisis, the bursting of the dot.com bubble and the ongoing crisis that started in 2007-08. The truth is, I have always been living through crises. This has led me to conclude that, in a world that is undergoing extremely rapid transformation thanks to science and technology, the global spread of the market economy and the fantastic progress made by China and India, it is necessary to be constantly on one's guard and in a state of alert. I first elaborated on this view in a speech I gave in 2005 at Jackson Hole in Wyoming, where central bankers from all around the world meet every year on an informal basis. Back then, I explained that one of the conditions for boosting long-term confidence was to remain visibly and constantly in a state of alert. The experience of the most serious crisis since the Second World War has only strengthened this conviction. More than ever, the benefit that the European Central Bank brings to Europeans is to be an anchor of stability and confidence in a turbulent and demanding period.

Interview with Süddeutsche Zeitung

Interview with Jean-Claude Trichet, President of the ECB, conducted by Helga Einecke and Hans-Jürgen Jakobs, Süddeutsche Zeitung, published on 23 July 2011

SZ: Mr Trichet, at the start of the 1990s former German Chancellor Helmut Kohl, together with the then French President, François Mitterrand, initiated the Maastricht Treaty and thus the euro. Now he is concerned about how Europe and its single currency are developing. Are you also concerned?

Trichet: Helmut Kohl played a pivotal role in establishing a single currency in Europe, and Europe owes him an immense debt of gratitude for that. It cannot be disputed that the euro has been a remarkable success over the last 12 years. Our currency has kept its value impressively and ensured price stability in Germany and throughout Europe since its introduction. The level of price stability has been greater than during the 50 years prior to the euro.

SZ: You are forgetting the excessive debt, for example in Greece, Portugal and Ireland. In endless new rescue packages, governments are pumping billions and billions of euro into a clearly ailing system. That is making the public nervous.

Trichet: We have a problem with fiscal policy in some countries where mistakes were made in the past, meaning that these countries are now saddled with deficits that are too high. Governments must take decisive action to correct this. As far as the ECB is concerned, we have always called for a strict and rigorous implementation of the Stability and Growth Pact, and have expressed our "grave concerns" when the letter and the spirit of the Pact were breached in 2004 and 2005. Today we are calling for a quantum leap in economic governance.

SZ: The euro area summit on Thursday created the next large financial package for Greece, this time amounting to €109 billion. How big is the danger that good money is being thrown after bad money?

Trichet: What is fundamental is that Greece implements its economic and structural adjustment programme rigorously and comprehensively. This is the key for everything. Scrupulous control of implementation, as well as very large-scale technical assistance from the Commission, the International Monetary Fund and the EU Member States are of the essence.

SZ: You have warned of the consequences of default and threatened to stop providing Greek banks with money. But it has nevertheless now come to a restructuring of debt. Have you changed your mind?

Trichet: We have very clearly and publicly said that our advice to governments was: first, to avoid compulsory private sector involvement; second, to avoid a credit event; and third, to avoid a selective default. At the moment I am speaking I can say that they have followed our first and second advice. With regard to the third piece of advice, we will see what happens. But I had also said very clearly that, in case of selective default, the ECB and the Eurosystem would ask for recapitalisation of the banks and for credit enhancement of our collateral in order to have sound counterparties and eligible collateral. The protection of the integrity of the central bank is non-negotiable. The Heads have accepted that and decided to recapitalise the Greek banks and earmark a pledge of €35 billion to enhance our collateral in case of any possible selective default.

SZ: The rescue umbrella, the European Financial Stability Facility (EFSF), has been significantly upgraded. What is your opinion on the construction of such a "European Monetary Fund"?

Trichet: There are four additional areas where the Heads have followed our public advice. First, as you mention, an increase in the flexibility of the EFSF, which is something we have always called for. Second, the reaffirmation by member countries of their inflexible determination to honour their signature. Third, the reinforcement of governance in Europe in the voting rules within the preventive arm of the Stability and Growth Pact. And fourth, the considerable reinforcement of technical assistance. Now the key word is "implementation". Rigorous and permanently controlled implementation.

SZ: How did the debt crisis spread so far?

Trichet: 2007-08 saw the worst financial crisis since the Second World War. All advanced economies have been heavily touched and have proven fragile. Weaknesses have to be corrected in all advanced economies, in Europe as well as in the United States and Japan.

SZ: 20 years ago you were personally involved, on the French side, in constructing the Maastricht Treaty. Did you factor in the risk that some countries could run riot in terms of fiscal policy?

Trichet: It was a privilege for me to be involved in the construction of the Maastricht Treaty, together with Horst Köhler, who was State Secretary at the time. We were all fully aware that it was necessary to prevent governments from running irresponsible fiscal policies. That is why we made it a legally binding part of the Treaty that no country can have a deficit of more than 3%. It was a very strong request by Chancellor Kohl and the finance minister Theo Waigel to create strict criteria to guarantee fiscal soundness. That was the binding legal framework. Unfortunately, the governments did not carry out the strict peer surveillance of behaviour that was called for by the Pact.

SZ: And in the end, the financial markets and rating agencies had to take control as Europe's governments were not in a position to do so.

Trichet: Public authorities have to be permanently alert, ensure fiscal soundness and preserve competitiveness. They cannot rely only on the financial markets' judgment. In the years before the 2008 crisis, the markets were totally ignoring the bad policies in some countries. That being said, we should not forget that the euro area as a whole will post, by the end of this year, a fiscal deficit of around 4.5% of GDP, compared with around 10% in the United States and Japan. The fiscal problems are concentrated in a few countries and not, fortunately, in the euro area as a whole.

SZ: ..countries on the periphery you mean?

Trichet: The countries that are part of an IMF and EU programme, also taking into account that Greece is a unique case.

SZ: In any case, many Germans are worried that their tax money will soon be used to support indebted countries and that, what's more, the euro could fall apart.

Trichet: The euro is a solid, strong and credible currency. We do not have a currency crisis because the euro is stable and keeps its value extremely well. Since the single currency was introduced, inflation in Germany has stood at only 1.5% per year! And in the euro area as a whole it has been 1.97%, which is less than, but close to 2%! The ECB is the guardian of the euro and represents an anchor of confidence and stability in Europe. What we need is a strong and strict implementation of the fiscal adjustment programmes.

SZ: So it is all exaggerated?

Trichet: The people of Europe and particularly the German citizens can have full confidence in the ECB's will and capacity to deliver price stability. Our track record proves this.

SZ: First, only small EU states were rescued. Most recently, however, Italy – a core country that is also highly indebted – was on the verge of being pulled into the maelstrom. There was hardly anyone who wanted their government bonds.

Trichet: I have confidence that all countries in the euro area will not only rigorously keep their present commitments, but will be “ahead of the curve “ and take appropriate measures, as is the case for Italy.

SZ: Europe’s citizens have heard this kind of appeal too many times before.

Trichet:. As I said, all advanced economies must put their house in order. The United States and Japan, for instance, have to adjust their fiscal policy. In the case of Europe, a major problem is the need to make decisive improvements in its governance. The Stability and Growth Pact must be strengthened. And we will have a new pillar of surveillance of competitiveness indicators and imbalances inside the euro area, namely the new legislation.

SZ: How will the new controls work?

Trichet: We are advising the governments and the European institutions to develop the surveillance functions so that they operate as automatically, quickly and professionally as possible, both in their preventive arm and in their corrective arm. And the sanctions are essential to prevent disorderly developments.

SZ: Is a new institution needed for this?

Trichet: At this stage we need to finalise the negotiations of the “trialogue” – between the Council, Parliament and Commission – on the new legislation for European governance. What has just been announced by the heads of the euro area should contribute to improving the preventive arm of the Stability and Growth Pact in line with our recommendations.

SZ: You yourself were much more daring when you were awarded the Charlemagne Prize in Aachen. There you spoke about a common finance minister for Europe.

Trichet: I think that in order to put Thursday’s decisions into perspective, it is important and legitimate to have a vision of what could be done – as I said in Aachen – tomorrow and even the day after tomorrow. That would require a change to the Treaty and is therefore fully in the hands of our democracies and of Europe’s citizens. Tomorrow it should be possible to impose measures on a country that does not implement the agreed adjustments. And as for the day after tomorrow, speaking as a European citizen, I think that the Europeans will invent a new type of confederation which, however, will not be like the federation in the United States; Europeans have their traditions and their history. At the level of this possible confederation, we would have, naturally, a European finance ministry with its own responsibilities.

SZ: That is still a political utopia.

Trichet: We are talking about a historic process that began 60 years ago. The vision of European unity goes back many centuries. You feel that very profoundly in Aachen when you are in front of the throne of Charlemagne. I firmly believe that, from the economic and monetary angle, there are even more reasons to unify Europe today than 60 years ago, with India, China and the formidable progress of the emerging economies.

SZ: French politicians have also spoken in favour of a European ministry – as a counterbalance to the ECB.

Trichet: I think they understood that it was a totally wrong approach. The ECB is fiercely independent and this is not challenged anywhere in Europe. It is at the heart of the Maastricht Treaty. And I do not forget that the Germans have always said in the past that there needs to be progress in terms of political union, together with Economic and Monetary Union.

SZ: Are there enough Europeans who support your vision?

Trichet: I speak as a European citizen, reasoning in the medium and long term. It seems clear to me that the European construction has not been completed.

SZ: If all of that is true, then there should also be shared eurobonds, guaranteed by all the Member States.

Trichet: We have looked into the issue and we are not in favour of it.

SZ: But that could be part of your vision?

Trichet: No, not necessarily. The ministry that I have in mind for the future shouldn't have a large budget.

SZ: How, in your view, should the current debt problems in Europe be resolved? You are something of an expert on debt – after all, you previously played a leading role in the Paris Club in negotiating the debt restructuring of Brazil, Poland, Egypt and the Soviet Union. This always involved partial losses for creditors, or a "haircut".

Trichet: Our position for Europe was always clear. We were not responsible for the negotiations concerning Greek debt. That was the task of the governments. We will monitor events closely.

SZ: Two years ago, you said that the entire regulation of the financial system needed major improvements. Has this already happened, or does more need to be done?

Trichet: We are half-way there. There has been a global increase in the capital requirements for banks, including those that are systemically relevant. What is still open is how we deal with other financial entities that are non-banks, what we sometimes call the shadow banking system. More transparency and appropriate oversight are needed here. Conflicts of interest must be eliminated. There are also still too many pro-cyclical elements in the financial system that should be eliminated. All of this is hard work, and we still have to make a lot of progress

SZ: The banks are moaning about too much regulation.

Trichet: I do not accept the idea that we have over-regulation. We have in any case an absolute obligation to make the financial system much more resilient. The idea of going back to business as usual is deeply inappropriate.

SZ: Is the euro still an important factor in the integration of Europe? Or is it now causing divisions?

Trichet: I believe that the euro is crucial to the achievement of a single market. Do you think we would consider the United States' single market complete if the money used in North Carolina were different from that used in Wyoming, California or Florida?

SZ: After eight years as "Monsieur Euro", as the top central banker, do you leave any kind of legacy?

Trichet: My colleagues and I are very proud of the fact that, in the first 12 years of the euro's existence, we have been able to keep prices stable for 331 million people. That is our mission and our mandate.

SZ: How does it fit into your mission that the ECB suddenly began, in May 2010, to buy government bonds from indebted countries such as Greece, Ireland and Portugal? The ECB had previously rejected such a policy. Was it a mistake?

Trichet: Certainly not. It was one of our "non-standard" measures that we introduced together with the policy of refinancing banks at fixed interest rates with full allotment of bids, and the Covered Bond Purchase Programme. All these measures, without exception, were designed to help restore a better monetary policy transmission at a time when markets were disrupted. At the same time, we completely separated these measures from the interest rate decisions – our "standard measures" are entirely designed to deliver price stability. This separation principle is for me absolutely fundamental.

SZ: The euro area countries have set up a rescue fund, the European Financial Stability Facility, soon to be called the European Stability Mechanism. What do you think of the idea of this fund taking over the government bonds held by the ECB, which are worth €75 billion? Your balance sheet would then be clean again.

Trichet: It goes without saying that the governments will have to redeem their bonds that are on the balance sheet of the Eurosystem without any change. Of course, being part of the official sector, we will not be participating in the voluntary private sector involvement mentioned on Thursday as regards Greece.

SZ: Some even say that the ECB is a "bad bank", speaking as if it were Goldman Sachs, BNP Paribas, Unicredit or Deutsche Bank, conducting securities transactions on its own account.

Trichet: That is clearly absurd. We are the central bank for 17 countries in a single market with a single currency. And our integrity is fundamental and fully protected.

SZ: Critics even say that the ECB and President Trichet are against debt restructuring because you have taken too many risks onto your books and would then need to write down losses.

Trichet: That is ridiculous. The integrity of the ECB and the Eurosystem is fundamental and fully guaranteed.

SZ: Mr Trichet, you have lived in Germany for eight years and so know both the Germans and the French very well, nations that were enemies until the end of the Second World War. How well do you think these two core euro area countries get on now?

Trichet: Yes, there were wars, but the two neighbours were frequently also friends and lived closely together. Charlemagne ruled the Germans and the French in one country. Three citizens of the small Breton town St Malo, to which I am closely attached, were, for example, members of the Berlin Academy under Frederick the Great! And the two nations know that their friendship is fundamental when it is put to the service of Europe as a whole.

SZ: Is this shared history enough, or will there soon need to be noticeably more shared undertakings?

Trichet: The successes of European unification over the last 60 years have been considerable. What we have today is, after all, what the euro's founding fathers dreamed of. We have to make further progress along this historic path.

SZ: Can your two sons and granddaughters understand this?

Trichet: My sons are convinced Europeans. But I notice that today's generation takes the success of the European Union and the euro as a given. We have to explain that if we have had peace, stability and prosperity over the last 66 years, it is not by chance, but because of Europe.

SZ: Germany and France could begin by having a joint finance minister in order to liven things up.

Trichet: (laughs) Do you think they are already ready for that?

SZ: What will you be doing in November?

Trichet: I will think about that on 1 November. Until then, I am sufficiently occupied and not thinking about the future.

SZ: Sleeping, reading, writing a book?

Trichet: I will certainly have more time when I finish on 1 November.

Statement on the decisions taken by the Euro Area Heads of State or Government at a press briefing on 21 July 2011 in Brussels

Statement by Jean-Claude Trichet, President of the European Central Bank, Brussels, 21 July 2011

I welcome the reaffirmed commitment of Euro area Heads of State or Government to ensure financial stability of the euro area.

In today's decisions, the following six points are particularly noteworthy:

First, the agreement by the Heads of state of government to support a new programme for Greece. The new EU/IMF support programme for Greece is crucial to foster sustainable economic growth and stabilize public finances. Strict and rigorous implementation of the programme is key to ensure public debt sustainability in Greece. Besides fiscal consolidation, the privatisation programme and the agreed structural reforms are of the essence to revitalising the Greek economy over time.

Second, the decision that Member States and the Commission will mobilise all resources necessary in order to provide exceptional technical assistance to help Greece implementing its reforms.

Third, the clarification of the approach to private sector involvement in the euro area. Here, what is most important, is the recognition that Greece is in an exceptional situation and that for that reason it requires exceptional and unique solutions, but that all other euro area member countries reaffirm solemnly their inflexible determination to honour fully their own individual sovereign signature. The ECB fully shares the view that this inflexible determination is fundamental and that

the credibility of all the sovereign signatures is a decisive element for ensuring financial stability in the euro area as a whole.

Fourth, the significantly enhanced flexibility in the use of the EFSF, including the intervention in the secondary markets, if warranted by exceptional financial market circumstances and risks to financial stability.

Fifth, the decision to rapidly finalise the legislative package on the strengthening of the stability and growth pact and the new macro economic surveillance framework and, in particular, the support to the Polish Presidency to reach an agreement with the European Parliament on voting rules in the preventive arm of the pact.

Sixth, we take note of the fact that the governments are supporting the new programme for Greece with a voluntary contribution of the private sector. As stated earlier, the ECB had made clear that it was advising that any contribution of the private sector should be voluntary, which is the case. The Governing Council had also made clear that it can only accept eligible collateral presented by sound counterparties. We do not prejudge at this stage what will happen to the Greek collateral. In any case, we had said that euro area governments would have to provide, if needed, the Eurosystem with a credit enhancement which would appropriately underpin the quality of securities issued or guaranteed by the Hellenic Republic pledged as collateral to the Eurosystem. This commitment has been made today.

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Interview with Postimees, Hospodárske noviny and Delo

Interview with Jean-Claude Trichet, President of the ECB, conducted on 13 July 2011 by Laura Raus (Postimees, Estonia), Ján Kováč (Hospodárske noviny, Slovakia) and Miha Jenko (Delo, Slovenia), published on 19 July 2011

Question: What will happen if the US politicians fail to agree on lifting the country's debt ceiling? What would the implications be for the euro area?

Trichet: I have no doubt that the US authorities will find an appropriate way to cope with the present difficulties and that they will succeed. If not, it would create a problem of great magnitude for the entire world. But I'm sure that they'll find a solution.

Question: After the past bad experience with United States-based rating agencies, would you now be in favour of the creation of a European rating agency?

Trichet: The present framework of a very small number of global rating agencies is pro-cyclical, amplifying the booms and busts. This "oligopolistic" structure is not optimal. In any case, we encourage all initiatives that go in the direction of eliminating conflicts of interests (where they exist), improving surveillance and oversight and permitting more competition in this industry. Everything that goes in this direction is correct.

Question: Despite the continuing debt crisis in the euro area, the ECB has raised interest rates by 25 basis points recently. It could be the beginning of a series of increases to occur during the year, as economists forecast. Disparities between countries are strong in the area and higher rates may be especially detrimental to the weak economies (Greece and Portugal, for example). What is your answer to this criticism?

Trichet: Throughout the crisis we have always applied the separation principle between the "standard" measures of monetary policy on the one hand and the "non-standard" measures on the other hand. Standard measures are the interest rates. Non-standard measures are designed to help restore a more correct transmission mechanism of our monetary policy when financial markets or segments of markets are disrupted. The interest rates must be decided upon with a view to delivering price stability to the euro area as a whole in line with our definition of price stability: an inflation rate of less than 2% but close to 2%. Over the past 12 years we have delivered a rate of 1.97% as a yearly average for the euro area as a whole, exactly in line with our definition. And we will continue to deliver this level of price stability in the next ten years to come. That is our primary mandate, our contribution to stability and, therefore, to confidence in Europe. It is a necessary condition for growth and job creation in the euro area. I think that this solid anchoring of inflation expectations and the credibility of the ECB to deliver price stability in the medium term is positive for all countries in the euro area, including those that have adjustments to implement. In particular, if we were not credible, the medium and long-term interest rates would incorporate a higher level of inflation expectations and therefore these market interest rates would also be higher everywhere in the euro area.

Question: The Nobel Prize laureate Paul Krugman has also criticised the recent rate hike. He believes that the ECB intends to place on the periphery of the euro area the burden of economic adjustment to avoid the eruption of inflationary pressures in Germany. Is this true?

Trichet: We look at the euro area as a whole. We are responsible for the currency of 331 million citizens. Just as the Federal Reserve in the United States looks at all the states of America and not particularly, for example, at Florida, California or Massachusetts. Our decisions are based upon our assessment of what the euro area as a whole needs to enjoy price stability in the medium term.

Question: The European Commission wants to increase its expenses in the next financial framework (2014-2020). What do you think of this move, also considering that thousands of European Commission officials earn more than, say, the Estonian Prime Minister. Is such a situation fair?

Trichet: These decisions are taken by the Council, namely the college of governments. In our view, governments should be very careful: if they increase spending at the level of Europe as a whole, they have to reduce their spending at the

national level. Because when everything is taken into account - the national level plus the European level – Europe has a very high level of public spending as a proportion of GDP in comparison with, for example, all other G7 advanced economies.

Question: Are you satisfied with the way the ECB, the EU and the governments are collaborating and managing the debt crisis and the financial crisis in Europe?

Trichet: We first have to avoid such crises and considerably improve governance. I have spoken of the necessity of a "quantum leap" in the domain of governance. That is work in progress. There is at the moment a trialogue going on between the European Parliament, the European Commission and governments, namely the European Council. In the present circumstances, we encourage Europe to go as far as possible in reinforcing governance, which is the position of the Parliament.

Question: Will the euro area still exist in its present form in five or ten years? Is it possible for you that any country (for example, Greece at the bottom or Germany at the top) might leave the club in order to manage its monetary policy by itself?

Trichet: It is not an assumption which I envisage in any respect. By the way, it is not in the Maastricht Treaty .

Question: How far do you think European integration will have developed by the year 2030? How far should it develop ideally?

Trichet: European integration and construction is a long-standing historical endeavour, which started more than 60 years ago. You are absolutely right to ask the question on what will come 20 or 30 years from now. As I said in a speech in Aachen, it is perfectly legitimate not only to do all we can to improve the situation today within the current framework of the Treaty as regards improving economic governance, but also to ask what could be done tomorrow and also the day after tomorrow. My personal understanding is that the European construction has not yet been achieved in a long-term perspective and that we will have to go further. In particular, the Europeans might design a new type of confederation which will not be exactly like the US federation, but will incorporate European features and will fully take into account European history. But these possible developments will be decided upon by our fellow citizens, by the people of Europe.

Question: Do you think that the EU will have a common finance ministry in 20 years?

Trichet: I can't say that this will come at a particular date in time. As I said in Aachen, I think, as a citizen, that at a certain moment we might have a confederation with various ministries, including a ministry of finance. Yes.

Question: Do you think the debt crisis will cause another recession in Europe?

Trichet: We have no recession in our baseline scenario (in accordance with the IMF, the European Commission and other international institutions) and, in the view of the Governing Council, the risks to the present scenario are balanced.

Question: Why are you unable to stop the debt crisis?

Trichet: This is being discussed by governments; we encourage them to find appropriate solutions as soon as possible.

Question: The ECB should stop its current policy of buying sovereign debt papers because the "risks are becoming too big", according to one of your former colleagues from the ECB's Governing Council. Is the ECB going to continue to buy this kind of papers?

Trichet: We are fully transparent in this domain and we publish every week what we do – or do not do.

Question: Whose fault do you think it is mainly that the euro area is in a debt crisis? Some experts say that Germany is also responsible for the crisis, since it lent money to Greece and other indebted countries recklessly in order to make them buy German goods. Do you agree?

Trichet: The sovereign risk tensions are a global phenomenon which, after the crisis of the financial system, is affecting the sovereign bonds of a number of advanced economies. A small number of European countries are particularly affected, but it is a global issue.

In Europe there is a paradox because the euro area as a whole is in a better situation than several other advanced economies. For instance, at the end of this year, our public finance deficit will probably be at the level of around 4½%. So

we will have a yearly deficit level which will be half the level of the public finance deficit of the two other very big economies of the G7, namely Japan and the United States. We have to keep that in mind.

The tensions and problems are due to the absence of sound, rigorous and correct management by the countries themselves: they have the primary responsibility. Second, they are due to the lack of rigorous surveillance by all the other countries, which is required by the Stability and Growth Pact.

Question: Could more euro area countries (e.g. Italy) need an international bailout package this year, or is such a scenario out of the question?

Trichet: As I just said, I am fully confident in their capacity to reinforce their credibility.

Question: The economists say that the bankruptcy of Greece is inevitable. They also say it is possible to avoid a chaotic bankruptcy. Don't you think that your aversion to rescheduling the debt might even worsen the situation of Greece?

Trichet: On behalf of the Governing Council of the ECB, I said that a credit event, selective default or default should be avoided.

Question: Your biggest objector among the euro countries is Germany. They want to prolong the repayability of Greek bonds and they want the participation of the private sector. Under which conditions would you support this?

Trichet: I have already mentioned the message of the Governing Council of the ECB.

Question: In what way can default be avoided?

Trichet: That is the responsibility of the governments.

Question: Is it possible for Greece to pay back the extra money that they will get from the European countries?

Trichet: That depends entirely on their capacity to adjust public finances and economic competitiveness, to redress the situation, to deliver a significant primary surplus and to engage in large-scale privatisations in a professional and active manner. All the conditionality of the international community and of the European Union is designed to produce this result.

Question: Why does the ECB consider the default of Greece such a bad solution? What will happen with the euro area if Greece defaults?

Trichet: Again, the message of the Governing Council of the ECB is known. The decisions are in the hands of governments. That being said, who would consider the default of any sovereign issuer – in the context of a European and global crisis of public finances in the advanced economies – a "good solution"?

Question: Estonia did not participate in the first bailout package for Greece since it was not in the euro area at that time. Do you think Estonia should now contribute to the second bailout package for Greece, considering that wages in this country are much higher than in Estonia?

Trichet: When one is a member of the euro area, one should participate as actively as possible in the discussion of the rigorous surveillance of the policies of the member countries. And, of course, participate actively in the discussions of the conditionality of the assistance programme, if any. Once you have decided on the conditionality, all countries in the euro area should act together. Being a member of a single market with a single currency creates a high level of interdependency. I always say that it means sharing a common destiny.

Question: According to our opinion poll, a huge majority of Slovaks don't want to help Greece. They also don't support the European Financial Stability Facility and the European Financial Stabilisation Mechanism. Why should they pay for the bad budgetary control of EU countries or too much risk-taking by the banks?

Trichet: Being a member of the euro area creates a lot of interdependencies, which are some of the advantages of the single currency area. Of course, the loans agreed to help finance the adjustment must be based on strong conditionality, which today is defined by both the European and the international community. Every country must participate very actively in the surveillance of other members and in the discussions on conditionality. And all countries must act together.

Question: Inflation in Slovakia is above the euro area average. Why is it so?

Trichet: In the long run it is important that national inflation is close to and oscillates around the average, which we know in advance will be less than 2%, but close to 2% over the next ten years (as it has been for the last 12 years). The main danger for any country is to be trapped in a spiral of cost, wage and price increases, which would lead to a deterioration of its competitive position. One has to look very carefully at the unit labour costs in each country. It is the new pillar for surveillance which we have asked for since 2005 and which will be integrated into the new legislation which is being discussed at present in Brussels.

Question: The deficit of the Slovak public finances is planned to be 4.9% of GDP. Do you think such consolidation effort is enough?

Trichet: I think that Slovakia, like all other countries, has to be fully in line with the Stability and Growth Pact and has to make sure that it reaches its 2013 target of 2.9% of GDP. All decisions that permit any country to be ahead of the curve are very important in the present situation.

Question: In Slovenia, having one of the lowest inflation rates in the euro area, people are not happy with the decision to raise interest rates. We expect money will be more expensive, slowing modest economic growth. Is the ECB therefore acting pro-cyclically in some euro area countries?

Trichet: As I said before, the ECB takes its decisions with a view to ensuring price stability in the euro area as a whole. This is extremely important. We look at each country as part of an overall economic area comprising 331 million people. We do what we judge to be necessary for all from the standpoint of the single market with the single currency.

It is very important that national governments fully take into account the fact that monetary policy is designed to ensure inflation of less than 2% but close to 2% as an average for the euro area, and that they take their own national economic policy decisions in the light of this. They have to take their decisions precisely with a view to optimising the overall situation of the country.

Question: Slovenia is called a "new member"; however, our country has been an active "new member" since January 2007, having now its own financing challenges, and simultaneously fully participating in financial bailouts for Greece, Ireland and Portugal, assuring essential sums of money for a nation of two million. What is your message to our citizens and taxpayers in this regard? Should they sacrifice for new bailouts for Greece and other countries in order to save the euro?

Trichet: First: it is not to save the euro. The euro is a very solid currency which is credible and has all the characteristics of a highly stable currency which keeps its value over time. As you know, the ECB has delivered price stability at the level of less than 2%, close to 2% per year over its first 12 years of existence. It is the public finance situation in some countries of the euro area which is at stake.

Second: this money that has been lent must be repaid. This is not a subsidy, it is not a transfer. It must, of course, be lent on the basis of very strong conditionality, which is based on European as well as international conditionality.

Question: What is your message to the decision-makers in Slovenia after the failure of pension reform in the June referendum?

Trichet: We have called for all appropriate measures to be taken to redress the situation of public finances and of competitiveness in the euro area. This is a message for all countries. Everything that goes in the direction of sound public finances is essential for sustainable growth, job creation and, particularly, for resilience in the situation of a global crisis. The efforts which were made by some countries in this direction have been amply rewarded. Germany, for example, is seeing its unemployment rate fall during the crisis. This is a reward for sound past decisions in the field of public finances and structural reforms. There are other examples from advanced economies outside the euro area: take the case of Sweden or Canada, for example, which proved to be remarkably resilient owing to their wise management. Sound management is always rewarded. It is regrettable that the pension reform in Slovenia was not supported.

Question: Slovenia doubled its "Maastricht" debt in the last three years, from 22% to 45% of GDP, while the government deficit stays relatively high at 5.5% of GDP for the third year in a row. Is the fiscal position of Slovenia becoming critical?

Trichet: Again, to Slovenia as well as to all countries in the euro area or Europe as a whole, the message is: be at least as sound and reasonable as required by the Stability and Growth Pact. Be ahead of the curve. It is the best way to be resilient and to create growth and jobs.

Question: Does the debt crisis mean a lot of additional work for you? Do you have holidays this summer?

Trichet: For all members of the ECB's Executive Board and the Governing Council, for all the staff of the ECB and the national central banks, the present crisis, which started four years ago in August 2007 and which has been the worst financial crisis since the Second World War, means additional work, permanent alertness and extreme attention. This is, of course, what is needed in demanding times. We all work very long hours on normal working days and also many hours on Saturdays and Sundays.

I will have holidays in the summer. But there is, of course, permanent availability to work even on holiday.

Question: What has been your most difficult moment as President of the ECB?

Trichet: There is no "most difficult" moment. One permanently has to be prepared, alert and ready to take appropriate decisions. I have to say that ever since its creation, the ECB has had many challenges – the bursting of the dot-com bubble, the terrorist attack of 9/11, oil and commodity price shocks. I was not President at that time, when my predecessor, Wim Duisenberg, had to cope with the 9/11 shock. And all my colleagues and myself have been coping for four years with a succession of tensions that are all demanding.

Question: What do you consider your biggest achievement as President of the ECB?

Trichet: The biggest achievement of the ECB is to be able to tell 331 million fellow citizens that 12 years after the introduction of the euro, we have average yearly inflation of 1.97%, which is fully in line with what the democracies in Europe have asked for, fully in line with our primary mandate and with our definition of price stability. And a better result than what was achieved in the euro area countries over the previous 50 years. But it's not an achievement of mine particularly, it's an achievement of the Executive Board, of the Governing Council, of all the staff of the institution and of the Eurosystem as a whole.

Question: Are you planning to write your memoir? It would be very interesting reading for all of us.

Trichet: Until the end of the month of October, I have no plans.

Interview with Financial Times Deutschland

Jean-Claude Trichet, President of the ECB, Interview conducted by Wolfgang Proissl on 14 July 2011, Publication - newspaper edition: Monday, 18 July 2011

FTD: The euro crisis is eating its way from the periphery to the core of the euro area. Is the euro in danger?

Jean-Claude Trichet: No, not the euro. The euro is a currency and the European Central Bank is responsible for it. The euro is a highly credible currency. It has been stable and has kept its value extremely well over the past 12 years. That is what the Treaty demands of the ECB. That is what the people of Europe and of Germany are asking for. And it is consistent with the aim of the Governing Council of the ECB, which is an inflation rate of just below 2 % and close to 2 % over the medium term. The average yearly inflation has been 1.97 % over 12 years which is a better result than over the last 50 years. In Germany the stability of prices is even more impressive: 1.5 % per year from 1 January 1999 to 31 December 2010.

FTD: So is the talk of a crisis an exaggeration?

Trichet: There are important problems at present which are related to bad public finances, by way of consequence, to financial stability. But these problems are the responsibility of the governments in question. Each government must keep its own house in order. In addition, the European Commission and all governments are responsible for ensuring that the fiscal policy of all euro area countries is constantly surveyed and monitored in line with the Stability and Growth Pact. We always made publicly the point that governments must live up to their responsibility.

FTD: Now that the markets are losing confidence in Italy and Spain, can Europe still manage this crisis?

Trichet: Naturally the Europeans can manage the issue. It is not a question of technique. It is a question of will and determination. And the situation, at the level of the euro area as a whole, is more sound than in the equivalent advanced

economies. For example at the end of the year the euro area will post around 4 ½ % of GDP public finance deficit when the US and Japan will post around 10 %.

FTD: The ECB argues against private sector involvement in the second rescue package for Greece on the grounds that, in international terms, this is not usual in such cases. But even the International Monetary Fund is now in favour of involving private bondholders. Why is the ECB still resisting such a move?

Trichet: If you read carefully what the IMF writes, you will see that it is much more prudent. In any case you know the position of the Governing Council on Greece, which I repeated in our last press conference. More generally, all over the world, the best private sector involvement is foreign direct investments, privatisation and going back as soon as possible to spontaneous market financing.

FTD: Is the ECB sticking to the line that any solution for Greece that leads to a credit event, a selective default or a default must be avoided?

Trichet: The Governing Council has not changed its position. Again we are in a domain where Governments are responsible. Our duty is to say clearly what we judge appropriate in order to avoid the risk of adverse developments in the euro area and in Europe. As you know there has been several times in the past when our advice was not followed, such as when we advised solemnly against watering down the letter and the spirit of the Stability and Growth Pact. If this advice had been followed, we may have avoided some of the problems we are facing today.

FTD: How is the ECB helping to battle the crisis?

Trichet: The most important thing for the Governing Council of the ECB is, for the future as it did in the past, to stick to its mandate and ensure price stability for the euro. The fact that the euro is a stable and credible currency is a prerequisite, a necessary condition for mastering this difficult situation. The ECB is an anchor of stability and confidence which is particularly fundamental at a time when everything else seems to be moving and shifting.

FTD: To cope with the crisis the European Central Bank used non-standard measures. The Securities Markets Programme, special treatment for government bonds of Greece, Ireland and Portugal, the liquidity provision for banks. How far does the ECB go with its special rules?

Trichet: We can not accept to put in questions our role as the anchor of stability and confidence in the euro area and in Europe. If a country defaults, we can no longer accept as normal eligible collateral defaulted bonds issued by the government of that country. Because, in the eyes of the Governing Council, this would impair our ability to be an anchor of confidence and stability.

FTD: What does the ECB say to the fact that, in the context of the second package for Greece, governments have nonetheless been talking about solutions such as a debt rollover or a partial debt buyback, which could lead to default?

Trichet: The responsibility for this lies with the governments. The governments have been warned, in no uncertain terms and using all possible means. I have said so publicly. I have explained in detail to the Heads of State and Government and to the finance ministers, on several occasions, that, if a country defaults, we will no longer be able to accept its defaulted government bonds as normal eligible collateral. The governments would then have to step in themselves to put things right. That would then be their duty.

FTD: What does that mean in concrete terms?

Trichet: In the event of a decision by the governments leading to a selective default or a default, which, again, we are warning against loud and clear, the governments would have to take care that the Eurosystem is presented collateral that it could accept.

FTD: When it comes to deciding whether a default has occurred, will the ECB rely, as it has until now, on the rating agencies, or might the decision not be dependent on what they say?

Trichet: Again, it is not the working assumption of the Governing Council.

FTD: Let’s talk about the crisis management of the euro area governments. The Heads of State and Government and the finance ministers give the appearance of being a chaotic bunch. They often create such a cacophony that it inflames the crisis rather than dampening it. What needs to change?

Trichet: There is an absolute need to improve “verbal discipline”. The governments need to speak with one voice on such complex and sensitive issues as the crisis. It is, of course, complex to take into account the need for sound, shared management of the Economic pillar of the Economic and Monetary Union, whilst fully respecting the functioning of the 17 democracies of the euro area. But speaking with one voice in a period of crisis is of essence. And, after all, it is what was possible after Lehman Brothers at the end of 2008.

FTD: Some euro area governments have said that Chancellor Merkel has frequently acted too slowly and has thus made the crisis even worse. Is that true?

Trichet: Not in the least. I would see a discussion of this kind as being completely misplaced in the current situation.

FTD: Do you fear that the euro area countries could fail to get the crisis under control?

Trichet: No. The countries of Europe have always demonstrated that they pull together when the challenges are very high. My strong belief in the continued integration of Europe, as a key historical endeavour to ensure stability, prosperity and peace, has not been shaken in any respect by the crisis.

FTD: Some governments want to beat the crisis by merging national government bonds to create eurobonds. Is this a good idea?

Trichet: The Governing Council has looked at the various proposals and is not in favour of them at present. What counts now is that we make optimal use of the instruments at our disposal. This includes a quantum leap in the economic surveillance governance of euro area countries. In addition, the adjustment programmes for Greece, Ireland and Portugal must be implemented in a decisive manner. It also means that the European Financial Stability Facility (EFSF) should be used as flexibly and effectively as it possibly can be.

FTD: The stress tests are very detailed in terms of various exposures of the tested banks (sovereign risk, housing risk, etc.) Some critics fear the stress tests will now lead to speculation against certain banks. Do you think this fear is justified?

Trichet: I welcome the publication of the EU-wide stress-testing exercise, which was prepared and conducted by the EBA (European Banking Authority) and the national supervisory authorities. I trust it is an important tool to enhance transparency in the EU banking system. I also support the EBA recommendations to promptly remedy the capital shortfall of the banks that do not meet the threshold ratio of 5 % core Tier 1 capital (as of end-April) and to strengthen the capital position of those banks that are above but close to the threshold.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Jean-Claude Trichet, President of the ECB, Brussels, 30 June 2011

Dear Madam Chair,

Dear Honourable Members,

It is a pleasure to be back in Parliament and your Committee for our regular exchange of views.

Once again, our meeting comes at a time when important decisions are being taken but also pending. Of particular concern is the conclusion of the legislative procedure on the economic governance package.

Je tiens tout d’abord à saluer les efforts continus du Parlement européen et du Conseil afin de rapprocher leurs positions sur le paquet de gouvernance économique. Le Conseil des Gouverneurs aurait souhaité que le Conseil européen du 24 Juin dernier fasse un geste d’ouverture envers le Parlement européen sur ce dossier. Le principal point de désaccord – l’extension de la majorité qualifiée inversée dans le volet préventif du pacte de stabilité et de croissance – est d'une importance clé. La zone euro a urgemment besoin d'un cadre de gouvernance économique renforcé et ambitieux. La crise actuelle démontre, de manière irréfutable, s’il en était encore besoin, les conséquences néfastes de politiques budgétaires et économiques malsaines.

Deshalb ist es unerlässlich, zu einer ambitionierten Einigung zu kommen. In der aktuellen Lage wäre eine Einigung besonders begrüßenswert, um deutlich zu machen, dass die richtigen Lektionen aus der Krise gezogen werden.

Let me now turn to the economic and monetary developments in the euro area since our previous meeting in March, as well as the two topics you have asked me to focus on, namely fiscal consolidation and monetary policy on the one hand, and sovereign debt developments on the other.

I. Economic and Monetary Developments

Let me first turn to the economic and monetary developments in the euro area since our previous meeting in March. In this context, let me also note that we are now in the purdah period, as the next Governing Council meeting will take place on 7 July. This means that nothing in what I will say is intended or should be interpreted in any respect in terms of future monetary policy.

Incoming information since I last spoke to you has confirmed a positive underlying momentum of economic activity in the euro area. We expect the continued expansion of the world economy and domestic demand from the private sector as the main driver of economic growth in the euro area. The latest Eurosystem staff macroeconomic projections are in line with this assessment. They foresee the economy to grow between 1.5% and 2.3% for 2011 and between 0.6% and 2.8% for 2012. In our view, the risks to this outlook remain broadly balanced in a context of elevated uncertainty.

As regards price developments, we are observing continued upward pressure on prices, especially in the earlier stages of the production process. Inflation in the euro area stood at 2.7% in May, after 2.8% in April. The inflation rates seen over the past few months largely reflect higher energy and commodity prices. Going forward, inflation is likely to stay clearly above 2% over the months ahead, mainly due to energy and commodity prices. The Eurosystem staff projections indicate inflation ranging between 2.5% and 2.7% for 2011, and between 1.1 and 2.3% for 2012. It is of paramount importance that the current relatively high inflation rates do not translate into second-round effects, via higher wages and price-setting, and thereby do not lead to broad-based inflationary pressures.

Risks to the medium-term outlook for price developments continue to be on the upside. Notably, energy prices could increase faster than currently expected, and indirect taxes and administered prices might be raised faster with a view to reducing budget deficits. In addition, increasing capacity utilisation may exert stronger upward pressure on domestic prices.

As regards our monetary analysis, we see the underlying pace of monetary expansion gradually recovering. At the same time, monetary liquidity remains ample. This has the potential to accommodate price pressures.

As you are aware, we are strongly determined to secure that inflation expectations remain firmly in line with our aim of keeping inflation rates below, but close to, 2% over the medium term.

Against this background the Governing Council raised the key ECB interest rates by 25 basis points in April, in order to adjust the very accommodative monetary policy stance in the light of upside risks to price stability. Since then we have kept the rates unchanged. At the same time, as I said in the press conference after the last Governing Council, we see the monetary policy stance as still accommodative and risks to price stability on the upside. Accordingly, I said that we are in a state of strong vigilance and that we stand ready to act in a firm and timely manner to avoid that recent price developments give rise to broad-based inflationary pressures over the medium term.

As regards our non-standard measures, the Governing Council earlier this month decided to maintain its fixed rate tender procedures with full allotment in its refinancing operations up to the third quarter of 2011.

II Fiscal consolidation and monetary policy

Let me now turn to the topic of fiscal consolidation and monetary policy.

In a monetary union, the central bank when setting interest rates has to take an area-wide perspective. In the same manner the US Federal Reserve do not and cannot tailor its interest rate to the specific economic conditions in individual US states.

Setting the policy rate with a clear focus on the euro area as a whole does not, however, mean ignoring the diversity in financial conditions. Since the financial crisis erupted, the ECB has adopted a number of non-standard measures to foster as much as possible a smooth functioning of the monetary policy transmission throughout the euro area.

- The current major challenges faced by a few euro area countries are mainly the result of some governments not conducting sound policies and not implementing reforms that would benefit their citizens and the European

public as a whole. It is essential that euro area countries fully assume the responsibilities at the national level that derive from their participation in the euro area. Past experiences of fiscal consolidation episodes demonstrate the long-term benefits of reducing sizeable fiscal imbalances. There are at least three reasons why well-designed fiscal consolidation is beneficial in the current circumstances. Accompanied by appropriate structural reforms, it promotes long-term growth. For those economies with large fiscal imbalances, it is indispensable to bolster confidence. And for all economies it helps create buffers that would be essential to deal with unforeseen events.

- It is also for this reason that the ongoing negotiations on the governance package should produce an ambitious outcome. I have been emphasising time and again why we are very much in agreement with the European Parliament on this – the need for a quantum leap in economic governance through the currently discussed legislative package.
- At this stage, I would like to recall two points:
- First, we should not be content with a stronger Stability and Growth Pact only at the later stages of an excessive deficit procedure. We need to halt any fiscal excesses early on and correct them. The obvious way is a higher degree of automaticity early on in the procedures, that is, more reverse qualified majority voting in the preventive arm of the Pact; and therefore the prospect of more timely sanctions, possibly of a reputational nature.

Second, we would benefit considerably from an equally ambitious macroeconomic imbalances framework that detects imbalances early on, through a well focused and rigorously applied scoreboard; and then corrects them, again in a timely fashion. Here, we need to focus on those countries that ultimately pose a risk to other euro area countries through in particular persistent and excessive competitiveness losses.

III. Sovereign debt developments

Let me now turn to the current sovereign debt developments.

As you know, at the euro area level, we see that fiscal consolidation in many countries is ongoing, and will, according to the European Commission's Spring 2011 Forecast, bring the euro area general government deficit down to 3.5% by 2012. This is an encouraging prospect, especially by international comparison. Also for the current year the euro area fiscal deficit is somewhat less than half of that of the US and Japan. However, selected euro area countries are currently still facing high debt and deficit levels.

The ECB has always made clear that the best way to cope with the current sovereign debt positions is a determined and disciplined implementation of agreed fiscal consolidation paths and the structural reform agenda to promote medium term growth. For the euro area countries under an EU/IMF programme, a determined implementation of those programmes is of utmost importance to get back to a sound economic situation. This call has been echoed by the European Council, which at its recent meeting urged the national authorities, especially but not only in Greece, to continue implementing rigorously and with the highest resolve the necessary adjustment efforts to put the country on a sustainable path. To that end, national unity and cross-party consensus are essential.

As to the possibility of debt action, let me recall what I have said many times on this matter, on behalf of the Governing Council: We strongly advise against all concepts that are not purely voluntary or that have elements of compulsion. We call for the avoidance of any credit events and selection default or default.

Let me add that I am from time to time surprised by the narrow view of private sector involvement that is generally taken in the present debate. We should not forget that private capital is also mobilised when embarking on privatisation. Privatisation is a good way of mobilising private capital and is something that we have encouraged considerably, particularly in the case of Greece. It is an effective way of mobilising private capital and has positive consequences not only on the financing of the country, but also in terms of positive structural effects on growth and employment. Finally, the private sector involvement that everybody is aiming at is to go back as soon as possible to private sector market financing.

Thank you for your attention.

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- The current major challenges faced by a few euro area countries are mainly the result of some governments not conducting sound policies and not implementing reforms that would benefit their citizens and the European public as a whole. It is essential that euro area countries fully assume the responsibilities at the national level that derive from their participation in the euro area. Past experiences of fiscal consolidation episodes demonstrate the long-term benefits of reducing sizeable fiscal imbalances. There are at least three reasons why well-designed fiscal consolidation is beneficial in the current circumstances. Accompanied by appropriate structural reforms, it promotes long-term growth. For those economies with large fiscal imbalances, it is indispensable to bolster confidence. And for all economies it helps create buffers that would be essential to deal with unforeseen events.
- It is also for this reason that the ongoing negotiations on the governance package should produce an ambitious outcome. I have been emphasising time and again why we are very much in agreement with the European Parliament on this – the need for a quantum leap in economic governance through the currently discussed legislative package.
- At this stage, I would like to recall two points:
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The ECB has always made clear that the best way to cope with the current sovereign debt positions is a determined and disciplined implementation of agreed fiscal consolidation paths and the structural reform agenda to promote medium term growth. For the euro area countries under an EU/IMF programme, a determined implementation of those programmes is of utmost importance to get back to a sound economic situation. This call has been echoed by the European Council, which at its recent meeting urged the national authorities, especially but not only in Greece, to

continue implementing rigorously and with the highest resolve the necessary adjustment efforts to put the country on a sustainable path. To that end, national unity and cross-party consensus are essential.

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Let me add that I am from time to time surprised by the narrow view of private sector involvement that is generally taken in the present debate. We should not forget that private capital is also mobilised when embarking on privatisation. Privatisation is a good way of mobilising private capital and is something that we have encouraged considerably, particularly in the case of Greece. It is an effective way of mobilising private capital and has positive consequences not only on the financing of the country, but also in terms of positive structural effects on growth and employment. Finally, the private sector involvement that everybody is aiming at is to go back as soon as possible to private sector market financing.

Thank you for your attention.

Completing Economic and Monetary Union

Speech by Jean-Claude Trichet, President of the ECB, at the Gala Dinner of the State of the European Union conference "Revitalising the European Dream: A Corporate View", Brussels, 28 June 2011

Ladies and gentlemen,

Thank you for inviting me to this conference. The theme to which it is dedicated is especially relevant today, when we have to draw all the lessons from the worst financial crisis since World War II.

These days, "Europe" and the benefits it brings have come to be taken for granted. Thanks to the success of European integration, the threat of war has become a memory of the past for many Europeans, in particular the younger generation.

This makes it all the more urgent to develop a renewed vision of the kind of Europe we want and indeed need – a vision that is easily understood and shared amongst EU citizens.

Each generation needs to affirm its commitment to Europe.

As Pierre Werner once observed, *"it is necessary that even those born well after the 1950s and 1960s realise that the European Union has not come about by chance, but that it is based on the fundamental necessities of life amongst the peoples of Europe"* [1].

Thankfully, these "fundamental necessities of life" – especially in the economic sphere – still seem to be felt and understood by the people in Europe. When asked, in the Eurobarometer surveys, which issues the European institutions should focus on in the coming years, Europeans believe that priority should be given to economic and monetary policy (37% in the EU and 41% in the euro area).

More than three out of four Europeans (78%) agree that measures to reduce the public deficit and debt in their country cannot be delayed.

More than three quarters of respondents (77%) consider that stronger coordination of economic and financial policies, as well as closer supervision of financial institutions would be effective in combating the crisis. The idea of initiating reforms to benefit future generations attracts equally strong support.

Revitalising Europe

Revitalising Europe means bringing the reality of today's Europe, of its institutions and policies, closer to these wishes and concerns of the EU citizens.

A Europe of stability and responsibility where the burdens of today's adjustments are not shifted onto future generations.

An open and flexible Europe fostering education, entrepreneurship and innovation, with ample employment opportunities and a high standard of living.

A Europe that fully brings its economic and political weight to bear in an ever more globalised economy.

There is a good basis for all of this - we can indeed take pride in our past achievements.

Having served as a member of the Governing Council of the ECB since the launch of the euro and as its President for almost eight years now, let me say that we have accomplished a lot:

For example, companies in the euro area do not have to worry about price stability - I will come back later on this issue - and possible devaluations in the countries of their main trading partners. They face lower transaction and hedging costs. There is more price transparency and more ample access to finance, in general.

Since the start of the euro, employment in the euro area has risen by over 14 million, compared with about 8 million in the United States. Adjusted for population growth differences, growth per capita in the euro area has been almost the same as in the United States over the past decade, at about 1% per year in terms of GDP per capita growth.

Trade among euro area countries has also risen strongly. The value of exports and imports of goods within the euro area increased from about one quarter of GDP in 1998 to one third of GDP in 2007, with trade within euro area countries representing about a half of the total euro area trade.

Economic and Monetary Union

The key to understanding the current challenges in the euro area is the specific construction of Economic and Monetary Union.

The coexistence of an achieved monetary union – the single currency, the single monetary policy and the Eurosystem with the ECB at its helm – and of a largely decentralised economic pillar.

Indeed, Member States are responsible for their fiscal and economic policies, but are called to treat them as a matter of common concern. Those policies are subject to a European governance framework to ensure that they are fully compatible with the requirements of a single currency.

Our governance framework largely relied on the self-discipline of national governments, with hard constraints at the EU level only in those few cases where hard rules were supposed to apply.

We had assumed that countries had sufficient incentives to 'keep their house in order' and thereby contribute to the common good of the euro area. An overly narrow interpretation of the principle of subsidiarity also shielded national economic policies from what was seen as undue European interference.

The experience of the first twelve years of EMU suggests that the limits of *de facto* soft policy coordination have largely been exhausted, with the interdependencies inside a monetary union calling for a stronger euro area dimension.

Let me now take a closer look at the two EMU pillars separately.

The 'M' of the EMU

The 'M' of the EMU, or the monetary pillar, has performed well.

The ECB has a clear assignment: to deliver price stability, which is defined as an annual inflation rate below but close to 2% over the medium term. And over the 12 years since the launch of EMU, the average annual inflation rate in the euro area has been 1.97%.

This is the best result of a major central bank in the euro area for any such period of 12 years, over the last 50 years.

We achieved this during challenging times. Over the years, we have had to cope with the bursting of the dot-com bubble, the aftermath of the events of 11September 2001, the jump in oil prices to $147 per barrel in 2008, rising prices of food and commodities, and then of course the worst financial and economic crisis since the Great Depression.

Yet throughout these very different economic shocks – which could have had either inflationary or deflationary consequences – citizens and market participants in the euro area have remained confident in our commitment. Inflation expectations have been firmly anchored in line with our definition of price stability.

The 'E' of the EMU

It is the 'E' of the EMU, where progress is needed.

Already the 1989 Delors report stated that *"an Economic and Monetary Union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries. (…) Uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the community."*

What does this mean in practice?

It means improving economic governance.

It means strengthening the rules to prevent unsound policies.

And it means to prohibit individual countries from pursuing policies that can harm themselves and the euro area as a whole.

For this reason, I have called, in the name of the Governing Council, on the Commission, the Council and the European Parliament to be very ambitious in reinforcing economic governance in the euro area.

We have called for a "quantum leap" in governance, for a substantially deepened economic union.

Essential reforms

In the short-term, we have to tackle the most urgent issues by implementing the structural adjustment programmes that are currently underway.

The new economic governance framework that is currently being negotiated needs to be agreed and implemented in full and without delay.

We must get the institutional framework for the medium-term right.

The two EU co-legislators and the Commission have been negotiating the new economic governance package during the preceding weeks.

The European Parliament has confirmed its position at last Thursday's plenary vote. The ECB particularly welcomes the strong message that is sent as regards the fact that the Stability and Growth Pact's procedures have to be made more automatic. Our past experience in applying the Pact, especially after weakening of its core provisions in 2005, have amply demonstrated that a reform of these procedures has to be a *sine qua non* of a determined response to the current crisis.

In this context, the Governing Council of the ECB regrets that the European Council did not decide to espouse the European Parliament's views on this issue at the end of last week. This is an issue of key importance for the ECB. We consider that an essential progress in decision-making procedures in the Council is to make them more automatic.

The extension of reverse qualified majority voting to the preventive arm of the Pact, which the European Parliament rightly insists on, is not about a perceived loss of sovereignty. It is a mechanism that would allow all Member States to protect themselves better from the harmful effects of unsound fiscal policies.

Since the very beginning of the discussions on the reform of economic governance in May 2010, the ECB has asked for greater automatism in the decision-making procedures to limit the room for discretion. This is a major component of the 'quantum leap' that we have called for.

Had the Council had less room for manoeuvre in suspending or halting fiscal surveillance procedures in the years preceding the crisis, some of the euro area countries would not be facing as severe a sovereign debt crisis today.

However, this was not the entire story – surveillance instruments were lacking altogether as regards the build-up of competitiveness losses and of macroeconomic imbalances, which have made any solution to fiscal problems even more challenging.

Therefore, the ECB has also called for a fully-fledged surveillance procedure for competitiveness indicators and for macroeconomic imbalances. As a matter of fact, we have been pointing to the risks associated with competitiveness losses since 2005 and insisting on peer review and mutual oversight. The new procedure needs to be focused on the countries with large competitiveness losses and high indebtedness, since it is those countries that pose a potential threat to the functioning of EMU.

In the short term, all parties have to take their responsibilities and agree on an ambitious governance package with two pillars – surveillance of fiscal policies and surveillance of macroeconomic policies, sending out a clear message to strengthen the economic policy framework that has been dented during the crisis. We urge a swift and ambitious completion of the legislative procedure to bring about certainty on this new framework.

An additional element of stronger economic policy coordination for competitiveness and convergence surveillance in the euro area is the newly agreed Euro Plus Pact. The ECB supports the four goals of this Pact, namely to foster competitiveness and employment, to contribute to the sustainability of public finances and to reinforce financial stability.

But we have also insisted that the Euro Plus Pact must be more than declarations. It must be followed up with concrete action. The ECB therefore welcomes the fact that the European Council last week called on the participating Member States to make their reform commitments more concrete, including specific timelines, to enable easier measurement of progress and benchmarking.

Single Market

Furthermore, let us not forget that the euro area of the 17 countries is participating actively in the larger Single Market of the 27 member countries of the European Union.

The Single Market forms an integral part of the wider Europe 2020 strategy for smart, sustainable and inclusive growth. The governance framework of this strategy underpins the wider surveillance efforts of the economic pillar of EMU. The first experience as part of the so-called European Semester is approaching its final stages, with the European Council's endorsement of the proposed recommendations for individual Member States last week.

The EU Single market offers a unique businesses environment with direct access to over 500 million potential business partners, employees and consumers with relatively high purchasing power. The Single Market has not been at the centre of the EU political priorities for quite some time and there have even been protectionist tendencies.

I, therefore, strongly support the initiatives aimed at re-launching the Single Market to address the prevailing structural challenges faced by the EU economy. The Single Market is at the core of the Union's growth agenda. A widening and deepening of the Single Market should be viewed as an opportunity to raise the "speed limit" of the economy, which is highly warranted in the aftermath of the impact the financial crisis had on the European economy.

Moreover, completion of the Single Market is an essential ingredient of the required quantum leap towards a deeper economic union that is commensurate with the degree of economic integration and interdependency already achieved through monetary union. EMU has led to a strengthening of trade integration and competition within the Single Market by enhancing market access, reducing the costs of cross-border activities and increasing price transparency.

At the same time, a well-functioning Single Market is pivotal for the smooth functioning of EMU. It allows for swift and market-based adjustment in case of shocks and facilitates the correction of economic imbalances.

A well functioning Single Market also requires proper design and implementation of financial sector policies. In this respect, the establishment of a new EU supervisory architecture to introduce genuine macro-prudential supervision and to strengthen the micro-prudential oversight at the EU level was a prerequisite for enhanced financial stability arrangements.

The establishment of the European Systemic Risk Board and the European Supervisory Authorities is an important milestone in providing the appropriate incentives to avoid excessive risk taking in the financial sector and to promote a level playing field in support of beneficial financial integration within the monetary union. Establishment of an EU framework for crisis management is an important complementary element of the new supervisory framework that still needs to be put in place.

Conclusion

This is a large agenda already. What more would be needed for EMU in the longer term?

I have sketched out in my speech in Aachen earlier this month some elements that in my view would warrant consideration in the design of a longer-term vision for Europe.

Developing these elements in more detail would, however, be the topic of another speech.

Ladies and Gentlemen,

I thank you for your attention.

Completing Economic and Monetary Union

Speech by Jean-Claude Trichet, President of the ECB, at the Gala Dinner of the State of the European Union conference "Revitalising the European Dream: A Corporate View", Brussels, 28 June 2011

Ladies and gentlemen,

Thank you for inviting me to this conference. The theme to which it is dedicated is especially relevant today, when we have to draw all the lessons from the worst financial crisis since World War II.

These days, "Europe" and the benefits it brings have come to be taken for granted. Thanks to the success of European integration, the threat of war has become a memory of the past for many Europeans, in particular the younger generation.

This makes it all the more urgent to develop a renewed vision of the kind of Europe we want and indeed need – a vision that is easily understood and shared amongst EU citizens.

Each generation needs to affirm its commitment to Europe.

As Pierre Werner once observed, *"it is necessary that even those born well after the 1950s and 1960s realise that the European Union has not come about by chance, but that it is based on the fundamental necessities of life amongst the peoples of Europe"* [1].

Thankfully, these "fundamental necessities of life" – especially in the economic sphere – still seem to be felt and understood by the people in Europe. When asked, in the Eurobarometer surveys, which issues the European institutions should focus on in the coming years, Europeans believe that priority should be given to economic and monetary policy (37% in the EU and 41% in the euro area).

More than three out of four Europeans (78%) agree that measures to reduce the public deficit and debt in their country cannot be delayed.

More than three quarters of respondents (77%) consider that stronger coordination of economic and financial policies, as well as closer supervision of financial institutions would be effective in combating the crisis. The idea of initiating reforms to benefit future generations attracts equally strong support.

Revitalising Europe

Revitalising Europe means bringing the reality of today's Europe, of its institutions and policies, closer to these wishes and concerns of the EU citizens.

A Europe of stability and responsibility where the burdens of today's adjustments are not shifted onto future generations.

An open and flexible Europe fostering education, entrepreneurship and innovation, with ample employment opportunities and a high standard of living.

A Europe that fully brings its economic and political weight to bear in an ever more globalised economy.

There is a good basis for all of this - we can indeed take pride in our past achievements.

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Ladies and Gentlemen,

I thank you for your attention.

The euro area and its role in the global economy

Remarks by Jean-Claude Trichet, President of the ECB, upon reception of the 2011 Global Economy Prize, Kiel, 19 June 2011

It is a privilege to receive this Global Prize today. I would like to thank the jury for this distinction, which honours the ECB and its staff.

Kiel has a long tradition of openness. It has forged close ties with the rest of the world, ever since it joined the Hanseatic League in 1283. Seven centuries later, Kiel is today part of the euro area, a vast economic continent, which is itself globally open and linked in many ways to the rest of the world. It is about the euro area and of its role in the global economy that I would like to share with you some thoughts in receiving this Prize today.

How can we characterize the salient features of the euro area and of its role in the global economy? And what are the challenges that need to be addressed in this context?

Three key aspects deserve attention in my view.

First, the euro area is amongst the most open of large economies in the world.

The euro area's trade relations with the rest of the world have grown appreciably since 1999, which underscores that the euro area is not a closed shop. The euro area's trade openness has increased by about 9 percentage points over the first years of the euro, from roughly one-quarter to one-third of output, notably as a result of rapidly growing trade with vibrant economies, such as the new EU Member States or China.

The euro area is the world's largest trading partner, after the European Union itself, accounting for about 14% of global exports and imports in 2010. Economic and Monetary Union has fostered trade. Not only inside the euro area (+50% increase in trade volumes over the first years of the euro), but even more so with the European Union as a whole and the rest of the world (+80% over the same period).

The euro area is also very open financially, and increasingly so. Its international assets and liabilities averaged each around 170% of GDP in 2009, compared with roughly 140% of GDP for the US and 90% of GDP for Japan. As financial globalisation unfolded in the last decade, the euro area's external assets and liabilities have grown in tandem, by roughly 80 percentage points of GDP between 1999 and 2009.

The euro area is a vast continent of more than 331 million citizens. By population size, it is comparable with the other large economiy of the developed world, namely the United States, with a population of 310 million.

In terms of economic output, the euro area is second only to the United States. It accounted for about 20% of world output in 2010, twice the share of Japan (about 10% of world output), and somewhat less than the United States (about one-quarter of world output).

Second, the euro is a stable and credible currency.

For over 12 years now, the European Central Bank –together with all national central banks– has been delivering what it is expected to deliver: price stability in the euro area as a whole over the medium-term, with an average annual inflation

of less than 2%, but close to 2%. Since we are in Kiel, let me add that in Germany the average yearly inflation has been 1.5%, which is a better result than for any such 12 year period over the last 50 years.

We have thereby been safeguarding the euro's purchasing power. This has been achieved despite several headwinds to the European economy: oil prices went up; the internet bubble burst; violence and wars have raged in some parts of the world; and starting in mid-2007 we had to cope with the most severe global financial crisis in over 60 years.

Taken as a whole, the euro area performed soundly also when looking at other macroeconomic indicators, or comparing with other large developed economies.

- Adjusted for differences in population growth, per capita GDP growth in the euro area over the last decade has been almost the same as in the United States, at about 1% per year.
- The dispersion of real GDP growth rates across euro area countries is comparable with the equivalent dispersion across U.S. states. For instance, the difference between the fastest and slowest-growing U.S. states is not of a markedly different order of magnitude as that between euro area countries.
- Overall employment in the euro area increased by 14 million during the first twelve years, compared with a rise of about 8 million in the United States.
- And the overall yearly public finance deficit in the euro area is presently about half that in the United States or in Japan. The IMF projects indeed the euro area's fiscal deficit to reach 4.4% of GDP this year, against 10.8% of GDP in the U.S. and 10.0% in Japan.

The euro's international status is the outcome of market forces. But one of the particular characteristics of the euro's international role is to be markedly regional and strongest in economies with close geographical and institutional links to the euro area.

The euro's international role also displays a high degree of stability. And the available factual evidence suggests that it has remained broadly unchanged since the outbreak of the global financial crisis, in particular.

For instance, the euro accounted in 2010 for about one-quarter of disclosed foreign exchange reserves globally (against around 60% for the US dollar and 4% for the yen). It also accounted for about one-quarter of the stock of international debt securities and for roughly 20% of foreign exchange turnover.

Third, the euro area has a balanced current account.

As such, the euro area does not contribute to global imbalances, one of the main challenges facing the global economy and the world community.

It is worth stressing that the euro area is the relevant dimension to consider for a vast single currency and economic area with a common exchange rate and monetary policy. And there, the numbers are clear: the euro area current account balance averaged less than 0.1% of GDP over 2005-2007 before the global crisis broke out, according to IMF figures. Moreover, the euro area current account is still projected by the Fund to be broadly balanced this year and the next up to 2015. The picture is very different in other parts of the world.

A concern is that after some partial reduction induced by the crisis, global imbalances are starting to widen again. This raises challenges for international monetary and financial cooperation. The euro area has a significant stake in effective global re-balancing, notably through sounder domestic policies worldwide which, in turn, would contribute to global external stability. The global economy has a lot of homework to do if it is to address these challenges.

People of goodwill, inspired by the desire to keep the global economy "open, market-based, just and protective" will surely be needed to that end. Credit should therefore be given to initiatives such as the Global Economy Prize to encourage them to press ahead in that direction.

Economic diversity on both sides of the Atlantic

Speech by Jean-Claude Trichet, President of the ECB, at the US Sciences Po Foundation Annual Benefit in New York on 16 June 2011

Ladies and Gentlemen,

It is a great pleasure for me to speak to you here tonight.

The past few years have been a testing time for the economies of both the United States and Europe. We were faced with the worst financial and economic crisis since the Second World War. Still today – on both sides of the Atlantic – we are dealing with the consequences of the crisis – for economic growth, for employment and for government finances.

The crisis has also exposed the United States and Europe to a number of asymmetric shocks – in which different parts of our economies have had a wide diversity of experience. Some countries within the euro area are the particular focus of market attention at the moment as a result of their sovereign debt issues.

Some observers have been wondering how diversity can be dealt with in Europe's Economic and Monetary Union (EMU), what it means for monetary policy and whether the variations in economic conditions are aggravated by product and labour market rigidities. It has often been argued that economic diversity or heterogeneity is very significantly larger in Europe than in the United States.

We at the European Central Bank (ECB) have been looking closely at the degree of diversity in the two large, continental advanced economies on either side of the Atlantic. And some of the findings from this comparison are quite interesting. Because they show that economic diversity within the two currency areas is very similar in many ways. The analysis also shows that, in fact, in a large number of respects the two economies are similarly diverse.

I would like to share some of the key insights of this analysis with you tonight.

I. Economic diversity in the euro area and the United States

The United States and Europe are often compared. This is quite natural. Americans and Europeans share a common cultural legacy. But our two economies, and I am speaking here of the economy of the euro area on our side, are also similar. Both are of similar size, in terms of population and in terms of economic output. Both have closely integrated financial and product markets. And both have a single currency.

Let me begin my comparison with an economic indicator that is particularly close to a central banker's heart: inflation. In historical terms, overall inflation has been low and stable in both the United States and the euro area since the late 1990s.

The ECB aims at an inflation rate of below, but close to, 2% over the medium term. Since the inception of the euro, the ECB has achieved that objective. Annual inflation in the euro area has been 1.97% on average over the first 12 years.

Importantly, the standard deviation in inflation across the members of the euro area has been around 1%. And it has remained broadly stable at similar levels to those observed in the US Metropolitan Statistical Areas. From that standpoint prices in the euro area are broadly homogenous and similar to those in the United States.

My second point of comparison is how diverse the United States and the euro area are in terms of economic growth. The results here are similar to that for inflation. First of all, the overall growth rates over the first twelve years of the euro were actually quite similar in the euro area to those in the US, once you adjust for differences in population growth. In both the euro area and the US, per capita growth was about 1% during 1999-2010. As concerns dispersion within the economies, before the crisis, the standard deviation of growth rates was around 2% in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns. [1]

Allow me to go one step further and compare the sources of this growth dispersion in the United States and the euro area. Both currency areas include regions that experienced a significant boom-and-bust cycle over the past decade. Both also contain regions that are facing significant structural challenges of a more long-term nature.

Let me start off with the United States. Here, several states experienced increases in house prices that outpaced the national average by a wide margin. The steep house price increases probably contributed to above average growth in these states, owing to strong positive contributions from real estate, construction and financial services.

Nevada, Arizona, Florida and California are good examples, where average growth between 1998 and 2006 exceeded that of most other states. The sharp fall in house prices in recent years turned boom into bust. These states experienced the harshest recession among the US states.

At the same time, some other US states have seen a long period of below average growth, particularly the former manufacturing powerhouses in the "Great Lakes" region. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP. In the decade before the financial crisis, growth rates in states with a high concentration of companies in manufacturing industries other than information and communications technology, such as Michigan and Ohio, were lower than in most other US states. Unsurprisingly, GDP growth in these regions remained below average during the crisis.

The euro area also contains examples of these two types of regions. On the one hand, some countries experienced asymmetric boom-and-bust cycles. Several euro area countries had higher than average growth in the pre-crisis years. For example, up to 2006, growth in Ireland was higher than in most other euro area economies, owing much to large increases in house prices.

On the other hand, a few euro area countries – Portugal for example – experienced growth below the euro area average in the decade preceding the crisis. This was typically a consequence of structural issues that could have been tackled earlier and with more determination.

Just a few years ago, this group of countries included Germany, then labelled completely wrongly the “sick man of Europe”. Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

In short, the effects of the crisis on the different economies in the euro area follow a similar pattern to those in the United States. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. More specifically, Ireland and Greece, in particular, remained in recession in 2010.

Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis. These relatively low growth rates are linked to a deterioration of competitiveness, driven by persistent losses in relative competitiveness, for example by above average increases in relative labour costs.

Again, this problem is not isolated to the euro area. Disregarding the most recent countries to join the euro area, dispersion of unit labour costs is similar in the euro area and the United States, both before and during the crisis.

It is worth noting that both currency areas include regions with persistently above or below average unit labour cost growth. Again leaving aside the most recent countries to join the euro area, Greece, Portugal and Ireland, in particular, have lost competitiveness vis-à-vis their main trading partners in the euro area. Germany, in contrast, has been able to lower relative unit labour costs.

There have been similar persistent losses and gains in competitiveness in the United States. Some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states have been gaining competitiveness vis-à-vis the national average over the past decade.

In summary, economic heterogeneity in the euro area and the United States has been broadly similar on a number of measures over the past 12 years.

II. Economic governance in the euro area

But the crisis has shown us that this should be no reason for any complacency in the euro area. Persistent losses in competitiveness on the part of individual members in a currency union lead to a build-up of external and internal imbalances. When these unravel, the cost for the affected economies can be large. They can also have spillover effects on other members of the currency union.

In any union, an economic governance framework is needed to prevent developments in an individual member state endangering the smooth functioning of the union. This is particularly true in a currency union that – in contrast to the United States – does not have a large federal budget to balance severe asymmetric developments.

For EMU, the economic governance framework devised in the 1990s has not been correctly implemented and, in any case, has proved too weak during the crisis.

As I speak today, the reform debate is still in progress. Allow me to take a few more minutes to outline the reforms required to make Europe's institutions of economic governance commensurate with monetary union.

As you may know, the ECB takes the strong view that there is the need for more speed and automaticity in the sanctioning mechanism. This is particularly true for the Stability and Growth Pact, the EU's framework for fiscal governance. But it is also the case for the broader framework for macroeconomic policy surveillance. The experience of recent months has vividly demonstrated the importance of a timely correction of internal and external imbalances.

But faster and more automatic sanctions alone will not be enough. The enforcement tools will also need to be made more effective. The macroeconomic surveillance framework, in particular, needs to provide clear incentives for sound policies in the member states by imposing financial sanctions at an early stage. This also means that there should be no room for discretion in the implementation of the surveillance framework.

At the same time, requirements on fiscal and other macroeconomic policies should be more ambitious. To ensure that none of the euro area members are left behind, they have to bring national policies in line with membership of a currency union.

Finally, the implementation of sound fiscal and macroeconomic policies is best ensured if these are solidly anchored at the national level. An effective way of achieving this is to implement strong national budgetary frameworks in the members of the euro area.

III. Conclusion

Let me conclude. The European Union and the Euro area on one side of the Atlantic, the United States on the other side not only share the common heritage of their culture and their nature of advanced economies. They are not only of similar size. Our economies are also showing remarkable resemblance in their diversity – among the 50 states on this side of the Atlantic and among the 17 euro area members on the other side. This is true for both the euro area and the United States before the crisis and also in their reaction to the asymmetric shocks during the crisis.

Therefore we have a common challenge. That of governing, in the best fashion possible, very large and similarly diversified economies as regards the economic features of member countries and states. This is naturally done in the US through the federal institutional framework.

We Europeans need to reform our economic governance framework, as I have briefly outlined here tonight. Here, we would do well to heed the words of Alexander Hamilton, a founding father of America's economic and political union,. Just as Hamilton once called to his fellow Americans, we Europeans should call on our leaders to "learn to think (more) continentally".

Thank you for your attention.

Interview with The Times

Interview with Jean-Claude Trichet, President of the ECB and The Times, conducted by Sam Fleming on 13 June 2011

The Times: There are two camps: one that emphases the benefits of the euro and another group that says look at what happened in Greece, Portugal and Ireland - this shows that the project is fundamentally flawed. Why are you in the first camp?

Jean-Claude Trichet: All advanced economies are still going through the aftermath of the worst crisis in 60 years. It could even have been the worst crisis since World War I, if central bank and governments had not taken tough and bold decisions. Had public authorities not acted, we would not have avoided a major depression. I am absolutely convinced of that.

What we are reflecting upon in Europe is not that different from the important discussions and reflections that are taking place in the US or Japan. Were we on a sustainable long term path on the previous business model? It seems to me that no big advanced economy – including the UK – can avoid to embark on a strategic reflection after this global crisis. It is

not at all surprising that we in the euro area, as one of the big advanced economies, are reflecting on our business model, on our governance and measures to reinforce our resilience.

What is very important is that a bird's eye view of the euro area gives elements that are rather encouraging and which are often not perceived: the euro area as a whole is less indebted and far less in deficit on a yearly basis than the US and Japan. Our current account is balanced, and our growth has been rather encouraging since the recovery started in the third quarter of 2009. As regards growth and job creation, compared with the US we have more or less the same growth per capita and we created more jobs since 1999.

But this is no time for complacency in any respect. The big issue to be addressed is to strengthen our surveillance of economic policies by member states. These economic policies are very important in a single currency area – fiscal policy on one hand and macroeconomic policies, including indicators of imbalances and competitiveness, on the other hand. "Economic Union" has to be improved considerably. That being said, as regards "Monetary Union", twelve years after the launch of the single currency, I can say that the euro is there, it is credible and it maintained price stability even better than was expected by almost all observers. Annual average inflation over the past 12 years has been less than 2%, close to 2%. This is better than in the euro area countries over the last 50 years. As a stable currency the euro is undoubtedly a success.

But if you are in Greece, Portugal, Ireland or even to an extent in Spain you will look and say it is a success if you are in Germany or in Northern Europe but if you are dealing with the changed public services, or the unemployment levels, the euro doesn't feel like a success.

You have to judge the euro area as a whole. I fully agree we have to improve the interaction between national economic policies in a number of domains and the surveillance by the centre; that is clear. It's absolutely clear that a country like Greece, for example, had a long period of growth that was largely artificial, boosted by unsustainable fiscal expansion. In such a case, the correction after such a period is necessary to bring the economy back on a sustainable path. It is clear that in any large economy, and also in a single currency area, it is extremely important to prevent divergences of this dimension driven by distortions. We have to be aware such issues are inherent for virtually all vast continental economies.

A lot of central banks are emphasising the fragility of the recovery, yet at the same time the ECB is tightening policy. Why is there this different position between, for example, the Fed and Bank of England on one side and the ECB on the other?

It is not for me to comment on other monetary policies. What I would say is that in our case it is very important that we continue to anchor very solidly inflation expectations. We consider that such anchoring has been a very important element in the way we went through the crisis; we avoided not only the materialisation of inflation risks in normal times but, in these exceptionally difficult times since the intensification of the crisis in 2008, also the materialisation of deflationary risks.

We had some words from Barack Obama last week about the importance that this crisis is well-handled, saying if it is not well handled it could have serious consequences for the US economy. Would you share that view?

I have no particular comment on what the President of the United States said. What I would say is that it was very important to take the appropriate and bold decisions to cope with the private sector crisis, to draw all the lessons from this financial crisis as far as financial regulation is concerned, and to be fully aware of the challenges that the addressing of the financial crisis had for public signatures. We were not at ease with the idea that in the heat of the crisis, all countries were called to spend as much as possible, embark on deficits as much as possible. I believe that the tensions we are observing in Europe today are part of a much more global phenomenon, namely the pressure on the sovereign signatures in the advanced economies. The current tensions on some euro area sovereigns are therefore not only a euro area issue, but also have a European aspect and a global aspect. In comparison with most emerging economies, most advanced economies have to cope with a real challenge as regards their fiscal policies.

The projections now suggest that Greek obligations to the official sector could in a couple outweigh Greek obligations to the private sector. That underlies why those in Germany say we should have private sector involvement. Do you not accept their logic?

The position of the Governing Council, which is public, is that we are not taking any decision in this domain. It is first of all for the executive branches to see what they want to do. We are telling them that to embark in a compulsory way of dealing with this issue is not advisable. We are telling them that doing anything that would create a credit event or selective default or default is not advisable. In any case it is their decision, and then we will take all the appropriate decisions ourselves as far as the Eurosystem is concerned, in line with our statutory obligations. But again, we are saying very clearly that they should avoid compulsion, credit event, or selective default or default. Our position is clear.

Do you think a compromise is possible on this?

No other comment.

There was a story a few weeks ago that some in Greece were considering a withdrawal from the euro. Has anyone in an official position ever raised with you that possibility?

No.

And likewise Ireland and Portugal?

Correct.

What would you say would be the consequences of such a thing?

It is not a working assumption that anybody considers.

You have bailout fatigue in Germany and austerity fatigue in Greece. Do you worry about the strain this situation is putting on the compact between democratic leaders and their populations?

We are living in democracies and we have to fully respect their functioning. It calls more than ever to communicate as clearly as possible to our people all the elements on the situation and the economic and financial diagnosis. It is true for all countries, including those in an adjustment programme and those contributing to the financing of these programmes.

The Aachen speech talked of a common European finance ministry: it seemed this would be an EU27 idea. Do you worry that the likes of Britain would see this as a threat to their sovereignty?

I mentioned explicitly it would be in a long-term perspective, which calls for changes of the Treaty and which is based on the assumption that, at a certain moment in history, Europeans would decide to create a new kind of confederation of sovereign nations. I said very clearly this is not for today. We know today what we have to do. It would be for the day after tomorrow. For that, we will depend entirely on the people of Europe and on its will.

Perhaps this is a day after tomorrow question also; do you see it as Britain's destiny to join the euro one day even if it seems unlikely today?

I always said the UK was much welcome in the euro area and that it depended entirely on the will of the UK government and people. It is as simple as that. That being said, even without the UK we are 331m people, the same order of magnitude as the US. Again, the UK is welcome and it depends entirely on the UK to decide. In any case, I am sure that the UK is a European country at the heart of Europe, by all means.

Does the Latin American debt crisis offer any lessons for this one?

What is striking to see is that virtually all countries and economies that had large problems in the past decades drew the lessons from their problems and became much more resilient than the advanced economies in the occasion of the last crisis of 2007-08.

For advanced economies now, financial sector reform is so important not only to make this sector much more resilient, but we also have to take into account that it is extremely unlikely that our democracies would put for a second time 27% of GDP of taxpayers risk on the table. It is very likely that the decision-making processes in our democracies would not allow us to avoid another great depression if we had exactly the same kind of challenge.

You were the author of the 3pc limit in the Maastricht Criteria and, when you were confirmed by the European Parliament, even then you were emphasising over and over again the importance of getting the fiscal side right. No one listened. Why will they listen this time?

They are paying a high price after a practice of benign neglect. We were preaching in the desert for a long period of time. If I have a message today, it would be to all governments, not only in the euro area, but particularly in the euro area, that they have to take fiscal policy very, very seriously. Not only fiscal policy but also the monitoring of competitive indicators, the monitoring of unit labour costs.

The other big lesson that emerges from reading about your earlier experiences before joining the ECB was your role in the franc fort. How important was the benefit that France evidently received from that policy in influencing the way you have approached your job in the ECB?

I was in France the fervent advocate of what I called with a number of colleagues 'competitive disinflation': it was to say that with inflation and successive depreciation of the currency or devaluation countries don't have a winning strategy but a losing strategy. That was the main message of 'competitive disinflation'.

I have heard it said that what Europe faces as a whole now is a crisis of competitiveness, vis-à-vis China for instance. What Germany succeeded in doing much of the West hasn't, and China provides a huge wake-up call for the West.

You have a formidable challenge which is coming from all emerging markets. The crisis reveals a lot of weaknesses in the advanced economies and we all have to accept that and reflect on that. All advanced economies, the US, the euro area, the UK, or the single market of the EU-27, clearly we have a major new challenge, which is to adjust to an important role of China, India, Latin America and all the emerging countries in our global economy.

The fact we have to review our business model is obvious. A lot of further attention is warranted to the appropriate flexibility of our economies. Structural reforms are absolutely necessary. Education, science and research & development are key success factors. The progressive diminishing of PhDs in science and technology in the many advanced economies is not a good sign.

The growth and catching-up of the emerging world is exactly what we wanted after World War Two. It calls for us to adapt permanently, perhaps more rapidly than we would like.

One of the impacts of the rise of emerging economies is the strain it puts on resources. This is also going to put a lot of strain on central bankers: how should central bankers respond via monetary policy to what could be a secular long-term increase in the price of raw materials?

Globalisation is a Janus with a double face. You have on the one hand this formidable challenge of volatile oil and commodities prices. On the other hand you have the formidable disinflationary trend of manufacturing goods, which are produced at lower prices. We have to deal with these simultaneous trends that are very complex and are accelerating changes of relative prices. It is a formidable challenge for all central banks of the world, not only in the advanced economies of course. That is something that I trust central banks can do in the medium term if they are vigilant, if they are attentive. In the very long run, I tend to be optimistic. I was trained as a scientist at the beginning. I trust that we will find technological ways to get rid of this incredible dependency on fossil energy or on the large number of minerals and commodities. It is an absolute must for our world, our environment and our civilisation. I therefore trust that we will deliver.

What are your plans after you retire after the ECB?

I have no plan. I will see after the end of my mandate. At the present moment I still have close to five months ahead of me and quite a lot of challenges obviously.

The euro, its central bank and economic governance

Stamp Memorial Lecture by Jean-Claude Trichet, President of the ECB at the London School of Economics and Political Science London, 13 June 2011

Ladies and Gentlemen,

It is a great honour for me to speak here at the London School of Economics and Political Science today.

The euro and its central bank, the ECB, are unique. The European single currency is the only major currency not issued by a single sovereign state, but by a union of sovereign states.

Indeed, the European Treaties specify a clear division of responsibilities between European-level policy-making and national policy-making. For countries that have adopted the euro as their currency, this implies that, on the one hand, monetary policy is inherently indivisible, and in the euro area it is thus conducted at the supranational level by the ECB. On the other hand, fiscal policies remain largely the competence of national governments.

In this lecture I would like to explore how the unique institutional framework of Economic and Monetary Union (EMU) in Europe has fared over the past 12 years and particularly during the global financial crisis.

As you will be aware, the primary objective of the European System of Central Banks is to maintain price stability in the euro area. In the first part of my lecture I will show how the ECB achieved this primary objective before, during and after the crisis. I will also try to convince you that the economic performance of the euro area as a whole has been quite remarkable over the past twelve and a half years.

At the same time, we have to recognise that several individual countries in the euro area are facing significant challenges and that experiences during the crisis in different parts of the euro area have been quite diverse. In the second part of my lecture, I will address the issue of economic diversity in the euro area and show that the euro area shares this characteristic with the United States – an economy and a currency area that is a natural reference point taking into account its size.

Finally, the crisis has exposed weaknesses in the economic governance framework of EMU that need to be addressed urgently. I will close my lecture with some comments about what these reforms of the economic governance framework should look like from the perspective of the ECB.

The ECB's primary objective: Price stability in the euro area before and after the crisis

I can say today that the ECB has fulfilled its primary objective to the letter. As you know, the ECB aims at inflation rates of below, but close to, 2% over the medium term. Annual inflation over the first 12 years of EMU has been 1.97% on average. A precision landing.

More generally, the degree of price stability has been greater, over the past 12 years, in the euro area as a whole than in the individual euro area countries over the previous 50 years.

This is no small achievement. The ECB has faced many challenges in pursuing its objective: the bursting of the dot-com bubble, the shock wave of 11 September 2001, the volatility of commodity prices and, of course, the worst financial crisis the world has known since the Second World War.

During the crisis, together with other central banks around the world, the ECB has had to operate in an uncertain environment. Allow me to explain our monetary policy response to the crisis in more detail.

Crucially, we were alert from the very first day. We were one of the first central banks to react, when the financial markets became abruptly turbulent, in August 2007, taking action swiftly.

Dysfunctional financial markets threatened to compromise our ability to guide the outlook for price stability by using only our conventional instrument – interest rates. Faced with this situation, over the years that followed, we have implemented a number of unconventional measures to ensure that our decisions on interest rates are transmitted to the whole economy, despite the problems observed in the financial sector and capital markets. In particular, the major task was to

allow banks – regardless of the level of the key interest rate which was designed to deliver price stability – to continue to lend to households and businesses.

[See figure on non-standard measures]

It is important to understand that we maintained a principle of strict separation between our conventional measures and our unconventional measures. Our interest rates are set so that we can ensure price stability over the medium term. The implementation of unconventional measures depends on the functioning of the monetary policy transmission mechanism and is intended to repair disruptions of monetary and financial markets and of specific market segments that might impede the overall transmission.

As the crisis called for rapid and unprecedented action, we did not lose sight of our main objective, namely to maintain price stability over the medium term for the benefit of the 331 million citizens of the euro area. All – I stress that word – all monetary policy decisions we have taken over the last 12½ years were aimed at fulfilling this commitment.

Let me elaborate on this point. As you know, in normal times, central banks mainly influence the economy and inflation by using the instrument for setting short-term interest rates.

In practice, the identification, at an early stage, of the risks to price stability is a delicate task. To see it through, the ECB bases itself on a monetary policy strategy supported by several sources of information. The economic analysis we undertake enables us to synthesise information on short-term inflationary pressures from a large number of economic indicators. Thanks to the monetary analysis that we also undertake, we can cross-check this information with medium-term inflationary pressures drawn from the monetary and financial indicators. These are the two “pillars” of our monetary policy, which indicate to us the necessary steps in respect of the interest rate to ensure price stability over the medium term.

The measures we have taken, sometimes in the face of political pressures have demonstrated our determination to stick to our mandate in full independence. We refused to lower interest rates in early 2004 when Germany, France and Italy in particular asked us to do so. And we did not hesitate to raise interest rates in December 2005, a time when 10 governments out of 12 in the euro area, plus many international observers, asked the ECB to leave its key rates unchanged.

International financial institutions, in particular, highlighted the risks that the tightening of monetary policy – after a prolonged period of accommodative monetary policy – could pose to the recovery. Despite these warnings, we conducted our monetary tightening, and international financial institutions, with the benefit of hindsight, have agreed that we were right to make that decision.

After the crisis escalated in mid-September 2008, while inflationary pressures subsided, we decided, in full accordance with our mandate, to reduce our key interest rate. We cut it rapidly, from 4.25% in October 2008 to 1% in May 2009.

We lowered the key interest rate at a pace and to a level unprecedented in the recent history of the euro area countries.

[See figure on monetary policy decisions]

With the benefit of hindsight, the decisions we took during the crisis were, I think, vindicated. They have in particular helped to preserve a very solid anchoring of inflation expectations over the past four years. Our determination to maintain price stability over the medium term has enabled us to prevent both the risk of inflation and of deflation from materialising.

With the recovery now more firmly established, we have seen in recent months upside risks to the outlook for price stability over the medium term. Again, the sharp increase in oil and other commodities has had a major impact on overall inflation. In these circumstances, the central bank must prevent increases in the prices of raw materials from being incorporated into the long-term inflation expectations, which could trigger second-round effects on wages and prices.

It is against this background that the Governing Council decided in April to raise interest rates. I stressed, in reporting this decision, that it had been taken unanimously. The action of the Governing Council is motivated by a common goal.

That decision in April confirmed that the separation principle is strictly applied and that our non-conventional measures do not restrict in any way our ability to toughen the monetary policy stance when facing inflationary pressures. Thus, when the Governing Council decided in April that it was time to raise interest rates, in parallel, at the same time, it decided to keep, in the second quarter, the provision of unlimited fixed-rate liquidity for a period of three months.

Contributing to economic performance

Price stability is the best contribution that central banks can make to sustainable economic growth and job creation. I think there is widespread agreement on this among central bankers and academic researchers.

In the short run, however, some academic research suggests that there might be a significant trade-off between low inflation volatility and low output volatility. If prices are stable, economic adjustment has to occur through the real economy channel. It may therefore be difficult to achieve these two goals at the same time.

The chart shows that the euro area scores relatively well on both dimensions. This is puzzling, given that the euro area has quite rigid product and labour markets, at least compared with the United States. The higher degree of price and wage rigidity in the euro area would suggest that output volatility should be significantly larger in the euro area than in the more flexible US economy.

[See macro volatility chart]

This would be particularly true during a period when the economy is subject to supply-side shocks, which are simultaneously exerting inflationary and recessionary influences. Yet surprisingly, and despite the negative supply-side shocks that had been hitting the euro area economy over the years up to 2007, the data suggested that both inflation volatility and output volatility in the euro area were lower than elsewhere.

Output volatility in the euro area is much higher when the crisis is included in the sample. But, remarkably, the euro area still scores well on both dimensions compared with other advanced countries.

How can we explain this puzzle? How can nominal rigidities plus supply-side pressures not produce bad or worse macroeconomic outcomes?

I believe that the strong anchoring of inflation expectations in the euro area is the key to understanding this good economic performance of the euro area.

[See the two charts on inflation expectations in the euro area and the US]

Inflation expectations have remained solidly anchored in line with our definition of price stability throughout the crisis. In particular, there was no materialisation of a deflation risk. This has enormously facilitated our task, especially during the period of economic freefall in the winter of 2008/09.

Other indicators corroborate the finding that at the aggregate level the real economy of the euro has proved relatively dynamic in comparison with the US: real output per capita has grown at a similar pace in the euro area as in the United States.

[See chart on GDP per capita growth in the euro area and the US]

Employment growth in the euro area has also been strong over the past 12 years. More than 14 million jobs have been created since the introduction of the euro, compared with 8 million in the United States.

This is not to suggest that there is time for complacency. Unemployment at 9.9% of the labour force remains much too high, and structural reforms are of the essence to make the euro area economy much more flexible and to elevate its growth potential.

Finally, public finances in the euro area as a whole are relatively sound. As elsewhere, the financial crisis has left its mark on government deficit and debt in the euro area. Yet, the fiscal deficit in the euro area on aggregate for this year is estimated at less than one half of that in the United States and Japan.

One may argue, however that this bird's eye view is misleading. One common belief is that the US economy is more homogeneous than the economy of the euro area. In other words, aggregate economic data may hide very significant differences in the variance in economic performance across regions within a monetary union.

Economic diversity in the euro area and the United States

Looking more closely at the regional dispersion across US regions and euro area economies show that, contrary to what is generally perceived, the dispersion of many of the key indicators is similar.

Let us take a look at the inflation indicator. The dispersion of HICP inflation in euro area countries remained broadly stable since the late 1990s, at a level similar to the 14 US Metropolitan Statistical Areas. During the crisis we saw a temporary increase in inflation dispersion in the euro area. As you can see, this has been reversed over the past 12 months.

[See figure on dispersion of annual inflation]

The picture is similar for the dispersion of GDP growth. Before the crisis the dispersion of growth rates was around 2%, in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns overall. [1]

[See figure on dispersion of real GDP growth]

Let us go one step further and investigate the sources of this growth dispersion in the US and euro area economies. This reveals parallels even in the root causes of dispersion in economic performance. Both currency areas comprise regions that experienced a significant boom and bust cycle over the past decade. Both also contain regions that are facing significant structural challenges of a more long-term nature.

Nevada, Arizona, Florida and California in the United States, for example, experienced increases in house prices that outpaced the national average by a wide margin. Steep house price increases and the related strong performance of real estate, construction and financial services probably contributed to above average growth in these states.

Some other US states, particularly the former manufacturing powerhouses in the "Great Lakes" region, saw a long episode of below average growth at the same time. Below average performance of the region – and particularly weaker growth rates in the states of Michigan and Ohio – are related to strong reliance on manufacturing. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP, with implications for areas with a high concentration of companies in manufacturing industries other than information and communications technology.

The sharp fall in house prices in Florida and the south-western US states turned boom into bust. These states experienced the harshest recession among the US states. But GDP growth in the "Great Lakes" region, which was below average before the crisis, also remained below average during the crisis.

Some euro area countries experienced asymmetric boom-and-bust cycles similar to those just described in the United States. Several euro area countries had higher than average growth in the pre-crisis years, while a few have experienced growth below the euro area average for the past decade due to structural issues that could have been tackled with more determination.

The effect of the crisis on the different euro area economies follows a similar pattern to those of comparable US states. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. More specifically, Ireland and Greece, in particular, remained in recession in 2010.

Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis.

Just a few years ago, Germany was – entirely wrongly – labelled the “sick man of Europe”. Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

The relatively low growth rates in some countries are linked to a deterioration of competitiveness, driven, for example, by persistent above average unit labour costs.

Ahead of EMU, unit labour costs converged in the euro area. What is more – disregarding the most recent countries to join the euro area – dispersion both ahead of the crisis and during the crisis was very similar in the euro area and the United States.

[See figure on dispersion of ULC]

At the same time, it is worth noting that both currency areas include regions with persistently above or below average growth of unit labour costs. Again leaving aside the most recent countries to join the euro area, here, Greece, Portugal and Ireland, in particular, have lost competitiveness vis-à-vis their main trading partners in the euro area. Germany, in contrast, has been able to lower relative unit labour costs over the same period.

[See fan chart on dispersion of ULC in EA]

Similar persistent losses and gains in competitiveness are also observed in the United States. Some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states, on the other hand, have been gaining competitiveness vis-à-vis the national average over the past decade.

[See fan chart on dispersion of ULC in the US]

In summary, these results suggest that those who are questioning the viability of the euro area as a single currency area on the grounds of economic heterogeneity are misguided. Over the past 12 years, this has been broadly similar in the euro area and the United States.

This should, however, be no reason for any complacency in the euro area.

As the crisis has taught us, persistent losses in competitiveness on the part of individual members in a currency union lead to a build-up of external and internal imbalances. When these unravel, the cost for the affected economies can be very large. They can also have spillover effects on other members of the currency union.

In any union, an economic governance framework is needed to prevent developments in an individual member state endangering the smooth functioning of the union. But for EMU, the economic governance framework devised in the 1990s has not been implemented and, in any case, has proved too weak during the crisis. The crisis has exposed a clear need for strong reform. As I speak today the reform debate is still in progress, and in the last part of my lecture, I would like to talk briefly about the present reform of economic governance in the euro area.

Economic governance in the euro area

The existing economic governance framework has been incorrectly implemented and, more importantly, has proved to be insufficiently binding while lacking appropriate comprehensiveness.

Today's reform of the governance framework has to take the current constitutional framework. We have to accept this situation as a given, at least for the foreseeable future, even if I am convinced that we have already to reflect upon further steps for economic governance in the longer term. Today, we have to empower the institutional arrangements that are already in place to the point at which they can really and durably inspire confidence.

The requirements for a very significant reinforcement of the fiscal surveillance of the Stability and Growth Pact and for the creation of a new surveillance of competitive indicators and macroeconomic policy have been discussed widely and in much detail.

As you may know, the ECB takes the strong view that there is the need for more speed and automaticity in the sanctioning mechanism, particularly in the Stability and Growth Pact, but also in the broader macroeconomic policy surveillance framework. The experience of the past months has vividly demonstrated the importance of a timely correction of internal and external imbalances.

Beyond faster and more automatic sanctions, the enforcement tools also need to be more effective. The macroeconomic surveillance framework, in particular, needs to provide clear incentives by imposing financial sanctions at an early stage. This also means that there should be no room for discretion in the implementation of the surveillance framework.

At the same time, requirements for fiscal and other macroeconomic policies should be more ambitious. To ensure that none of the euro area countries are left behind, they have to bring national policies in line with membership of a currency union.

The implementation of sound fiscal and macroeconomic policies is best ensured if these are solidly anchored at the national level. An effective way of achieving this is to implement strong national budgetary frameworks in the euro area Member States.

[See figure on governance reforms]

Another important area of reform, at the global level, is the reform of financial governance.

I have to say that on financial reform we have made relatively rapid progress at the global and European levels. As you know, we have drawn up a set of more stringent banking regulations, more ambitious capital requirements to absorb

losses, improving coverage and reducing the risk of excessive borrowing. The countercyclical capital buffers are designed to reduce pro-cyclicality.

At the same time, the supervision of financial institutions, financial markets and market infrastructure has been tightened, and the organisational structure of financial oversight has been overhauled. The European Systemic Risk Board (ESRB), which I chair together with Mervyn King, and the European Supervisory Authorities (ESAs) – the three new authorities created for the European banking sector, insurance and occupational pensions, and capital markets – have taken up their work at the beginning of this year. The ESRB is in the process of developing the tools necessary to warn and, if appropriate, make recommendations as regards systemic risk. And the ESAs will allow closer monitoring of the interrelationships within the EU's financial system.

But much remains to be done. Most importantly, we need to ensure the full implementation of the envisioned reforms. In addition, key areas where work is still in progress – not only at the European, but also at global level – include: the treatment of systemically important financial institutions; the mechanism of bank crisis management and resolution; oversight of the shadow banking system; and – very importantly – the further regulation and oversight of financial markets and their functioning.

[See figure on financial reforms]

Conclusion

Let me conclude. Europe's European Union on the one hand and European Economic and Monetary Union on the other hand have always had their critics. For example, as regards EMU, some have argued that a single currency was inappropriate for a continent that is economically more heterogeneous than the United States. And some have claimed that the ECB would not be able to set appropriate interest rates for the euro area to maintain price stability and contribute a positive economic outlook.

The evidence I have presented here proves these sceptical views not confirmed. The euro area as a whole has witnessed an unprecedented degree of price stability since its inception more than 12 years ago, including during the crisis. This achievement has been accompanied by economic performance in terms of growth per capita and job creation that compares positively with other large advanced economies.

It is also remarkable that there is convincing evidence that the euro area and the United States have similar features in terms of diversity of the economies that are part of these vast continents: member countries on this side of the Atlantic and the States on the other side. This is documented, in particular, as regards asymmetric inflation, asymmetric growth developments and even in terms of somewhat persistent asymmetric gains and losses of competitiveness.

As I have said, none of this should make us complacent. The sovereign debt crises in three smaller euro area countries underline the urgency of a far-reaching overhaul of the fiscal and macroeconomic surveillance institutions in Europe. Here the governments of the Member States are called on to create the institutions that are commensurate with full economic and monetary union.

Two continents compared

Keynote address by Jean-Claude Trichet, President of the ECB at the "ECB and its Watchers XIII" conference Frankfurt am Main, 10 June 2011

Ladies and Gentlemen,

As always, it is a pleasure for me to open this conference today.

Four years ago at this gathering, I compared monetary policy in the euro area and in the United States. Today, I would also like to talk to you on the theme of "two continents compared". As we are all too well aware, much has happened on both sides of the Atlantic since 2007, and it is useful to take stock again. But this time, I would like to focus less on monetary policy and more on the wider economies of the two continents.

The crisis has exposed in both continents the issue of heterogeneity – a wide diversity of experience across different parts of the whole. As we will see, the economic fallout from the crisis and the ensuing recovery have shown considerable variation among the US states. And as we know, the same is true in the euro area, where some countries are a particular focus of attention.

But before turning to the issue of regional heterogeneity and the appropriate coordination of regional policies within an economic and monetary union (EMU), let me briefly take a bird's eye view of the euro area.

I. A bird's eye view of the euro area

Speaking here four years ago I looked back at the ECB's monetary policy over the period 1999-2006. I showed a scatterplot of inflation volatility and output volatility for the euro area and other advanced countries.

Academic research suggests that there might be a trade-off between these two variables and that it is therefore difficult to have low inflation volatility and low output volatility at the same time. But what the chart showed was that the euro area scored well on both dimensions.

This seemed puzzling given that the euro area has quite rigid product and labour markets, at least compared with the United States. The higher degree of price and wage rigidity in the euro area would suggest that output volatility should be significantly larger in the euro area than in the more flexible US economy.

This would be particularly true during a period when the economy is subject to supply-side shocks, which are exerting simultaneously inflationary and recessionary influences. Yet surprisingly, and despite the negative supply-side shocks that had been hitting the euro area economy over the years up to 2007, the data suggested that both inflation volatility and output volatility in the euro area were lower than elsewhere.

Has the crisis changed this picture?

[See macro volatility chart]

Obviously, output volatility in the euro area is much higher when the crisis is included in the sample. But, remarkably, the euro area still scores well on both dimensions compared with other advanced countries.

So what is behind this apparent puzzle? How can nominal rigidities plus supply-side pressures not produce bad or worse macroeconomic outcomes?

As I explained in detail four years ago, I believe that the strong anchoring of inflation expectations in the euro area is the key to understanding these developments.

[See chart on inflation expectations in the euro area and the US]

Inflation expectations have remained solidly anchored in line with our definition of price stability throughout the crisis. There was no materialisation of a deflation risk. This has enormously facilitated our task, especially during the period of economic freefall in the winter of 2008/09.

Other indicators corroborate the finding that at the aggregate level the euro has been a remarkable success:

- Annual inflation over the first 12 years of EMU has been 1.97% on average. This outcome is fully in line with our aim of keeping inflation below, but close to 2% over the medium-term. What is equally noticeable is that it is a better result, in terms of price stability, than in the euro area Member States over the last 50 years.
- Real output per capita has grown at a similar pace in the euro area than in the United States, which – in terms of economic dynamism – remains the benchmark for the advanced countries.

[See chart on GDP per capita growth in the euro area and the US]

- Employment growth in the euro area has been strong over the past 12 years. More than 14 million jobs have been created since the introduction of the euro, compared with 8 million in the United States.
- Finally, public finances in the euro area as a whole are sound. As elsewhere, the financial crisis has left its mark on government deficit and debt in the euro area. Yet, the fiscal deficit in the euro area on aggregate for this year is estimated at less than one half of that in the United States and Japan. Recent forecasts indicate that the euro area as a whole is on track to bring the deficit to GDP ratio below the 3% reference value by 2013 and to stop the adverse debt dynamics caused by the financial crisis.

Of course, there is absolutely no reason for complacency in the euro area. Much more remains to be done, especially in terms of employment creation, reduction of the level of unemployment and enhancement of Europe's growth potential.

But, we should recognise that the euro has acted in many areas as a catalyst for structural change. If euro area member states take up the challenge of adjusting, there is every reason to be confident about the future.

II. Heterogeneity in the euro area and the United States

So much for the bird's eye view. Let me now zoom in on the regional dimension and focus on heterogeneity within EMU compared with the United States.

You may argue that the bird's eye view is misleading. The US economy may be more homogeneous than the economy of the euro area. In other words, aggregate economic data may hide the variance in economic performance across regions within a monetary union.

Looking more closely at the regional dispersion across US regions and euro area economies suggests otherwise. In fact, the dispersion of many of the key indicators is similar.

Let me start off with the inflation indicator. Before the crisis, the dispersion of HICP inflation in euro area countries had remained broadly stable since the late 1990s, at a level similar to the 14 US Metropolitan Statistical Areas. During the crisis we saw a temporary increase in inflation dispersion in the euro area but this has been reversed over the past 12 months.

[*See figure on dispersion of annual inflation*]

The picture is similar for the dispersion of GDP growth. Before the crisis the dispersion of growth rates was around 2%, in both the euro area and the United States. Dispersion rose somewhat during the crisis in both currency areas but remained broadly in line with pre-crisis patterns overall. [1]

[*See figure on dispersion of real GDP growth*]

Going one step further, investigation of the sources of this growth dispersion in the US and euro area economies reveals parallels even in the root causes of dispersion in economic performance. Both currency areas comprise regions that experienced a significant boom and bust cycle over the past decade. Both also contain regions that are facing significant structural challenges of a more long-term nature.

In the United States, for example, Nevada, Arizona, Florida and California experienced increases in house prices that outpaced the national average by a wide margin. The steep house price increases probably contributed to above average growth in these states, owing to strong positive contributions from real estate, construction and financial services. These sectors all saw their share in terms of value added to GDP increase at the national level during the years of the housing boom.

But at the same time, some US states, particularly the former manufacturing powerhouses in the "Great Lakes" region, have seen a long episode of below average growth. Below average performance of the region – and particularly weaker growth rates in the states of Michigan and Ohio – are related to strong reliance on manufacturing. Structural shifts in the US economy towards services have gradually reduced the value added of manufacturing relative to GDP, with implications for areas with a high concentration of companies in manufacturing industries other than information and communications technology.

The sharp fall in house prices in Florida and the south-western US states turned boom into bust. These states experienced the harshest recession among the US states.

But GDP growth in the "Great Lakes" region, which was below average before the crisis, also remained below average during the crisis.

Note that the states with the best economic performance in the United States during the crisis – among them, Wyoming and Alaska – have benefited from their dependence on mining.

Similarly, in the euro area some countries experienced asymmetric boom-and-bust cycles. Several euro area countries had higher than average growth in the pre-crisis years. In Ireland and Spain particularly, a large part of this growth can be ascribed to increases in housing prices.

Other countries in Europe – Portugal, for example – have experienced growth persistently below the euro area average for the past decade due to structural issues that could have been tackled with more determination.

Just a few years ago, this group of countries included Germany – then labelled, totally wrongly, the “sick man of Europe”. Yet Germany is now an example of how big the dividends of reform can be if structural adjustment is made a strategic priority and implemented with sufficient patience.

The effect of the crisis on the different euro area economies follows a similar pattern to those of comparable US states. The countries in the euro area that have been hit hardest are those in which either large asset-bubble driven imbalances unwound or structural problems were left unaddressed before the crisis. More specifically, Ireland and Greece, in particular, remained in recession in 2010.

Those countries that have yet to implement more far reaching structural reforms also have relatively low growth prospects after the crisis.

These relatively low growth rates are linked to a deterioration of competitiveness, driven, for example, by persistent above average unit labour costs.

Ahead of EMU, unit labour costs converged in the euro area. What is more – disregarding the most recent countries to join the euro area – dispersion both ahead of the crisis and during the crisis was very similar in the euro area and the United States.

[*See figure on dispersion of ULC*]

At the same time, it is worth noting that both currency areas include regions with persistently above or below average unit labour cost growth. Again leaving aside the most recent countries to join the euro area, here, Greece, Portugal and Ireland, in particular, have lost competitiveness vis-à-vis their main trading partners in the euro area. Germany, in contrast, has been able to lower relative unit labour costs over the same period of time.

[*See fan chart on dispersion of ULC in EA*]

Similar persistent losses and gains in competitiveness are also observed in the United States. Some states have experienced large or persistent increases in unit labour costs, currently exceeding the national average by as much as 20%. Other states, on the other hand, have been gaining competitiveness vis-à-vis the national average over the past decade.

[*See fan chart on dispersion of ULC in the US*]

In summary, these results suggest that those who are questioning the viability of the euro area as a single currency area on the grounds of economic heterogeneity are misguided. Over the past 12 years, heterogeneity in the euro area and the United States has been broadly similar.

This should, however, be no reason for any complacency in the euro area.

As the crisis has taught us, persistent losses in competitiveness on the part of individual members in a currency union lead to a build-up of external and internal imbalances. When these unravel, the cost for the affected economies can be very large. They can also have spillover effects on other members of the currency union.

In any union, an economic governance framework is needed to prevent developments in an individual member state endangering the smooth functioning of the union. But for EMU, the economic governance framework devised in the 1990s has not been correctly implemented and, in any case, has proved too weak during the crisis. The crisis has exposed a clear need for strong reform. As I speak today the reform debate is still in progress, and in the last part of my remarks today, I would like to talk briefly about the present reform of economic governance in the euro area.

III. Economic governance in the euro area

The euro is the only major currency not issued by a single sovereign state, but by a union of states.

The Treaties specify a clear division of responsibilities between European and national policy-makers within EMU. On the one hand, monetary policy is inherently indivisible, and in the euro area it is thus conducted at the supranational level by the ECB. On the other hand, fiscal policies remain largely the competence of national governments.

Today's reform of the governance framework has to take the current constitutional framework as a given. For the foreseeable future we have to empower the institutional arrangements that are already in place to the point at which they can really and durably inspire confidence.

The economic governance framework has been incorrectly implemented and, more importantly, has proven to be insufficiently binding whilst lacking appropriate comprehensiveness.

The requirements for a very significant reinforcement of the fiscal surveillance of the Stability and Growth Pact and for the creation of a new surveillance of competitive indicators and macroeconomic policy have been discussed widely.

As you know, the ECB takes the strong view that there is the need for more speed and automaticity in the sanctioning mechanism, particularly in the Stability and Growth Pact, but also in the broader macroeconomic policy surveillance framework. The experience of the past months has vividly demonstrated the importance of a timely correction of internal and external imbalances.

Beyond faster and more automatic sanctions, the enforcement tools also need to be more effective. The macroeconomic surveillance framework, in particular, needs to provide clear incentives by imposing financial sanctions already at an early stage. This also means that there should be no room for discretion in the implementation of the surveillance framework.

At the same time, requirements on fiscal and other macroeconomic policies should be more ambitious. To ensure that none of the euro area countries are left behind, they have to bring national policies in line with the membership to a currency union.

The implementation of sound fiscal and macroeconomic policies is best ensured if these are solidly anchoring at national level. An effective way of achieving this is to implement strong national budgetary frameworks in the euro area Member States.

Another important area of reform, at the global level, is the reform of financial governance.

I have to say that on financial reform we have made more rapid progress. As you know, we have drawn up a set of more stringent banking regulations, more ambitious capital requirements to absorb losses, improving coverage and reducing the risk of excessive borrowing. The countercyclical capital buffers are designed to reduce pro-cyclicality.

At the same time, the supervision of financial institutions, financial markets and market infrastructure has been tightened, and the organisational structure of financial oversight has been overhauled. The European System Risk Board and the European Supervisory Authorities – the three new authorities created for the European banking sector, insurance and occupational pensions, and capital markets – have taken up their work at the beginning of this year. The ESRB is in the process of developing the tools necessary to warn and, if appropriate, make recommendations as regards systemic risk. And the ESAs will allow closer monitoring of the interrelationships in the financial system of the European Union.

- But much remains to be done. Most importantly, we need to ensure the full implementation of the envisioned reforms. In addition, key areas where work is still in progress – not only at the European, but also at global level

– include: the treatment of systemically important financial institutions; the mechanism of bank crisis management and resolution; oversight of the shadow banking system; and – very importantly – the further regulation and oversight of financial markets and their functioning.

IV. Conclusion

Let me conclude. The euro area as a whole has witnessed an unprecedented degree of price stability since its inception more than 12 years ago. This has been accompanied by economic performance in terms of growth per capita and job creation that compares positively with other large advanced economies.

It is also remarkable that there is convincing evidence that the euro area and the United States of America have similar features in terms of diversity of the economies that are part of these vast continents: member countries on this side of the Atlantic and the States on the other side. This is documented, in particular, as regards asymmetric inflation, asymmetric growth developments and even in terms of somewhat persistent asymmetric gains and losses of competitiveness.

Therefore, it is important to redress a common belief which is unfounded, in my opinion, namely that the euro area as a whole is significantly more heterogeneous economically, with more dispersion and higher levels of standard deviation of a number of important indicators than the US.

But what remains true is that governing these very vast and equally diverse economies with a single currency is more of a challenge in a union of sovereign states than in a political federation. That is the reason why the European Central Bank is stressing tirelessly the necessity of strongly reinforcing the euro area economic governance. The economic policy of each member of the euro area has to be aligned with the requirements of EMU. As Alexander Hamilton said two hundred years ago: we should ourselves “learn to think (more) continentally”.

The monetary policy of the ECB during the financial crisis

Speech by Jean-Claude Trichet, President of the ECB, Montreal, 6 June 2011

Prime Minister,

Rector of the University of Montreal,

Chancellor,

President of the Board of Governors,

Secretary-General of the University of Montreal,

It is a great honour and pleasure to be awarded this honorary doctorate. The University of Montreal has a global reputation for excellence. And I particularly appreciate the kindness of your introduction, even if it seems to me to be too flattering…

I intend to share with you my thoughts on the decisions taken by the European Central Bank in the period we have been experiencing since August 2007. This period started, as you know, several weeks after the Montreal conference of June 2007 which I had the pleasure to attend.

Just a comment to journalists here: I should say that I’m in the one-week period preceding the meeting of the Governing Council during which no indication must be given about future decisions. Please don’t draw any conclusions on what I’m about to say in terms of future monetary policy decisions.

* * *

As you know, the main task of the ECB is to ensure price stability in the euro area. The heads of state or government in Europe enshrined this mission in the European Union treaties in 1992. Pursuant to this mandate, the Governing Council’s objective is to keep inflation rates below, but close to, 2% over the medium term.

The ECB has accomplished its mission over the past 12 years. During this period, the average annual inflation rate stood at 1.97% in the euro area.

It is important to grasp the significance of this achievement. Over these 12 years, the ECB has faced many challenges in pursuing its objective of price stability: the bursting of the dot-com bubble, the shock wave of 11 September 2001, the volatility of commodity prices and, of course, the worst financial crisis the world has known since the Second World War.

I would like to discuss today in particular our response to the crisis and the reform programmes of financial regulation and economic governance in which the euro area and the European Union as a whole are engaged.

I. The measures taken by the ECB in response to the crisis

During the crisis, together with other central banks around the world, the ECB has had to operate in an uncertain environment.

It should be noted that we have been vigilant from the very first day. When the problems started to appear in the financial markets, on 9 August 2007, we were the first central bank to react, taking action very quickly.

In parallel, dysfunctioning financial markets have threatened to compromise our ability to guide the outlook for price stability by using our conventional instrument – interest rates. Faced with this situation, over the years that followed, we have implemented a number of unconventional measures to ensure that our decisions on interest rates are transmitted to the whole economy, despite the problems observed in the financial sector and capital markets. In particular, it was to allow banks – regardless of the level of the key interest rate – to continue to lend to households and businesses.

From the outset of the crisis we have established the principle of strict separation between our unconventional and our conventional measures, that is to say, our policy rate of interest. Our interest rates are fixed so that we can ensure price stability over the medium term. The implementation of unconventional measures depends on the functioning of the monetary policy transmission mechanism and must respond to the degree of dysfunctioning or disruption of monetary and financial markets and market segments.

As the crisis called for rapid and unprecedented action, we never lost sight of our main objective, namely to maintain price stability over the medium term for the benefit of the 331 million citizens of the euro area. All – I stress that word – all monetary policy decisions we have taken over the last 12½ years were aimed at complying with this commitment.

Let me elaborate on this point. As you know, in normal times, central banks mainly influence the economy and inflation by using the instrument for setting short-term interest rates.

In practice, the identification, at an early stage, of the risks to price stability is a delicate task. To see it through, the ECB bases itself on a monetary policy strategy supported by several sources of information. The economic analysis we undertake enables us to synthesise information on short-term inflationary pressures from a large number of economic indicators. Thanks to the monetary analysis that we also carry out, we can cross-check this information with that concerning medium-term inflationary pressures drawn from the monetary and financial indicators. These are the two “pillars” of our monetary policy which indicate to us the necessary steps in respect of the interest rate to ensure price stability over the medium term.

The decisions we have taken in response to political pressures have demonstrated our independence. We refused to lower interest rates in early 2004 when Germany, France and Italy in particular asked us to do so. We did not hesitate to raise interest rates in December 2005. At that time, ten governments in the euro area out of 12 and many international observers asked the ECB to leave its key rates unchanged.

International financial institutions, in particular, highlighted the risks that the tightening of monetary policy – after a prolonged period of accommodative monetary policy – could pose to the recovery. Despite these warnings, we conducted our monetary tightening, and international financial institutions have agreed that we were right to make that decision.

After the crisis escalated in mid-September 2008, while inflationary pressures subsided, we decided, in full accordance with our mandate, to reduce our key interest rate. We cut it rapidly, from 4.25% in October 2008 to 1% in May 2009.

We lowered the key interest rate at a pace and a level unprecedented in the recent history of the euro area countries.

With the benefit of hindsight, the decisions we took during the crisis were effective. They have in particular helped to preserve a very solid anchoring of inflation expectations over the past four years. Our determination to maintain price stability over the medium term has enabled us to prevent both the risk of inflation and of deflation from materialising.

With the recovery now more firmly established, we have seen in recent months upside risks to the outlook for price stability over the medium term. Again, the sharp increase in oil and other commodities has had a major impact on overall inflation. In these circumstances, the central bank must prevent increases in the prices of raw materials from being incorporated into the long-term inflation expectations, which could trigger second-round effects on wages and prices.

It is against this background that the Governing Council decided in April to raise interest rates. I stressed in reporting this decision it had been taken unanimously. The action of the Governing Council is motivated by a common goal.

That decision in April confirmed that the separation principle is strictly applied and that our non-conventional measures do not restrict in any way our ability to toughen the monetary policy stance when facing inflationary pressures. Thus, when the Governing Council decided in March and April that it was time to raise interest rates, in parallel, at the same time, it decided to keep, in the second quarter, the provision of unlimited fixed-rate liquidity for a period of three months.

Let me remind you of what I said earlier: nothing of what I have just said can or should be interpreted in terms of future decisions of the Governing Council next Thursday.

II. The economic and financial reforms brought about by the crisis

The tensions we face in Europe today are not a crisis of the euro. They do not indicate a crisis in the monetary union. The single currency has kept its promise to provide price stability in the euro area.

The current crisis stems rather from insufficient monitoring of economic policies in some Member States. Today, it's not the monetary pillar of Economic and Monetary Union that is at stake, but the economic pillar. If we refer to the acronym of that union, EMU, we can say that the concerns relate to the "E" rather than "M" in the EMU.

In the rest of my remarks I'll consider what is being done now in Europe to strengthen the economic pillar of EMU.

The main cause of the crisis has been the negligence of financial risk. It has necessitated the implementation of a programme of comprehensive reforms for virtually every aspect of the global financial system. We have to control the forces that led the system to think only about itself and put an end to this situation so that the system serves the real economy. And we have to ensure that the financial system contributes to sustainable economic growth.

At this point, we have drawn up a set of more stringent banking regulations, providing capital to absorb more losses, improving coverage and reducing the risk of excessive borrowing. The countercyclical capital buffers are designed to reduce pro-cyclicality.

The supervision of financial institutions, financial markets and market infrastructure is increasing, while the organisational structure of financial oversight is being overhauled.

But much remains to be done. The most important aspect concerns the implementation of these reforms. In addition, the issue of financial institutions of systemic importance still has to be settled, and should strengthen the oversight of financial markets. We cannot allow ourselves to suffer from a lack of transparency and the excessive influence of dominant players and oligopolistic market structures.

The new European System of Financial Supervision (ESFS) represents an important step forward. The three new authorities created for the European banking sector, insurance and occupational pensions, and capital markets allow closer monitoring of the interrelationships and impact of contagion in the financial system of the European Union. Finally, the European Systemic Risk Board (ESRB) is developing the tools necessary to warn and, if appropriate, make recommendations on measures to cope with potential sources of systemic risk.

If negligence of financial risk is the main cause of the crisis, the macroeconomic risk – and the many channels through which this risk interacts with fragile budgetary structures – is causing the budget problems which some countries in the euro area are facing today. These considerations bring me to the issue of reforming economic governance.

The euro is unique among international currencies. It is the major currency that is not issued by a sovereign state, but by a union of states. Monetary policy is inherently indivisible in a monetary union, and for the euro area, it is conducted at European level. In contrast, fiscal policies and other macroeconomic policies continue to be largely the responsibility of national governments and reflect national political preferences.

Our economic governance framework has so far not managed to guarantee the implementation of sound policies in all Member States. The Treaty makes clear that Member States have pledged to pursue economic policies aimed at furthering the objectives of the Union, one of which is a stable single currency. It's an obligation which they have not yet fully discharged.

The European Union is about to set up monitoring mechanisms, specifically targeting the imbalances and differences in competitiveness within the euro area. This should have been done long ago. Since 2005, within the Eurogroup, and then publicly, shortly thereafter, the ECB has warned against the considerable risks arising from these differences, which would be the subject of corrective action.

If fully implemented – which of course is absolutely essential – macroeconomic surveillance will ensure a smoother functioning of EMU. It will require Member States to take measures to counter the emergence of macroeconomic imbalances at an early stage, before they weigh down on the macroeconomic outlook and assume a systemic dimension.

From 1997, even before the creation of EMU, the euro area governments had adopted the Stability and Growth Pact to prevent a debt crisis. As you know, the Pact requires EU countries to limit their budget deficit and national debt to 3% and 60% of GDP.

But in 2005, Member States decided to reform the Pact. At the request of Germany, France and Italy in particular, a greater freedom of action and greater flexibility was introduced into the monitoring procedures, to the detriment of the effectiveness of the Pact, a move which has weakened it considerably.

I then expressed, on behalf of the Governing Council, the serious concerns of the ECB regarding the negative impact of these reforms on the functioning of EMU.

It is important that Member States have recognised their error and intend to strengthen the Pact. The focus on fiscal sustainability and reducing public debt levels, supported by more effective sanctions, is a step in the right direction.

That said, the Governing Council of the ECB is concerned that, although they are going in the right direction, the economic governance reforms being discussed are not ambitious enough to correct the structural weaknesses of fiscal governance and, more broadly, macroeconomic governance, of the euro area. We believe that we can immediately go further in the 'secondary legislation' with the current Treaty. It is particularly suited to enhance the automaticity of the application of sanction mechanisms. Countries in the euro area that violate our common rules should be accountable for their policies, and freedom of action and flexibility in this field should be reduced as much as possible. This implies a reduction of the margin of manoeuvre to terminate or suspend proceedings and the introduction of stricter deadlines.

In this context, we advocate a strengthening of sanctions to encourage countries to abide by the rules. This would require, first, a wider range of financial and non-financial measures and, second, reduced freedom of action to reduce or suspend them. Such strengthening would improve efficiency and create the right incentives.

Meanwhile, more ambitious demands in terms of economic policy would be more in line with the reality prevailing in the euro area. Ambitious benchmarks should be the basis when establishing the level of the excessive deficit and setting the adjustment path leading to a sound fiscal position. It is very important that macroeconomic surveillance clearly focuses on the countries with the greatest vulnerabilities.

The anchoring of these new rules at national level would strongly inscribe them in national legislation. A binding commitment on the part of Member States to implement sound domestic fiscal frameworks is essential to ensure national 'ownership'. Finally, in our opinion, it would be appropriate to further improve the production of fiscal statistics.

All these issues are being discussed in the trialogue between the Commission, European Council and Parliament. The Governing Council of the ECB is confident that Parliament will push the Council further towards strengthening economic surveillance.

III. Conclusion

Let me conclude. The crisis has posed significant challenges for the euro area. But we have reacted to them. The European Central Bank has been an anchor of stability in a turbulent period. Price stability has been ensured. All countries in the euro area – without exception – have benefited from it.

We must not forget either that the euro area as a whole has made significant progress over the past 12 years. The economic dynamics of the euro area is the same order of magnitude as those registered in the United States. In both economic regions, per capita income has risen on average by about 1% annually. In the euro area, job creation has been stronger than in the US. Over the past 12 years, more than 14 million jobs have been created in the euro area.

I can assure you that the European Central Bank will continue to contribute to the smooth functioning of monetary union by continuing to be the anchor of stability and confidence that is so necessary.

Rector of the University, Secretary-General, let me thank you again for the great honour of being awarded this honorary doctorate from the University of Montreal.

Building Europe, building institutions

Speech by Jean-Claude Trichet, President of the ECB on receiving the Karlspreis 2011 in Aachen, 2 June 2011

Lord Mayor,

Presidents of the European Council, the European Commission, the European Parliament and the Eurogroup,

Former recipients of the Karlspreis,

President of the Deutsche Bundesrat,

Excellencies,

Ministers,

Members of the European Parliament and national parliaments,

Members of the ECB's Governing Council,

Members of the Karlspreis Foundation,

Ladies and gentlemen,

It is an immense honour to receive the Karlspreis today.

I find it difficult to put into words how deeply humbled I am to join the most impressive company of the prize recipients. To borrow the words of Sir Isaac Newton, I feel as if I *am standing on the shoulders of giants.*

I express my most profound gratitude to the Karlspreis foundation for bestowing this honour. I know that this prize goes to my colleagues of the Executive Board who are present today and to all staff of the European monetary team: the European System of Central Banks. I am moved by the kind words of President Barroso and the faith the Karlspreis foundation have placed in us as true Europeans.

* * *

Each generation needs to affirm its commitment to Europe.

For the generation that lived through the Second World War, Europe was essential to prevent a return to the depression and the horrors of that war.

For the generation after, Europe was the cornerstone of building prosperity through economic freedom and open markets.

For the current generation, these achievements are taken for granted. Citizens have new concerns.

They want to be told why European unity is more important than ever in the present globalised world to ensure peace and security; why the European Union is vital to ensure and promote the interests of the European nations; why the

European economies and societies are much more interdependent today than immediately after World War II; and how these interests and this interdependence should be best governed.

In all domains this calls for continuing to strengthen Europe's institutional framework. In the economic and financial fields it demands to reinforce in a decisive way the institutions of the economic and monetary union.

By institutions, I do not mean technocrats making complex decisions remote from citizens.

I mean the rules and organisations that preserve our core values and guide our actions towards the common good.

Institutions that build trust between peoples and nations in Europe.

Institutions that foster cooperation for mutual benefit.

Institutions that manage our interdependence by preparing collective decisions.

As Jean Monnet put it, *"Nothing is possible without men and women, but nothing is lasting without institutions."*

We are privileged in Europe to have institutions that contribute to binding together our continent, that embody the values of the European project and carry it further.

The European Commission, led by Mr. Barroso, is at the heart of this process. The European Council, led by Mr. Van Rompuy, gives it direction and momentum from the highest level. In the domain of Economic and Monetary Union, the Eurogroup, led by Mr. Juncker, drives forward its agenda and confronts its challenges.

In keeping with the vision of the Karlspreis, I will focus my remarks today on how developing further our common institutions is the key to the next stage of European economic and financial integration.

My main message is that the achievements of economic and monetary union (EMU) to date have been made possible by the ECB and the Eurosystem, the strong institutions of monetary union – the M in EMU. In the same vein, confronting the challenges of the future requires strengthening the institutions of economic union – the E in EMU.

Economic and Monetary Union

EMU is the area where Europe has progressed furthest.

It is a union where sovereign nations share a single market, a single economy and a single currency. Where they bind their actions through common laws and institutions. Where they remain unified and diverse at the same time.

This unique arrangement fulfils the visions of centuries of great European thinkers.

… of Erasmus in the 16th century, who spelled out the moral limitations of a strict concept of nationhood

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… and of Robert Schuman in the 20th century, who saw that the foundation of all of the above would be economic integration.

It is important to keep in mind this historical perspective, seeing beyond the current challenges in the euro area. EMU is itself an unprecedented achievement in the history of sovereign nations – a goal to which generations of Europeans have aspired.

EMU is a historical process designed to bring real economic benefits for Europe's citizens. We should not overlook what has been achieved in this area.

EMU has brought growth. Over the first decade of the euro, GDP growth per person has been of the same order of magnitude as in the United States.

EMU has fostered trade. Not only inside the Euro area (+50% increase in trade volumes over the first years of the euro), but even more so with the European Union as a whole and the rest of the world (+80% over the same period). EMU is not a closed shop. On the contrary, it is the most open of the large economies in the world.

EMU has brought employment. Employment has increased by 14 million since the creation of the euro, compared with a rise of about 8 million in the United States.

EMU has brought price stability. The average yearly inflation rate in the euro area during its first 12 years was 1.97%. That is fully in line with our definition of price stability at the European Central Bank (ECB): an inflation rate below but close to 2% over the medium term.

And EMU has brought monetary stability. The euro is a solid and credible currency, trusted by our fellow citizens, investors and savers.

There is no "crisis of the euro".

The ECB and the euro

In 2002, the Karlspreis Foundation awarded the prize to the euro. The Foundation stressed how the euro was the logical step to maximise the benefits of the single market for sustainable growth and job creation.

On the evidence accumulated in the first twelve and a half years, the ECB has delivered on this promise.

The Treaty has mandated the ECB to keep safe the money of Europe's citizens. And it has given the ECB the capability and the full independence to perform this task effectively.

These two aspects are akin to Max Weber's ethics of conviction and responsibility. Our mandate gives us our conviction. Determined action reflects our responsibility.

In the difficult circumstances afflicting all the advanced economies since the start of the crisis in 2007, the ECB Governing Council demonstrated both conviction and responsibility.

We have shown conviction in steadfast commitment to price stability. Before and during the crisis, all our decisions on interest rates – we call them "standard decisions" – have been designed in order to give our fellow citizens price stability over the medium term.

And, as I just said, over the first twelve years we have delivered average yearly inflation at the level of less than 2%: it is a better result than the previous national currencies over the last 50 years, including the Deutsche Mark. Here in Aachen, I can say, the promise "stark wie die Mark" has been fully respected.

Since the crisis we also had to cope with financial turbulences, abnormal functioning of markets and disruption of certain segments of markets.

We showed our responsibility in taking monetary policy measures – we call them "non standard" decisions, strictly separated from the "standard" decisions, and aimed at restoring a better transmission of our monetary policy in these abnormal market conditions.

All these "non standard" measures – whether exceptional refinancing with full allotment and longer duration, or the interventions in private or public securities markets – have been designed to be commensurate to the tensions observed on these markets and allow a better transmission of our interest rates decisions.

In demonstrating both conviction and responsibility, the ECB has been, during the last four years, a reliable and solid anchor of stability to the service of our fellow citizens in the worst economic and financial circumstances since World War II.

Had we not been able to present a solid anchor of stability and confidence, the recovery the euro area has experienced since May 2010 would probably have been very different. The increase in GDP of over 2.5% in the past 12 months would not have happened. The increase in employment by 350,000 jobs since then might not have been there.

In deciding on all our measures, standard and non-standard, we have the needle in the compass on our primary objective: price stability for the 331 million fellow citizens of the euro area.

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The same gratitude goes to the 1,600 staff members at the ECB in Frankfurt. They come from all 27 countries of the EU. They are a shining example of professionalism and team spirit, of what it means to work together for Europe.

Current challenges for governance

Just as the success of the euro as a currency is due to well-designed institutions, addressing EMU's difficulties requires a major strengthening of the rules and organisations that govern fiscal and economic policies.

Looking at the euro area today, we see clearly that countries that abide by the rules of the single currency can thrive and prosper. Sound policies and a healthy economy are strongly correlated.

But we also see the opposite. Countries that have not lived up to the letter or the spirit of the rules have experienced difficulties. Via contagion, these difficulties have affected other countries in EMU.

Strengthening the rules to prevent unsound policies is therefore an urgent priority. It is the means to allow all countries to reap the full benefits of the single currency. And it prohibits individual countries from pursuing policies that harm themselves and the euro area as a whole.

For this reason, I have called, in the name of the Governing Council, on the Commission, the Council and the European Parliament to be very ambitious in reinforcing economic governance in the euro area. We have called for a "quantum leap" in governance now, to draw all the immediate lessons from the first years of Economic union and from the weaknesses revealed by the global crisis.

I count particularly on the European Parliament to reinforce the draft secondary legislation that is presently examined in the "trialogue" between the Parliament, the Commission and the Council.

Which possible changes of governance could be envisaged in the medium term?

In the aftermath of the global financial crisis, we face the challenge of supporting countries that experience financial difficulties.

Arrangements are currently in place, involving financial assistance under strict conditions, fully in line with the IMF policy. I am aware that some observers have concerns about where this leads. The line between regional solidarity and individual responsibility could become blurred if the conditionality is not rigorously complied with.

In my view, it could be appropriate to foresee for the medium term two stages for countries in difficulty. This would naturally demand a change of the Treaty.

As a first stage, it is justified to provide financial assistance in the context of a strong adjustment programme. It is appropriate to give countries an opportunity to put the situation right themselves and to restore stability.

At the same time, such assistance is in the interests of the euro area as a whole, as it prevents crises spreading in a way that could cause harm to other countries.

It is of paramount importance that adjustment occurs; that countries – governments and opposition – unite behind the effort; and that contributing countries survey with great care the implementation of the programme.

But if a country is still not delivering, I think all would agree that the second stage has to be different.

Would it go too far if we envisaged, at this second stage, giving euro area authorities a much deeper and authoritative say in the formation of the country's economic policies if these go harmfully astray? A direct influence, well over and above the reinforced surveillance that is presently envisaged?

The rationale for this approach would be to find a balance between the independence of countries and the interdependence of their actions, especially in exceptional circumstances.

We can see before our eyes that membership of the EU, and even more so of EMU, introduces a new understanding in the way sovereignty is exerted. Interdependence means that countries *de facto* do not have complete internal authority. They can experience crises caused entirely by the unsound economic policies of others.

With a new concept of a second stage, we would change drastically the present governance based upon the dialectics of surveillance, recommendations and sanctions.

In the present concept, all the decisions remain in the hands of the country concerned, even if the recommendations are not applied, and even if this attitude triggers major difficulties for other member countries.

In the new concept, it would be not only possible, but in some cases compulsory, in a second stage for the European authorities – namely the Council on the basis of a proposal by the Commission, in liaison with the ECB – to take themselves decisions applicable in the economy concerned.

One way this could be imagined is for European authorities to have the right to veto some national economic policy decisions. The remit could include in particular major fiscal spending items and elements essential for the country's competitiveness.

Which possible changes of governance in the historical long term?

Looking much further ahead, we should wonder what will be the future political institutional framework of Europe.

Immanuel Kant argued that, where countries are interdependent, institutions will continue to develop between them until a stable equilibrium is reached. In his words, "a state of affairs… that can maintain itself automatically."

And Jean Monnet in his memoirs 35 years ago wrote: "Nobody can say today what will be the institutional framework of Europe tomorrow because the future changes, which will be fostered by today's changes, are unpredictable."

In a long term historical perspective, Europe – which has invented the concept and the word of democracy – is called to complete the design of what it already calls a "Union".

The future political institutional framework of the Europeans will not be the simple imitation of existing models. On a personal basis, as a European citizen, I think that, like at the very moment of the birth of the concept of democracy, the Europeans will not be imitators but rather setting examples, with a Union that will be a confederation of sovereign states of an entirely new type. This naturally will call for a very important change of the Treaty and will have consequences in all the Union's responsibilities.

In this Union of tomorrow, or of the day after tomorrow, would it be too bold, in the economic field, with a single market, a single currency and a single central bank, to envisage a ministry of finance of the Union?

Not necessarily a ministry of finance that administers a large federal budget. But a ministry of finance that would exert direct responsibilities in at least three domains: first, the surveillance of both fiscal policies and competitiveness policies, as well as the direct responsibilities mentioned earlier as regards countries in a "second stage" inside the euro area; second, all the typical responsibilities of the executive branches as regards the union's integrated financial sector, so as to accompany the full integration of financial services; and third, the representation of the union confederation in international financial institutions.

Which institution of this confederation of sovereign states of a new type will exert these responsibilities, will be decided by the people of Europe, as Jean Monnet suggested. I am sure that the President of the European Council, the President of the Commission, the President of the Eurogroup and the German Minister of Finance – who are all present here – have their own sentiment on this question.

Conclusion

Let me come to a conclusion, and don't be surprised that a central banker shares with you some thoughts on the subject of culture. It is often suggested that Jean Monnet said "if I had to do it again, I would start first through culture." The cultural unity of Europe is at the root of the European endeavour, including economic and monetary union.

Let me give you two complementary readings of Europe's cultural unity.

The first is the vision of Husserl in his famous Vienna lecture of May 1935. He sees the origin of the spiritual form of Europe in its philosophical roots. I am quoting: "One can see that it is the starting point of a new kind of community, one which extends beyond nations. It is now no longer a number of different nations living alongside each other and only influencing each other through commercial competition or power struggles, but it is: a new spirit – stemming from philosophy and the sciences based on it – a spirit of free criticism, providing norms for infinite tasks, and it dominates mankind creating new, infinite ideals".

The second is the vision of Paul Valéry. He stresses the spiritual character of Europe in his essay "l'Européen". In 1924 he wrote: "Wherever the names Caesar, Gaius, Trajan and Virgil, wherever the names Moises and St. Paul, wherever the names Aristotle, Plato and Euclid have a significance and carry weight, that is where Europe is". Here in Aachen, I would say wherever the name of Charlemagne carries weight, that is where Europe is.

Particularly in these times of global challenges, of stress, of crisis, such a return to the "spiritual form of Europe" is enlightening.

Husserl concluded his lecture in a visionary way: "Europe's existential crisis can end in only one of two ways: in its demise (…) lapsing into a hatred of the spirit and into barbarism ; or in its rebirth from the spirit of philosophy, through a heroism of reason (…)".

I think that eventually a confederation of sovereign states of a new type, with new institutions to manage the interdependence of today and tomorrow, would be fully in line with such a heroism of reason.

* * *

The city of Aachen has a special significance for Europe as a whole and also for the peoples of France and Germany.

As a French citizen on German soil, I do not forget the start of the European endeavour, with the speech of Robert Schuman. This endeavour was founded, in particular, on the ties between our two countries, put to the service of all other nations and of Europe as a whole, the deepening integration of our economies and currencies, and ultimately the common bond of the euro. It has been a great privilege that the path of my career has allowed me to participate in this historical endeavour.

In the almost eight years I have lived in Germany, I have developed a strong admiration for the country, its culture and its history.

Germany combines local, regional and national identities with a strong European identity, each mutually reinforcing.

This is unity in diversity – a strong whole with equally strong parts.

Europe is progressing along this path. But to go further, the European nations must continue to lead the way. It is vital that all nations engage fully in the European historical endeavour and look with confidence to the future.

There are many grounds to be confident in our long-term future.

Europe is in the vanguard of nations working peacefully together.

We have replaced confrontation and conflict with cooperation and consensus.

We have combined political freedom with economic freedom and social peace.

We have proved that our single currency is stable and credible, preserving price stability over time.

Let us carry this noble endeavour further by giving Europe now and for the longer term the institutions it deserves.

Thank you for your attention.

Building Europe, building institutions

Speech by Jean-Claude Trichet, President of the ECB on receiving the Karlspreis 2011 in Aachen, 2 June 2011

Lord Mayor,

Presidents of the European Council, the European Commission, the European Parliament and the Eurogroup,

Former recipients of the Karlspreis,

President of the Deutsche Bundesrat,

Excellencies,

Ministers,

Members of the European Parliament and national parliaments,

Members of the ECB's Governing Council,

Members of the Karlspreis Foundation,

Ladies and gentlemen,

It is an immense honour to receive the Karlspreis today.

I find it difficult to put into words how deeply humbled I am to join the most impressive company of the prize recipients. To borrow the words of Sir Isaac Newton, I feel as if I *am standing on the shoulders of giants.*

I express my most profound gratitude to the Karlspreis foundation for bestowing this honour. I know that this prize goes to my colleagues of the Executive Board who are present today and to all staff of the European monetary team: the European System of Central Banks. I am moved by the kind words of President Barroso and the faith the Karlspreis foundation have placed in us as true Europeans.

* * *

Each generation needs to affirm its commitment to Europe.

For the generation that lived through the Second World War, Europe was essential to prevent a return to the depression and the horrors of that war.

For the generation after, Europe was the cornerstone of building prosperity through economic freedom and open markets.

For the current generation, these achievements are taken for granted. Citizens have new concerns.

They want to be told why European unity is more important than ever in the present globalised world to ensure peace and security; why the European Union is vital to ensure and promote the interests of the European nations; why the European economies and societies are much more interdependent today than immediately after World War II; and how these interests and this interdependence should be best governed.

In all domains this calls for continuing to strengthen Europe's institutional framework. In the economic and financial fields it demands to reinforce in a decisive way the institutions of the economic and monetary union.

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My main message is that the achievements of economic and monetary union (EMU) to date have been made possible by the ECB and the Eurosystem, the strong institutions of monetary union – the M in EMU. In the same vein, confronting the challenges of the future requires strengthening the institutions of economic union – the E in EMU.

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There are many grounds to be confident in our long-term future.

Europe is in the vanguard of nations working peacefully together.

We have replaced confrontation and conflict with cooperation and consensus.

We have combined political freedom with economic freedom and social peace.

We have proved that our single currency is stable and credible, preserving price stability over time.

Let us carry this noble endeavour further by giving Europe now and for the longer term the institutions it deserves.

Thank you for your attention.

Making decisions in an uncertain world

Speech by Jean-Claude Trichet, President of the ECB, Rheinisch-Westfälische Technische Hochschule (RWTH), Aachen, 1 June 2011

I. Introduction

It is a pleasure for me to be here in Aachen, a city that has played such a central role in the project of European integration.

As students at RWTH Aachen, you must be proud to be part of one of Europe's leading institutions for science and research. This university has an international reputation, demonstrated both by its participation in global networks of higher education and by the presence of a large contingent of students from around the world. A degree from such a renowned university is indeed a great asset and a remarkable insurance against the uncertainties of your working lives.

In pursuing your studies, you have already had to make important decisions under uncertainty. Your choices of university and degree course were made with limited information – about the chances of obtaining the degree, about the impact of your degree on future job opportunities and about its relative merits compared with alternatives. Such uncertainty is a constant feature of our lives, as we experience the structural transformation of our economies driven by new technologies and globalisation.

Fifty years ago, future career paths were clear for most graduates. Engineering students would become engineers and medical students would become doctors. Nowadays all professions change at much greater speed. Engineers and doctors work side-by-side in such areas as nanotechnology and biomedical engineering. Many of you will be not so much filling existing jobs as inventing whole new jobs.

At the same time, increasing interactions between people and organisations across geographical borders makes it more difficult to appreciate the potential impact of economic developments elsewhere in the world on the prospects for your home country. The process of globalisation has many positive consequences, such as the benefits of trade, financial market integration and the acceleration of global growth. But there are risks too, such as the accumulation of so-called 'global imbalances', which were a key underlying cause of the global crisis.

All of you will be aware of the difficulties that the world economy has experienced in recent years: the financial crisis that began in 2007 and led to the deepest recession since World War II. Devising appropriate policy responses to the crisis has been a challenge for central banks everywhere. Many decisions have had to be made under exceptionally uncertain conditions, sometimes with very limited information and in constantly changing circumstances.

Today I would like to discuss with you our recent experience of decision-making in an uncertain world. I will outline how the crisis developed and then describe how we at the European Central Bank (ECB) responded – the kinds of information we draw on, the tools we use and the principles on which we base our decisions. I will close with some brief reflections on dealing with uncertainty.

II. Uncertainty and the crisis

The origins of the crisis lay in changes in the economic and financial environment over the past two decades. During that time, there was a marked decline in the volatility of such aggregate economic indicators as total household consumption and total business production. This led to a widespread perception that we were living in very benign economic conditions.

At the same time, some developed countries underwent a process of financial deregulation and innovation aimed at improving efficiency. New financial products were developed with the promise of enabling financial institutions to manage the risks in their lending activities more effectively. As a result, larger segments of the population obtained mortgage financing, and credit generally was more easily available.

But the promised benefits of financial risk management turned out to be illusory. Risk did not disappear, indeed in many cases it was magnified. And the process of deregulation led to a huge increase in private indebtedness and an accumulation of financial imbalances.

At the global level, a number of developed economies were able to finance increased household consumption by borrowing from fast-growing emerging economies that had an abundance of savings. These sustained global imbalances

contributed to lower interest rates, which further encouraged the process of credit creation in countries that were receiving capital inflows.

It was clear to many careful observers that this process eventually should come to a halt. With the considerable benefit of hindsight, warning signals of the subsequent financial distress in the data for 2006-07 are clearly evident. In the name of my colleague central bankers, I gave myself a clear warning in January 2007 on the likelihood of a major market correction due to a significant under-assessment and under-pricing of risks in the financial markets. But the specifics of how a crisis might be triggered and the course of its subsequent propagation proved hard to predict in real time.

Ultimately, the crisis was ignited in August 2007 by unprecedented tensions in the interbank market, in which financial institutions lend to and borrow from one another. Following the bankruptcy of Lehman Brothers in September 2008, the financial market tensions developed into a loss of confidence across the whole economy and eventually a deep recession. After years of benign economic developments, all policy-makers suddenly faced very uncertain circumstances.

A key feature of the uncertainty generated by financial crises is that it places decision-makers in uncharted territory. Events happen that were deemed to be almost impossible before the crisis, and were therefore difficult to forecast on the basis of statistical methods.

This was the case for developments in the interbank market in the first phase of the crisis. Up until July 2007, the general perception among market participants was that loans between financial institutions were essentially safe. Banks trusted each other, both because bank defaults in developed economies had previously been rare events and because the very short loan periods minimised the risks that borrowers would not repay their loans.

As a result, banks were happy to lend to other banks in large amounts at the same interest rate that they were charged when borrowing from the central bank. Occasional differences of a few hundredths of a percentage point between these interest rates were interpreted as signs of stress, but they were often due to technical factors and therefore very short-lived.

But in August 2007, in response to negative developments in the market for US sub-prime mortgages, uncertainty about the creditworthiness of many financial institutions suddenly increased. Banks became unwilling to lend in the money market. As funds disappeared from the market, the difference between the cost of unsecured short-term funding from other banks – what in the euro area is called EURIBOR – and the interest rate on money provided by central banks suddenly jumped from near zero to unprecedented levels of around 60 basis points.

This sudden widening in the interest rate differential – what is known as the spread – happened simultaneously in the euro area, the US and the UK (see Figure 1). Not only was this unpredictable, but policy-makers and market participants were also extremely uncertain about whether the spread would widen further and when there would be a return to normal conditions.

Some researchers have drawn a parallel between the money market crisis and Nassim Taleb's [1] description of 'black swan' events. The idea of black swan events originates from the assumption, based on centuries of experience in Europe, that there was only one kind of swan: white swans. This assumption was invalidated only in the eighteenth century by the observation of a black swan in Australia.

In Taleb's analogy, 'black swans' are extreme outcome but low probability and highly unpredictable events. The parallel arises as the opening up of interbank market spreads in August 2007 could not be predicted based on historical data, because it was a low probability event. It became predictable – and justifiable – only with hindsight.

What happened next was that tensions remained high for a protracted period. In September 2008, spreads increased much further with the bankruptcy of Lehman Brothers. Economic uncertainty – as reflected, for example, in stock market volatility – rose dramatically.

The unpredictability of rare events highlights an important distinction between 'risk' and 'uncertainty', which was first made by the famous economist Frank Knight in 1921.

According to Knight, 'risk' refers to a situation of randomness where the range of possible events and the associated probability distribution are known. Risk therefore characterises situations such as the toss of a coin or weather forecasting. In both cases, we can characterise the set of possible outcomes and we can compute their likelihood.

'Uncertainty' refers instead to a situation where events cannot be enumerated and/or it is not possible to attach a probability to them. Events like the 'black swan' can more easily be characterised as uncertain, rather than risky. Since they have never been observed before, we do not know how to judge their likelihood.

III. Permanent alertness, judgement and experience

So how did central banks respond to the crisis?

I would like to highlight one simple principle: the timing of the policy response is crucially important. Financial crises can strike suddenly. The response to the crisis should be commensurably swift and decisive. This requires a stance of what I call permanent alertness, to identify promptly new threats to economic stability and price stability, including those arising from the crisis itself.

The decline in banks' ability to raise funds on the interbank market led to a tightening of credit conditions facing households and businesses. There was a clear danger that this tightening would lead to a serious decline in economic activity, further credit losses and a vicious downward cycle of distress in financial markets and the real economy. When the crisis intensified in 2008, permanent alertness led to a resolute sequence of actions using the ECB's standard policy tool, the short-term nominal interest rate.

But the crisis also demonstrated that deeper market failures in the financial sector might mean that standard policy responses alone prove insufficient to restore economic stability and price stability. Identifying these market failures and introducing measures to address them was a second dimension of the ECB's policy response. This led to the introduction of a variety of what we call 'non-standard' measures to complement the reduction of policy interest rates.

Permanent alertness is my lesson on how to deal with the unpredictability of events. But alertness *per se* may suggest that we should simply be ready to adopt a specific, known reaction, once we observe a certain, possibly unpredictable, event. The problem in situations of "Knightian" uncertainty is that we are also uncertain in our assessment of the overall consequences of the unpredictable event and how we respond to it.

Let me again illustrate this point with an example. Once the crisis intensified in September 2008, central banks faced the major new difficulty of assessing how the combination of this exceptional event and of the unprecedented response of policy authorities would affect the medium-term outlook. We normally employ various statistical tools to help make this assessment, but would these tools provide useful guidance at this particular time?

Figure 2 provides an answer showing the evolution of our projections for annual economic growth in the euro area in 2009 together with the corresponding forecasts from a range of private sector and international organisations. Observations correspond to forecasts for GDP growth in 2009 made at different points. Over the months, information is updated and the forecast horizon becomes shorter and shorter. At the end of 2009, forecasting GDP growth in 2009 is almost tantamount to forecasting the past, so forecasts converge to the actual value indicated by a constant red line.

In 2008, all projections were strongly lagging actual developments. Only at the end of the year did public and private institutions begin to make downward adjustments to their growth forecasts for 2009, while nonetheless clearly underestimating the actual developments.

There is a similar pattern in Figure 3, which shows the forecasts for 2010 produced during the period 2009-10. In this case, forecasts systematically underestimated the strength of the recovery. In 2009, most forecasters expected very slow growth in 2010. As more positive news emerged in the second half of 2009, the forecasts were steadily revised upwards but still remained well short of the final outcome until the last quarter of the year.

The lagging nature of the information contained in most projections, together with the large projection errors, highlight the relative inadequacy of standard tools to deliver accurate forecasts during times of heightened economic distress.

What can guide a decision-maker in such circumstances?

A well-known recommendation of control theory is to apply robust control. This is designed to achieve robust performance in the presence of potential modelling errors. One approach will deliver the best possible outcome in the worst case scenario. This strategy is used widely in engineering applications, and it has the advantage of avoiding nasty surprises.

But the strategy also has disadvantages, should the worst case scenario be too extreme or highly unlikely. For example, if students think that the worst case scenario is that they will never find a job after gaining a degree, they may act accordingly and immediately abandon their studies. But that choice would be very far from ideal in the event that jobs are indeed available for graduates.

In very uncertain circumstances, judgement and experience may be the safest bets for a policy-maker. To illustrate this point, I like to draw a comparison to chess.

Over several decades, psychologists have explored how chess grandmasters obtain their advantage over lesser players. The evidence indicates that grandmasters rely significantly on a vast store of carefully structured knowledge of game positions, which has been accumulated over many years. So their advantage is not necessarily due to innate superior mental computation ability, but rather the stock of knowledge built up from countless hours of practical experience.

Monetary policy is not chess. Nevertheless, knowledge and experience are always useful in complementing a strong analytical exploration of the possible decisions. When dealing with a very high degree of uncertainty the analytical work might be less reliable and experience appears to be playing a more important role in the decision-making process. The occurrences of such very uncertain situations are also an additional reason for central banks to rely upon what I call "collegial wisdom". From different vantage points we could take stock of our knowledge of the sovereign debt crisis of the emerging countries in the 1980s, of the crisis of the European monetary system in 1992 and 1993 of the Mexican and Asian crisis of the 1990s and the dotcom bubble burst in the 2000s. Pooling experiences of members of the members of the Executive Board and the Governing Council of the ECB proved extremely important in the circumstances.

IV. Conclusions

Let me sum up my three simple lessons for dealing with highly uncertain circumstances: first, remain permanently alert and ready to respond to change when it happens; second, always ask the analytical preparation to be as comprehensive and robust as possible; and third, do not forget that in such circumstances collegial wisdom and experience are always of the essence.

I am of course fully aware that my three lessons are not a straightforward solution to life's uncertainties. Nor are they contingent mathematical laws that you can apply when you see fit. As the great physicist and Nobel laureate Richard Feynman once said "Imagine how much harder physics would be if electrons had feelings!"

Monetary policy-making – and life – would certainly be much simpler, but also much duller, if as in physics a few basic laws could explain most experiences.

Thank you for your attention – and may I wish you well in your studies and in your future when making decisions in an uncertain world.

Interview with Aachener Zeitung on the occasion of the awarding of the 2011 International Charlemagne Prize of Aachen

Interview with Jean-Claude Trichet, President of the ECB, conducted by Ms Birgit Marschall, Mr Bernd Mathieu and Mr Peter Pappert of the Aachener Zeitung, 27 May 2011

Question: Mr President, people in Europe are worried about the debt crisis in the euro area. What is your take on the current situation?

Trichet: We are experiencing a dramatic global financial crisis, which is also impacting on the euro area. This is the deepest recession since the Second World War. All the advanced economies – the United States, Japan and Europe – must draw lessons from it. The outlook for the monetary union is favourable: the euro and prices are stable. The average inflation rate in the euro countries over the last 12 years has been just under 2%, and in Germany it has been as low as 1.5%; this is a better result than was achieved during the 50 years of the Deutsche Mark.

Question: So where does the problem lie?

Trichet: The real problem in the euro area is that the economic union – the "E" in EMU –between the euro countries has not been properly implemented. There is a need for much improvement on that score. The most important lesson from the crisis is that the euro countries must coordinate their economic and financial policies better – and do so urgently.

Question: We are a long way from there, look at Greece.

Trichet: In recent years the EU governments have ignored the rules of the Stability and Growth Pact. Unfortunately the large countries – i.e. France, Germany and Italy – tried to weaken the Stability and Growth Pact or even rescind it in 2004 and 2005, when they themselves were not complying with it. I expressed grave concerns at the time, because the letter of the Pact was weakened and the spirit of the Stability Pact was being violated. The weakening of the Pact had devastating consequences. We urgently require effective and reliable governance that conforms to common economic goals.

Question: The Heads of State or Government recently agreed on tougher rules for the Stability Pact. Is this enough?

Trichet: No. We are asking the Heads of Government, the European Commission and the European Parliament to go further and to be far more rigorous. We need automatic sanctions for excessive deficits. The entire process – from the discovery of looming budget difficulties to the actual imposition of penalties – should be automatic. We saw in the past all the dangers of the complacency of governments.

Question: Is it conceivable that a euro country might leave the single currency?

Trichet: No, that is entirely unrealistic. There's not even any provision for it in the EU Treaty. The euro area is a community that shares the same destiny: each member is dependent on the others.

Question: Why is the ECB taking such a tough stance against a rescheduling of Greece's debt?

Trichet: The adjustment and reform programme agreed by the EU and the International Monetary Fund with Greece does not envisage restructuring. Greece must implement the programme fully and rigorously; this is very important to correct the errors of the past and pave the way for sustainable job creation.

Question: Many Greeks are not accepting this reform programme and taking to the streets.

Trichet: It is never easy when a country has to put right many years of economic and financial mismanagement. Greece has lived beyond its means for years while continually raising public-sector pay. It is absolutely essential to reform the country so that it can stand on its own two feet once again. It is in the Greeks' own best interests that growth is generated and jobs are created again in future.

Question: In Germany, there is growing discontent among politicians and taxpayers about the billions upon billions of assistance. Does that worry you?

Trichet: When we decided to have a single market with a single currency, we created a strong interdependence. If a member gets into difficulties – despite the surveillance which was supposed to be exercised by the other governments – it is the responsibility of all other countries to oversee the fiscal and economic adjustment. Where necessary, they can support the adjustment, as the IMF does, with non-concessional loans under strict conditionality.

Question: Many people on the streets think otherwise. They've been saying things like: "If we give Greece even more money, then we don't have it here at home – for tax cuts, for example." What do you say to the German people?

Trichet: I think it is certainly right to say that very strong conditionality is of the essence, and that the loans complementing IMF financing must be non-concessional. On the other hand, it would be very paradoxical for Europeans to appear less united in times of difficulty than other continents. I have no wish to moralise. However, in other parts of the world – Asia, for example – there were no discussions during the Asian crisis. Provided there is strong conditionality, all over the world friends can help each other. But I would also like to say to the Germans: you yourselves have every interest in getting Greece to adjust its economy and for it to be a stable partner in Europe and in the euro area.

Question: Is such scepticism with regard to financial assistance "typically German"?

Trichet: No, you also find it in other countries.

Question: What are the main reasons for the rising inflation in the euro area?

Trichet: The prices of oil and raw materials have risen worldwide. This is also pushing up the consumer price index in the euro area. Our responsibility is to prevent price-setters and social partners from increasing other prices and wages in the medium term. We are there to prevent these second-round effects. Over the medium term prices increases will go back to our definition of price stability: below 2%, close to 2%.

Question: When Chancellor Kohl paved for the way for the euro – not single-handedly, but with real determination – he saw it above all as a political, not an economic, decision. Was this a key conceptual defect of the common currency?

Trichet: That is a very direct question. The fundamental idea of having European unity has always been to guarantee peace, prosperity and stability on our continent. From the outset this has included the idea of a common market. Europeans' efforts to join closely together and create a single currency have deep roots in European politics. Chancellor Kohl, Chancellor Helmut Schmidt before him, and, with them, many other political leaders across Europe, pressed ahead with the project, knowing that it would combine peace and prosperity. Monetary Union is a resounding success. The scepticism about its capacity to maintain price stability has not been borne out at all. The problem is that not everyone has learnt their lessons from the global financial crisis. We have to re-affirm the visions of Helmut Schmidt and Valéry Giscard d'Estaing and of Helmut Kohl and François Mitterrand.

Question: The promise of taking the decisive step towards political union with the euro has not been kept. Will the promise ever be fulfilled?

Trichet: To fulfil this promise, cooperation between the 27 EU countries, and even more so between the 17 euro countries, must be improved significantly. That much is obvious. Better coordination of fiscal and competition policy over time automatically creates greater political cooperation. At present each of us has his or her own opinion on the long-term outlook for political union in Europe. As a European citizen, I am convinced that we should head further down the path of significantly closer political union. However, this is not one of the European Central Bank's responsibilities. Jean Monnet once commented that he was unsure what the European political institutional framework would look like in the future, but was sure that today's improvements would lay the foundations for the European institutional framework of tomorrow.

Question: Do we need a two-speed Europe in order to ensure that the tempo is not dictated by those moving forward more slowly?

Trichet: The European Treaties make no such provision. We have to insist on Member States moving forward together. However, it is also quite clear that if you share a single currency, you must make much more of a joint effort and cooperate much more effectively on economic policy.

Question: What are Europe's basic values?

Trichet: Europeans are deeply attached to democracy. They are deeply committed to human rights and the market economy. This is fundamental. Europeans also have their own particular way of giving the market economy a social face. This was apparent not least during the crisis. It seems to me that the social market economy, which the Germans are so proud of, was also embraced by the other countries a long time ago. As I see it, the most important thing is: we have a shared cultural identity which is developing from shared roots.

Question: How is this idea of Europe being conveyed to younger people?

Trichet: Peace, prosperity and stability can never – never – be taken for granted. Every country, community and individual must stand up for it time and again. As Europeans, we have more political and geostrategic reasons to forge close ties today than we did right after the Second World War. Back then, the United States of America was the sole major single market. Today we have India, China, Brazil and other emerging countries with a bright future in front of them. That's good, and that's exactly what we were aiming for 60 years ago when we created the World Bank. For us Europeans it also means uniting even more so as to take into account the existence of these new economic giants. What I would say to young people is: take a look at the many good reasons that we have for uniting Europe; together we can respond far more effectively to tomorrow's challenges.

Question: Your term of office as ECB President ends in October. What has been your most significant or most cherished experience in the course of these eight years?

Trichet: As president of such an organisation, you are constantly facing new challenges. From the start there was a tremendous team spirit throughout the ECB, even in the most difficult situations. It is gratifying to note that we do not function simply as an institution, but as true Europeans who are deeply attached to the historic construction that is the European Union.

Question: What significance does the Charlemagne Prize have?

Trichet : Everyone at the ECB is moved and impressed that we – especially in today's challenging circumstances – are being awarded this prize. I know all about the prize and have attended in the past. It is a very moving and impressive celebration. We were just talking about Europe's roots. In Aachen, we are at the very roots of Europe.

How well do you know Aachen?

Trichet: I have been to Aachen several times. I am familiar with the big historic buildings, and of course with Charlemagne. At the age of ten I won a prize in a school competition: a medal, struck with a portrait of Charlemagne. A German emperor, a French emperor – it makes no difference.

The ECB's response to the crisis

Speech by Jean-Claude Trichet, President of the ECB, at the WDR Europa-Forum, Berlin, 26 May 2011

Sehr geehrte Damen und Herren,

ich freue mich sehr, heute hier zu sein. Vielen herzlichen Dank für die Einladung.

Ich freue mich besonders, zu einem so wichtigen Thema – der europäischen Antwort auf die Wirtschafts- und Finanzkrise – zu sprechen.

* * *

Wie Sie wissen, ist das primäre Mandat der EZB, für Preisstabilität im Eurogebiet zu sorgen. So ist es von den Europäischen Staats- und Regierungschefs in den Verträgen zur Europäischen Union 1992 festgeschrieben worden. Und dementsprechend strebt der EZB-Rat eine mittelfristige Inflationsrate von unter, aber nahe bei 2% an.

Die EZB ist diesem Mandat in den vergangenen zwölf Jahren gerecht geworden. Die jährliche Teuerungsrate betrug über diesen Zeitraum im Eurogebiet 1.97%. In Deutschland lag sie mit 1.5% seit 1999 sogar noch deutlich darunter. Für Deutschland ist dies das beste Ergebnis über einen vergleichbaren Zeitraum seit 50 Jahren mit der D-Mark. „Stark wie die Mark" sollte der Euro sein – und stark wie die Mark ist er geworden.

It is important to understand the significance of this achievement. Over the past 12 years, the ECB has faced many challenges in the pursuit of our goal of price stability. They include the bursting of the internet bubble, the aftermath of 11 September 2001, sharp volatility in commodity prices and of course the worst financial crisis since World War II.

Today I would like to focus specifically on our response to the crisis – and on the programmes of reform of financial regulation and economic governance on which the euro area and the European Union as a whole are engaged.

While there is no doubt of the scale of the challenge that the crisis has posed for all advanced economies, including the US and Japan, there is also no doubt that we have taken significant measures in responding to that challenge. But much more needs to be done.

I. Financial and economic reform prompted by the crisis

Let me begin with financial regulation. The crisis calls for a comprehensive agenda of reform of virtually every aspect of the global financial system. We must control the forces that led the system to become absorbed with itself and ensure instead that it serves the real economy. And we must be assured that the financial system provides a sustainable contribution to economic growth.

At this point, we have achieved a blueprint of more stringent bank regulations, which includes more loss-absorbing capital, better risk coverage and limitations on undue leverage. Countercyclical capital buffers are intended to lower pro-cyclicality.

The oversight of financial institutions, financial markets and market infrastructure are being strengthened, and the organisational structure of financial supervision is being overhauled.

But much remains to be done. The most important aspect is implementation of these reforms. Moreover, the issue of systemically important financial institutions still requires decisions, and oversight of financial markets must be

strengthened. We cannot afford the consequences of limited transparency and excessive influence of dominant players and oligopolistic market structures.

The new European System of Financial Supervision is an important step forward. The three new European Authorities – for banking, for insurance and occupational pensions, and for securities and markets – are strengthening our focus on interlinkages and spillovers within the EU's financial system. And the European Systemic Risk Board is developing the tools it needs to issue warnings and make recommendations for action on potential future sources of systemic risk.

Inattention to financial risk was the prime cause of the crisis. Inattention to macroeconomic risk – and the many ways in which such risk interacts with fragile fiscal structures – prepared the ground for the budgetary troubles that some euro area countries are facing today. This brings me to reform of economic governance.

The EU is about to introduce surveillance focused on imbalances and divergences in competitiveness across the euro area. This is long overdue. Since 2005 within the Eurogroup and – shortly thereafter – publicly, the ECB has warned that such divergences create considerable risks and must be corrected.

If fully implemented, macroeconomic surveillance will make a strong contribution to the smooth functioning of EMU. It will compel Member States to take measures to counter emerging macroeconomic imbalances at an early stage, before they become a drag on their macroeconomic prospects and potentially escalate to systemic proportions.

Governments had agreed on the Stability and Growth Pact to prevent a debt crisis. But in 2005 the Member States agreed on a reform of the Pact. At the request of Germany and France, more discretion and flexibility was added to the surveillance procedures. This turned out to be to the detriment of the Pact. It weakened the Pact considerably.

At that time, the ECB expressed serious concerns about the negative effect of these reforms on the functioning of EMU.

It is important that Member States have acknowledged this mistake and intend to strengthen the Pact again. The new focus on fiscal sustainability and reducing government debt levels, backed by more effective sanctions, certainly goes in the right direction.

The euro is unique among international currencies. It is the only major currency that is issued not by a single sovereign state but by a union of states. Fiscal policies remain largely the competence of national governments and reflect national political preferences. Monetary policy is inherently indivisible in a monetary union, and in the euro area it is thus conducted at the European level.

The current crisis is not a crisis of the euro. Neither is it a crisis of monetary union. Rather, it is a crisis of the economic policies in some Member States and a crisis of mutual surveillance. If we recall that EMU stands for Economic and Monetary Union, it is not the monetary pillar of EMU that is under scrutiny at present, but the economic pillar. Speaking in terms of letters, the "E" and not the "M" in EMU is giving cause for concern.

Our economic governance framework has not been sufficient to ensure sound policies are conducted in all Member States. The Treaty clearly specifies that Member States have committed to economic policies geared to contributing to the objectives of the Union, one of which is a stable single currency. They have yet to live up to this commitment fully.

The Governing Council of the ECB is concerned that the reforms to economic governance currently under discussion are a step in the right direction but do not go far enough to address the structural weaknesses of fiscal and broader macroeconomic governance in the euro area. At the very least, we require more automaticity in the sanctioning mechanisms. Euro area countries that are breaching our common rules should be called to account, with as little room for discretion and flexibility as possible. This implies less room for halting or suspending procedures and stricter deadlines.

Behind this we argue in favour of stronger sanctions to encourage compliance. This would require, on the one hand, a wider range of financial and non-financial measures, and on the other hand, less discretion to reduce or suspend them. Such a strengthening would improve effectiveness and set the right incentives.

At the same time, more ambitious policy requirements would better match the current reality of the euro area. This means having ambitious benchmarks when establishing an excessive deficit and when setting the adjustment path towards a "safe" budgetary position. It is very important for macroeconomic surveillance to have a clear focus on the countries with the greatest vulnerabilities.

Anchoring these new rules at the national level would forcefully anchor them in national legislation. Binding commitments by Member States to implement strong national budgetary frameworks are key to ensuring national ownership. Finally, further improvements in the production of fiscal statistics are in our view warranted.

These are all areas in which the ECB is presenting arguments. In the end, these matters are decided by the Council and the Parliament, and they have therefore the key responsibility in shaping the new framework.

II. The ECB's response to the crisis

Let me now turn to my final topic – the "M" in EMU, which is the direct responsibility of the ECB. During the crisis, along with central banks around the world, the ECB has had to operate in uncharted waters.

The ECB demonstrated its alertness from the very first day. When the problems in financial markets first became apparent on 9 August 2007, we were the first central bank to respond, acting within hours.

While the crisis required fast and unprecedented action we have never lost sight of our primary objective: to maintain price stability over the medium term for the 331 million citizens of the euro area. All – and I emphasise *all* – our monetary policy decisions during the past twelve and a half years have aimed at delivering on that commitment.

As you know, in normal times central banks mainly influence the economy and inflation through the setting of short-term interest rates.

In practice, identifying risks to price stability at an early stage is far from trivial. To accomplish this task the ECB relies on a robust monetary policy strategy that draws on several sources of information. Economic analysis allows us to synthesise information on short-term inflationary pressures from a multitude of economic indicators. Monetary analysis allows us to cross-check this information with information on medium-term inflationary pressures extracted from monetary and financial indicators. It is on this basis that we decide on the appropriate monetary policy stance and adjust interest rates accordingly.

Our positive track record has endorsed our approach. Over the past twelve and a half years we have built a strong reputation for setting interest rates as appropriate to maintain price stability.

Our decisions in the face of political pressure have demonstrated our fierce independence. We refused to decrease rates at the beginning of 2004 when Germany, France and Italy, in particular, asked us to do so. We did not hesitate to raise interest rates in December 2005. At that point, ten euro area governments out of 12 and many international observers pressured us to keep rates on hold.

The IMF, for example, was emphasising the risks that tightening – after a prolonged period of policy accommodation – could pose for the recovery. We tightened policy despite these warnings, and we were vindicated – by the IMF's own admission.

We also did not hesitate to raise interest rates in July 2008. Then, our analysis indicated that past oil price increases threatened to create second-round effects on wages and prices.

After the intensification of the crisis in mid-September 2008, as inflationary pressures receded, in full consistency with our mandate, we decided to reduce our policy interest rate rapidly between October 2008 and May 2009, from 4.25% to 1%.

We reduced the interest rate to a level and at a pace that has not been experienced in the countries of the euro area at any time in recent history.

With the benefit of hindsight, the interest rate decisions we took during the crisis have proved successful. Over the past four years we have maintained a very solid anchoring of inflation expectations. Our determination to preserve price stability in the medium term has allowed us to avoid the materialisation of the risk of inflation as well as of the risk of deflation.

In most recent months, with the overall recovery more firmly established, we have witnessed the emergence of upside risks to the medium-term outlook for price stability. Once more, strong increases in oil and other commodity prices have had a strong impact on headline inflation. Once more, we have to avoid commodity price increases becoming entrenched in longer-term inflation expectations, which could have second-round effects on wages and prices.

It is against this background that the Governing Council decided to raise interest rates in April. And I would like to emphasise that this decision was unanimous. The Governing Council is united by a common purpose.

We are carefully monitoring the situation and we stand ready to do whatever is necessary to fulfil our mandate – just as we have done over the past twelve and a half years.

This logic applies not only to our policy interest rate but also to the other measures we have adopted in response to the crisis. When the crisis hit, dysfunctional financial markets threatened our ability to steer the outlook for price stability with our standard interest rate instrument. In response, we adopted a number of non-standard measures to ensure that our interest rate decisions were transmitted to the broader economy, despite the problems in the financial sector and financial markets. In particular, the aim has been to enable banks – at any level of the monetary policy interest rate – to continue lending to household and firms.

Let me emphasise that our non-standard measures do not in any way impinge on our capacity to tighten our monetary policy stance in response to inflationary pressures.

There is a clear separation principle between our non-standard measures and our interest rate policy. Interest rate policy depends on the outlook for price stability. The use of non-standard measures depends on the functioning of the monetary policy transmission and must be commensurate with the level of malfunctioning or disruption of money and financial markets and segments of markets.

This separation principle is strictly applied. To give you a recent example, the Governing Council decided in March and April both that it was now time to increase interest rates and, at the same time, that it was appropriate to maintain in the second quarter the full allotment at fixed price refinancing on a 3 month duration.

III. Conclusion

Damit komme ich zum Schluss. Die Krise hat den Euroraum vor große Herausforderungen gestellt. Aber wir haben diese Herausforderungen angenommen. Der Euro hat sich als Stabilitätsanker in stürmischer See erwiesen. Davon haben alle – ich betone, alle – Länder des Euroraums profitiert.

Bei alledem sollten wir nicht übersehen, dass der Euroraum als Ganzes in den vergangenen zwölf Jahren erhebliche Fortschritte gemacht hat. Die wirtschaftliche Dynamik im Euroraum hat derjenigen in den Vereinigten Staaten in nichts nachgestanden. In beiden Regionen ist das Pro-Kopf-Einkommen im Jahresdurchschnitt um etwa 1% gestiegen. Dabei hat der Euroraum deutlich mehr Beschäftigung geschaffen als die Vereinigten Staaten. Im Euroraum als Ganzes ist die Beschäftigung in den vergangenen zwölf Jahren um mehr als 14 Millionen gestiegen. In den Vereinigten Staaten betrug der Anstieg 8 Millionen. Und all das haben wir erreicht vor dem Hintergrund von Inflationserwartungen im Eurogebiet, die auf einem niedrigen Niveau verankert sind. Dies ist eine mehr als beachtliche Bilanz.

Ich kann Ihnen versichern, dass die Europäische Zentralbank auch in Zukunft ihren Teil zum reibungslosen Funktionieren der Wirtschafts- und Währungsunion beitragen wird: wir werden ohne Wenn und Aber die Preisstabilität sichern.

Ich danke Ihnen für Ihre Aufmerksamkeit.

Interview with L'Agefi Hebdo

Interview with Jean-Claude Trichet, President of the European Central Bank, conducted by Philippe Mudry, 18 May 2011

Agefi: **A survey of our readers on the future of finance reveals deep scepticism about the nature of the benefits resulting from regulation and also about its possible contradictions. What do you think?**

Jean-Claude TRICHET: Considering the gravity of the situation which the international community has had to face, the lingering scepticism in some areas is understandable. It is important to understand that we had to cope with a crisis of extraordinary severity in 2007 and in 2008 which intensified following the collapse of Lehman Brothers. Without the unwavering determination of the central banks on the one hand, and of governments on the other, and without significant exposure to budgetary risk, on both sides of the Atlantic and in all the developed countries, we would have faced a very deep depression and the worst financial crisis since the First World War! Our calculations at the European Central Bank and throughout the European System of Central Banks tell us that, in total, some 27 % of gross domestic product, in terms of risk to the taxpayer, had to be mobilised on both sides of the Atlantic in order to avoid the worst. Fortunately, of course, this risk was not converted into losses in the majority of cases, and many such cases have yielded profits; nonetheless, without this risk-taking we would have been facing a terrible disaster. The central banks as well as all the governments of the developed and the emerging countries have been very determined. Inasmuch as disaster has been averted, a number of partners, in the private sector essentially, feel that there is no point after all in making sweeping

improvements to the rules and regulations governing the financial sector, in particular the prudential rules. This is not our view at all. The central banks all consider that it is absolutely essential to remain aware of the fragility of the financial system and to implement the reforms we need. We would be unable to address a situation as severe as the one in September 2008 a second time.

When you look at the path followed since 2007 in terms of financial regulation, what strikes you as being the main benefits, but also current limits, of the process prompted by the G20?

- The G20's action follows two major pillars: financial regulation and the coordination of economic policies aimed primarily at reducing major imbalances. On financial regulation itself, we are halfway down that road. We managed to reach a global agreement in record time, not just between the industrialised countries, but also now with the systemically important emerging countries on new prudential regulations and fresh requirements in terms of own funds for all banks, with decisions that have far-reaching repercussions. Moreover, the decisions required a great deal of goodwill from all European and American partners, but also from those in China, India, Brazil, Mexico, Russia and all the other major emerging countries. I regard this as a notable success. It must not be called into question. Here and there I hear market participants, who are members of private financial institutions, saying that some decisions are too stringent and too demanding. The decisions taken must of course be implemented. In addition, there are still a lot of things to do, particularly as regards the so-called systemically important financial institutions. Equally, there is the "shadow banking" issue which is related to those financial institutions that do no fall under the scope of the regulatory framework for banks. Of course, there is also the issue of effectively implementing the prudential rules on liquidity. These are all examples of work in progress, and they are being examined by the G20, the Basel Committee and the Financial Stability Board.

Do you regard the convergence of national laws as satisfactory today?

- The rigorous implementation of the rules defined at the global level by each of the countries affected is absolutely essential. If there is uneven implementation, we immediately create extremely dangerous distortions in the functioning of the global financial system; we open the way for what is known as "regulatory arbitrage", the aim of which is to attract to one's own country the most financial activities possible by having more lenient and more limited regulation. All the conditions for a fresh disaster would then be in place. The same rules must be implemented by countries worldwide. This is especially true on both sides of the Atlantic. That's why it is vital for the so-called 'Basel III' framework to be implemented rigorously, particularly by all the European countries of course as well as by the United States. We must not repeat the bad experiences of previous years, notably with 'Basel II', which was not implemented uniformly, particularly on the other side of the Atlantic. As central bankers, we continue to stress this fundamental aspect. If we fail to adhere to it, we will then have all the ingredients for further crises.

A number of the criticisms directed at re-regulation concern its contradictions, real or assumed. For example, some feel that the tightening of capital and liquidity ratios is too severe and risks adversely affecting the financing of economies. Does this criticism strike you as justified?

Jean-Claude TRICHET: In our view, the rules which have been defined for capital requirements are optimal. We reflected long and hard on them. Of course, there are arguments in both directions, but considering the drama resulting from a crisis in terms of lost growth and job creation, we gain a lot more by being reasonably demanding in terms of capital. Preventing further crises from occurring is a benefit that far outstrips the potential losses, if certain analyses are anything to go by. Let's be clear one more time: these decisions, debated at length by those primarily responsible, have been evaluated at governor and ministerial level and adopted at the global level by heads of state and government. They must be implemented.

Another criticism: this tightening of the rules runs the risk of producing a concentration in the financial sector, and on the financial markets as well, which is even stronger than it is today.

Jean-Claude TRICHET: I do not believe so. We must be constantly and closely vigilant with regard to the structural changes to international finance. There are permanent risks that we must continue assessing, but I do not think the rules we have just defined, or those still being worked out, will lead to this hyper-concentration. On the contrary, I have to say that one of the main lessons of the present crisis is that there were very high risks associated with what I would call the "financial mammoths".

Is too little attention being paid to the much-discussed area of "shadow finance"?

- The issue of the "non-banks", of shadow finance, and of all the institutions or market participants not under the oversight of the banking supervisors, is very important. Over the last two decades we have witnessed a tremendous explosion in new financial institutions. I myself lived through a period during which all the institutions with high leverage, by the end of the 1980s, were managing capital worth something in the region of USD 100 billion. 17 years later, in 2007, the figure was USD 3,000 billion! Very significant financial services have been, and are being, rendered by these market participants, but the systemic risk which can be associated with them must be considered from every angle. Obviously it

would be counterproductive if tighter regulations had the effect of pushing regulated finance into the unregulated area. This is a major topic which is being examined right now at the request of the entire international community, particularly at the level of the Financial Stability Board. I think I am expressing the feelings of all central bankers when I consider that there are crucial issues here in terms of transparency and appropriate regulation. We must be sure that these financial market participants do not create new systemic risks.

Are you satisfied with the rise of the organised markets compared with over-the-counter (OTC) transactions, with specific reference to centralised compensation?

- Here again, we are dealing with another core issue on which the entire international community is reflecting. The act of pushing activities which are very broadly disorganised towards clearing houses, towards organised markets, is a formidable undertaking. Of course, there will always be OTC contracts, but we have a major interest, in terms of regulation, financial stability and the removal of as much systemic risk as possible, in ensuring that these contracts, these derivative instruments, become as standardised as possible and can be traded through organised markets.

In more macroeconomic terms, how do you judge the actions of the G20 aimed at reducing global imbalances?

- The reasons for the crisis and the responsibilities are manifold, because there were multiple failures. It is unnecessary to dwell on finding a single scapegoat. However, one of the causes was certainly the prevailing complacency over a long period about very large international imbalances. One of the main lessons from the crisis is the need to have the right kind of coordination of macroeconomic policies, which is the international community's responsibility. We have created integrated global finance and a globalised economy: there is a need to strenghten very considerably the governance of these. The International Monetary Fund is playing a leading role here by providing significant conceptual support for this strategy of the G20 and the entire international community. We have a lot of progress to make in this area as well. Everyone is well aware of the dangers associated with these major imbalances – surpluses on the one hand, deficits on the other – in a full-blown crisis. Then, as we emerge from it, as is the case, with a perceptible upturn that is getting stronger, some then start to question things. I'm rather shocked by the number of voices being raised to explain how we can, after all, easily live with major imbalances and that they can be economically justified. I do not believe this to be the case at all. I think we have to resolutely carry on and bolster the efforts being made in this area. From that viewpoint, the euro area as a whole does not have an external imbalance since our current account balance is broadly in equilibrium.

What importance do you ascribe to the debate on the international monetary system?

- I think that the points identified by the G20, from a long-term standpoint, particularly the issue of capital flows, special drawing rights and other topics associated with the international monetary system, are interesting. It is good to discuss them. Ultimately, though, we have two questions for the short to medium term. One of these involves the relationships between the major convertible currencies: the dollar, the euro, the yen, the pound Sterling, the Canadian dollar. For over 30 years we have had a system in which these important relationships have been monitored by the G7. From that viewpoint, these relationships have not been destabilised in the course of the crisis. We should congratulate ourselves on this, even though it calls for constant vigilance of course. Then there is a topic on which it seems to me that the international community also agrees, i.e. the ties between the currencies of the major emerging countries, which themselves have very large surpluses, and all the other currencies, including the major convertible currencies. The currencies of these major emerging countries with large surpluses must progressively become more flexible, i.e. appreciate in an orderly and progressive manner.

In Europe there are genuine concerns about the Union's capacity to overcome the debt crisis facing the peripheral countries. The markets are highly sceptical. What can they be told in order to convince them of the relevance of the measures undertaken at the European level?

- On the issue of fiscal policies, I believe that the European Central Bank, through me, can reiterate certain points. Firstly, we always said that when there was a single currency but no political federation, there was a clear need for budgetary supervision. This was hotly disputed. I can remind you how in 2004 and 2005 major countries, notably France but also Germany and Italy, were telling us that we did not need this surveillance framework for fiscal policies. We had to fight very hard to preserve it. Today, this episode obviously seems totally outlandish, bearing in mind what has happened since. Some, moreover, said that the Stability and Growth Pact itself was "stupid". We always said that the careful monitoring of fiscal policies was essential, as were healthy policies. This remains true today. However, one should add another pillar of governance, particularly within the euro area, in the form of monitoring competitiveness indicators, and unit production costs especially; the changes to these must also be tracked extremely carefully. For six years at least, we have been telling all European governments to monitor very closely changes to competitiveness indicators and imbalances within the euro area. We emphasise the three pillars necessary for European governance, all three of which must be improved substantially: supervision of fiscal policies, supervision of competitiveness indicators, and structural reforms. The central banks across the whole of the Eurosystem – the ECB and the national central banks, i.e. the Banque de France in France's case, for instance – have a very clear message for governments: Europe's governance must be improved decisively, and governments are not going far enough. We expect a great deal from the dialogue with Parliament in order to push governments towards taking a decisive step.

Contribution to Bild am Sonntag

By Jean-Claude Trichet, President of the ECB, 15 May 2011

Our currency, the euro, has all what it takes to be an anchor of stability and confidence. The euro unites 331 million citizens of a region that is among the most prosperous in the world.

For over 12 years now, the European Central Bank – together with all national central banks including in Germany the Bundesbank – has been delivering what it is expected to deliver: price stability in the euro as a whole over the medium-term, with an average annual inflation of less than 2%. In Germany the average yearly inflation has been 1.5% which is a better result than for any such 12 year period over the last 50 years. Thereby, we have been safeguarding the euro's purchasing power. This has been achieved despite some headwinds to the European economy: oil prices went up; the internet bubble burst; violence and wars have raged in some parts of the world; and starting in 2008 we had to cope with the most severe global financial crisis in over 60 years.

We can be proud to have a stable and credible currency. There is no crisis of the euro. Instead, what we are currently observing in parts of the euro area is first and foremost a fiscal crisis. Several member states of the euro area have to adjust rigorously their economic and fiscal policy after having made mistakes in the past. All member countries must respect the principles of prudent fiscal policies. Substantial reforms are needed to ensure that common rules are improved and respected by all.

The current period is still not easy. The citizens can trust that the ECB will ensure price stability in the years to come as we did in the last 12 years. We are on the side of citizens. We know that inflation hurts the weakest members of society most, and we will do all that is necessary to prevent inflation. The euro is the European response to economic integration and globalisation. It is a currency that the citizens can trust.

Interview with El País

Interview with Jean-Claude Trichet, President of the ECB, 15 May 2011

Question: How would you describe the situation of the euro?

Answer: We are in an economic and monetary union. From my point of view, Monetary Union has worked well: we have delivered price stability – fully in line with our definition of "below, but close to 2% – during the first 12 years of the euro, the euro is a solid and credible currency, and inflation expectations are solidly anchored over a horizon of five or ten years. The Economic Union, for its part, has shown its weaknesses during this global crisis and it has to improve very significantly. All pillars of the Economic Union have to be reinforced: first, we need a strengthened Stability and Growth Pact to ensure a rigorous surveillance of fiscal policies; second, we need a close surveillance of the competitiveness indicators and of the imbalances in the euro area, something that we have been calling for all over these last years, since 2005; third, we need to accelerate the implementation of structural reforms, which is an objective for the economic union (the "27") as a whole, as well as in the euro area (the "17"), in order to elevate the growth potential of European economies.

Q. What's behind the dissatisfaction that seems to be affecting the euro?

A. I think there is criticism of the behaviour of some governments regarding their own economic and fiscal policies, and also on others, because they did not exert appropriately the surveillance on their peers. . But I don't think the criticism concerns the single currency, which is a clear success. I have seen many surveys in different countries showing that citizens are supporting the euro. That is the case in Spain.

Q. Does rising debt indicate that the euro may be at risk?

A. As I said, the euro is a solid and credible currency. The economy of the euro area as a whole is in a better fiscal position than the US or Japan, with a likely deficit of 4.6% this year compared with around twice that figure in the US or Japan. Sovereign debt problems are global, not just a European problem. The paradox is that, while fiscal performance at the consolidated European level is relatively good, we have in the euro area some countries which are clearly in a difficult situation, and that require a major adjustment.

Q. Despite your rejection of a possible restructuring of Greek debt, markets are insisting that that is the only way out.

A. The ECB's position has been clear from the beginning. We have an adjustment plan set by the IMF and the Commission. What we are asking for is that the plan be implemented as strictly as possible, as it was negotiated, with rigorous efforts being made by Greece. The adjustment, engaged by this country is essential for its sustainable, medium term growth, job creation and the stability in the euro area. And there is no other way than the strict application of this adjustment plan.

Q. What can we expect from the summit in Brussels on Monday?

A. The Ecofin and the Eurogroup will have to examine a number of issues, including the programme for Portugal, which has been negotiated by the IMF and the Commission, in liaison with the ECB. The ECB attaches a great importance to the fact that this programme has been approved by various political sensitivities in Portugal.

Q. Has it been ruled out that a country could leave the euro?

A. I already said that I consider this an absurd hypothesis. But let me come back to the euro. If, in 1998, we had been told that for the 12 first years of the euro, we would have a single currency that keeps remarkably its value, with average inflation below 2%, a better result than in any Member State in the past 50 years, many people would probably have said that it was too good to be true. Today it’s a reality and these achievements are documented.

Q. Is the standing of the ECB at risk because of the rating cuts for the countries from which you have collateral?

A. We are applying our own rules on the matter and are paying close attention to risk management. It is also useful to bear in mind that we are talking about three economies that account for around 6% of the GDP. The other 94% of the GDP of the EU are in a very different position.

Q. The ECB has embarked on debt purchasing but is doing it intermittently.

A. I've always said we are transparent in the management of this issue. I have no other comment.

Q. But that is a function that is not supposed to be performed by the ECB, it is not part of the mandate. Should another institution take on that task?

A. All these non-standard measures have been decided by the Governing Council to better transmit our monetary policy decisions, in times of financial crisis. It is fully in line with our mandate. These measures, including the full allotment of liquidity at fixed rate, are transitory by nature, as I say regularly in the name of the Governing Council.

Q. Three years after the start of the crisis, where are we now?

A. Since the recovery started in the third quarter of 2009, Europe’s economy has experienced often upward revisions to previous projections of real growth. Quarter after quarter, the data has frequently exceeded expectations. This has been particularly evident in the first quarter of this year, with an increase of 0.8% more than projected, and several economies in the euro area with better results, even significantly better than expected. That includes Spain, which is growing a little bit better than anticipated. It is no time for complacency, we have to be very cautious and we do not declare victory, but I think that's encouraging. As for the role of the ECB, we are responsible for issuing the currency for 17 countries and 331 million citizens. That is a huge responsibility and it is normal that sometimes there are countries that go faster and others that go slower. What matters is that it’s not always the same ones who go rapidly or slowly because that would be unsustainable. There was a time when Greece and Ireland were growing very rapidly and then it was Germany that was lagging. So it's good that there are now countries, including Germany, which are growing again fast and quickly recovering the ground they lost, while others need to undertake indispensable major adjustments. Again, what counts is that in the euro area as a whole the recovery is confirmed. But let us not be complacent, we have hard work ahead of us.

Q. Oil prices have fallen by more than USD 10 since the ECB decided to raise rates. How do you see price stability at the moment, with raw material prices so volatile?

A. The decline in oil prices is good news: it reduces both the inflationary impact and the depressive effect of high oil prices on the economy. That said, there is a high degree of volatility. The present price level is high; 2.8% in the euro area. We cannot do anything immediately to reduce the price of oil and raw material. We have to ensure that price setters and social partners fully understand that we are there to deliver price stability in the medium term at less than 2%, close to 2%. It would be for them a big mistake to think that the present hump in the CPI inflation signals the level of inflation in the medium term. Because we are there to take decisions that will prevent this. That’s why there is an independent central bank – to ensure price stability over the medium term.

Q. Are you seeing excessive wage increases?

A. Let me say something to the people of Spain: we are providing price stability in line with our definition, an average of 1.97% in the first 12 years, we are credible for the future five to ten years, and that has to be accounted for in all decision-making within the euro area. If prices and costs in a particular economy are permanently above that level, with spiralling of nominal inflation and nominal wages, in particular there will be unavoidable losses in competitiveness and less growth and less job creation.

Q. Does that apply to Spain in particular?

A. To all countries, without exception, and of course to Spain also. This is a very important message.

Q. So those involved in wage negotiations should forget about national price data.

A. All price-setters, in particular the social partners, must be conscious that there is a benchmark for the euro area inflation as a whole, which is less than 2%, close to 2%. If the unit labour costs in particular are not in line with the evolution of the euro area as a whole, a loss of competitiveness of the economy will be unavoidable, with its consequences in terms of growth and jobs creation. Again, the worst that could happen in terms of growth, is a cost/price signalling over and above the average of the euro area.

Q. That is the conclusion that many people are drawing about the situation in Spain, do you share it?

A. Some of these phenomena happened in the past undoubtedly. It seems to me now that everybody understands that competitiveness of the productive sector is essential for the economy.

Q. It is doubtful that the citizens of southern Europe understand the rise in rates resulting from the threat of inflation.

A. I think they understand. Because if we were to lose credibility in price stability, then inflation expectations would not be anchored and all medium- and long-term market interest rates in Europe, would rise, driven by those higher inflation expectations. Then we would all, I insist, all without exceptions, be suffering the consequences of a less favourable financial environment and its impact on growth and job creation.

Q. This is very reminiscent of the situation in July 2008. Are you still defending that rise in interest rates?

A. Of course it was an appropriate decision. The collapse of Lehman Brothers came later and we took the right measures to cope with the dramatic crisis. We decided to raise rates to counter an unwelcome increase in inflation expectations. By taking that step we confirmed that we are extremely determined to anchor inflation expectations. It helped us considerably during the crisis in preserving us both from the materialisation of the risk of inflation as well as the materialisation of the risk of deflation – which was a very important element to surmount the crisis.

Q. Jürgen Stark has said that the debt crisis is our own Lehman Brothers.

A. We are experiencing at the global level a second episode of the crisis. After the private-sector crisis we are now seeing tensions in the public sector and amongst sovereign risks. This is a global phenomenon, observed in advanced economies. It’s crucial to deal with these tensions correctly, especially in Europe.

Q. Let's turn to Spain. Don’t the markets understand the reforms that have been made?

A. From our point of view, there are three key issues: fiscal policy, the financial sector and structural reforms. Spain is moving in these three areas, it has made decisions; it has set goals and has done a lot, and has still work ahead of it. I'd say that this is appreciated by external observers, who believe that the country is going in the right direction. But this is no time for complacency. On the fiscal side, the government has been convincing. That being said, measures have to be followed up and the deficit target of 3% in 2013 is essential for credibility. Regarding the financial sector, there is a huge difference in perception compared with a few months ago, but work has not been finished there yet. As for structural reforms, they are absolutely essential because it is through them that growth potential increases. There are reforms that need to be tackled, especially labour market reform, which is being discussed by the social partners. All this is true for Spain, but also for Europe, which has to push forward bolder structural reforms.

Q. Isn’t fiscal orthodoxy, the surge of austerity, condemning Europe to slow growth for a long time?

A. On the contrary, fiscal soundness is essential for confidence, and confidence is the most important ingredient for sustainable growth. Financial soundness and structural reforms are also of essence. But speaking for the past, let me

give you two or three figures. In the past 12 years, GDP per capita has grown in Europe at the same pace as in the US, around 1%. In the labour market, despite the years of crisis, the euro area has created around 14 million jobs since the birth of the euro: about 6 million more than in the US. This is again no time for complacency. And nobody can say that we are satisfied when unemployment is still so high.

Q. Is Spain the red line in the EU?

A. Spain in the past has shown a remarkable capacity for innovation, for creativity, growth and job creation. It is a very dynamic country. That makes me optimistic, provided Spain continues to implement very actively and convincingly its programme in three areas already mentioned: fiscal soundness, banks' reshaping, and structural reforms.

Q. And the savings banks are the red line in Spain?

A. In this sense, Spain has three main challenges. As regards the savings banks challenge, a lot of hard work has already been done and should continue to be very actively performed.

Q. Especially after the leaks in Germany, do you think all the European partners, especially the political leaders, are aware of the danger of the current fiscal situation?

A. I appeal to all governments to show a high sense of responsibility, both individually and collectively, and to keep a strong sense of direction.

Q. At first you didn't seem very happy about the IMF involvement in the bailouts. Some were even calling for a European Monetary Fund. Why did you change your point of view?

A. The worst thing would have been benign neglect by the Europeans, which was a big danger at the beginning. Having overcome this temptation, the rescue brought together the conditionality and the financial support from the IMF and the European partners, which was necessary.

Q. On the subject of eurobonds, Europe has no treasury, unlike the United States. Do you think that a step could be taken in that direction?

A. At the present stage of European integration, with the current institutional framework, we consider that a major improvement in governance, particularly in fiscal policy, is absolutely decisive. At this stage we are not in favour of euro bonds.

Q. What is your opinion of Zapatero?

A. It is not for the President of the ECB to judge or give good marks or bad marks to the prime ministers! We are fiercely independent from the executive branches and we are issuing the currency for all the people, all the 17 nations, and political sensitivities.

Q. What about Draghi?

A. The appointment of the President of the ECB is the responsibility of the Heads of State and Government, after having had the advice of the Parliament and the Governing Council of the ECB.

Q. Does he have the right profile?

A. We have a great Governing Council, with very wise and experienced colleagues. And I have to say that Miguel [Fernández Ordóñez], José Manuel [González-Páramo], and Mario [Draghi] and all others have the right team spirit. And it is this very good team spirit which counts.

Q. What will you do after 31 October?

A. We'll see. I have a very hard job ahead of me. There's no time for complacency in many ways. I still have five and a half month! I will be completely absorbed by my work until the end of October.

Q. In these eight years, what has been the worst moment? May 2010?

A. We have had major challenges from the start. Immediately after my arrival the largest countries in the euro area, Germany, France and Italy, were asking for an easing and even a dismantling of the Stability and Growth Pact. We had to fight that. And there were other big challenges afterwards; the crisis has certainly been one. This is the greatest crisis since the Second World War. It could have been even worse – the worst crisis since First World War – if we had not made the decisions we made. They were times that required a great deal of effort. It has been very rewarding to see the team spirit of the Governing Council and of the staff of the ECB and of the other central banks of the Eurosystem. There have been some intensely challenging moments, during which my greatest satisfaction has been to see a formidable dedication to the euro and to Europe, in serving our 331 million fellow citizens..

Q. What is your legacy?

A. It's not up to me to talk about that.

Financial reform: what has been achieved and what remains to be done

Speech by Jean-Claude Trichet, President of the ECB, Madrid, 13 May 2011

Ladies and Gentlemen,

Introduction

We are nearly four years on from the first tremors in the world's financial system that started in the summer of 2007, and in a few months we will approach three years since the dramatic intensification of the crisis in the early autumn of 2008.

As you are all well aware, the euro area, the world's second largest and most open economy, was immediately and strongly affected. And as guardians of what is generally considered the world's second most important currency, the European Central Bank (ECB) was profoundly involved in the response to the crisis.

Our consistent aim in the crisis has been to protect as far as possible the real economy from the financial distress in the system. Over the past few years, our toolkit has featured the standard monetary policy measures of setting interest rates, as well as a range of non-standard monetary policy measures. The latter have included temporary measures such as full allotment of liquidity, expanded eligibility for collateral, longer-term refinancing operations and interventions in bond markets.

The ECB has also been involved in actions focused on the long term to try to ensure that the financial sector cannot pose such a danger to the real economy again. The financial turmoil that emerged from the US housing market and which sent shockwaves across the world economy revealed deep flaws in the way the financial system in advanced economies operates and in the way that system is supervised and regulated.

Tackling those systemic flaws through financial reform is what I would like to discuss today.

The ECB's involvement in financial reform takes place through our role in the institutional framework of the European Union as well as the institutional framework of the global economy – the G20, the Basel Committee and other fora of international cooperation.

Last year several important decisions were taken on the pillars of the new supervisory and regulatory framework. First, the adoption of Basel III. Second, reforms of market infrastructure. And third the establishment of macro-prudential oversight institutions, including the European Systemic Risk Board (ESRB).

Key areas where work is still in progress include the treatment of systemically important financial institutions, crisis management and resolution, oversight of the shadow banking system, and – very importantly – the regulation and oversight of financial markets and their functioning.

* * *

Today I would like to lay out what I believe are the three main building blocks of the financial reconstruction that is currently in progress – to outline what has been achieved and what remains to be done.

The first building block is banking regulation. Here, the global community has made the right diagnosis and, in the Basel III framework, drawn the appropriate lessons.

The second building block is regulation of the financial markets. Here, reform must create greater transparency for the various market segments and products, ensure sufficient competition in all markets, and attenuate as far as possible the pro-cyclicality from structural features such as ratings and market phenomena such as herding.

The third building block is macro-prudential oversight. This new discipline focuses on the interactions between the various parts of the financial system and between the financial sector and the real economy. New institutions, including the ESRB, will pursue the task of identifying sources of systemic risk, issuing early warnings and recommending remedial action.

The birth date of macro-prudential oversight in Europe will probably be identified as the start of this year but it was originally conceived in 2009 through the work of the Committee presided over by Jacques de Larosière. The fact that it took little more than a year and a half from policy design to institutional establishment was made possible by thorough groundwork by the European Commission and very rapid decisions by the European Parliament and the European Council. I feel very honoured to chair this new body, the ESRB, together with Mervyn King and Andrea Enria.

Let me discuss each of these three building blocks, focusing on both progress to date and the challenges that lie ahead.

1. Banking regulation and Basel III

First, banking regulation, where the Basel III framework represents the cornerstone of the newly revised international regulatory architecture. This framework envisages higher minimum capital requirements, better risk capture, stricter definition of eligible capital elements and more transparency. It introduces entirely new concepts, such as non-risk-based leverage ratios and mandatory liquidity requirements.

Beyond the micro-prudential dimension of regulation – typically represented by institution-specific solvency requirements – Basel III also introduces macro-prudential elements, most prominently the capital buffer regime based on aggregate credit growth.

From both a macroeconomic and financial stability perspective, the implementation of Basel III should bring substantial long-term benefits. As painfully experienced in recent years, financial crises impose enormous costs on society. The main benefit of the reform will stem from the reduced frequency of future crises.

The new standards aim at improving banks' capital base and the sector's resilience to a crisis. Financially sounder banks will, in turn, help foster financial stability as well as mitigating systemic risk. The prevention and mitigation of downside tail risks for the economy implies a sizeable reduction in the expected output losses associated with systemic events, contributing to more sustainable growth.

Although the net benefits from Basel III are difficult to quantify precisely, the Committee's analysis indicates that the potentially negative impact of the new framework on long-term output is considerably lower than the growth benefits associated with the reduced frequency of crises. Additional benefits include lower funding costs for banks and a decline in risk premia.

At the same time, it is acknowledged that implementation of the new framework will impose some transitional costs on the sector as banks need to meet the more stringent regulatory requirements. Banks can adjust their capital ratios through a combination of several measures, for example, by raising capital or reducing dividends for some time.

The length of the implementation period matters crucially for the transition costs. The Basel Committee has designed relatively long phase-in arrangements to mitigate adjustment costs. If the new framework had been implemented hastily, banks would have needed to reorganise their balance sheet structure quickly, which could have had adverse impacts on credit intermediation in the short term.

Implementation over the time frame 2013-19 has been agreed to provide the sector sufficient time to adjust to the new requirements. The gradual implementation should prevent disruptions in credit flows and bring enough clarity and scope for banks to absorb the necessary adjustments smoothly over time.

Looking forward, the introduction of the new standards presents the international regulatory and supervisory community with two major challenges. The first is to ensure proper implementation of Basel III at the global level. In line with the G-

20 recommendations, all national authorities should honour their commitment to implement the framework without any undue postponement.

The second challenge relates to thorough assessment of the new regulatory concepts and measures. Some of the new concepts, such as liquidity standards and leverage ratios, have sparked controversy and delayed final agreement. To alleviate concerns about potential unintended consequences, an observation period has been agreed to serve as a basis for the final design and calibration.

Work in progress on systemically important financial institutions, crisis resolution and shadow banking

Let me turn to some issues of banking regulation on which it is important that work continues. The first is systemically important financial institutions, which the G20 and the Group of Governors and Heads of Supervision have stated should satisfy additional solvency requirements beyond the levels agreed in Basel III. The main goal here is to reduce the externalities related to the financial distress of such institutions, and ultimately avoid a repetition of the crisis.

The Financial Stability Board (FSB) has been working on identifying systemically important financial institutions and evaluating the desirable magnitude of additional capital with which they should comply. Its recommendations will be delivered to the G20 summit in November.

The FSB's work is a fundamental step towards an international framework that fully reflects the greater risks posed by these large institutions. Looking forward, it is crucial that effective peer reviews of final implementation are set up, ensuring consistency across jurisdictions. Enforcing a level global playing field remains a priority for the regulatory agenda, to prevent regulatory arbitrage to parts of the financial sector with less supervision and weaker regulation.

In parallel with higher solvency requirements for systemically important financial institutions, important initiatives are underway – both in Europe and globally – to improve the capacity of authorities to resolve financial institutions, especially in a cross-border context.

An effective resolution regime should consist of a comprehensive toolkit of gradually increasing powers, complemented by credible financing arrangements that reduce the reliance on government budgets. It is essential to make significant progress in the coming years to ensure that all systemically important financial institutions can be resolved in an orderly manner and without taxpayers' support.

The FSB is identifying the key elements of effective resolution regimes. At the same time, the reform of national (or in the case of the EU, supra-national) resolution frameworks is already underway in the major jurisdictions, including the Dodd Frank Act in the United States. Here, the European Commission has published a public consultation document on the planned EU framework, for which legislative proposals are expected in June.

Let me briefly mention shadow banking. The introduction of more stringent capital requirements for credit institutions may provide further incentives for banks to shift part of their activities outside the regulatory perimeter. Against this background, the FSB is developing recommendations to strengthen oversight of the shadow banking system in collaboration with other international standard setting bodies.

Work on the shadow banking system should aim to develop a better understanding of the interconnections between regulated banks and unregulated entities that are conducting credit intermediation, either directly or as part of a complex chain of intermediation activity, as well as the channels for possible contagion. In this context, it is crucial to understand the functioning of the repo market. It is also vital to identify entities or activities within the shadow banking system that may be sources of systemic risk.

2. Market regulation

Let me turn to the second building block, namely regulation of financial markets. One of the key lessons from the crisis is that the risks to market returns did not come mainly from shocks to the real economy. The risks came from the financial sector itself. The financial structures that we thought were in place to assess, absorb and neutralise risk were either dysfunctional or worked to magnify volatility.

Key factors in creating this risk were opaque financial structures and pro-cyclicality in financial markets. The lack of transparency in many financial instruments meant that some market players could exploit – for their own, private benefit – information that was not generally available.

Pro-cyclicality acts as a formidable accelerator of financial trends. Two important factors that drive such amplification are distorted incentives and herd behaviour. The role of distortions in economic incentives is widely understood, but herd behaviour as a driver of pro-cyclical patterns in financial markets still needs a thorough explanation.

One explanation lies in the significance of market players' evaluation of their performance relative to the rest of the market. This is reminiscent of Keynes' famous beauty contest analogy. To be successful in this environment, individual participants do not form their own opinions, but follow the general mood. Everybody seeks to ride the wave, hoping to step off before the mood turns.

A second complementary explanation is that global markets are in fact less atomistic than we think. Derivatives activity in the US banking system, for example, is dominated by a small group of large institutions. And, of course, the market for credit ratings is famously dominated by three signatures, which act as standard-setters for an enormous volume of transactions.

Many regulatory initiatives are underway to remedy these issues, including work on OTC derivatives, which comprise 80% of traded derivatives. The near-collapse of Bear Stearns in March 2008, the default of Lehman Brothers in September 2008 and the bail-out of AIG the same month highlighted shortcomings in the functioning of the OTC derivatives market, and underlined the need for appropriate action to increase transparency and address concerns about financial stability.

To this end, there is now a regulation underway in Europe aimed at bringing more safety and more transparency to the derivatives market. According to the draft regulation, information on OTC derivative contracts should be reported to trade repositories and be accessible to supervisory authorities. Furthermore, standard OTC derivative contracts should be cleared through central counterparties, thus reducing the risk that one party to the contract defaults. Any possible concentration risk involved in the set-up of the CCPs could be assessed at the macro-prudential level.

Of course, financial market infrastructures can only help to foster the stability of markets to the extent that they are safe and sound. To this end, the Committee on Payment and Settlement Systems and the Technical Committee of the International Organization of Securities Commission are reviewing the relevant regulatory and oversight standards. A consultative report published in March 2011 outlines principles that will provide greater consistency in the oversight of financial market infrastructures worldwide.

3. Macro-prudential supervision and the ESRB

Let me come to the final building block: macro-prudential oversight.

As my earlier remarks suggested, the financial crisis has been revealing in many respects. It has revealed the fallout from the failure of large financial institutions. It has revealed the fragility of the financial system to features and trends that cut across institutions, markets and infrastructures. And it has illustrated the amplitude of the consequences of the adverse feedback loop between the financial system and the real economy.

All these three elements are key features of systemic risk: first, contagion; second, the build-up of financial imbalances and unsustainable trends within and across the financial system; and third, the close links with the real economy and the potential for strong feedback effects.

The strengthening of macro-prudential oversight – with the establishment of institutions devoted to that task such as the ESRB, the US Financial Stability Oversight Council and the UK's Financial Policy Committee – should enhance our ability to identify and address systemic risk. How can these new bodies reach their full potential?

The first precondition is that they have an adequate infrastructure to identify and analyse systemic risks. This demands a state-of-the-art analytical toolkit, which can provide a solid basis for systemic risk analysis and the ensuing formulation of policy responses.

In the field of systemic risk assessment, great attention is currently devoted to macro stress testing as a tool to evaluate the impact of shocks on the financial sector and the real economy. This complements micro stress tests relating to individual financial institutions. A key challenge is modelling feedback effects between the financial system and the real economy.

Another promising area relates to network analysis, which aims to identify systemic inter-linkages across firms, sectors and countries. This type of analysis, which is well established in other domains, is still at its infancy for the financial sector.

A key point in this context is that the effectiveness of the analytical toolkit is strongly dependent on the availability and quality of data. There are several data gaps, which make it difficult to assess the sources and magnitude of systemic risks and the very complex network of inter-linkages in the financial system.

The second precondition for the success of the new bodies is a coherent framework for macro-prudential oversight and policy development. In this context, it is important to note that the institutions do not have direct control over policy tools. In the case of the ESRB it may issue risk warnings and recommendations to other authorities, which should comply with them or give reasons for non-compliance.

Since existing policy tools that can be used for macro-prudential purposes fall in other policy domains (e.g. micro-financial supervision, monetary policy or fiscal policy), it is essential that effective coordination mechanisms should be developed between the responsible authorities. In particular, close cooperation between macro- and micro-supervisory authorities is essential as most of the macro-prudential tools are micro-prudential in nature. It is therefore of utmost importance that the mandate of macro-prudential authorities as well as the role of supervisory authorities in macro-prudential surveillance are clearly defined.

Conclusion

Let me conclude. I believe we are now about halfway through the comprehensive financial reforms that the crisis has demanded. We have achieved a blueprint of more stringent bank regulations that includes more loss-absorbing capital, better risk coverage and limitations for undue leverage. The oversight of financial institutions as well as markets and market infrastructure are being strengthened. And the organisational structure of financial supervision is being overhauled.

But much remains to be done. The key aspect is implementation of the reforms. Moreover, the issue of systemically important financial institutions requires further reflection. And oversight of the proper functioning of financial markets in a way that avoids undue volatility, excessive influence of dominant players and oligopolistic market structures, while reinforcing transparency, needs to be addressed resolutely.

Thanks, in particular, to prompt and resolute action by central banks and by governments, the international community avoided a great depression, after the intensification of the crisis in mid-September 2008. With the global recovery being confirmed, numerous voices in the financial sector are arguing that we are now back to business as usual. Achieving an ambitious programme of reforms of rules, regulations and oversight of the financial sector is considered by some as unnecessary and counterproductive. I do not at all share those views. It is an absolute obligation, for all of us, to do all what is necessary to reinforce the resilience of the financial system and ensure its sustainable contribution to growth. We must be sure that the excessive fragility that was revealed in 2008 and 2009 is eliminated. Not only because the costs of financial crises in terms of growth is always considerable but, even more, because it is extremely likely that our democracies would not be ready to provide once again the financial commitments to avoid a great depression in case of a new crisis of the same nature. Our people would not permit, for a second time, that governments mobilize 27% of GDP of tax payer risk, on both sides of the Atlantic, to avoid the collapse of the financial sector. For these reasons public authorities must pursue and implement their G20 programme with inflexible determination, and it is essential that the private sector fully implements this programme.

Thank you for your attention.

Monetary policy in uncertain times

Speech by Jean-Claude Trichet, President of the ECB at the Bank of Finland 200th Anniversary Conference Helsinki, 5 May 2011

Ladies and gentlemen,

It is a pleasure to have the opportunity to speak at your conference on monetary policy.

It is remarkable to think that the Bank of Finland will celebrate its two hundredth anniversary this year. The ECB, as the youngest central bank in the world, but with such an extraordinarily solid historical legacy in the Eurosystem, looks at such a storied history in the European monetary team with pride.

This conference occurs at a point in time when central banks and governments of the advanced economies continue to face a wide range of challenges. I would like to start by reflecting in front of you on a challenge that, at first sight, may seem not directly related to monetary policy: strengthening economic governance in the euro area. Strong economic governance – and therefore closer economic union – is however the fundamental counterpart to the single monetary

policy. With a centralised monetary policy but decentralised fiscal and economic policies – in the absence of a federal institutional framework - those policies have to be placed in a solid framework and appropriately coordinated.

The duty of public institutions is to fulfil their mandate and, by doing so, to meet the expectations of the citizens. The ECB's Governing Council has done so and fulfilled public expectations in line with its mandate. Citizens in Europe expect overall stable prices and their purchasing power to be maintained. Over the first 12 years, the ECB has delivered an average annual rate of inflation of 1.97%.

Citizens expect a stable economy and public authorities that are alert and effective in combating crises. The ECB has taken unprecedented steps to mitigate the effects of the recent crisis on the real economy by ensuring the flow of credit to the households and firms and preserving financial stability – of which I will talk more later.

In the field of economic governance, however, public institutions still need to make a 'quantum leap' to meet public expectations. European citizens recognise the value of closer economic cooperation, particularly those in the euro area. Surveys indicate that, on average in euro area countries, more than four out of five euro area citizens are in favour of greater policy coordination between countries to overcome the crisis. This is something, which I consider very important: citizens want a stronger and better coordination of economic and financial policies in the euro area.

The challenge facing policymakers today is how to deliver the deeper economic union that is so fundamental to EMU and to the expectations of its citizens. All agree that the existing economic governance framework needs to be reformed. Fiscal and broader macroeconomic policies have to be consistent with rates of sustainable growth and price stability in a stability-orientated economic and monetary union. To achieve this, the Stability and Growth Pact needs to be reinforced and a strong surveillance of macroeconomic imbalances and competitiveness needs to be installed.

Important negotiations are ongoing between the Commission, the Council and the European Parliament to reach agreement on the legislative package to reform economic governance. For these reforms to reach the 'quantum leap' that is required, the following elements are essential:

First, greater automaticity is needed in all surveillance procedures, including the new macroeconomic surveillance framework. The Council should have less room for halting or suspending procedures against Member States. Strict deadlines to avoid lengthy procedures and the deletion of escape clauses would further automaticity. This is critical to ensure the credibility of the new framework and address spillovers in a timely manner.

Second, enforcement tools need to be more effective. In addition to financial sanctions, political and reputational measures would help foster early compliance, as would the application of earlier and more gradual financial sanctions within the macroeconomic surveillance framework. Discretion to reduce or suspend financial sanctions is undesirable as it strongly reduces effectiveness and sets the wrong incentives.

Third, more ambitious policy requirements would better match the current reality of the euro area. It makes sense for macroeconomic surveillance to have a clear focus on the euro area countries with large current account deficits, significant losses of competitiveness and high levels of public and private debt. As regards fiscal surveillance, ambitious benchmarks are needed when establishing an excessive deficit and in setting the adjustment path towards a country's medium-term budgetary objective.

Finally, the gap between the EU and national level must be closed. New procedures will not be sufficient if they are not solidly anchored at national level. Binding commitments by Member States to swiftly implement strong national budgetary frameworks are essential.

In my view, the proposals agreed by the Council do not represent the significant leap towards closer economic union that is required. The European Parliament has been more ambitious in its approach, particularly as regards greater automaticity and the broader and more timely use of sanctions. I hope that the ongoing negotiations over the legislative package will permit the texts to be significantly improved along these lines. I believe that the citizens of Europe count on the European Parliament to take a broader perspective and drive these changes forward.

There are also some important areas in which care should be taken not to weaken the texts. In particular, softening the Stability and Growth Pact by introducing further exceptions or treating in a special way specific expenditure items, such as public investment, would create further room for unwarranted discretionary decisions. It is also of crucial importance that the economic governance reform is fully implemented as soon as possible and without any transition period.

Beyond fiscal and broader macroeconomic governance, it is important to remember that economic union comprises a third governance pillar which is equally important: the structural reforms embedded in the "Europe 2020" strategy and the Euro Plus Pact. Structural reforms are essential to elevate the growth potential of the euro area in the face of ongoing debt sustainability challenges and future age-related expenditures. A specific example where urgent progress is needed

is the incomplete single market in services. It makes full economic sense and it is urgent to complete the single market in the sector in which a very large majority of people in Europe work.

When EMU was first established, many people asked how monetary union could function effectively in a Europe of sovereign states. The answer is simple: it can function effectively with an appropriate economic union.

It is fully recognised that this economic union must be one where countries that wisely follow a virtuous economic path are rewarded, and those that pursue unsustainable policies have to internalise the costs of their actions.

At the same time, economic union implies interconnectedness, and it is in all countries' interest not to exacerbate difficulties by creating uncertainty in financial markets.

We look to an economic union where all countries face up to their individuals responsibilities, but also an economic union which remains guided by a common cause and destiny.

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Turning now to monetary policy, the challenges central banks are facing in fulfilling their role of a stable anchor are large.

First, decisions have to be made in an environment marked by a very high degree of uncertainty. Although operating in an uncertain environment is common business for central banks, I would argue that structural transformations of our economies, the ever-growing complexity of global finance and the overall process of globalisation are itself creating a multidimensional acceleration of change leading to increased uncertainty on the transmission mechanism of monetary policy.

In addition, in crisis times there is an elevated degree of Knightian uncertainty. The character of this uncertainty can not be calculated or modelled. Acting pre-emptively to avoid possible grave consequences of events for which a priori probabilities do not exist implies that crisis prevention is a crucial part of policy.

This leads to another challenge, which is the need to communicate clearly the actions taken in the realm of crisis prevention. The immediate decisions that appear necessary to avoid crisis might not be fully understood by external observers, including the general public for the simple reason that they do not see the counterfactual. When measures are wisely taken ex ante, precisely to avoid the unfolding of an acute crisis, then decision-makers' face the problem of explaining their actions in the light of something that did not happen.

This is yet one more reason for why the independence of central banks is absolutely key. It is essential to permit them to take the appropriate preventive decisions. As the world around us is rapidly changing, swift action is often called for. I have previously proposed a posture of "credible alertness", suggesting that it was the best approach for a central bank to anchor inflation expectations firmly, while being ready to take action at any point in time without being the prisoner of previous commitments on policy actions. The threat to act will be more effective the more credible the central bank has been over time in actually delivering price stability.

In addition, the knowledge that the central bank will normally make use of all available options – as circumstances dictate – to counteract situations that have the potential for undermining confidence and perturbing market conditions enhance control of private expectations. Our readiness to act prior to the crisis, during the crisis and as far as the existing use of standard interest rate measures is concerned also currently is clearly demonstrated throughout time.

Allow me to elaborate a little bit on some of the actions taken. In the exceptional times of the past three years, the response to the crisis by central banks around the world has led to the adoption of non-standard measures. In the case of the ECB, the non-standard measures adopted during the crisis are precisely designed to help restore a more normal functioning of the transmission mechanism and contribute to recreating an environment where the "standard measures" can operate effectively. It should be clear what the non-standard measures of the ECB are not. They can not be seen as liquidity measures to stimulate activity at a lower bound for interest rate, where they would act where standard interest rate policy fails. Rather "non-standard" measures can co-exist with different levels of the policy rate.

The monetary policy stance is always chosen by the Governing Council to deliver price stability in a medium term. The non-standard measures have a clear purpose: ensuring that the standard measures themselves are transmitted as effectively as possible despite the otherwise abnormal functioning of some markets. The types of non-conventional operation implemented by the ECB fully allow us to amend the monetary policy stance, in particular through a change in the interest rates. In other words, decisions about interest rates can be separated from the non-conventional measures.

I refer to this duality as the “separation principle”. The non-standard measures have to be commensurate with what we are observing on the market, namely to help the transmission of our monetary policy to function better again. The standard measures are there to deliver price stability in the medium term.

Seen through the lens of the separation principle, I stress that we have been and will take in the future decisions on standard measures independently of our decisions on non-standard measures. For example, the ECB has indicated clearly that interest rate increases could perfectly well take place independently of the timing of the phasing out of the non-standard measures - if those non-standard measures continue to be fully justified by the situation.

The separation principle can be seen operating recently. On April 7 the Governing Council decided to increase the interest rate on the main refinancing operations of the Eurosystem by 25 basis points. I was particularly pleased that this decision was taken unanimously. That was of course a very important decision that the Governing Council was implementing as regards the “standard measures”. At the same time “non-standard measures” were maintained for the second quarter of this year, particularly the policy of full allotment and a fixed rate for the supply of liquidity with a duration of three months.

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Let me conclude. I am convinced that when central banks and governments take up the tasks that are before them then we will surmount the difficulties our economies are experiencing. But this is no time for complacency in any respect. The ECB, for its part, will do all that is necessary to continue to be a solid and reliable anchor of stability and confidence in these challenging times. And there is little doubt that the future will continue to present new and unexpected challenges.

The citizens of Europe can rely on our strong determination to ensure a very solid anchoring of inflation expectations – something that is more important than ever in turbulent times.

Thank you for your attention.

Short Address in honour of Axel Weber

Speech by Jean-Claude Trichet, President of the ECB, Deutsche Bundesbank Festakt, Frankfurt am Main, 2 May 2011

Ladies and gentlemen,

ich freue mich sehr, heute bei Ihnen zu sein. Ich möchte im Namen des EZB-Rats Axel Weber für seinen Beitrag über die vergangenen sieben Jahren danken und Jens Weidmann als neues Ratsmitglied begrüßen.

The Eurosystem is a large team, and it is a cohesive one, with a variety of perspectives linked by a common purpose. The Eurosystem is also a very successful team. Ever since the introduction of the euro we have been fully faithful to our mandate of maintaining price stability over the medium term, defined as medium-term inflation at “below, but close to 2%”.

As you know, the average annual inflation rate in the euro area over the past twelve years has been 1.97%.

This is a remarkable achievement, also considering that the economic environment during those 12 years can hardly be described as benign. The beginnings were marked by a severe oil price shock, which compounded the cost pressure and inflation implications of a secular decline in European productivity trends. Due to these adverse supply side adjustments, the bursting of the dot-com bubble brought a downswing with no disinflation. Later, over the recovery that followed – Axel remembers – there was no time or disposition within the Governing Council for complacency, as we were all too concerned about insistent signs of excessive credit market euphoria, about – once more – strong pressures on commodity and food prices and – ultimately – about the global imbalances that such a combination of forces were causing worldwide. Axel became member of the Governing Council in 2004, at a time when many voices, including in the executive branches and in the international financial institutions were calling for looser monetary policy. We rightly resisted these calls based on our own assessment of the risks to price stability. Back then and throughout the past seven years Axel has made influential contributions to the discussions shaping the view of the Governing Council on the appropriate monetary policy stance.

The fact that we have been able to solidly anchor inflation expectations in the euro area at a level consistent with price stability throughout all these phases has bolstered our credibility. The Eurosystem clearly stands in the tradition of best practice in central banking – as exemplified by the Bundesbank prior to the introduction of the euro. The Eurosystem's two-pillar monetary policy strategy inherited the concept of the Bundesbank monetary pillar – which my own previous institution, the Banque de France had also chosen in January 1994 as soon as it became independent. The Eurosystem's two pillar strategy is built on the conviction that, in the medium to long term, inflation is a monetary phenomenon and that independent central banks have the strategy and the instruments to achieve price stability. The Eurosystem's track record proves that this important insight translates one for one to the monetary union context.

I would like to take this opportunity to also express my gratitude, not only to Axel Weber but also to all Bundesbank staff, for the commitment shown on a daily basis during the past twelve years and in particular during the financial crisis. The Governing Council of the ECB knows and highly appreciates the crucial contribution of national central banks to the smooth functioning of monetary union. The financial crisis has made more visible to a broader public the essential tasks that national central banks carry out day by day within the Eurosystem.

For the sake of brevity allow me to focus here on two such activities, and I am fully aware that there are many other tasks that equally deserve our full recognition. On both dimensions, the Eurosystem benefited enormously from the Bundesbank's dedication to our common cause, and on both dimensions the Bundesbank contribution found in Axel its voice.

The first task is financial supervision, the importance of which cannot be underestimated. For one thing, the information gathered in supervision has been particularly useful in the preparation of monetary policy decisions during the financial crisis. This has been especially true when and since the Governing Council of the ECB decided to introduce non-standard monetary policy measures to ensure the proper transmission of the monetary policy stance. The information also helps the Governing Council of the ECB assess the interconnectedness of national financial systems and vulnerabilities threatening financial stability in the euro area as a whole.

In this context the Bundesbank has done a crucial job in containing the fallout from the financial crisis. After the collapse of Lehman Brothers immediate and determined action was crucial to avoid a meltdown of the financial system in Germany and the other euro area countries. The Bundesbank under the leadership of Axel offered the best possible diagnosis to protect the stability of the German banking sector at the height of the crisis.

Nonetheless, the financial crisis has revealed serious weaknesses in existing supervisory arrangements both at the national and euro area level. In response to these shortcomings, the EU among other initiatives has created the macro-prudential European Systemic Risk Board (ESRB) in which the Eurosystem is very actively involved. Axel has generously devoted his time to the Steering Committee of the ESRB as he has done for the Financial Stability Board at the international level.

The second task for which the Eurosystem has to rely critically on the support of the national central banks is the implementation of monetary policy. This role comprises the conduct of monetary policy operations, the design and operation of payment systems and the provision of banknotes and coins. At several points in time the efficient and effective functioning of the infrastructure has been absolutely essential to the success of the euro. This was true in the very beginnings in 1999, it was true at the moment of the cash changeover in 2002 and it has been true most recently during the financial crisis. The Eurosystem infrastructure has been exposed to a formidable stress test and it has proved its robustness throughout.

Again, Bundesbank expertise proved immensely valuable, for example in the design of our new payment system TARGET2 but also in the design of our non-standard monetary policy measures, most notably our covered bonds purchase programme, which as you know are a German innovation dating back to the time of Friedrich des Großen. Their success over hundreds of years shows that asset-backed securities need not be toxic. Pfandbriefe are a prime example of finance at the service of people's well-being. Therefore the Governing Council in May 2009 decided to lend its support to this asset class, following Axel's advice.

Damit komme ich zum Schluss. Beruht der Erfolg des Euro nur auf Glück? Erlauben Sie mir, darauf mit einem Zitat zu antworten, das Axel Weber in anderem Kontext zugeschrieben wird: „Nicht Glück – Können!“ [1] „Und Beharrlichkeit“ würde ich in unserem Kontext hinzufügen. Das Eurosystem ist für die Zukunft sehr gut gerüstet.

Lieber Axel, ich wünsche Dir alles Gute für Deine Zukunft!

Lieber Jens, as you know, we are still living in a very demanding environment. The crisis is not over. The responsibilities of the private sector and public authorities are as important as ever during the last three years. The Eurosystem has kept and will keep its sense of direction, strictly separating the standard measures, designed to deliver price stability, from the non-standard measures, designed to help restore a more correct monetary policy transmission mechanism. We shall never forget that we are issuing a single currency for 17 sovereign countries and 331 million citizens. This is a situation

which has no equivalent in the world. More than ever, the unity of the Eurosystem and the unity of the Governing Council is of the essence.

Lieber Jens, herzlich willkommen im Eurosystem!

Interview with Helsingin Sanomat and Kauppalehti

Interview with Jean-Claude Trichet, President of the ECB , conducted on 20 April 2011 by Mr Jorma Pöysä (Kauppalehti) and Mr Juhana Rossi (Helsingin Sanomat), published on 26 April 2011.

Question: As you may know, a populist and euro-hostile party called True Finns won the general election in Finland last weekend, obtaining almost one-fifth of the votes. Are you worried that this anti-euro sentiment will grow in other euro area countries? Could it dampen the willingness of triple A countries to accept new rescue arrangements and therefore slow the gradual recovery from the recession and the debt/banking crisis?

As a central bank we issue a currency for absolutely all political sensitivities. We are the guardian of a public good – a credible and stable currency – and that public good is for the service of all our fellow citizens. We are, by construction, a multi-partisan and multinational institution. I will not comment on the functioning of our democracies. We fully respect the functioning of our democracies in which we have the fortune to live in Europe.

Question: But what is the atmosphere in Europe? Do you think there are worrying phenomena?

In a democracy all opinions are expressed. I have observed that there was always a very strong European drive in Finland, and I am very happy with that. As I said, the euro was created on the basis of a multi-partisan and multinational vision to deepen European construction and to reinforce solidarity between Europeans. Taking into account the historical challenge, which Finland perhaps knows better than other European countries over the last 60 years, it seems to me that all the reasons why the "founding fathers" had this vision of European unity are still there and they are even stronger now. When we look at the changes all over the world, the extraordinary growth of the emerging economies, such as India, China, Brazil, Mexico, Russia, and the remarkable development of Latin America and Africa, we see that European unity is more important than ever.

Question: The level of the ECB's refinancing rate is still unusually low. Also the non-standard measures are in use, and banks have access to ample liquidity. At the same time global price pressures in energy and food are elevated, and headline inflation exceeds the ECB's definition of price stability. With this frame of reference, is the Governing Council engaged in very close monitoring of price developments in the euro zone?

As I said after the Governing Council's last decision, we judged it necessary to increase rates by 0.25 percentage point in order to deliver price stability in the medium term. For us it is extremely important to prevent second-round effects after the "hump" in the headline inflation rate. Some price-setters and social partners might be tempted to view this hump not only as a transitory phenomenon, due to a shock in the price of energy and commodities, but as something more permanent. Such a perception is not acceptable for the ECB's Governing Council, which is responsible for price stability in the medium term. That is the reason why we increased rates.

We are proud of the fact that during the first 12 years of the euro we have delivered price stability, in line with our definition, namely "below 2%, but close to, 2%". To be precise, we have delivered an average yearly price increase to our 331 million fellow citizens of 1.97%.

And it is extremely important to continue solidly anchoring inflation expectations in a period which is marked by uncertainties and turbulences.

Question: Do you see second-round effects caused or any signs of second-round effects anywhere in the euro area?

We have risks of second-round effects here and there. We have to be very alert that they do not materialise.

At the moment I do not see any significant materialising of second-round effects and I do not see un-anchoring of inflation expectations. But this is no time for complacency. We have to be permanently alert to avoid the materialisation of such risks.

Question: To what extent is the ECB's freedom of action limited by the poor condition of some of the euro zone banks?

We have to deliver price stability to the whole of the euro area – which means 17 countries and 331 million people – just like the Federal Reserve has to deliver a single monetary policy to all the states of the United States of America, and not one policy for particular states that are growing rapidly and another one for states that are in difficulties. Our mandate is very clear, and it addresses the euro area as a whole.

From the very beginning of the financial turmoil we set up a strict separation principle between our standard measures, namely the interest rate decisions, which are designed to deliver price stability, and the non-standard measures, which are designed to help restore a better transmission of our monetary policy, taking into account the abnormal functioning of some markets.

Question: How is the ECB's room for manoeuvre influenced by the poor condition of public finances in euro zone countries, and especially in the countries with acute crisis?

As I said, we are not compromising on our primary goal of maintaining price stability, and our interest rate decisions are designed to fulfil that aim. Any other approach would be unthinkable. And one should never forget that price stability is a precondition for sustainable growth and job creation.

Question: There are some heavily indebted nations within the euro area, most prominently Greece. Yesterday (Tuesday, 19 April) the news agency Reuters reported that Clemens Fuest, who chairs the German Finance Ministry's Technical Advisory Committee, said Greece's extremely weak balance sheet meant a restructuring of the Greek sovereign debt was inevitable. He said that: "One must recognise the realities – I am expecting a haircut". Do you agree with Mr Fuest and other prominent economists and policy-makers who have expressed similar views?

There is an important adjustment plan which has been adopted by the Greek government to reform its fiscal and structural policies. This plan has been approved by the IMF, by the international community and by the European Commission in liaison with the ECB. This plan is being applied.

Question: How worried should we be about credit rating agency S&P's negative outlook for the AAA rating of US debt? Is there a rising risk of higher long-term interest rates worldwide?

The ECB has always thought and said that it was important for all advanced economies, without exception, in Europe and the rest of the world, to be very keen on the sustainability of their long-term fiscal policies. It is extremely important that the authority of the signatures of the advanced economies is unchallengeable. I personally have full trust in the United States for preserving its creditworthiness and the authority of its signature.

Question: The ECB has postponed its exit from the non-standard measures on several occasions. Can the non-standard measures de facto co-exist with any level of interest rates?

Yes, indeed, the "separation principle" that we apply permits us always to have the right level of interest rates, even when markets are still not functioning perfectly. As I said, we set interest rates at the right level to deliver price stability. This is independent from the decisions we take regarding the non-standard measures, which have to be commensurate with the situation in the markets and the need for a proper transmission of monetary policy.

You have seen an example this spring. Following the March meeting of the ECB's Governing Council we pre-announced that there was a possibility that the Governing Council would increase interest rates. That was of course a very important message that the Governing Council was sending as regards the "standard measures".

At the same time we decided to maintain the "non-standard measures" for the second quarter of this year, particularly the policy of full allotment and a fixed rate for the supply of liquidity with a duration of three months.

Non-standard measures are temporary by nature. I do not imagine that we would have them permanently, because that would be relevant only in a permanent situation of dysfunctional markets, which is of course not our working assumption.

Question: The ECB began purchasing government bonds from the secondary market (i.e. the Securities Markets Programme or SMP) in May 2010. Is there a limit to the size of this programme?

This is one of the non-standard measures we have taken. I have nothing further to add to what I have already said on that.

Question: When will this programme be terminated?

I have nothing to add.

Question: The yields on the stressed euro area government debt securities in some maturities are now much higher than on several occasions in the past during the SMP. Yet the ECB has not particularly actively purchased securities from the markets during recent weeks and months. Why?

We take the decisions that we consider appropriate in the circumstances.

Question: Do you consider the outgoing president of the Deutsche Bundesbank, Axel Weber, a constructive and discrete member of the Governing Council of the ECB?

Axel Weber has been an important member of the Governing Council and his contribution has been appreciated during the entire period of his membership of the Governing Council.

Question: In a recent interview in the Der Spiegel magazine Mr Weber made the following statement: " *There are minutes of meetings of the American Federal Reserve Bank and the Bank of England in which divergent opinions are documented. I think that's exemplary. I had already told my colleagues ahead of time that we weren't with a routine decision, but an important change in direction, and that I could not keep my opinion to myself on such a fundamental issue.*" Was Mr Weber correct when called the launching of the SMP an " *important change in direction*" for the ECB?

We are, in the European framework, in a unique situation. We have a single currency, a single monetary policy and a single system of central banks for the euro area, the "Eurosystem", comprising the euro area national central banks and the ECB. We issue the single currency for 17 sovereign nations and for 331 million fellow citizens. That explains why we have features ourselves that are not the same as in a fully-fledged federation. In particular it explains why we have a principle of speaking with one voice.

Question: Why could the majority of the Governing Council accept the decision to launch the SMP, but not Mr Weber? What is your explanation for this divergence of opinions?

I have no comment.

Question: How do you explain the SMP to ordinary citizens who fear that the ECB is engaged in the monetisation of debt and creation of inflation?

As you know, securities are purchased by the Eurosystem in the secondary market, after they have been issued and found a first buyer. And we always withdraw all the liquidity which has been injected with the SMP, so that we do not practise quantitative easing, which has been used in other economies. The SMP is one of the non-standard measures, which are transitory, we deemed necessary in view of the abnormal situation in markets, to help restore a normal transmission of monetary policy. Another example of important non-standard measures was the full allotment at a fixed interest rate for liquidity with a duration of six months, even up to a full year. This programme of liquidity provision with exceptionally long maturities has been phased out. We also had a programme in which we purchased covered bonds. That has also expired.

Question: In your opinion, should an ordinary euro area citizen take a fixed-rate mortgage or a variable rate mortgage? By a variable rate mortgage I mean a bank loan with one of the EURIBORs as its reference rate.

[Laughter] Do not count on me to take the job of the investment advisors. I would only say to my fellow citizens that they can rely on us to be an anchor of stability at the level of the entire euro area. Since the euro was set up we have had challenges within Europe and challenges coming from the outside. Citizens can count on us to deliver price stability in the future as we have done over the past 12 years. This is important in terms of confidence, and confidence is the most precious ingredient for consolidating the economic recovery.

Question: Stable and predictable inflation is one important issue when companies make investment decisions. Recently there has been prominent volatility in headline inflation rates. What is your message to entrepreneurs: how they can trust you to deliver what you have promised?

We delivered price stability over the first 12 years of the euro. The performance was better than what had been achieved in the countries of the euro area over any 12-year period since World War II. That is a remarkable record of price stability. These are deeds, not only words or promises. It is something we have done in the past. In a number of cases, decisions we took were criticised out of short-term considerations. We had the medium and long term in mind. All observers can look at our track record. Inflation expectations are well-anchored for the next five and ten years, based on our credibility. But this is no time for complacency. And this is why we took our last decision on interest rates.

Question: There is a relatively large number of medium-sized saw mills in Finland which are dependent on the export markets. When the euro is strong, they soon lose market share to their Swedish and Russian competitors. This makes them lose money and forces them to put their staff on furlough. What would be your advice to these entrepreneurs?

I would tell them that we have been living in a universe of floating exchange rates between the major currencies for the last 40 years. As regards the relationship between the euro and the US dollar, I will stress the statements made by the United States Secretary of the Treasury and the Chairman of the Federal Reserve: that a strong dollar vis-à-vis other major floating currencies is in the interest of the United States. I entirely share this view. I will also say to all economies in the euro area – and not only to Finland – that keeping a lid on costs, in particular by increasing productivity as much as possible, is essential to be competitive.

Question: The ECB decided recently to suspend the application of the minimum credit rating threshold in the collateral for the debt instruments issued or guaranteed by the Irish government – as you did previously with Greece. Why did you do this? Can the same procedure be applied later possibly to Portuguese debt instruments?

In these two cases the Governing Council of the ECB has taken into account the programmes the governments in these countries have set up with the IMF – namely by the international community – and the European Commission in liaison with the ECB. The programmes have been approved by the IMF and the European institutions, and they incorporate strict conditionality. We took our decision on the basis of this strict conditionality.

Question: Now markets know that the ECB will accept junk bonds as collateral. Likewise, euro area governments have one incentive less to maintain an investment grade credit rating because they now know that the ECB will accept in an extreme situation their bonds regardless of their quality. Did this softening of collateral requirements set a dangerous precedent?

I repeat: the decision of the Governing Council was made on the basis of very strong conditionality of the international community. No government takes lightly the fact that it has negotiated a programme that implies very strong conditionality with the international community and the European institutions.

Question: Once the sovereign debt crisis has been resolved, it may well take years before Greece and possibility Ireland have regained solid investment grade credit ratings. How is the ECB planning to exit from this softening of collateral requirements?

Again, strong conditionality and strict implementation of the adjustment programme. It is the sine qua non. At the end of the road stands the return to normal financing with market access. That is always the goal.

Question: You have a lot of experience of central banking within the European context. You first led the Banque de France for ten years and now you are approaching the end of your eight-year term at the helm of the ECB. Based on your experiences, what skills and abilities are an absolute must for your successor?

I never comment on my succession. One has to consider what a central bank is. A central bank is an institution that is there to be an anchor for stability and to have a sense of medium and long-term direction. It should not depend on an individual. Jean Monnet said: " *Nothing is possible without individuals; but nothing is lasting without institutions.* " We are an anchor for stability in Europe. What counts is the institution and the team. I have had the fantastic privilege of being part of a fantastic team. I like to use the metaphor of a football team: you have all the players on the field and among them is a captain, which is undoubtedly an inspiring responsibility. What counts is to have a good team spirit, a solid institution and all the wisdom of collegial decision-making.

Question: Is the President of the ECB more of an academic/technocrat or a diplomat/politician? Should the President of the ECB be a career central banker with impeccable academic credentials, such as Athanasios Orphanides of the

Central Bank of Cyprus? Or should the President of the ECB have a background in high-level national and European politics and multinational institutions with extensive personal networks, such as Erkki Liikanen of the Bank of Finland?

I have no comment on the decision which will be taken by the heads of state and government. I will only say that, of course, all members of the Governing Council have a solid academic background. That being said, all kinds of experience can be important and useful. And again: what is decisive is the team spirit.

Question: Based on your experience, is central banking more art than science?

Central banks need formidable analytical capacities and skills. You need both state-of-the-art analytical work, as deep and robust as possible, and you need judgement, based on experience and a solid capacity to synthesise all pertinent analyses. That is true in absolutely all circumstances, and particularly in times of crisis.

Question: Professor Barry Eichengreen of the University of California, Berkeley, recently published a book about the US dollar entitled *Exorbitant Privilege*. In the book Prof. Eichengreen makes the following assessment when he analyses the strengths and weaknesses of the major currencies.

" *If a first-class international currency needs a first-class central bank, then this, too, is something the euro possesses. The ECB has shown itself to be extraordinarily serious about the maintenance of price stability. Although it was roundly criticized for its exceptional purchases of government bonds in the spring of 2010, it continues to take its price-stability mandate seriously. It shows absolutely no inclination to embark on reckless inflationary policies.*"

First of all, do you agree with this assessment? Secondly, is the perception that the ECB is extraordinarily serious about the maintenance of price stability something that you would like to see as your personal legacy as a central banker?

I did not know that you would quote Barry Eichengreen. But yes, you can see that we consider price stability to be fundamental. It is our primary mandate and we are faithful to our primary mandate. We trust that fulfilling this primary mandate is a precondition for delivering sustainable growth and sustainable job creation. In the first years of the euro a great number of new jobs were created in Europe: around 14 million. That is not to say that we are satisfied. We cannot be complacent in any respect and structural reforms are still necessary to combat unemployment. Let me add that delivering price stability is a strong request we get from all our fellow citizens.

Question: When an economic historian looks back at the economic history of Europe 30 years from now, would you, on a personal level, like to see Jean-Claude Trichet remembered, both as head of the Banque de France and the ECB, as a central banker for whom the most important mandate was the maintenance of price stability?

It is not for me to make a judgement. But to the extent that I was called on to pursue price stability as the primary mandate it goes without saying that I hope I can be remembered for this, together with all my colleagues of the Executive Board and the Governing Council. That has also indeed been the mandate of the Banque de France since 1 January 1994, when the Banque de France became fully independent. It is also what we are asked to do at the ECB, But again, it is not for me to judge. It is for external observers to make the judgement.

Question: Do you have any memories of your visits to Finland or your work within the Eurosystem with your Finnish colleagues?

Already before I was President of the ECB I had a relationship with the Finnish central bank and Finnish society in general. I had a very good professional relationship with Sirkka [Sirkka Hämäläinen, a member of the Executive Board of the ECB from 1998 to 2003]. I have to say it is always moving to be in Finland for many reasons, including the very special situation of Finland after World War II. Finland experienced directly some of the tensions that unfortunately marked the post-war period. I was also close to Matti [Matti Vanhala, the late Governor of the Bank of Finland]; in meetings of the Governing Council we sat next to each other and often exchanged views. I also have a close relationship with Erkki [Erkki Liikanen, the current Governor of the Bank of Finland] for a host of reasons, including that not only do we speak English together but we also speak French together from time to time. He has a wealth of experience and vision. In all my meetings with Finnish people I have always observed that Finland has a culture of soundness and wisdom.

Question: You visited Finland in 2007. You attended a concert in the Pori Jazz Festival and stayed overnight in the Villa Mairea, an architectural masterpiece of Alvar Aalto. What impression did you gain of Finnish nightlife and architecture?

[Laughter] It was not nightlife, it was "day"-life. The jazz was excellent and the festival remarkable. We were lucky to have such exceptional weather and were treated to excellent music.

Question: Your term of office expires at the end of October. Would you like to conclude your career as a central banker with a rate hike in the October monetary policy meeting of the Governing Council?

[Laughter] No comment.

Question: You have a smart phone and a tablet computer on the table in front of you. I take it that you use them actively in your work. How do you find the user experience?

I am absolutely fascinated by the scientific and technological progress we are presently experiencing. I sometimes have the feeling that I am myself in a science fiction novel, because of the new marvels that technology displays every other year. You see new possibilities, but at the same it creates challenges. When you make jumps in science and technology, it transforms society. If I have a message to my own sons and granddaughters, it is: be prepared. We all have a tendency to underestimate the pace of change in our society and in the globally integrated economy.

La gouvernance de la zone euro

Speech by Jean-Claude Trichet, President of the ECB, at the Notre Europe Séminaire en Hommage à Tommaso Padoa-Schioppa, in the session "Quel bilan pour l'Union Economique et Monétaire", Brussels, 4 April 2011

Ladies and gentlemen,

Let me begin by thanking Notre Europe and the Egmont Institute for the invitation to this conference today in honour of Tommaso Padoa-Schioppa.

Tommaso was a man of culture, a man of vision and a man of action. I had the privilege, during a great number of years, to work close to him in different positions and then to work with him in the Executive Board of the European Central Bank. In the Executive Board he did marvels, particularly in the area of international relations where his tireless activity permitted many advances, in the domain of payment systems in which he had acquired in Basel the best global expertise, and in the crucial dimension of financial stability where his diagnosis on our global and European institutional weaknesses proved unfortunately to be prophetic.

But, overall, Tommaso was a European, a militant of the European Union's historical endeavour. And although it is with a heavy heart, it is inspiring to speak on a subject that was so dear to him and so central to his life's work.

Let me also remind us that I am in the purdah period, and nothing I will say can be interpreted in terms of future monetary policy.

We all know that the Chinese leader Zhou Enlai, when asked in 1971 about the impact of the French revolution, famously replied that it was "too early to tell".

What Zhou Enlai confirmed in this comment is the difficulty of making assessments of historical processes at a particular point in time. There is always a risk of being too influenced by the circumstances of the present. This can lead to judgements that lack an appropriate, encompassing perspective.

The same remarks apply when assessing EMU at a particular point in time.

To avoid the trap of being over-influenced by the present, a broader framework for assessing EMU is needed. To this end, I would like to draw on a framework put forward by French historian Fernand Braudel.

In his seminal study of the development of social structures in Europe, Braudel identified three levels of time which are necessary to understand historical change. The first level was the *longue durée*: the deep processes over long periods that shape the structures of economy and society. Such a long term perspective is important to assess EMU because a key objective is to further the historic project of European integration.

The second level of time was the *époque*: the trends that define a particular period of history. This medium-term perspective is also relevant because the Treaty has set aims for EMU which are best assessed over the medium-term – most notably ensuring price stability.

The third level was *l'histoire événementielle*: the events of the day that shaped the course of current affairs. This near term perspective is significant because the litmus test of any union is how it responds to unforeseen stresses and challenges – and EMU has experienced just such circumstances together with all advanced economies since 2007.

Such a textured approach may give a more comprehensive picture of Economic and Monetary Union. I will discuss each level in turn.

The longue durée

Let me start with the long-term perspective, the *longue durée*. For Braudel the *longue durée* concerned the slow and subtle effects of deep social and economic changes. It is an important perspective because EMU is part of a historical process to deepen economic integration in Europe, and thereby, as Montesquieu famously argued, to make the countries of Europe " *reciprocally dependent; and their union is founded on mutual necessities.'*

It would be fair to say that this ambitious aim has been achieved. The ideas for the start of a European Community, presented as early as in the speech of Robert Schumann in 1950, for an economic and monetary union laid out in the Werner Report in 1971 and then in the Delors Report in 1988 have become reality. Going further back, a single market with a single currency represents – to various degrees – the fulfilment of the visions of thinkers like Victor Hugo in the 19th century, Immanuel Kant in the 18th century, Hugo Grotius in the 17th century, and Erasmus in the 16th century. EMU has brought economic gains and thereby help lay the foundations for "perpetual peace" in Europe.

This wish for deeper integration is not only a philosophical pretension but also evident in the attitudes of European citizens. Surveys indicate that, on average in euro area countries, more than 80 per cent of euro area citizens are in favour of greater policy coordination between countries to overcome the crisis. This suggests that European integration has led Europe's citizens to fundamentally reappraise the value of cooperation in difficult times. Economic and Monetary Union constitutes the*avant garde* of this long term historical process.

It is important to keep in mind this long term perspective, looking beyond the ongoing economic and financial challenges in the euro area. EMU is an unprecedented achievement in history of sovereign nations. Euro area countries have voluntarily chosen to share sovereignty for the sake of common goals.

The "époque"

Let me now turn to the *epochal* view. The *epoch in Braudel's view* is a period of time over which medium term trends can be meaningfully assessed. The medium term for central banks, as regards the definition of price stability, is a duration of several years. Therefore the 12 years since the launch of EMU is an appropriate length of time to allow for a review of whether medium term goals have been met.

As regards Monetary Union the first aim is price stability, the primary mandate of the ECB. The ECB Governing Council has defined price stability as an annual increase in consumer prices of below 2%, but close to 2%, over the medium term. Since the launch of EMU the average annual inflation rate in the euro area has been 1.97%. This is a better performance than any large European economy over the last 50 years. It has also helped the euro establish itself as the second-most important international reserve and transaction currency, trusted by financial markets.

This has been possible because the ECB's actions were enshrined in a medium-term oriented monetary policy strategy. Our definition of price stability is the needle in our compass and has guided the steady course of monetary policy over the last 12 years.

On a consolidated basis the euro area performed well in terms of growth and employment, also in an international comparison. Adjusted for differences in population growth, per capita GDP growth in the euro area over the last decade has been almost the same as in the United States, at about 1% per year. As regards the dispersion of real GDP growth rates across euro area countries, they are comparable to the equivalent dispersion between the states of the U.S. On employment, the euro area made significant progress as well, with overall employment increasing by 14 million during the first twelve years, compared with a rise in employment of about 8 million in the United States. And the overall yearly public finance deficit is presently about half of that in the U.S. or in Japan.

However, the crisis has revealed that not all of these gains in all countries were sustainable or balanced. Some euro area countries did not follow rules for the conduct of national economic policies. Between 1999 and 2008 significant fiscal and broader macroeconomic imbalances appeared.

In a stability-orientated economic and monetary union, countries have to keep their fiscal house in order. Fiscal and broader macroeconomic policies have to keep domestic demand in line with rates of sustainable growth and price stability. Otherwise the result will be escalating unit labour costs, increases in public and private debt and losses in competitiveness.

So if I sum up the "époque" from the start of the euro until the global crisis, during the first nine years of the euro I would say that we could observe a remarkable success of monetary union as a whole and a much less flattering behaviour of the economic union, both because a number of countries were not respecting individually the rules of the Stability and Growth Pact, and also because all member countries collectively did not exert the surveillance, which was commanded by the Pact.

In that sense, the global crisis, which intensified in 2008, has acted as revelatory. It marks the end of the first "époque".

More than before, from now on it appears absolutely essential that all euro area countries adhere to the ambitious fiscal consolidation plans to which they have committed in front of their peers and restore the confidence of firms, households and investors in the soundness of public finances. Fiscal consolidation is an essential first step on the path back to sustainable and balanced growth in the countries concerned, and ultimately to achieve the objectives of the Treaty and the expectations of European citizens. It is equally essential that all euro area countries create a strong surveillance of their competitiveness indicators and of their imbalances as a second "pillar" of their governance.

L'histoire événementielle

Now let me turn to the near-term perspective, *l'histoire événementielle*. For Braudel this period of time concerned "events, politics and people" and how their real time activities shaped the course of history. This is a significant perspective because EMU is a "community of destiny" that is responsible for taking measures to ensure the best interests of its citizens. Thus an assessment of EMU has to take into account how it responds to and manages challenges.

The severe challenges since 2007 and, more particularly, since the intensification of the crisis, in September 2008, have provided EMU, as well as all advanced economies, with the toughest global test since at least 65 years.

EU policy makers have so far responded to these testing times effectively.

The ECB has been fully faithful to its primary mandate, price stability, in deciding on interest rates, its standard policy measures. And, taking into account that the financial crisis was hampering the normal transmission of its monetary policy, it has decided a number of non-standard measures to help restore a more normal function of this transmission.

Member States also took important measures. No systemically important financial institution in the euro area was allowed to fail. All euro area countries undertook ambitious fiscal consolidation. Two stability facilities with a total volume of €500bn were established.

And these achievements have to be set in context. Observers often compare EMU with a unitary state like the U.S. and Japan and expect similar policy responses. Yet EMU remains a union of sovereign states that has its own logic for addressing challenges. This leads to outcomes that are not always linear. Seen in this light, EMU's response seems all the more impressive.

Indeed, one should not exaggerate the differences, as regards diversity of economic behaviour of member economies, between a full fledged political federation like the US and the Euro area. As I mentioned before, the difference between the fastest and slowest-growing U.S. states is not of a different order of magnitude as that between euro area countries. For instance, between Oklahoma and Nevada there was a 13 % difference in growth in 2009; between Slovakia and Ireland the difference, which was the highest that year, was around 9 % in 2008. The same is true of employment. In 2009 the largest difference in unemployment in the euro area was between Spain, with 18%, and the Netherlands, with 3.7%; for the U.S. between Michigan, with 13.6 %, and North Dakota, with 4.3 %.

But, that being said, if a lot has been done in Europe a lot remains to be done in the domain of economic governance. The problems with the economic pillar of EMU that I described above result from weak governance. The solution to these problems involves resolutely strengthening economic union by a major change in its governance. As I said, we need to make a "quantum leap" by both reinforcing the fiscal pillar of governance, which is the Stability and Growth Pact, and by creating a new pillar of governance, namely a strong surveillance of competitiveness indicators and imbalances. There is a third pillar of governance of the Economic Union in the EMU, which is as important for the European Union as a whole as it is for EMU: the structural reforms embedded in the "Europe 2020" strategy. These structural reforms are essential to elevate the growth potential of the single market of Europe as well as of the single market with a single currency.

The Council has recognised the need for stronger rules for fiscal policy and the necessity of a new surveillance framework for macroeconomic imbalances. But in my view, it does not go far enough.

The proposals currently on the table should be strengthened to reach this very significant jump towards closer economic union that is required. The ECB strongly believes that more ambitious reforms are needed for the euro area and it is convinced that the *Trialogue* between the Council, the Commission and the Parliament will permit the Parliament to significantly improve the texts that were presented to it.

This is much more than a simple procedural concern. Stronger economic governance is essential to support the fundamental construction of EMU. A union with a centralised monetary policy but decentralised economic policies needs appropriate mechanisms to balance the independence of countries and their economic interdependence.

Conclusion

It is essential when discussing Economic and Monetary Union to take an appropriately broad view. EMU is a major step in a major long historical process that cannot be judged solely on the basis of passing events, of *l'histoire événementielle*.

That said, how the euro area responds to the challenges of the "époque" it is currently facing together with all other advanced economies, will influence the historical trajectory of Europe. The key question is whether governments can put in place a very significantly reinforced governance of their economic union in order to reap the full benefits of the single currency. This will determine whether the new *"époque"* which is ahead of us after the crisis is a time of economic and financial stability, of sustained growth and of sustained job creation. It will also be decisive in giving a direction to the historical evolution of Europe in the perspective of the "longue durée".

The historical stakes are important. Either we prove that we are able to find the new strong reinforced governance concept, which will fit with a constellation of sovereign states and permit the European Union to face up with the new globalised world. Or, we do not convincingly succeed into this direction, and then a new jump in the institutional framework of Europe toward a political federation will appear necessary.

It is often said that Europe has demonstrated the capacity to make progress when it has to draw lessons from its own difficulties. I find this notion in Jean Monnet's remarks, immediately after the conference of the "six" on 23 July 1952, on the E.C.S.C., almost 60 years ago. At the end of Chapter 14 of his mémoires, he writes: "Je dis à François Fontaine: Nous avons quelques heures pour nous reposer, et quelques mois pour réussir. Ensuite… Ensuite – poursuivit Fontaine en souriant, nos rencontrerons de grandes difficultés dont nous nous servirons pour avancer à nouveau. – C'est bien cela, n'est-ce pas ? – C'est cela même. Vous avez tout compris sur l'Europe."

"I told François Fontaine : We have a few hours to rest, and a few months to succeed. Then… Then said a smiling Fontaine, we will meet great difficulties which we will use to advance further. Is it the right way to look at it ? It is exactly the right way. You have understood everything about Europe!"

Tommaso was often mentioning this remark of Jean Monnet when we were discussing together the future of Europe.

More than ever, Europe, coping with the present challenges, needs to demonstrate its sense of direction. This is no time for fatigue. This is no time for complacency.

Thank you for your attention.

Taking stock on financial reform

Speech by Jean-Claude Trichet, President of the ECB at the Frankfurt Main Finance Summit "The Future of Risk Management and Regulation: Smarter regulation, safer markets" Frankfurt, 23 March 2011

Ladies and Gentlemen,

I am very pleased to be able to open this conference here at the House of Finance in Frankfurt.

Frankfurt now hosts *three* European institutions: the European Central Bank (ECB), the European Insurance and Occupational Pensions Authority (EIOPA) and the European Systemic Risk Board (ESRB).

This city is now the home not only of Europe's monetary authority, but also of important supranational responsibility for supervisory matters. With the EIOPA and the ESRB, Frankfurt hosts half of the European bodies in the new European System of Financial Supervisors, with the other two European Supervisory Agencies (ESAs) – the European Banking Authority (EBA) and the European Securities and Markets Authority – based in London and Paris respectively.

I have looked with great interest at today's programme, which is of exceptional quality.

In my opening remarks, I would like to lay out a scheme of the building blocks of the financial reform that is still in progress.

I believe that when we look back in a few years on the financial reform following the global crisis, we will identify three main building blocks:

The first is banking regulation. The global community is making a big step forward here. It has made the right diagnosis and, in the Basel III framework, drawn the appropriate lessons. My friend Nout Wellink is chairing the Basel Committee; I myself have the privilege of chairing the Committee of Governors and Heads of Supervision, which provides guidance to the Basel Committee.

The second building block is regulation of the financial markets. Here, reform must ensure much greater transparency for the various market segments and products, ensure sufficient competition in all markets, and attenuate as much as possible the pro-cyclicality that derives from information asymmetries, structural features such as ratings and market phenomena such as herding.

The third building block is macroprudential oversight. This new discipline focuses on the interactions between the various parts of the financial system and between the financial sector and the real economy. New institutions, including the ESRB and equivalent oversight committees around the world, will pursue the task of identifying sources of systemic risk, issuing early warnings and recommending remedial action.

The birth date of macroprudential oversight in Europe will probably be identified as the start of this year but it was originally conceived in 2009 through the work of Jacques de Larosière and his high-level group, which included my friend Otmar Issing. Eighteen months from policy design to institutional establishment is a remarkable achievement. It was made possible by thorough groundwork as well as excellent transposition by the Commission and very rapid decisions by the European Parliament and the European Council. I feel very honoured to chair this new body, the ESRB.

Let me focus on each of these three building blocks in turn, starting with banking.

I. Banking regulation and Basel III

Basel III, which constitutes the cornerstone of regulatory reform for the banking sector, provides for higher minimum capital requirements, better risk capture, a stricter definition of eligible capital elements with a particular focus on common shares and more transparency.

The revised regulatory framework allows appropriate transition periods for financial institutions to adjust to the new standards, thereby ensuring a smooth phasing-in of the new regulatory requirements without compromising the nascent economic recovery. By 1 January 2015, the minimum capital requirements for common equity Tier 1 and total Tier 1 capital will gradually be raised up to a level of 4.5% and 6.0%, respectively. This gradual phasing-in of minimum requirements will be complemented by an appropriate observation period for the non-risk-based leverage ratio and the liquidity standards. The ESRB, together with the EBA, will play an important role in policy setting and implementation, with the former contributing to ensuring consistent implementation of the policy framework throughout the EU. We are just beginning that process.

In addition to the necessary transposition into national or European law of the Basel III rules, there are two issues that still need to be addressed: systemically important financial institutions; and capturing the so-called shadow banking system within the regulatory framework.

Work is in progress on systemically important financial institutions, in particular in the Financial Stability Board. The main objectives are to reduce the probability of failure of such institutions and, in case a failure occurs, to reduce the impact on the financial system.

In September 2010, the Governors and Heads of Supervision agreed that systemically important financial institutions should have additional loss absorbing capacity. Work is currently underway on how to define institutions that are systemically important, and how to determine the capital surcharges, contingent capital and other elements to limit systemic fallout.

With the shadow banking system, we have to ensure that tighter regulatory rules do not provide incentives for financial institutions to shift their activities to unregulated areas. Oversight of the shadow banking sector needs to be improved. The FSB has already done valuable work – supported by the ECB – on shadow banking. In this context, the ECB is providing the Financial Stability Board (FSB) with flow of funds data on the composition of the financial sector concerning the euro area. The concrete challenges lie in the establishment of a suitable definition of shadow banking and outlining possible regulatory options to address the risks posed by this sector.

Given the background of the crisis, regulatory effort on financial institutions has focused on banking, but there is important work underway also for other financial institutions, such as the further specification of the capital adequacy regime for insurance companies ("solvency II").

II. Market regulation

Let me turn to the second building block, namely regulation of financial markets. This area is as challenging and as complex as banking.

The main observation we have to draw from the crisis is that the risks in market returns were not mainly exogenous, coming from the stochastic variation in the real economy. They came from financial risk itself. The financial structures that we thought were in place to assess, absorb and neutralise risk were either dysfunctional or worked to magnify volatility.

Key factors in creating this risk were opaque financial structures, particularly vulnerability to contagion and domino effects, and pro-cyclicality in financial markets.

The lack of transparency in many financial instruments meant that some market players could exploit – for their own, private benefit – information that was not generally available.

Pro-cyclicality acts as a formidable accelerator of financial trends. Two important factors that drive such amplification are distorted incentives and herd behaviour.

The role of distortions in economic incentives is probably better known as it had traditionally been widely appreciated even within neo-classical modelling. By comparison, herd behaviour as a driver of pro-cyclical patterns in financial markets still needs a thorough explanation.

It is difficult to rationalise herd behaviour. There are two possible explanations. One is the significance of a market player's evaluation of his or her performance relative to the rest of the market. This is reminiscent of Keynes' famous beauty contest analogy. To be successful in this environment, individual participants do not form their own opinions, but follow the general mood prevailing among market participants. Everybody seeks to ride the wave created by general sentiment, hoping to step off before the general sentiment turns.

The second explanation is that global markets are in fact less atomistic than we think. Indeed, despite globalisation, increasing market concentration was already a long-term trend before the crisis. Derivatives activity in the US banking system, for example, is dominated by a small group of large institutions. And, of course, the market for credit ratings is famously dominated by three signatures, which act as standard-setters for an enormous volume of transactions.

Many regulatory initiatives are underway to remedy these issues, including work on OTC derivatives, ratings agencies and alternative investment vehicles. But addressing these challenges could also be supported by reorienting significant resources in research. In particular, I would welcome an enrichment of thinking in economics and finance, by including new approaches that do not necessarily rely only on the notions of equilibrium, universal rationality and efficiency.

Inspiration from other fields, such as the natural sciences, may be particularly pertinent. I am thinking for example of market movements from stability to instability, from tranquillity to turbulence. In physics such phenomena are described as phase transitions. When some factors exceed a critical level, a system behaves qualitatively differently from a situation when the factors stay below this level.

Let me now turn to the third building block of regulatory reform, macroprudential supervision.

III. Macroprudential oversight

As my earlier remarks have suggested, the financial crisis has been revealing in many respects. It has revealed the fallout from the failure of large financial institutions. It has revealed the fragility of the financial system to features and trends that cut across institutions, markets and infrastructures. And it has illustrated the amplitude of the consequences of the adverse feedback loop between the financial system and the real economy.

All these three elements are key features of systemic risk: first, contagion; second, the build-up of financial imbalances and unsustainable trends within and across the financial system; and third, the close links with the real economy and the potential for strong feedback effects.

The crisis has revealed the fundamental importance of systemic risk. Of the three elements I have mentioned, contagion and the link to the real economy are the least novel in the current episode. The most unexpected element has been the rigour with which systemic risk has been triggered by the collective behaviour of financial institutions and the ways in which they interact in financial markets.

The main new avenue to explore is therefore to improve our understanding of interconnectedness in the financial system, both via the direct links between financial institutions and the indirect ones created in financial markets. Everybody now sees that major risks can emerge from within the financial system itself. It was not the real economy that threw the financial system into disarray, but the reverse.

Endogenous risks – risks that emerge from within the financial sector – can have many causes. They may arise, for example, because large parts of the system rely on the same sources of funding, or because they have similar exposures – to rising financial imbalances, to currency mismatches and to widespread mis-pricing of risk.

We have also seen that turbulence can arise from relatively modest initial shocks. The system is so interconnected that what looks stable can turn out to be 'meta-stable', which means potentially highly instable. Snow on mountain slopes can be meta-stable, looking pristine and tranquil yet turning into an avalanche after only a minor disturbance.

For all these reasons, we have established a new framework of macroprudential supervision as have our counterparts elsewhere, including in the United States with the new Financial Stability Oversight Council. In the case of Europe, there is still one more reason for macroprudential oversight, and that is the single European market.

Cross-border and cross-sectoral financial integration within the EU is fostered by competition, freedom of establishment and the free flow of capital. The single financial market is a crucial component of the overall single market project, and macroprudential supervision should enhance the resilience of this market.

So how exactly will the new discipline of macroprudential oversight be conducted? Financial stability is not an issue exclusively for central banks. Micro-prudential supervisors have a key role, because stable institutions are an essential and necessary condition for achieving financial stability. This is why the ESAs and national supervisors together with the central banks are members of the ESRB and why the ESRB and the ESAs form the European System of Financial Supervisors.

The ESRB's main tasks are threefold: to identify and prioritise systemic risks; to issue early warnings when significant systemic risks emerge; and to issue policy recommendations for remedial action in response to the risks it identifies.

The ESRB will not focus on individual institutions, individual countries or individual macroeconomic issues – it will take a strong horizontal focus, across countries, across sectors and across the boundaries between the financial sphere and the real economy. Interlinkages and spillovers should be key terms in its analysis.

To achieve these tasks, the ESRB is drawing on information from many sources, including strong analytical input from its members; intelligence gathered from financial system participants; and the data necessary to understand the nature of interlinkages that define the financial system. ESRB analysis must be broad-based covering potentially any aspect of the EU's financial system – markets, institutions and infrastructure.

The ESRB is being established at a time when the concerns of markets and policy-makers about short-term vulnerabilities seem to prevail over perceptions of medium- and longer-term risks. This confronts the ESRB, as well as other macroprudential bodies around the world, with specific challenges. The ESRB needs to consider what activities to initiate, well before a fully-fledged macroprudential policy framework is developed in the medium term. At the same time, it must develop this policy framework, for which no template exists and for which the analytical background captures only parts of the tasks.

In the medium term, the ESRB and the macroprudential authorities of the 27 EU countries will need operational policy frameworks with specific instruments. The ESRB is ready to support – at a technical level – the work that European institutions have started to design the implementation of countercyclical capital buffers. Other macroprudential instruments are also desirable. Work on these issues has been initiated. For example, new rules on margins and collateral should counteract the fluctuations of the cycle. The specific capital requirements for risk-weighted assets might also be adjusted over the cycle.

When these macroprudential instruments are established, possibly around the middle of this decade, the authorities will finally have tools to mitigate the pro-cyclical behaviour of financial players. Authorities will set part of the regulatory requirements not against the solvency or liquidity situations of single institutions, but taking a view of the macroprudential cycle.

Other instruments will be needed to address interconnectedness, including the most complex and innovative elements of market functioning. One specific focus of authorities is to ensure that efficient and secure central counterparties are created to reduce risks in OTC markets.

Concentration risks produced by increasingly large financial institutions in trading and post-trading will also need to be addressed. Finally, authorities will need new regulatory instruments to keep pace with the impact of new technologies – including high frequency trading, algorithmic trading and the new universal trading platforms, which are gaining ground very rapidly.

Last week, the ESRB selected the members of its Advisory Scientific Committee to provide advice on analytical issues. We have also established the Advisory Technical Committee, which assembles experts from all central banks. The institutional set-up is completed and the ESRB will now focus on its substantive tasks, of which we will have a substantive review in June this year. Combining a focus on short-term risks with the medium- and longer-term perspective will be the major challenge

Conclusion

Let me conclude. I believe we are now about halfway through the comprehensive reforms that the crisis has called for. We have achieved a blueprint of more stringent bank regulations that includes more loss-absorbing capital, better risk coverage and limitations for undue leverage. Countercyclical capital buffers are meant to lower pro-cyclicality.

The oversight of financial institutions as well as markets and market infrastructure are being strengthened, and the organisational structure of financial supervision is being overhauled.

But much remains to be done. The most important aspect is the implementation of these reforms. Moreover, the issue of systemically important financial institutions requires further reflection, and oversight of the proper functioning of financial markets in a way that avoids undue volatility, excessive influence of dominant players and oligopolistic market structures, while reinforcing transparency, needs to be addressed resolutely.

Such understanding would be enhanced by greater focus in academic research on analysis of the intricate interactions in complex financial systems.

The appropriate benchmark for the financial system is whether it is providing appropriate financing to the real economy in a stable and sustainable way. Thereby, and thereby only, will it make a valuable contribution to our economy.

Thank you for your attention.

Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductory statement by Jean-Claude Trichet, President of the ECB, Brussels, 21 March 2011

Dear Madam Chair,

Dear Honourable Members,

As on a number of occasions before, our regular meeting takes place in extraordinary times. The tragic developments in Japan with the deplorable loss of human lives, but also their potential global economic and financial implications have galvanised the international community into action.

Here in Europe, our hearing today comes at a time between two meetings at the level of Heads of State or Government. And it comes at a time when the very important decisions on the economic governance reform in this Parliament are coming closer. Before focusing on the economic outlook and topics for today, let me therefore say a few words on the economic governance reform.

Comme vous le savez, le conseil Ecofin a adopté la semaine dernière une « approche générale » sur ce dossier. Cette approche contient diverses améliorations. Pourtant, plusieurs des propositions très importantes pour renforcer suffisamment le cadre de gouvernance ne sont pas encore prises en compte. Ceci est nécessaire pour tirer toutes les leçons de la crise. Nos concitoyens européens, qui ont le souci de notre avenir à long terme, demandent aux autorités de faire tout ce qui est nécessaire pour empêcher une répétition des développements que nous avons vécus ces dernières années. Ainsi, selon un «Eurobaromètre» récent, presque 80% des citoyens dans les pays de la zone euro considèrent qu'une plus grande coordination des politiques économiques entre les Etats membres - c'est-à-dire une gouvernance effective et efficace - serait nécessaire pour combattre la crise financière et économique. [1]

Vor zehn Tagen haben die Mitgliedsstaaten eine Erklärung zur verstärkten Abstimmung der Wirtschaftspolitik im Eurogebiet gegeben. Diese Erklärung berührt inhaltlich viele Punkte der vorliegenden sechs Gesetzesvorschläge. Besser noch als diese Erklärung parallel stehen zu lassen, wäre es, ihre Kernpunkte in das gegenwärtige Gesetzgebungsverfahren einzubringen. Dies würde der Absichtserklärung ihre volle Glaubwürdigkeit zukommen lassen.

I. Economic and Monetary Developments

Let me turn to the euro area economic and monetary developments since our previous meeting last November. I will concentrate on the analysis of the Governing Council on the occasion of its meeting of 3 March.

Incoming data have confirmed our view that the underlying momentum of economic activity remains positive. Looking ahead, we expect the economy to further benefit from the ongoing recovery in the world economy, the very accommodative monetary policy stance and the measures adopted to improve the functioning of the financial system.

As regards price developments, inflation in the euro area is on the rise. In February HICP inflation stood at 2.4%, after 2.3% in January. This increase largely reflects higher commodity prices. In particular, sharp increases in energy prices have led to upward price pressures in the earlier stages of the production process. It is crucial at this stage to avoid that the recent rise in inflation translates into broad-based second-round effects, for instance via price-setting or higher wages. Such effects would give rise to broad-based inflationary pressures over the medium term.

In the view of the Governing Council, as expressed on 3 March, risks to the price outlook are on the upside. Commodity prices could increase more than expected. Also, indirect taxes and administered prices could turn out higher given the need for fiscal consolidation in the coming years. Finally, the ongoing recovery in activity could result in stronger than expected domestic price pressures.

As regards our future monetary policy stance, I have nothing to add to what I said, on behalf of the Governing Council, on the occasion of our last monetary policy decision meeting earlier this month.

As regards liquidity-providing operations, the Governing Council decided to conduct them in the second quarter of 2011 on the same conditions as in the first quarter of 2011. This means that we will continue to apply fixed-rate tender procedures with full allotment in all our refinancing operations at least until mid-July.

II. Interaction between banks and sovereign debt

Let me now turn to the specific topics you have asked me to address and start with sovereign debt. I should like to emphasise once again that the right way to avoid the risk of sovereign debt crises in an economic and monetary union is through sound national macroeconomic policies and strengthened economic governance.

At the same time, the governments have considered that a permanent crisis management mechanism would be useful. From the side of the European Central Bank, the design of such a mechanism is essential for it to provide a positive contribution to financial stability in the euro area as a whole. I would like to highlight two aspects: first, the mechanism may in no way weaken the incentives for sound fiscal and macroeconomic policies pursued in all member states. It must in particular not weaken incentives for preemptive fiscal and macroeconomic adjustment by countries concerned, thereby avoiding moral hazard. Second, given that the euro area is characterised by an exceptionally high degree of economic and financial integration among countries, the mechanism should be able to employ a range of instruments to be effective in stemming against contagion in situations of acute market instability. If indispensable, supporting countries

while still keeping some market access, may be an appropriate way and would imply a prudent use of funds. In this context, I continue to consider secondary market interventions as a helpful tool in this context.

Regarding the institutional method to set up the ESM, the ECB, like the Parliament, supports the largest possible recourse to the Union method. It would welcome that, on the basis of the experience gained, the ESM could become a Union mechanism at the appropriate point in time. In the meantime, the ECB encourages that the assessment of circumstances leading to the activation of the ESM and the conditions on financial assistance entail an appropriate involvement of Union institutions, thus benefiting from their expertise and their Union-wide perspective.

Turning to the issue of bank resolution, the presence of sound bank resolution mechanisms, limiting the costs associated to a bank failure in the case of a cross-border group, is likely to facilitate the negotiations to share the public costs incurred if and when required. Therefore, we support the overriding policy objective of the new EU framework for bank recovery and resolution proposed by the Commission.

Although the implementation of the new resolution regime in the EU could already reduce the fiscal costs of bank failures, I believe that explicit arrangements should also be put in place to ensure that in the future the financial sector bears the burden of possible crises to come. As part of a credible resolution framework, bank levies (possibly accumulated in resolution funds) could possibly be considered.

However, a levy on banks should be seen as a complementary tool in the set of instruments aiming at increasing the loss absorbency of systematically important banks – notably capital and liquidity surcharges, and contingent capital. The Financial Stability Board is currently exploring several options, in particular on contingent convertible capital and bail-in debt instruments.

To this end, I welcome the fact that the European Commission is considering bank levies and bail-in in its plans for the future EU crisis management framework. The ECB stands ready to further contribute to the challenging work that is still ahead of us in the development of this framework.

I would like to take the opportunity of today's meeting to address another topical issue: the finalisation of the proposed EU Regulation for OTC derivatives, central counterparties and trade repositories. We would welcome if the draft report of your Committee on this significant legislative initiative took account of the important role that central banks play for ensuring the stability and efficiency of market infrastructures. Central banks have proven their relevant role during the financial crisis and we would thus welcome that their contribution to financial stability be fully reflected in the new Regulation.

This means that the central banks would be adequately involved in the new EU framework for central counterparties (CCPs) and trade repositories. They would cooperate with supervisors in the authorisation and the ongoing risk assessment of infrastructures, technical standard-setting and decisions regarding the recognitions of third country central counterparties and repositories. Regarding the arrangements for cooperation and information-sharing among authorities, the Commission's proposal of colleges provides, in our view, a set-up that is preferable to bilateral contacts between those authorities and ESMA.

III. Eurobonds

Let me now say a few words on the other subject you suggested: so-called 'Eurobonds'. The ECB is not in favour of introducing such 'Eurobonds', understood as guaranteed government bonds on a joint and several basis, in the present circumstances. We note that the aim is to support the development of euro area bond markets, as well as at providing a possible mechanism to alleviate or resolve the ongoing sovereign debt crisis.

With respect to supporting the euro area bond market, the main advantage could be cost savings from reducing the liquidity premium in the bond markets. This could arise particularly if Eurobonds gained benchmark status, comparable for instance to US Treasury bonds. As regards the impact on sovereign debt developments, moving to Eurobonds would remove the financial market pressure in the short term but, if not replaced by new mechanisms, fundamentally reduce incentives for sound fiscal policies.

In our institutional set-up, fiscal discipline is induced via existing domestic provisions; the fundamental institutional framework of governance (the Treaty and the Stability and Growth Pact) and the assessment by savers and investors.

Jointly guaranteed bonds would not permit savers and investors to assess fiscal policies of individual countries. As long as we do not have a political federation with a federal budget, this would create an incentive problem. It would impair the incentives for fiscal prudence at the domestic level.

Consequently, Eurobonds would be the natural counterpart if national fiscal competences were clearly at the level of a union which would be a federation. In the present institutional framework we need to make very important progress in the collegial governance and surveillance of fiscal policies which remain national.

Dear Honourable Members, I thank you for your attention and am at your disposal for questions.

Reforming EMU: time for bold decisions

Speech by Jean-Claude Trichet, President of the ECB at the conference of the Group of the Progressive Alliance of Socialists and Democrats in the European Parliament "What future for the euro?" Frankfurt, 18 March 2011

Ladies and gentlemen,

honourable members of the European Parliament,

It is a pleasure to have the opportunity to speak at your conference this afternoon.

We meet at a time of multiple challenges for our world. For more than three and a half years now, we have been focused on the challenges to our economies and our societies by the unfolding financial crisis. But the tragic events in Japan over the past week remind us of even greater threats.

The potential impact of the earthquake and its aftermath on both the Japanese economy and the world economy is something we will be thinking about deeply in the coming days and discussing with our friends at the Bank of Japan. For the moment, my heartfelt thoughts are with the people of Japan, whose lives and whose livelihoods have seen such havoc.

Your conference today asks 'what future for the euro?' In addressing that question, I would first like to speak about the achievements of the past, before focusing on the challenges ahead for Europe's economic and monetary union (EMU).

I would like to reiterate and explain the need for what I have called a 'quantum leap' in the economic governance of Europe. And I would like to outline what that means in practice and what more needs to be done to make that quantum leap a reality.

1. Achievements of the euro

First, let me take a brief look back at the history of the euro. Having had the privilege of serving as a member of the European Central Bank's (ECB) Governing Council since the launch of the euro and as the ECB's President for the past seven years, I can report that we have achieved a great deal. All Europeans should take pride in these achievements.

The key to understanding the current challenges is to recall that the specific construction of our modern economic and monetary union rests on two separate economic and monetary pillars. Under the monetary pillar, there is only Europe: the single currency, the single monetary policy and the single central banking system – with the ECB at its core.

The economic pillar is decentralised, with responsibility for fiscal and economic policies in the hands of individual countries. These policies should be steered by overall rules and coordinated to ensure that national economic policies are fully compatible with the fact that we have a single currency without being part of a political federation.

When it is working properly, this structure balances the independence of nations and their economic interdependence that is at the heart of EMU.

It should represent an approach where sovereignty is shared, meaning that it is neither exclusively national nor exclusively European.

When EMU was first established, many people asked how monetary union could function effectively in a Europe of sovereign states.

The answer is that it can function effectively with an appropriate economic union.

2. The 'M' in EMU

Let me discuss the two pillars in a little more detail, first the "M" in EMU. In monetary policy terms, the ECB has a clear assignment: to deliver price stability.

According to our primary mandate, our definition of price stability means an inflation rate below but close to 2% over the medium term. And over the 12 years since the launch of EMU, the average annual inflation rate in the euro area has been 1.97%.

This is the best result of a major central bank in the euro area over the last 50 years.

For Germany, the inflation rate has been even lower than the average since the euro was launched. From 1999 to 2010, inflation averaged 1.5% per year.

And we achieved this during challenging times, not just in the period since August 2007. Over the years, we have had to cope with the bursting of the *dot com* bubble, the aftermath of the events of 11 September 2001, the jump in oil prices to $145 per barrel, rising prices of food and commodities, and then of course the worst financial crisis since the Great Depression.

Yet throughout these very different economic shocks – which could have been either inflationary or deflationary – citizens in the euro area have remained confident in our commitment. Proof of this is that medium- to long-term inflation expectations have been firmly anchored in line with the ECB's definition of price stability.

Observers and financial markets are also expecting in the years to come that price stability will be maintained. For the next five years, professional forecasters currently foresee an inflation of precisely 2%.

These achievements have not come at the expense of employment. On the contrary, since Economic and Monetary Union began, employment in the euro area has risen by over 14 million, compared with about 8 million in the United States.

And these achievements have not come at the expense of growth either. Adjusted for population growth differences, growth in the euro area has been almost the same as in the United States over the past decade, at about 1% per year in terms of GDP per capita growth.

3. The 'E' in EMU

Let me turn to the economic pillar, the E of EMU.

Here, we need fundamental reforms.

Economic union is a fundamental counterpart to monetary union.

A single market with a single currency calls for a very solid framework for handling the collegial governance of national fiscal policies and macroeconomic policies.

I recall the 1989 Delors report that stated: "an Economic and Monetary Union could only operate on the basis of mutually consistent and sound behaviour by governments and other economic agents in all member countries. (…) Uncoordinated and divergent national budgetary policies would undermine monetary stability and generate imbalances in the real and financial sectors of the community."

The need for better coordination is recognised by the citizens of Europe, particularly those in the euro area. The recent Eurobarometer survey has shown that, on average, more than four out of five euro area citizens are in favour of greater policy coordination between countries to overcome the crisis.

This is very important: citizens want a stronger coordination of economic and fiscal policies among the countries of the euro area. European integration has led the people of Europe to appreciate the value of cooperation, especially in difficult times.

So what does more coordination require? At its core, it means strengthening the economic governance of Europe, a project to which I know that the European Parliament is fully committed.

Let me share with you our view at the ECB on what progress has been made and what remains to be done.

4. The ECB's position on reforming economic governance

The ECB has recently published its legal opinion on the economic governance proposals. In a separate publication on our website, we have highlighted 10 points where we have called for more ambitious steps. We believe that we must draw not just some, but all appropriate lessons from the crisis.

In essence, the thrust of our message is as follows.

More automatic and speedy procedures, a broader range of enforcement tools and more ambitious policy requirements are all urgently required at euro area level. But these will not be sufficient if they are not solidly anchored at national level: the gap between the EU and national level must be closed. An effective way of achieving this would be to swiftly implement strong national budgetary frameworks in the Member States.

Earlier this week, the Ecofin Council took some steps forward. In particular, the Council accepted the introduction of an annual fiscal expenditure benchmark and a numerical benchmark (the 1/20th rule) for debt reduction.

The fact that the Council 'expects to, as a rule, follow the recommendations of the Commission, or explain its position in writing' – is a step in the right direction. It would be a big step if there were assurances that it would be implemented in a strict and rules-based manner.

As regards the anchoring of the objectives of EU fiscal coordination in national budgetary frameworks, it is of the essence that the directive is transposed into national law as faithfully as possible, and no later than by the end of 2012. It would be helpful if the Eurogroup could issue a formal statement to that effect.

The Ecofin Council also agrees with a framework for the prevention and correction of excessive macroeconomic imbalances, including an early warning mechanism and eventual sanctions in the case of euro area countries. The ECB welcomes the intention to channel any fines collected to the crisis resolution fund.

Nevertheless, in our view, still more ambition on governance is warranted.

5. The need for greater ambition in governance reform

Let me briefly highlight the main points and explain why we find them so important. You will see that my remarks are very specific. This is because we are at a point where it is time for decisions, and the matter before us is complex. Parliament has received about 2000 amendments on the six legal texts. Therefore, specificity in recommendations is essential.

Let me summarise them under four headings.

First, all surveillance procedures have to be faster and more automatic, including the new macroeconomic surveillance framework.

We have seen more than ever the importance of a timely correction of fiscal imbalances. Therefore, we cannot wait months or even a year until policies are corrected. In the meantime, spillovers would hurt other Member States.

In the past, the Council has often suspended the procedures of the Stability and Growth Pact, thereby weakening its credibility. This must not happen again. The newly agreed 'comply or explain' principle under fiscal surveillance still leaves too much room for discretion. Moreover, it does not cover the new macroeconomic surveillance framework.

Beyond this, the ECB believes that the use of reverse majority voting could be extended further across the various surveillance provisions – not just the two regulations on financial sanctions for euro area countries.

Second, the enforcement tools also need to be more effective. For example, the new macroeconomic surveillance framework needs to provide clear incentives by envisaging financial sanctions already after the first instance of non-compliance. Discretion to reduce or suspend financial sanctions – either on grounds of exceptional economic circumstances or in response to a reasoned request by a Member State – strongly reduces the effectiveness and sets the wrong incentives. This should not be permitted: it will help nobody.

Third, the policy requirements should be more ambitious to match the current reality of the euro area. The new macroeconomic surveillance framework, as amended by the Council, does not yet provide a clear focus on the euro area

countries with large current account deficits, significant losses of competitiveness and high levels of public and private debt, as well as any other vulnerabilities challenging our economic and monetary union.

As regards fiscal surveillance, ambitious benchmarks are needed when establishing an excessive deficit. The scope for considering 'any relevant factors' in case of an excessive deficit should be clearly reduced.

The adjustment path towards a country's medium-term budgetary objective also needs more ambition. In this context, the annual improvement in the structural balance should be significantly higher than 0.5% of GDP when a country's government debt exceeds the reference value of 60% of GDP, otherwise there are fiscal sustainability risks.

Fourth and finally, it is also crucial to guarantee the quality and independence of fiscal and economic analysis. We propose the establishment of an EU advisory body of recognised competence. It goes without saying that remaining weaknesses in the collection and reporting of data have to be addressed immediately and rigorously.

These are my main areas of recommendation.

It is clear that implementation of the new governance framework will have a significant impact on national policies, which will call for enhanced democratic legitimacy. A key issue will be to anchor the forthcoming reforms firmly at national level by means of strong budgetary frameworks.

For euro area countries, independent national fiscal policy institutions should be mandatory. Clear borrowing frameworks should also be considered.

I welcome the euro area countries' commitment of 11 March to transpose the EU fiscal rules into national legislation and including for sub-national levels.

The ECB and, I believe, also the citizens of Europe count on the European Parliament to drive these changes forward. We are mandated as European institutions to take a broader perspective. We are independent of specific national circumstances. And we are here to think long-term, as do our citizens.

Let me borrow the words of Willy Brandt, speaking as the first Head of Government of a member state of the European Communities to address the plenary of the European Parliamentary Assembly, back in 1973. "This is where the political will should, at long last, carry the day over the many national administrative egoisms, which may be justified individually, but all in all can no longer be tolerated. Having gone so much astray in the past years, we must now achieve a better harmonization of our economic policies. New decisions are needed which place more precise obligation on us, and bind Member States more closely."

6. The quantum leap

If the European Parliament were to go further in this direction, it would provide a true 'quantum leap' in the rules that regulate how countries make their national economic policies. Countries need clear rules to guide policy-making, and sanctions if they stray from a sustainable path.

For those still hesitating whether to go that far, let me recall what happened some years ago: after a period generally acknowledged as a period of economic fair weather, governments decided to weaken the Stability and Growth Pact in 2004 and 2005.

This initiative was led by the euro area's largest economies. The ECB voiced its 'grave concerns' at the time. Governments had not used the more benign years to put their fiscal houses in order. I now see that many acknowledge that the weakening of the Pact was a serious misjudgement.

The crisis has given us an opportunity. It has made plain the flaws in the Stability and Growth Pact that allowed countries' fiscal policies to become a problem – not just for themselves, but for everyone else within the monetary union.

We now have an obligation to fix the flaws. All of them.

We now have to lay the ground for policies towards sustainable and balanced growth. It is only such growth that will contribute to lasting job creation and social harmony.

7. Conclusion

Let me draw to a conclusion. As I have indicated, the history of the euro is something in which all Europeans can take pride. I have every confidence that the future of the euro will be one in which we can equally take pride. But to get to that point, several improvements need to be made to our economic union.

As I have indicated, progress is being made. Yet we need to draw all the lessons from the current situation to complete the work on Europe's economic and monetary union.

We must ensure that the well-functioning monetary union is complemented by an equally well-functioning economic union.

All of this should be done to achieve the common goal: a union of individual freedom and collective respect; a union of responsibility and cooperation; and a union of stability and prosperity.

Thank you for your attention.

Decision on a memorial commemorating the deportation of Jewish citizens from the Grossmarkthalle in Frankfurt am Main

Remarks by Jean-Claude Trichet, President of the ECB, Frankfurt am Main, 11 March 2011

Sehr geehrte Frau Oberbürgermeisterin Roth,

sehr geehrter Herr Schnabel,

sehr geehrte Kolleginnen und Kollegen der Jury,

sehr geehrte Damen und Herren,

I am honoured to be here today with Lord Mayor Roth and Mr Schnabel of the Jewish Community Frankfurt for the announcement of the final decision on the design concept for a Jewish memorial at the Grossmarkthalle in Frankfurt.

Since the very beginning of its new premises project, the European Central Bank (ECB), together with the Jewish Community Frankfurt and the City of Frankfurt, has been committed to establishing a memorial commemorating the deportation of Jewish citizens from the Grossmarkthalle. To honour this commitment, a design competition for such a memorial was launched by the City of Frankfurt. During the competition's revision phase, which concludes today, we met with each of the three prizewinners to discuss the details of their design concept. As two of the proposals involved building the memorial on the ECB's grounds, it was necessary to ensure that they could be built in line with the overall site development.

I believe we can all see that each prizewinner put in a considerable amount of work and effort to fine-tune and further develop their concept. The decision-making process involved long and in-depth discussions on the advantages and disadvantages of the three very different designs. These discussions were extremely fruitful and I am delighted that they led to a unanimous decision in favour of a remarkable memorial that will take full account of the location's characteristics and reflect the drama of deportation and the holocaust.

The construction of the chosen design, as developed by Cologne-based architects KATZKAISER GbR, and in particular the construction of the ramp, will be carried out in close cooperation with the ECB, the architects of our new premises and the relevant planners. I am looking forward to the inauguration of the memorial.

Competitiveness and the smooth functioning of EMU

Speech by Jean-Claude Trichet, President of the ECB, Lecture at the University of Liège, Liège, 23 February 2011

1. Introduction

What should we understand by the concept of competitiveness, what does it mean in particular for the euro area – and how should we act upon it? These are the questions I would like to explore with you today. They are questions I have been contemplating all my life as an economic policy-maker. [1] And they are questions that are central to the future of the national economies of Europe – and of particular importance among those that constitute our Economic and Monetary Union.

Competitiveness is a difficult idea to nail down decisively and is commonly used to depict very different things – from securing export market shares, through taxation of corporate profits, indexation of wages and investment in high-tech, to boosting productivity growth.

In my view, the appropriate definition of competitiveness is a country's ability to achieve sustainable improvements in the economic living standards and job opportunities of its citizens in an open economy. Therefore, competitiveness is about the entirety of our economic lives in a time of globalisation.

It is obvious that being successful in terms of price and cost competitiveness is one key condition for enhancing living standards and job creation in open economies. Exports are naturally an important part of the picture. But all sectors of our economies are involved in competitiveness. Public goods and services – and private goods and services. Tradable goods and services – and non-tradable goods and services. Financial services firms – firms active in all parts of the real economy – and households and governments.

As diverse and multifaceted as our countries are, as manifold are the means of achieving sustainable long-term economic growth and job creation.

The objective of achieving sustainable long-term growth in an open economy is both European and global. It has to do with the thriving of nations within Europe, as well as within the global economy that is undergoing very rapid structural changes.

The European Union is the world's largest economy and trading partner. It is therefore very appropriate that it has designed its own strategy of developing its growth potential in tomorrow's global economy. This strategy, called Europe 2020, is focusing on three main areas: education, research and innovation; resource efficiency; and high employment and social cohesion. These elements are all relevant for Europe's competitiveness in a global economy, and the ECB fully supports the Europe 2020 strategy.

Today, I would like to focus on the aspect of competitiveness that is internal to Europe's Economic and Monetary Union, i.e. the euro area. In such a union, competitiveness must be examined at national levels, with a view to take into account in particular the very high level of interdependence between economies created by the single currency. Therefore, competitiveness is not only about raising our economic living standards: it is also about strengthening the cohesion of the economic union. I will therefore focus my remarks on what arrangements of competitiveness surveillance we need in the euro area, and how this could be further enshrined in the current economic governance framework that is examined by the EU Council and the European Parliament.

In an economic and monetary union, it is of the essence, by implementing sound economic and fiscal policies, to avoid too large and too sustained divergences. That is why the Treaty devotes an entire chapter to the "economic policies" of the union, with a particular focus on countries that have adopted the single currency.

In an economic and monetary union, the Member States must develop and share a common economic understanding of mutual surveillance. This common understanding of the implications of being members of a currency union should ensure that structural features of the economies help them to preserve their relative competitive position in an open environment while ensuring collective stability. Such collective stability, as opposed to sustained and large imbalances, implies in particular that macroeconomic policies need to be fully consistent with a stability-oriented monetary policy.

I should emphasise that this in no way means that competitiveness or avoiding internal imbalances is about making everybody look the same. The economic diversity that we enjoy in Europe is an asset that we should seek to strengthen rather than dissipate.

What matters, however, is that diversity does not lead to large, persistent divergences. To prevent such divergences from arising, we need a common framework that ensures that all Member States – within their specific national settings – stay committed to regain, when necessary, consolidate and preserve their relative competitiveness.

Misguided national economic policies can lead to the emergence of excessive competitiveness gaps between the members of the currency union. The primary symptoms of such competitive gaps are usually mounting current account deficits, significant accumulated differences in indicators of price and cost competitiveness, leading, in particular, to inflation rates persistently above the euro area common objective. Such developments are also associated with tensions, painful adjustment processes and spillovers for other members.

It is for these reasons that the European Central Bank (ECB) regularly provides analysis and insight into the importance of competitiveness for Economic and Monetary Union.

Indeed, it is now five and a half years since the ECB injected an analysis of relative competitiveness into the European policy surveillance.

When, around 2005, the signs of imbalances and divergences in key nominal developments, in particular in prices, costs and wages, started to accumulate significantly, the Governing Council sent the first analysis to the Eurogroup. The focus was on price and cost developments in individual countries; the message was one of divergence that warranted interpretation, assessment and policy action. At the same time, an ESCB Task Force was set up to look more deeply into competitiveness issues of the individual euro area countries. [2]

Ever since, the ECB has provided updates of the analysis to the Eurogroup. The information on unit labour costs, productivity and sectoral wage developments in euro area countries have become a recurrent theme distributed at these meetings.

Since 2007, the ECB has undertaken regular, comprehensive competitiveness reviews of developments in individual euro area countries. And in 2010, the ECB provided a detailed outline of how the Governing Council envisages a competitiveness framework for the euro area.

In my remarks tonight, I would like to focus on the main issues at stake – for national economies in general and for members of the euro area in particular.

I will begin by reminding you of some of the stylised facts that have characterised economic developments in the euro area over the past 12 years, as well as some of the fallacies about competitiveness that I have encountered over the years.

I will then outline the key elements of a framework for analysis and action on competitiveness, and subsequently discuss the implications for the current proposals on the strengthening of macroeconomic surveillance from a euro area perspective.

II. Some empirical evidence

Let me give you some stylised facts about macroeconomic developments in the euro area over the past decade or so. For now, I will just provide you with the data, without going into their causes and policy implications. [3]

1. Between 1999 and 2009, nominal **unit labour costs** grew by 24% in cumulative terms in the euro area as a whole. In Austria and Germany they grew by 13% and 8%, respectively; in Greece and Ireland, they grew by 34% and 38%, respectively.
2. Between 1999 and 2009, public sector wages **in the euro area** grew by close to 40%. In Germany, they grew by 19%; in Ireland and in Greece, they grew by more than 100%, roughly 50 percentage points more than private sector wages.
3. Between 1999 and 2007, residential **property prices** in the euro area rose on average by around 6% per year. In Greece they rose on average by 9.5% each year; in Ireland they rose each year by almost 12%.
4. **Household indebtedness** in the euro area average rose from about 50% of GDP in 1999 to about 65% of GDP in 2009, an increase of about 30% over the period. It doubled in the economies with the highest increase.

These are some illustrative facts. Let me now turn to some fallacies that I hear sometimes when discussing these and similar facts.

III. Fallacies on competitiveness

Discussions on competitiveness often reveal misconceptions or fallacies that, in my view, are wrongly guiding the debate.

Fallacy No 1: "Only the tradable sector matters for competitiveness", some say. "There is no problem with the competitiveness of our economy: companies in the exporting sector are doing well, prices are low and profits are good."

Fallacy No 2: "Public wage developments do not affect an economy's competitiveness", some say. "Since the public sector is sheltered from international competition, developments in public sector pay have little connection with the private sector and certainly not with the international competitiveness of companies."

Fallacy No 3: "Let's discount wage and cost developments with the (relatively) high current domestic inflation rate and we get a benign picture", some say. "Our wage increases of 6% are fully justified because we have 2% productivity and 4% inflation; moreover, the higher inflation rate is purely a catching-up phenomenon because we are growing so fast."

Fallacy No 4: "Intra-euro area current accounts don't matter", some say. "The current account balance reflects inter-temporal optimisation of savers and investors; moreover, current account deficits are good as they reflect capital inflows, attracted by higher returns."

Fallacy No 5: "Fiscal consolidation can harm competitiveness", some say. "Fiscal consolidation is going to have dampening effects on growth and can weaken competitiveness, which requires substantial government expenditure."

IV. Key elements of a competitiveness strategy

So if these points are fallacies, what is the right strategy for economies in general and the euro area in particular? Let me share with you my reflections on five key elements of what I think is the correct diagnosis:

1. First, **the non-tradable sector is essential** for the competitiveness of an economy. Hence, we must look at all sectors when assessing competitiveness.
2. Second, **wage developments in the public sector** are much more important than is generally realised. Therefore, the public sector must set its compensation levels with the implications for the whole economy in mind; it must be aware of its role model.
3. Third, less than **2% but close to 2% over the medium term** – namely the level of medium-term inflation that is ensured as an average in the euro area by the ECB – is the right benchmark to use for all countries to calculate competitiveness indicators in real terms. Hence, one must not be misled by temporary inflation differentials into price-wage spirals which would be very detrimental for employment.
4. Fourth, the **current account balance** is an important summary indicator that may signal losses of competitiveness and emerging imbalances. As a result, policy-makers should monitor this balance closely, and especially the related external debt accumulation.
5. And finally, **sound public finances** are a pre-condition for sustained competitiveness. This is yet a further reason for fiscal solidity.

Let me elaborate on each of these elements.

1. The non-tradable sector is essential for the competitiveness of an economy

There are two main reasons why the non-tradable sector is essential for an economy's competitiveness. First, non-tradable goods and non-tradable services are important inputs for the production of tradable goods. Hence, rising prices in the non-tradable sector push up costs in the tradable sector. Second, price and unit labour cost increases in the non-tradable sector will ultimately lead to upward pressure on unit labour costs in the tradable sector (López-Salido et al., 2005). This second-round effect pushes up the productions costs of tradable goods and reduces the competitiveness of the tradable sector.

There is some recent evidence that those countries with higher growth of unit labour costs in services and construction than in industry and manufacturing have experienced a worsening of their current accounts (see, for example, Zemanek et al., 2010).

If unit labour costs in the non-tradable sector persistently exceed those in the tradable sector, firms in export industries may see themselves forced to squeeze their profit margins because they are unable to pass on higher input prices to world prices. Price and cost pressures from an expanding non-tradable sector induce exporters to reduce their margins. Thus, at first, the exporting industry might not be doing too badly and export prices remain unaffected. But the industry is gradually getting squeezed, rather than expanding. This not only reduces the relative weight of exporters in the economy, but also the overall growth potential.

2. Public sector wages are much more important for competitiveness than is generally realised

In the euro area, the government wage bill accounts, on average, for more than 10% of GDP and more than 20% of the total compensation of employees. It is already clear from the sheer size of this sector that public wage increases can have a very important signalling effect for private sector wage negotiations.

The larger the public sector is, compared with the tradable sector, the stronger will be the signal for wages in the private sector, and therefore the influence on the unit labour costs in the private sector, taking due account of productivity developments. Hence, the larger the public sector, the more important, and the more challenging, will be its role in the overall evolution of cost competitiveness.

Evidence reveals an important influence from public sector wages to private wages in many euro area countries. Public wage spillovers seem to be particularly important in countries that have experienced high and volatile public wage growth. Thus, rapid increases in unit labour costs and severe losses in intra-euro area competitiveness do not come as a surprise in these countries (Pérez and Sanchez, 2010 and Holm-Hadulla et al., 2010).

3. Less than 2% but close to 2% over the medium term is the right benchmark to use for euro area countries to calculate competitiveness indicators in real terms.

In the euro area, the average annual inflation rate over the first 12 years of the euro was 1.97%. This outcome is in line with the ECB's definition of price stability of below, but close to, 2%. This definition is deeply entrenched in medium to long-term inflation expectations, which confirms the ECB's credibility and the public's confidence in the ECB's ability to deliver price stability over the medium term. The ECB therefore provides the nominal anchor for future price developments in the euro area as a whole.

Now, in a currency union, it is a natural phenomenon that Member States, at times, have different inflation rates. These differences can result from some differences in the economic development level of Member States, their position in the business cycle or their dependence on trade and hence global developments.

So temporary deviations from the euro area-wide inflation average should not be a matter of concern. Indeed, they constitute an important potential adjustment channel within a currency union where exchange rates are fixed. But inflation differentials can turn into a source of concern when they become large and persistent.

For a significant period of time, persistent above area-wide inflation rates in some Member States had been regarded by some economists as justified on the grounds of catching-up effects. The argument is that lower-income countries usually import productivity gains in the tradable sector, which in turn leads to higher economy-wide inflation due to the adjustment of nominal wages across sectors. This is the Balassa-Samuelson effect.

But increasingly evidence suggests that this effect has been overstressed as an explanation for inflation differentials in the euro area. In some cases, these differentials were not driven by healthy catching-up effects, but were largely the outcome of inappropriate macroeconomic policies and debt-financed booms in domestic demand.

Thus a medium-term inflation rate of somewhat below 2% over the medium term is the appropriate benchmark also at the national level. Unit labour costs, and therefore developments in compensation, after having taken due account of the labour productivity increases, need to be consistent with this in order to avoid a rise in unemployment.

Moreover, using contemporaneous (or lagged) inflation as a benchmark for wages can lead to a nominal persistent spiralling of both compensation and inflation over and above the average of the euro area. This would lead to a progressive loss of cost competitiveness and higher unemployment. This is why central bankers are in general against indexation, including wage indexation, particularly in a single currency area.

4. The current account balance is an important summary indicator that may signal emerging imbalances and losses of competitiveness.

For the record, let me first stress that a current account deficit, just like a current account surplus, does not necessarily point to economic malfunctioning. Indeed, it can be optimal for a country, given the macroeconomic conditions. This is also true in a monetary union, where some differences in national current account balances are a normal feature.

Capital flows, for example, may be favouring Member States with better growth prospects and higher expected returns, related to catching-up processes and successful structural reforms, and current account balances may diverge across countries as a natural result of responses to asymmetric shocks.

Increasingly, however, larger current account deficits, in combination with significant losses in competitiveness, high levels of private and public indebtedness and overheating in non-tradable sectors, may signal domestic macroeconomic imbalances and deeper structural problems.

Countries with large current account deficits or worsening current account balances, for example, often exhibit cumulated losses in price competitiveness, and vice versa, which again, in turn may be related to price and cost developments that are not economically justified. Rather than financing productive investment in the tradable sector and fostering the export performance, capital inflows in deficit countries might fuel asset prices and household and corporate debt.

Hence, even if inter-euro area current account balances do not matter because of the same currency and will not trigger exchange rate crises, at the euro area level, internal current account imbalances are relevant for policy-makers, as one of the major indicators of the fundamental functioning of their economies.

5. Sound fiscal policy is a pre-condition for sustained competitiveness

Some observers are concerned that fiscal consolidation at the current juncture might dampen economic growth and also provide negative externalities by constraining demand for trading partners. I disagree with this view. [4] On the contrary, I see three main reasons for fiscal consolidation being presently positive for medium-term economic growth and competitiveness.

First, experience from past episodes of fiscal consolidation suggests that, in a situation of sizeable fiscal imbalances, short-term costs of fiscal adjustment in terms of forgone economic growth tend to be contained or very limited, provided that consolidation is pursued as part of a comprehensive reform strategy. Experience also suggests that the success of a fiscal consolidation strategy strongly depends on its design. Adjustment on the spending side, accompanied by structural reforms to promote long-term growth, has typically been the best strategy, especially when combined with a credible long-term commitment to fiscal consolidation.

Second, in a situation where fiscal sustainability is being questioned, consolidation boosts confidence, which is a pre-condition for the consolidation of the present recovery and for sustainable medium-term growth.

Third, public authorities need to preserve the ultimate capacity of public finances to intervene in difficult circumstances. This is already true when our economies are going through the usual business cycle. The reconstitution of fiscal buffers is always necessary. It is even more necessary when our economies are coping with exceptional circumstances, such as the recovery from the deepest economic crisis in over 60 years. The soundness of public finances and the creditworthiness of the sovereign signatures are therefore a decisive component of economic and financial stability in a medium and long-term perspective.

V. Implications for the reform of the European surveillance framework

Let me now discuss what the implications of these insights are for the surveillance of economic policies in Europe, and in particular how the above five elements should be reflected best in the existing European framework of macroeconomic surveillance and in the envisaged new elements of this framework.

Within an economic and monetary union, national economies form an interdependent system, in which spillovers are important for the cohesion of the union. It is not straightforward for countries to take account of these spillovers sufficiently on their own. This is the reason why strengthened surveillance at the euro area level is needed to prevent economies from falling behind by losing competitiveness and becoming subject to macroeconomic imbalances.

I have already mentioned developments in prices, costs and wages, current account deficits and indicators of private and public sector indebtedness as well as countries' external debt position.

For many years, I have strongly advocated in various European fora that the accumulation of substantial losses of competitiveness, as revealed by developments in unit labour costs among other indicators was not sustainable. Therefore, I trust that this is where a surveillance framework aimed at preventing and correcting macroeconomic imbalances has to start.

Of course, these elements are not the only ones we have to analyse carefully. As I have said before, economic reality is much more complex than just a pure set of indicators. Nevertheless such basic indicators are central for starting the analysis and for understanding the policy considerations.

Let me therefore briefly sketch out the key indicators that ECB staff have been selecting after reviewing and assessing the relevance of a much wider set of variables. These indicators shall provide early warning signals when macroeconomic imbalances emerge and when countries are experiencing significant losses in competitiveness, or when there are risks thereof. The seven key indicators in the view of ECB staff are as follows:

- a long-term measure of the growth of **unit labour costs**;
- the stock of a country's **net external debt** as a ratio to GDP;
- the national **inflation rate**;
- the **current account deficit** as a ratio to GDP;
- the **private and government debt ratios**;
- and the **stock of private sector credit**.

These variables are all common economic indicators, they are easily available from official statistics and they are broad based. They have been selected to keep the first diagnosis as simple as possible, while still covering the most relevant dimensions of economic fitness.

Such a scoreboard of indicators can help focus our attention on the key issues and trigger more detailed surveillance procedures in cases in which indicators rise beyond certain pre-defined threshold levels.

The European Commission and the related Council working group have been working intensively on such a framework, including an alert mechanism on the basis of a limited set of macroeconomic indicators – similar to those I have just presented – which would initiate more detailed surveillance procedures.

The current discussions are based on the Commission's proposal for a new framework that will apply to all 27 EU Member States with a preventive and a corrective arm.

Without going into all the technical details, let me make very clear once again which fundamental elements in its design should be improved. The ECB's Governing Council, being responsible for ensuring price stability, has a major interest in the smooth functioning of the euro area economy. In this respect, the ECB considers it fundamental to set up an effective surveillance mechanism in the euro area that avoids the challenges that some countries are currently facing. The ECB published yesterday its opinion on the proposals made by the European Commission (ECB, 2011). It regards these proposals as appropriate for the Single Market, but considers that they need to be strengthened as regards the euro area. With respect to the new macroeconomic surveillance framework, the ECB calls, in particular, for the following specific measures to strengthen the framework for the euro area:

First, the specific nature of membership of a monetary union should be indicated more explicitly. This should be reflected in differentiated indicators and thresholds of the scoreboard for the members of the euro area, in comparison with the other members of the European Union. Tighter thresholds for competitiveness indicators in the scoreboard are required for the euro area countries. The set of indicators for the euro area countries should focus on the detection of macroeconomic imbalances, and therefore they should refer to losses of price competitiveness, private and public sector indebtedness and external indebtedness indicators. They differ by nature from the much wider set of indicators reviewed to assess progress in structural reforms in the context of the Europe 2020 strategy to enhance sustainable growth and employment in Europe. These are the concepts that will address the "thriving of nations in the dynamic global economy" which I alluded to at the outset.

Second, a clear focus of the surveillance framework can be maintained best if only cases of macroeconomic imbalances that hamper the smooth functioning of monetary union are addressed. The framework proposed by the European Commission is symmetric with respect to detecting, preventing and correcting both excessive losses as well as gains in competitiveness. I think that a totally symmetric approach misses an important point: the European Union and the euro area are not closed economies. On the contrary, they are amongst the most open economies in the world. Gaining more competitiveness through the improvements in one particular economy is a win-win game for all members: we are not playing a zero sum game. Therefore, a totally symmetric approach runs the risk that the surveillance lacks focus and becomes distracted from the most serious challenges to the monetary union, which are significant losses of competitiveness, persistent current account deficits, unsustainable increases in asset prices, including real estate prices, and high external and internal levels of indebtedness. Given the magnitude of the imbalances accumulated, the required policy action is urgent in some Member States.

Third, a much greater degree of automatism should be introduced into the macroeconomic surveillance framework. A substantial discretionary power puts the credibility of the macroeconomic surveillance mechanism at risk, if the rules and enforcement measures are not consistently applied. Therefore, the possibility of derogation from the imposition of sanctions on the grounds of exceptional economic circumstances or at the request of a Member State should be avoided.

Fourth, in the same vein as the reforms introduced in the Stability and Growth Pact, financial sanctions in the macroeconomic surveillance framework need to be applied at an earlier stage and gradually, to provide Member States with the right incentives to comply with the policy recommendations. This implies that financial incentives – such as an interest bearing deposit – should be applied after the first instance of non-compliance or non-cooperation by a Member

State, while the current proposals foresee fines only after a repeated failure of a Member State to comply with Council recommendations.

I am convinced that the European Parliament, with its co-decision power, will improve the framework very significantly and trust that the proposals above are helpful in this respect.

VI. Conclusion

Let me draw to a conclusion. Competitiveness improvements will enhance a country's ability to achieve sustainable improvements in the economic living standards and job opportunities of its citizens.

Europe's 2020 strategy is fully part of the overall concept of competitiveness. It is, in a way, the "external" angle of competitiveness in the global economy. Today, I focused more on the "internal" angle of competitiveness, to strengthen the economic management of the Single Market and, more specifically, of the euro area.

When the data are analysed within an appropriately comprehensive framework, several fallacies become evident. We know that we must look carefully at the non-tradable sector when assessing competitiveness. We must monitor compensation in the public sector very closely. We also understand – and this is absolutely fundamental – that a euro-wide price perspective must dominate over national computations when discounting nominal evolutions including revenues and wages. We see that the current account provides an important summary indicator. And finally, we trust that appropriate fiscal consolidation will lay the foundations for sustained competitiveness and durable employment of our economies.

Figuratively speaking, competitiveness is not about becoming athletes in a world sprint competition. It is about staying fit and thriving for the long term. It is also about avoiding falling behind and ultimately becoming more dependent on others.

Because the community benefits, competitiveness is not about becoming richer at the expense of others – the infamous beggar-thy-neighbour doctrine. Competitiveness is about individual and collective health, with the two of them being mutually reinforcing.

We also need a commitment to sound and sustainable public finances and sound national economic policies. Both must be monitored by a rigorous, credible and focused surveillance framework.

A rigorously implemented Europe 2020 strategy, coupled with a reinforcement of the governance framework before the European Parliament that we are calling for, will pave the way for prosperity, job creation and stability of the EU and the euro area in tomorrow's global economy.

The contribution of the single monetary policy to this process is clear. Monetary policy provides a reliable nominal anchor for households, enterprises, savers and investors that euro area-wide consumer prices will increase, as in the past 12 years, in line with the ECB's definition of price stability over the medium term.

Our 331 million fellow citizens can rest assured that the ECB is fully faithful to its primary mandate. By maintaining price stability over the medium term and by solidly anchoring inflation expectations at a level consistent with our definition of price stability, monetary policy can make the best contribution to the achievement of sustainable long-term economic growth and job creation.

Thank you for your attention.

Intellectual challenges to financial stability analysis in the era of macroprudential oversight

Speech by Jean-Claude Trichet, President of the ECB, for the panel discussion on: "Global imbalances and financial stability" at the Eurofi G20 High Level Seminar, Paris, 18 February 2011

Comments on the article published in the Banque de France Financial Stability Review Nr. 15, February 2011.

1. To focus the Banque de France Financial Stability Review on " **Global imbalances and financial stability**" is extremely timely. After some partial reduction induced by the crisis global imbalances have started to widen again. This poses challenges for international monetary cooperation and exchange rate relationships. Moreover, a further surge in private capital flows to emerging economies could lead to an acceleration of reserve accumulation and to the re-emergence of the pattern of imbalances that contributed to the factors causing the crisis. **The potential disorderly unravelling of these imbalances remains one of the main risks to the European and global financial systems over the medium term.**

2. Therefore we need to continue thinking about how we can make the international monetary system more resilient to such imbalances and policy structures more flexible in addressing them more effectively than the case in the past. In this regard **I welcome the focus of the French G20 Presidency on the process of mutual assessment of its members' macroeconomic and structural policies.**

3. I decided to focus my remarks today on a related but more specific topic. My starting point is that **we have recently entered a new era of financial stability policies, the era of macroprudential oversight**. Both the European Union and the United States of America have established new bodies whose task it is to identify early emerging systemic financial risks and to consider policy measures that could mitigate them. These are the European Systemic Risk Board and the Financial Stability Oversight Council, respectively.

4. One pre-condition for matching the expectations to this new era is that the competent authorities possess a comprehensive and reliable analytical apparatus for identifying systemic risks and for assessing the effectiveness and efficiency of policies that could contain them. In my contribution today I would like to highlight*four challenges* that I see in advancing such an analytical apparatus and point in some directions one could go in meeting these challenges.

5. The first challenge relates to the **basic functioning of financial systems**. Whereas important parts of – let me say – the "DNA" of financial systems is known, the crisis has shown that there remain significant difficulties (1) in grasping the benefits and risks of some major "mutations", namely important financial innovations and new business models, and (2) in predicting how the overall "body" reacts to specific stresses.

6. More specifically, I would argue that our analytical apparatus would still have to make progress in characterising the role of non-bank financial intermediaries. For example, the "explosion" of the industry of highly leveraged financial institutions from around 100 billion US dollars of capital under management in 1990 to 3 trillion dollars in 2007 implies that this industry is likely to generally have important systemic implications, even though the present crisis was not caused by failures of large hedge funds. Many hedge funds are highly sophisticated, but this does not imply that in the aggregate they always act in the stabilising contrarian way perceived by some observers. Recent research about the "dot.com" bubble episode by Brunnermeier and Nagel, for example, suggests that many hedge funds were heavily invested in technology stocks rather than acting as a force correcting prices towards fundamentals.

7. The second intellectual challenge for such an analytical apparatus relates to **when and how a financial system migrates from tranquility to a severe crisis**. It appears to me that in economics we have some way to go in understanding the triggers, speed and abruptness of such migrations. See, for example, the sudden eruption of systemic instability in August 2007 and its dramatic worsening in September 2008, as reflected in a new indicator of systemic stress developed by ECB staff displayed in chart 1 of my article. In physics, however, "phase transitions" are the subject of ample research since a long time. For example, Jean-Philippe Bouchaud from the Ecole Polytechnique here in Paris has shown how fundamental research in physics on "crackling noise" and "self-organised criticality" can be applied to transitions to financial crises. This helps, for example, to understand the initial persistence and subsequent abrupt breakdown of financial bubbles. While this type of approach closely matches a number of important empirical patterns in asset prices, for example, it does not assume very high levels of rationality of economic agents, a strong tendency towards equilibrium situations or universal efficiency of financial markets. This observation might be insightful, if we compare it with the standard models that are nowadays used in economics.

8. The third challenge concerns **how financial instability interacts with the macroeconomy**. In my article, in chart 2, I have illustrated how drastically major forecasting institutions missed the start of the "Great Recession", the "free fall" of economic activity in late 2008 and in 2009. A tremendous challenge is therefore to improve macroeconomic forecasting models, so that they give us also faster and more accurate characterisations of such situations over the relevant policy making time horizon. Two directions in which we probably have to go in order to make progress are to generally integrate more realistic characterisations of financial systems in macroeconomic models and to capture the relevant nonlinearities that are so typical for the unfolding of financial crises.

9. Fourth and last, we need to make further progress in the **regulation of systemic risk**, as opposed to only regulating individual risks. To be fair, Basel III goes some way in this direction. It generally increases the quantity and quality of capital and liquidity buffers. And the conservation of capital against excessive distributions will be complemented with a counter-cyclical element. Moreover, major international initiatives are under way to further reduce the probability and impact of failures of systemically important financial institutions (the so-called SIFIs), including the development of effective resolution regimes and recovery planning. One area

where our analytical apparatus supporting macroprudential policies could make further progress is in terms of the assessment of early regulatory responses to credit bubbles. Some moderately sized Asian emerging countries, for example, have made some interesting experiences with the tightening of loan-to-value ratios or debt-to-income limits when property markets started to boom. We would benefit from more work about the effectiveness of these instruments in large industrial countries and as fully counter-cyclical tools, which would mean to also relax them in downturns.

10. Europe has pushed ahead with establishing the **European Systemic Risk Board**, which started to work last month. The ESRB will monitor systemic financial risks to the EU, including the ones emerging from global imbalances. When necessary, it will issue risk warnings and/or policy recommendations. One of its strengths is the ESRB's broad membership, bringing around the table the right institutions and expertise. In this way, all relevant issues can be tackled in a coordinated way and its recommendations carry due weight.
11. Let me now conclude. The agenda we have to meet in the era of macroprudential oversight is tall. We need to advance our analytical and policy apparatus along the four types of challenges I just discussed. This will require, inter alia, **enriching the way of thinking in economics and finance**. New approaches should be considered that do not necessarily rely on the notions of equilibrium and universal rationality and efficiency. Going beyond the latter concepts may **benefit from inspiration of approaches used in other fields, such as notably the natural sciences**. This would not only help us advancing the foundations of national and regional supervisory policies but also the foundations of global macroeconomic policy coordination.

Interview with Die Zeit

Interview between Die Zeit and Jean-Claude Trichet, President of the European Central Bank, conducted by Mark Schieritz and Uwe Jean Heuser

DIE ZEIT: Mr Trichet, you've been tirelessly battling this euro crisis for quite some time now, and yet it's still not over.

Jean-Claude Trichet: There is no euro crisis. The currency has retained its value very well and is credible and remarkably stable – not just in one country, but in the euro area as a whole. Our problem is that the fiscal policies of some member countries have not been sound and that some countries are also lacking in competitiveness.

Zeit: What needs to happen?

Trichet: Here in Europe, we have an economic and monetary union. We at the European Central Bank take care of the monetary union; it is up to politicians to very significantly improve the functioning of the economic union. The member countries have to do their homework. We've always demanded this, and there is no longer any excuse for sitting back and doing nothing.

Zeit: That's precisely why Angela Merkel has proposed her "pact for greater competitiveness".

Trichet: We do not yet know what exactly this pact comprises. If its aim is to improve the functioning of the economic union through greater coordination and integration, we will support it. Ironically, however, we are already talking about this new pact, while the countries of the euro area are, at the same time, still discussing the reform of their Stability and Growth Pact and the other elements of economic governance.

Zeit: … which, among other things, set upper limits for national budget deficits ...

Trichet: And these reforms are, in our view, not ambitious enough. The proposals made by the European Commission went in the right direction, but were already not ambitious enough in our view. And the Member States – including Germany, France and other countries – have watered them down further. Our message is clear: we have to go as far as possible in reinforcing European economic governance, at all levels. We won't give up on that.

Zeit: Calls for more Europe aren't going down that well with the public. Is Europe really ready for greater integration?

Trichet: We have to tirelessly explain to people in the 17 countries of the euro area what the rationale for the historic process of establishing a highly integrated European Union is. All in all, that process has proceeded remarkably successfully for more than half a century now.

Zeit: So, what is its rationale?

Trichet: European integration is essential for ensuring the peace, stability and prosperity of the nations of Europe. All of the reasons we had to engage in this historic endeavour after the Second World War are still valid. The balance of power is shifting at the global level. New powers are on the rise in Asia, Latin America and Africa. We are experiencing a very rapidly changing new world with a lot of opportunities, challenges, risks and uncertainties. European unity is more important than ever.

Zeit: What role does Germany play in that?

Trichet: Germany played a decisive role in the establishment of the Treaty of Rome in 1958, the Single European Act in 1986 and, in particular, Monetary Union. Germany has also succeeded remarkably well in regaining its competitiveness over the last ten years. Your country is now reaping the rewards of its patient efforts, and the euro area is benefiting from this. A strong German economy is good for Europe.

Zeit: In Germany, of all places, Eurosceptic voices are now being heard. Are the Germans even ready for Europe?

Trichet: I travel a lot in Germany, and my impression is that while the initial reaction may be sceptical, deeper down everybody is aware of the importance of our historic project, aware of the importance of close cooperation and friendship between the nations of Europe. I believe people know that there is no other way of achieving peace, prosperity and stability.

Zeit: Even Germans are feeling anxious – they have the impression that Monetary Union is no longer what they were promised. Rules were broken. People are apprehensive that the euro will become a soft currency.

Trichet: There are many ways of seeing things in a democracy. Concerns like these were voiced even when I was involved in negotiating the Treaty of Maastricht with Theo Waigel, the Minister of Finance, Horst Köhler, Staatssekretär, and the other members of the German delegation. But the facts are much more important. For instance, it was unfortunately Germany and France which weakened the Stability and Growth Pact in 2004 and 2005. It's also a fact that price stability is greater today than during the period of the Deutsche Mark. The average annual inflation rate in the euro area over the past 12 years has been 1.97%, and in Germany only 1.5%. The average annual inflation rate in Germany in the 1990s prior to the introduction of the euro was 2.2%. In the 1980s it was 2.8%, and in the 1970s it was even higher.

Zeit: It has been like that in the past, but will it be like that in the future?

Trichet: It has been like that in the past, despite the fact that we have had to cope with difficult challenges over the last 12 years, because the Governing Council of the ECB has taken the appropriate decisions. And we are determined to always take the necessary decisions. But on top of that, we need a quantum leap in terms of economic governance: better coordination between countries, clear rules for economic policy and sanctions for misbehaviour which are as automatic as possible. Some major changes must be made here. That's the lesson of this crisis. Before it erupted, governments thought they could practise benign neglect. Now it is obvious that that is no longer the case. And we are telling them that.

Zeit: What happens to democracy if more and more decisions are taken in Brussels? The EU does not have the legitimacy that a nation state has.

Trichet: It is true that a functioning economic and monetary union presupposes that part of the sovereignty of the participating countries is exerted at the level of the union. It is obvious as regards monetary policy, which is a single policy decided by the Governing Council of the European Central Bank. But it is also true as regards fiscal policy. The Stability and Growth Pact, with its sanctions, constrains budgetary decisions and therefore limits national sovereignty in terms of fiscal policy. As long as the transfer of sovereignty to European institutions has been decided by our own democracies, it is fully legitimate.

Zeit: And we'll end up with a European super-state? Trichet: The people of Europe will decide where they want to go in terms of the political and institutional framework. They will decide whether or not to create a fully fledged federation, a United States of Europe. But we are a long way from that at the moment.

Zeit: For you personally, that's not fast enough, is it?

Trichet: Speaking as a European citizen and not as President of the European Central Bank, I am convinced that we should go further than planned. But in any case, we should never forget that it is our people who will decide. The concept

of modern state sovereignty was devised in Europe. It goes back to the Peace of Westphalia, which reorganised the continent politically after the Thirty Years War. With the European Union, we are drawing up a new concept: together, a number of sovereign states have decided to exert part of their sovereignty at the level of the European Union. This is the current European response to a question which is not just European, but global, with the rapid integration of global finance and the global economy.

Zeit: The scepticism felt by many people also has to do with their fear of inflation, which recently has risen sharply. Are we now paying the price for the crisis policy?

Trichet: The one has nothing to do with the other. We are observing a global increase in the prices of oil and commodities. That's a result not of the crisis, but of the current rapid economic recovery in emerging markets.

Zeit: So you will have to raise the interest rate?

Trichet: As I said at the last two press conferences in January and early February, all observers know that we will always take the decisions necessary to deliver price stability in the medium term. What is essential is to avoid what we call "second-round effects": namely a situation where a transitory oil shock becomes entrenched in other prices, particularly through a wage-price spiral.

Zeit: In the 1970s such a spiral of increasing wages and higher prices led to inflation getting out of control. How will you stop history from repeating itself?

Trichet: A central bank must do this – and can, if it is credible and takes the appropriate decisions. The last 12 years have seen prices surge in commodity markets time and again. We have ensured price stability by taking the necessary decisions.

Zeit: Even if you continue to do so, this will not solve the problem of increasing commodity prices.

Trichet: First, we, as central bankers, are responsible for avoiding second-round effects. But the international community is not powerless when faced with such global phenomena. People in large emerging economies are changing their consumption patterns, which is fuelling food prices. It is quite possible that this will continue for a while longer. However, at the same time, there are huge expanses of land in Africa which could be used for agricultural purposes. We need to provide the right incentives for African farmers in this respect. This is an important global issue which should be taken up by bodies such as the G20. This particular problem is not impossible to solve in the medium and long run.

Zeit: Returning to the issue of inflation. The problem is in fact that, during the crisis, the central banks – including the European Central Bank – flooded the economy with money. No one knows if you or your successor will be able to reabsorb this money in a timely fashion.

Trichet: First of all, the ECB has not flooded the economy with money. While adopting a range of non-standard measures, we have never lost sight of the fact that our mandate is to deliver price stability. For example, when we purchase government bonds in order to help restore a better monetary policy transmission mechanism, we immediately withdraw this liquidity from the economy.

Zeit: Those in the political arena have an interest in interest rates remaining low for as long as possible, though – if only on account of the massive government debt. This could become a problem for you.

Trichet: We refused to reduce rates in 2004 against the advice of the German Chancellor, the President of the French Republic and many other politicians. We increased rates in December 2005 with ten governments expressing their opposition at the time. We also raised them in 2008, even though we were criticised for doing so. We are independent and we know what our Treaty mandate is.

Zeit: Nevertheless, it is a difficult situation for you. Germany is booming and actually needs higher interest rates, while southern Europe is in crisis and would not be able to cope with this.

Trichet: It is an unavoidable characteristic of very large economies that the speed of growth varies across the individual states or countries. This phenomenon also exists in the United States. We, at the European Central Bank, must concern ourselves with inflation in the euro area as a whole. This means that the individual countries must accept the monetary policy as a given and adjust their national policies accordingly.

Zeit: Which means?

Trichet: When a country experiences a boom, it needs to make its own national policies – namely fiscal policies, wage policies, structural policies and prudential supervisors' autonomous decisions – more restrictive in order to avoid the economy overheating or speculation getting out of control. That goes for every country in the world, but all the more so for members of a monetary union.

Zeit: So, German politicians should put the brakes on?

Trichet: If that were to become necessary, they would definitely have the instruments to do what was needed. But let us remain cautious: although Germany has made up a lot of ground, output has not yet returned to pre-crisis levels. The recovery has been remarkable, more rapid than in other countries. But it has still to be fully confirmed. It is too early to declare the crisis over.

Zeit: Germany is becoming stronger, while other countries are becoming weaker. This threatens the balance in the euro area, don't you think?

Trichet: No, I don't. Just as the balance wasn't in danger when Germany itself was growing slowly in the first ten years of the euro. In large currency areas, we see economies oscillating around the average over the years. Sometimes they're up, and sometimes they're down. In any case, the current growth in Germany is good for Germany, good for the euro area and good for Europe as a whole.

Zeit: Would it help the stability of the euro area if your successor were a German?

Trichet: The appointment of the President of the ECB is in the hands of the Heads of State or Government.

Zeit: What is your opinion of Axel Weber's withdrawal in this context?

Trichet: This is Axel's personal decision, which I respect. Over the years I have had good collaboration with him on a wide range of issues.

Interview with Les Echos

Interview of Jean-Claude Trichet, President of the ECB, conducted by Henri Gibier, Jean-Philippe Lacour and Isabelle Couet on 10 February 2010

You have recently expressed your concern about a return of inflation in the euro area. Which feeling is uppermost today? Between concern about growth and inflation, which one prevails?

The real economy has had some rather good surprises for us, quarter after quarter. The return of growth was observed in the third quarter of 2009 and since then we have seen that the euro area is doing a little better than expected. The latest indicators since the end of 2010 confirm this. I emphasise that this does not only relate to Germany but to the euro area as a whole. At the ECB, we have not shared the fears of a "double dip" recession, even if our talk was cautious. I am sure that because the central bank has been an anchor of stability and confidence throughout this very difficult period, it may have played a part in consolidating this pick-up.

So the recovery seems to you less "chaotic", to take up the term you used on one occasion...

We must always be wary of quarterly figures, as they can be very volatile. We may have good news and bad news from one quarter to the next. In any case, the new medium-term economic projections of our staff will be released in early March.

The concern has now shifted to price stability...

Everyone knows that we are inflexible on inflation risks. We have always done what we had to do to maintain price stability over the medium term, which is our mission. We are proud to have had an average price increase of 1.97% per annum over the first 12 years of the single currency, which precisely matches our objective of an increase of close to, but below, 2%. Moreover, this result is better than that of all the larger economies of the euro area over the past fifty years. It has given us high credibility with regard to price stability over the next ten years. We note that inflation expectations are

well anchored, and that's essential. As I said during the last two press conferences, the Governing Council still considers the risks to future inflation as balanced, but that they could move upwards in the future.

Do you believe in the possibility of second-round effects resulting from wage increases, as we are now seeing in Germany?

It is up to each central bank to avoid second-round effects when we see a price shock affecting raw materials and energy sources, on which we cannot take action. That's even our fundamental duty. What matters is to prevent other prices from matching those movements, which have to remain temporary. In particular, the various economic agents and the social partners must not imagine that the correct inflation rate to take into account is that which comes from the abrupt rise in energy prices. In the medium term, all economic agents must bear in mind that the correct reference is that of less than 2%, close to 2% in the medium term, which we've made completely credible. That medium-term price stability is our primary mandate, and we owe it to our fellow citizens. Let's not forget that inflation affects in particular the poorest and least advantaged members of society.

The ECB has embarked on a series of non-standard measures to react to the crisis. What's your initial assessment?

Alongside standard measures relating to the key interest rates, set solely in order to attain medium-term price stability, we have been using non-standard tools: they aim to help restore the efficiency of the transmission of monetary policy to the economy in a context of certain dysfunctional markets. As it happens, we intervened as early as August 2007, providing unlimited liquidity at fixed rates, because the crisis had led to a dysfunctioning of the money market. Today, we are seeing that the interbank market is working better. There are however a small number of banks which are still too dependent on the ECB. To solve this problem gradually, it is important that they are not encouraged to resort to the central bank rather than to the markets, and that's why the Governing Council is insisting that they increase their capital and use all the facilities offered to them by the Member States.

Is your policy of buying the bonds of "peripheral" states on the markets efficient?

It's one of the non-standard measures that we have taken to restore the transmission of monetary policy. We make public every week the scale of our interventions, but not the specific market we are intervening in. In any case, we absorb each week the liquidity that was injected as a result of this programme. We do not carry out quantitative easing. But don't forget: our primary mandate is price stability in the euro area as a whole. Interest rates are set according to this medium-term objective. And the intervention programme is such as to allow the best possible transmission of our policy in the euro area as a whole.

Why did you say that you would prefer the European Financial Stability Facility (EFSF) to buy government bonds rather than the ECB, if what is at stake is restoring monetary policy transmission ?

It is because certain governments, individually, have behaved in an abnormal manner, and because all governments have fallen short in their collective supervisory duties that we are seeing anomalies in the behaviour of certain markets. The governments have to meet their responsibilities. It is for this reason, in particular, that I have asked for the EFSF to be enhanced, in quality and quantity. The possibility for the EFSF to purchase government bonds is part of this thinking.

The euro area has gone through a rocky period because of the sovereign debt crisis in certain countries, to the point of doubt being cast on the sustainability of the single currency. Do you believe the measures being taken concerning the EFSF are appropriate to avoid a similar situation arising again in the future?

The euro is a currency which inspires confidence. It is credible for the next ten years, and beyond. Moreover, the situation in the euro area as a whole is in many respects better than that in comparable economies. Our current account is in balance, which is far from being the case in all major industrial countries, and our consolidated annual government deficit for 2011, as a proportion of GDP, should be half those of the United States and Japan. The monetary union part of Economic and Monetary Union (EMU) is working well, thanks to the fact that we are constantly on our guard. On the other hand, there is still much to be done as regards economic union. This is because some countries have not had satisfactory budgetary policies, and because the supervisory system in place since the creation of the euro has not functioned correctly. Our message has always been that, in the context of a single currency without political federation, there has to be an extremely strong framework of budgetary stability. We signalled this again most forcefully when in 2005 a number of major member countries, including France, Germany and Italy, tried to weaken considerably the Stability and Growth Pact by denouncing what they said to be its excessive orthodoxy. Having lived through the recent challenges, both individual and collective, nobody is any longer suggesting that we should weaken the governance of Europe. The Governing Council for its part is in favour of a very considerable strengthening of economic governance in the euro area, as indeed it always has been.

How can we resolve the growing gap within the euro area between those industrial countries which have been able to keep their finances on an even keel and those which are not very competitive and are sinking into debt?

I am not sure that the euro area really can be split in two like that. To be sure, when you have a vast single market to manage, there are bound to be significant differences from state to state or from country to country. But you have to remember that the differences you see today are the opposite of those that existed five years ago. When the euro was introduced Germany was described as the "sick man' of Europe. It has made a remarkable effort, by itself, and has since become competitive again. Germany's return to growth benefits the whole of the euro area. Other countries have in the past experienced excessive nominal growth and now have to adjust. The important thing is that the countries of the euro area, taken as a whole, should remain around the average in the long term. The same phenomenon of disparity can also be seen in the United States, where the differences between states in terms of growth or indeed unemployment levels are comparable to those we see in the euro area. It is a feature of major continental economies of this size.

If we look at a specific case, do you think that the issue of Greek solvency has been resolved or do new ways need to be found for Greece to reduce its debt?

A plan has been put in place by the Greek government. This plan was approved by the international community and by Europe. It is currently being implemented and it is this that is very important. It is rigorous implementation of the plan which will allow Greece to regain a credible level of creditworthiness.

What do you think of the competitiveness pact proposed by Germany and France to avoid further crises of this kind?

We are in the middle of a process, led by Herman Van Rompuy, President of the European Council, and are waiting to see what will come of it. As far as the ECB is concerned, anything which serves to strengthen economic governance is not only good but also absolutely essential. I would add the hope that the European governments will be minded to strengthen the proposals which are currently being scrutinised by the European Parliament because in our view they are very insufficient.

In wanting to strengthen competitiveness and budgetary orthodoxy, are we not condemning Europe to sluggish growth for some time to come?

Competitiveness is at the root of everything. The euro area is more open to the rest of the world than Japan or the United States. We accept global competition. When one member of EMU achieves a good level of competitiveness, as Germany currently has, this benefits the euro area as a whole. If we wish to improve standards of living and create employment in the EMU the only way is through competitiveness.

A new round of "stress tests" is going to be launched in order to assess banks' risk. What can we expect from this new exercise, the credibility of which has been diminished by what happened in Ireland? Should a State's risk of default be taken into account, something which wasn't done in the last round of tests?

These stress tests are currently being very carefully prepared by the relevant institutions. I have every faith that they will be rigorous in their preparation. As you know, a State's risk of default as measured by the market is taken into account in the "trading book". In the "banking book", where instruments are held until maturity, default is not an envisaged possibility.

Is the ECB better equipped to prevent/anticipate a country's risk of default now that it is at the helm of the new European Systemic Risk Board (ESRB)?

The ESRB's objective is certainly not to be a giant rating agency for European countries. Our working hypothesis is of course that no default of any country of the euro area should be envisaged.

The French presidency of the G20 is pursuing two very ambitious objectives: international monetary system reform and the development of measures to curb the volatility of the prices of raw materials. Do you think that it will be possible to achieve tangible results in these two areas?

These are areas of great importance, which merit a substantial degree of attention on the part of the G20 countries. On the subject of exchange rates, the major emerging market economies that are growing very rapidly and exhibiting considerable current account surpluses should gradually introduce more flexibility into the management of their exchange rates. This has already been made public by previous G20 statements. In due course, there is the question of these major new currencies becoming fully convertible and freely floating, which would lead to a very significant structural change.

As for raw materials, the issue of the optimal management of rare natural resources has long been ongoing. Some of them are not renewable, and we must therefore ensure the long-term preservation of our common heritage, in the best possible conditions. The demand for agricultural products will increase, owing to the rising standards of living in the major emerging market countries. It is important that we do everything we can to ensure the supply of these products increases substantially, both in the medium and long term.

How much importance should be attached to speculation causing the prices of basic foodstuffs to rise?

We mustn't confuse very short-term speculation, which probably doesn't have a significant and lasting impact on the medium-term price level, with the phenomenon of change in the portfolio allocations of global fund managers who for a long time didn't invest in raw materials at all. Now that raw materials are gradually playing a more important role in asset allocation, this could generate a lasting upward pressure on prices. It is a phenomenon that we must watch very closely.

A potential favourite for your successor, the President of the Bundesbank Axel Weber, has taken himself out of the running, citing a lack political support from certain governments. Does this mean that the European debate on the subject is still far from being settled?

This is a decision that Axel Weber has taken for personal reasons. I respect that decision. The appointment of the President of the ECB is a very important decision, which is in the hands of the heads of state and government.

Would you be prepared to stay on if necessary?

The question does not arise! I have a clear mandate, with a time limit.

Interview with Weser-Kurier

Interview by Jean-Claude Trichet, President of the ECB, conducted by Annemarie Struß-von Poellnitz on 11 February 2011

Weser-Kurier: Is this your first time in Bremen?

Trichet: Yes, indeed. I've been to Lübeck and Hamburg, but I'm really eager to get to know Bremen.

Weser-Kurier: In 1978 Bremen was the setting for the launch of the virtual single currency, the ECU. We've now had the euro for 12 years. Although most Germans accept the euro, they don't love it. Can you understand that?

Trichet: It is important to look at facts and figures. The euro is a stable and credible currency, and the European Central Bank is here to ensure that our currency serves its purpose well – namely ensuring price stability – for the German people and the 331 million citizens of the euro area as a whole. The euro has held its value remarkably well in the 12 years since it was launched, with an average annual inflation rate of below 2% (1.97% to be precise). That's better than anything achieved by the national central banks before the introduction of the euro. Our primary mandate is to maintain price stability, which we have done.

Weser-Kurier: But fears of inflation are currently increasing. According to the German figures for January, which have just been announced by the Federal Statistical Office, the inflation rate rose to 2%, compared with 1.7% in December. This worries people.

Trichet: The average annual inflation rate in Germany in the last 12 years has been 1.5%, which is even lower than the euro area average. I'll say it again: that's better than in the 50 years before the introduction of the euro. Of course, we're not the masters of the price of oil or other commodities. We've also witnessed large swings in the price of oil and other commodities in the past, mainly driven by strong demand from emerging economies. But people can rest assured that we'll continue to do everything in our power to avoid the second-round effects of external shocks, thereby ensuring price stability in the medium term.

Weser-Kurier: It's not just commodity prices, but also high debt levels in some euro area countries that are stoking fears of rising inflation.

Trichet: The ECB's job is always to guarantee price stability, however complex the circumstances are, even if some governments don't behave according to the agreed framework. That being said, if governments behave improperly, they put their own economies in danger, which could threaten financial stability. All governments must take their responsibilities within economic and monetary union seriously, in accordance with the Maastricht criteria and the Stability

and Growth Pact. Some countries had probably forgotten this before the global crisis. In 2004 and 2005 Germany, as well as France and Italy, decided to weaken the rules. The Governing Council of the ECB fought against this weakening of the Pact. In the interest of the single currency, we need to insist on clear rules for the economic and fiscal policies of the individual countries in order to ensure the financial stability of the euro area as a whole. The bad experiences of the past demonstrate that we also need strict enforcement of the agreed rules.

Weser-Kurier: You point out that governments have committed to limiting public debt to a maximum of 60% of GDP. Germany has come through the crisis relatively well. Nevertheless, the national debt was over 75% in 2010. I won't even talk about Greece. Is 60% a realistic target?

Trichet: This requirement is not only in the Stability and Growth Pact, but also in the Treaty of Maastricht itself. We have to comply with the Treaty. Experience has shown how important it is that all euro area countries are creditworthy. This is why compliance with these criteria is essential in order to ensure sustainable growth and job creation. I'm not saying that's easy, but it's necessary in the long term.

Weser-Kurier: Do we need to improve the existing conditions?

Trichet: We need what we call a "quantum leap", a decisive step forward. We called for this even before the current crisis. The experiences of the crisis make it even more imperative for us to monitor countries' competitiveness and the correction of imbalances in the individual national economies.

Weser-Kurier: You call for a higher authority, a new system of mutual checks. Are Angela Merkel and Nicolas Sarkozy on the right track with their call for an "economic government"?

Trichet: If this proposal does mean that there is a strong political will to coordinate and monitor economic policies in the euro area, I'll firmly support it, because it's in line with what the ECB's Governing Council has consistently said. We'll see the results of the consultations undertaken by EU Council President Herman van Rompuy. But I expect this new initiative to lead to a strengthening of the legislation on economic governance which is now being examined by the European Parliament: we're calling for a major improvement compared with the governments' previous position, which the Governing Council of the ECB regarded as unsatisfactory.

Weser-Kurier: Will there be a majority in favour of it?

Trichet: Our message is crystal clear: we call on all those concerned to exercise their responsibility. And it's not just about words, but also deeds. Therefore, our strong message to the European Union is that monetary union, based on the euro, is working. The currency is credible and has been proven to maintain price stability. It's now time for economic union to work just as well. This wasn't the case in the past. This is why we need to strengthen the surveillance of economic policies.

Weser-Kurier: You recently said in a keynote speech in Tutzing: "Our judgement was sharpest at the height of the crisis." Are we already on the way back to business as usual?

Trichet: This is no time for complacency. The dangers and risks are permanent. Central banks have avoided a depression by acting quickly to make difficult decisions. Governments in industrialised countries have also taken very difficult decisions. This prevented a disaster that would have been worse than the Great Depression in the 1930s. To continue as before would be a great folly. I don't accept for one second the argument that we're back to business as usual. We now know how vulnerable the financial system was, and we must do everything possible to strengthen this fragile system in such a way as to prevent such events from happening in the future.

Weser-Kurier: You were awarded this year's Charlemagne Prize of Aachen for outstanding service to European monetary union. What does Europe mean to you?

Trichet: I've devoted a large part of my life to strengthening European unity, not least by promoting a single currency. In 1978 I was an adviser to President Valéry Giscard d'Estaing, who, together with the then German Chancellor Helmut Schmidt, made the decision to launch the European Monetary System. Since then I've worked in different ways and in different functions to realise the single currency, which is a milestone in the deepening of the European Union. As a result of these functions, I had the great privilege to contribute at critical junctions. These historic, major efforts, which began shortly after the Second World War, are of fundamental significance for European peace, stability and prosperity. I was extremely touched to be told that I would be receiving this year's Charlemagne Prize.

Weser-Kurier: Is there a special relationship between Germany and France?

Trichet: The friendship between Germany and France has played a historic role in creating a united Europe. This friendship needs to be put to the service of overall European unity, for all European nations. There are 27 countries in the European Union and now 17 in the euro area.

Weser-Kurier: You are about to enjoy cod and green cabbage at the Schaffermahl. Today is also the 85th birthday of Paul Bocuse, the inventor of "nouvelle cuisine". What does good food mean to you?

Trichet: I love good food and "nouvelle cuisine". I always like to discover something new. I'm sure I'll do just that at the Schaffermahl.

The essence of Economic and Monetary Union

Jean-Claude Trichet, President of the ECB, Speech as the Guest of Honour at the Schaffermahlzeit, Bremen, 11 February 2011

Gentlemen,

I have given speeches in many different places over the years, but today's setting here in Bremen is a very special one.

Speaking at an event that has taken place every year since 1545 is a very great honour. We central bankers pride ourselves on thinking about the long term, but even for us, 466 years is a deeply humbling period of time.

I would like to thank you very, very warmly for inviting me to become part of this longstanding tradition in the nautical, commercial and political life of your city.

This dinner is unique, not just in Germany but across Europe. And as guests can be invited only once in a lifetime, we cherish every minute of this fortune. Let me therefore thank you on behalf of all of the guests here today.

* * *

The name 'Freie Hansestadt Bremen' speaks volumes of this city's long history of proud independence. Yet the historic independence of Bremen has never meant isolation.

On the contrary, the greatness of this city lies in the Hanseatic League, an early example of the principles on which the European Union is founded – that commercial and cultural interchange builds common interests between peoples – and that such interchange raises the costs of conflict, facilitates compromise and fosters cooperation.

The Hanseatic cities symbolised the principle of ' *doux commerce*' about which Montesquieu would later write: *'nations that traffic with each other become reciprocally dependent; and their union is founded on mutual necessities.'*

Monetary matters were part of a thriving environment for commerce for centuries, and at times single currencies were established. For a long period in the 14th to 16th centuries, in the Wendischer Münzverein, the core cities of the Hanseatic League – Lübeck, Hamburg, Lüneburg, Wismar, Rostock, Stralsund – shared a common currency, the 'Lübische Mark'.

Today, a far wider group of great port cities shares a common currency. The ports of the old Hanse-cities Bremen, Hamburg, Lübeck, Rostock, Wismar and Tallinn all lie within the euro area – but so too do Helsinki, Rotterdam, Antwerp, Bordeaux, Cadiz, Porto, Marseilles, Genoa and Venice – to name but a few.

The European single market is a vast economy. The euro area itself is a truly continental economy. The population of 331 million exceeds slightly that of the United States, and in geographical terms Lisbon and Helsinki are almost as distant as Los Angeles and New York.

Interestingly, the European Union as a whole and, in particular, the euro area are significantly more open in terms of trade and finance.

In the year prior to the crisis, 34% of GDP of the euro area was imported or exported. In the United States, the ratio was 24% of GDP. The euro area is the world's largest exporter, accounting for 15% of world trade – 50% higher than the shares of each the United States and China.

Europe's openness is also remarkable in international finance. Last year, international financial assets and liabilities reached almost 170% of GDP, compared with 140% for the United States and 80% for Japan. Inward and outward direct investment, at 47% and 39% of GDP, are larger than for the United States, where both are less than 30%. The euro area is indeed a remarkably open economy.

Speaking in Bremen, I would say that the euro area of today is a continuation of the best tradition of the Hanse: open to the world.

* * *

The maritime traditions of Bremen resonate deeply with me. Having family roots in Saint-Malo in my beloved region of Bretagne, I share your passion for sailing and the sea.

Indeed, I have often used a seafaring metaphor for Europe's monetary union, arguing that it is better to be on a large and steady ship rather than on a small vessel, particularly in the turbulent waters we have experienced in recent years.

As guardians of the single currency, we at the European Central Bank know that we have to stay on course. We have only one needle in our compass, which is price stability. We are presently observing an increase of prices largely reflecting higher energy prices. As I said on behalf of the Governing Council both in January and in early February, risks from the medium-term outlook for price developments are still broadly balanced but could move to the upside. This is the reason why we must remain permanently alert.

* * *

This evening I would like to speak to you about the achievements of our monetary union and about the challenges for the broader construction of EMU – Europe's economic and monetary union.

Having had the privilege of serving as ECB President for the past seven years, I can report that we have achieved a great deal, and all Europeans should take pride in these achievements. Yet several improvements need to be made to our economic union.

We need to ensure that monetary union is complemented by fiscal and macroeconomic policies that are focused on sound and stable principles and, therefore, foster sustainable growth.

We need to ensure that all governments have sound public finances.

And we need to ensure that the rules that govern EMU are sufficiently strong to ensure that all parties act in a way that serves our common interest.

All of this to achieve our common goal: a union of individual freedom and collective respect; a union of responsibility and cooperation; and a union of stability and prosperity.

1. Achievements of the euro

Let me begin with what we have achieved. The euro was introduced to manage economic and monetary interdependence between European countries; to reap the full benefits of their economic and political cooperation for the individual and collective good; and thereby to contribute to lasting peace and friendship among peoples. All of this, while preserving the diversity that makes Europe unique.

The specific construction of our modern economic and monetary union rests on two separate economic and monetary pillars. Under the monetary pillar, there is only Europe: the single currency, the single monetary policy, and the single central banking system – the Eurosystem, which consists of the ECB and the national central banks of the 17 members of the euro area.

The economic pillar is more decentralised, with responsibility for fiscal and economic policies in the hands of individual countries. These policies should be steered by overall rules and coordinated to ensure that national economic policies are fully compatible with the fact that we have a single currency without being part of a political federation.

When it is working properly, this structure balances the independence of nations and their economic interdependence that is at the heart of EMU. It should represent an approach where sovereignty is shared, meaning that it is neither exclusively national nor exclusively European.

When EMU was first established, many people asked how monetary union could function effectively in a Europe of sovereign states. The answer is that it can function effectively with an appropriate economic union.

Not necessarily an economic union with a single fiscal authority. Not necessarily an economic union that presupposes an achieved political federation. But an economic union in which national policies are set within agreed limits and are subject to rigorous and effective mutual surveillance.

If the question is asked how to improve the economic pillar, the answer is to have more stringent rules and stronger mechanisms to ensure compliance.

2. The 'M' in EMU

Let me discuss the two pillars in a little more detail, first the M in EMU. In monetary policy terms, the ECB has a clear assignment: to deliver price stability.

According to our primary mandate, our definition of price stability means an inflation rate below but close to 2% over the medium term. This is the needle in our compass. Our medium-term orientation means, figuratively speaking, that we provide the steady hand on the tiller.

How can the citizens of the euro area have confidence in the steady course of monetary policy? They need only look at some facts.

Over the 12 years since the launch of EMU, the average annual inflation rate in the euro area has been 1.97%. This is the best result of a major central bank in the euro area over the last 50 years.

For Germany, the inflation rate has been even lower than the average since the euro was launched. From 1999 to 2010, inflation averaged 1.5% per year. By comparison, the average inflation rate in Germany in the 1990s, prior to the introduction of the euro, was 2.2% per year. In the 1980s, it was 2.8%. In the 1970s, it was 4.9%.

The ECB has sailed this steady course in what has often been stormy weather. We are currently focused on the crisis, but even before 2008 we did not always experience calm waters.

In 1999, we began with a completely new institution – the ECB – and a cooperation among central banks as one unified system. Over the years, we have had to cope with the bursting of the internet bubble, the aftermath of the events of 11 September 2001, the jump in oil prices to $145 per barrel, rising prices of food and commodities, and then of course the worst financial crisis since the Great Depression.

Yet throughout these very different economic shocks – which could have been either inflationary or deflationary – citizens in the euro area have remained confident in our steering. Proof of this is that medium- to long-term inflation expectations have been firmly anchored in line with the ECB's definition of price stability.

Observers and financial markets are also expecting in the years to come that price stability will be maintained, and inflation will remain low. For this year and next, inflation rates are expected to be just below 2%, and for the next five years, professional forecasters currently foresee inflation of precisely 2%.

As you can see from these figures, it is clear that monetary policy in EMU has fulfilled its role of delivering price stability and will continue to do so.

3. The 'E' in EMU

Let me turn to the economic pillar, the E of EMU.

Here, we need fundamental reforms.

Economic union is a fundamental counterpart to monetary union.

A single market with a single currency calls for a very solid framework for handling the collegial governance of national fiscal policies and macroeconomic policies.

This is something recognised by the citizens of Europe, particularly those in the euro area. Surveys indicate that, on average in euro area countries, more than four out of five euro area citizens are in favour of greater policy coordination between countries to overcome the crisis. This is something very important: Citizens want a stronger coordination of economic and financial policies among the countries of the euro area. [1]

European integration has led the people of Europe to reappraise the value of cooperation in difficult times. The euro area countries are in the *avant garde* of this process. Being together in a single ship – in an ever closer union – is what holds Europe together through stormy weather.

Already Jean Monnet recognised, back in 1950, that it is the necessities of interdependence, which become more evident in times of crisis: "L'Europe ne se fera pas d'un coup, ni dans une construction d'ensemble: elle se fera par des réalisations concrètes, créant d'abord une solidarité de fait."

What does more coordination require? It means making two vital sets of changes – strengthening economic governance and enhancing the opportunities for sustainable growth. Let me address these changes in turn.

a. Need to strengthen economic governance

The first change that is required is what I have called a true 'quantum leap' in the rules that regulate how countries make their national economic policies. Countries need clear rules and procedures to guide policy-making and sanctions if they stray from a sustainable path.

This means strengthening the Stability and Growth Pact, the framework first negotiated by the German finance minister Theo Waigel to prevent countries accumulating excessive public debts and deficits.

Equally importantly, it means putting in place a new framework for overseeing economic policies more broadly – such as competitiveness, current account balances and levels of private borrowing – to prevent problems emerging in the private sector.

Let me lay out for you why strengthening the Pact is so important.

The period between 1999 and 2008 was generally acknowledged as a period of economic fair weather. Yet in this period, hardly any euro area country put their fiscal house in order, attaining what might be called a safe budgetary position.

What is more, governments decided to *weaken* the Pact in 2004 and 2005. This initiative was led by the euro area's largest economies. The ECB voiced its 'grave concerns' at the time. I now see that many acknowledge that the weakening of the Pact was a serious misjudgement.

But the crisis has given us an opportunity. It has made plain the flaws in the Pact that allowed countries' fiscal policies to become a problem, not just for themselves, but for everyone else within the monetary union. We now have an obligation to fix the flaws.

First and foremost, this means creating stronger and more binding rules for fiscal policy, backed up by reinforced sanctions or mechanisms to ensure compliance with the rules.

Second, a new framework is needed to monitor competitiveness and to ensure that measures are taken to control them. We need to put in place binding rules that guide policies towards sustainable and balanced growth.

Such a reform package is currently before the European Parliament. The ECB very much counts on the Parliament to call for very clear and strong governance rules, including automaticity in triggering procedures and sanctions, which will be to the long-term benefit of Europe's citizens.

In a union with a single monetary policy and 17 different fiscal and economic policies, a 'quantum leap' in economic governance is necessary to ensure that the degree of economic union is fully commensurate to the already achieved monetary union.

b. Need to enhance growth potential

The second change that is required to the economic pillar of EMU relates to Europe's potential for growth.

Europe has fared reasonably well in the past decade. Adjusted for differences in population growth, per capita GDP growth in the euro area has been almost the same as in the United States, at about 1% per year. The euro area has also

made significant progress on employment, which has grown by over 14 million, compared with a rise of 7.8 million in the United States.

This is encouraging, but it remains insufficient. We cannot be complacent in any respect. Europe must develop its growth potential continuously. All countries must pursue resolutely their structural reforms, in pension systems, product market and labour markets. Jointly, they have devised the Europe 2020 strategy. Education, research and innovation is one key area; resource efficiency a second; and high employment and social cohesion the third main area.

The European Central Bank fully supports all efforts along this Europe 2020 strategy. A specific example is the completion of the Single Market in services. It makes full economic sense that the internal market in services, which is the sector in which the majority of people work, is fully completed. New areas of growth, like the digital sector, energy and the environment will clearly benefit from more competition and create new jobs.

4. Conclusion

Let me draw to a conclusion. We are today 12 years into economic and monetary union. I have emphasised our achievements and I have emphasised where we need to strengthen the framework.

Monetary union can function effectively in a Europe of sovereign states with an appropriate economic union. And creating an appropriate economic union is where the reform efforts need to be directed.

For that, we have to do in Europe what Alexis de Tocqueville so admired in 19th century America, whose greatness did not lie ‘in being more enlightened than any other nation, but rather in the ability to repair her faults.’

When repairing the faults in our governance framework, we must not let the indications of economic recovery distract ourselves from the urgency for action. Policy-makers must keep in mind that the governance failures of the past are still to be fixed and the growth challenges of the future still to be solved.

While I have stressed the challenges we face, we must also recognise our achievements.

Europe is in the vanguard of nations working together peacefully.

We have replaced confrontation and conflict with cooperation and consensus.

We have combined political freedom with economic freedom and social peace. These are remarkable achievements – and they are quite clearly achievements to which many people elsewhere in the world are aspiring.

It is for this reason that I have dedicated all my working life to put the French-German friendship to the service of Europe as a whole, with all nations united. And it is for this reason that I believe deeply in our economic and monetary union.

The Europe to which I have dedicated my career is one where different countries, different regions and different cities retain what Victor Hugo called their ‘distinct qualities or glorious individualities’.

It is also a Europe whose cities, regions and countries realise that, through working together, they can be greater still.

Thank you for your attention.

Interview with L’Espresso

Interview with Jean-Claude Trichet, President of the ECB, conducted by Claudio Lindner, 10 February 2011

L’Espresso: President Trichet, conflicting information is coming from the euro area regarding the state of the economy. What’s the view from the Eurotower?

Trichet: Since the start of the recovery, namely from the third quarter of 2009, each quarter has seen slightly better than expected growth in the euro area. We have had positive surprises over the last year and a half. But we must remain

prudent. We are not claiming victory; there is still much to be done by all to consolidate confidence and, therefore, the recovery.

L'Espresso: Because the situation varies across the euro area?

Trichet: The euro area as a whole has relatively solid fundamentals, an external current account that is balanced and a yearly public finance deficit which, this year, will be half the respective deficits of both the United States and Japan. But of course, internal differences exist. Those countries that have worked hard to strengthen their competitiveness and, in particular, those that have managed to reduce their unit labour costs are the ones that are growing more rapidly, as well as those that have increased the flexibility of their labour market.

L'Espresso: The main problem being unemployment?

Trichet: Yes, creating new net sustainable jobs is a necessity to combat unemployment. Many European countries will need to implement the necessary structural reforms with great determination in order to increase their growth potential. That being said, since the inception of the euro, the euro area as a whole has seen a greater increase in employment than the United States (around 14 million compared with around 7.8 million). But this is no time for complacency. A lot of hard work remains to be done.

L'Espresso: Italy included?

Italy, in particular, must make very significant progress in the areas of labour productivity and "total factor productivity", in order to significantly improve its competitiveness.

L'Espresso: How do you assess Mr Marchionne's initiative at Fiat? Is it an example that other companies should follow?

Trichet: I do not wish to go into the merits of the behaviour of individual companies, but I will say that every attempt to increase productivity is certainly important for improving the Italian economy as a whole.

L'Espresso: You have sounded the alarm many times on the rise in inflation in Europe. Should this materialise, interest rates would be raised. But how high do you consider this risk to be?

Trichet: Before talking about the current situation, I would like to highlight the very important results achieved by the ECB over the long term. Consider the following figure by way of just one example: over the last 12 years, the average European rate of inflation has been less than 2%, and close to 2%, (1.97% to be precise), fully in line with our definition of price stability and the best result of the last 50 years in the countries that share the euro. Bearing in mind that our primary mandate is price stability and taking into account the clear message of our fellow citizens, we can be extremely proud of this result.

L'Espresso: Currently, though, some countries have exceeded 2%. Germany itself has reached 1.9% ...

Trichet: What counts is, of course, the euro area as a whole. At this level, taking into account all information and analysis, we continue to see evidence of short-term upward pressure on overall inflation. The Governing Council of the ECB considers, as I said in the press conference of 3 February, that the risks to medium-term price developments are still broadly balanced, but could move to the upside. We said that also in January.

L'Espresso: Some analysts are already anticipating a slight rise in interest rates by the end of the year.

Trichet: As you know, we always take interest rate decisions which will permit us to deliver price stability in the medium term, in line with our definition: less than 2%, close to 2%. It is not by chance that we have delivered price stability over the last 12 years. Observers know that.

L'Espresso: For several months, starting with the Greek crisis, the euro area has been experiencing one of its most dramatic periods. Some are even speaking of risks to the single currency. Are you also concerned?

Trichet: The euro as a currency is not in crisis. The single currency is sound and credible. It has kept its purchasing power remarkably well over the last 12 years and is credible to keep price stability for the next 10 years.

L'Espresso: Very optimistic. Some are suggesting that some of the weaker countries may leave the euro, while others are mentioning that Germany may leave. Is this likely?

Trichet: Again, the currency is not in crisis. A number of fiscal policies have to be improved very significantly because they are contributing to the creation of financial instability. We are experiencing a crisis of some sovereign signatures in the euro area, namely in Greece and Ireland. On the question of leaving the euro, I do not comment on absurd speculation.

L'Espresso: Actually, public debt is becoming a huge problem for many countries. How can this be resolved?

Trichet: In all of the advanced economies, there is a problem with national debt. However, let us not forget that, as I have already said, in terms of the annual deficit to gross national product ratio, the euro area is in a better position in 2011 than the United States and Japan: we average 4.6% compared with 8.5–9%. There is a widespread problem relating to fiscal policy. This, of course, does not negate the fact that some European countries need to do everything necessary to regain control of their public finances and, in parallel, continue to implement the much needed structural reforms.

L'Espresso: Which are?

Trichet: To reduce public spending, especially unproductive spending, and to improve the functioning of the economy.

L'Espresso: For example?

Improve the management of public services (the quality of which is sometimes insufficient) at national and regional level as regards the fiscal policy. Increase competition and enhance the flexibility of all markets of goods and services. Improve the flexibility of the labour market, in order to raise participation, address the duality of the labour market and further strengthen the link between wages and productivity. All these actions would raise the growth potential of the economy.

L'Espresso: And Italy, in particular, where the debt ratio is close to 120%?

Trichet: It is vital to continue to pursue a very prudent fiscal policy. Major efforts should be made to fully achieve public sector spending cuts and to increase efficiency in tax collection in order to implement a credible and ambitious consolidation strategy. The multi-annual package approved in 2010 and the recently approved 2011 budget go in the right direction, and Italy should seize any opportunity presented by better budgetary and economic conditions to accelerate deficit and debt reduction.

L'Espresso: What causes more concern: Italy's debt, its low productivity or its political instability?

Trichet: To all countries our message is the same: sound fiscal policies and structural reforms are of the essence. Particularly important, for all, is continuity in the adjustment policies so that the credibility of the economy is progressively reinforced. I will add that, in a country like Italy, which possesses remarkable human resources and an equally exceptional entrepreneurial spirit, the very low level of productivity growth is to be corrected without delay. Improving flexibility in markets, improving education and training, fostering universities of excellence and enhancing research and development are among the necessary measures.

L'Espresso: Merkel has suggested raising the retirement age to 67 across the whole of Europe. Is this a useful suggestion?

Trichet: Taking into account the progress of medicine and the permanent lengthening of life expectancy in all advanced economies, there is a need to extend the retirement age itself, as is being done in practically all countries. A coordination of such decisions within the framework of the enhanced Economic Union would be a good thing in my view.

L'Espresso: An important European summit will take place on 25 March to update the Stability and Growth Pact. There is also a proposal to impose sanctions on those that do not respect the regulations. Do you think this is the correct approach?

Trichet: The Governing Council of the ECB calls for a very significant improvement of economic governance at the level of the 27 and, particularly at the level of the 17 members of the euro area. We are recommending the Commission, the Council and the Parliament to go as far as possible: reinforcement of all procedures, quasi-automation of the start of procedures and sanctions, enlargement of sanctions, strong surveillance of macro policies, etc. Experience has demonstrated that this is absolutely necessary.

L'Espresso: The Germans would like all countries to write a balanced budgetary position into the Constitution (just as they have done), wouldn't they?

Trichet: It is not only the Germans, to my knowledge. And it is clear in the eyes of the ECB that sound and rigorous national legislation could very significantly facilitate the implementation of the reinforced Stability and Growth Pact. We are calling for a reinforcement of European legislation in this domain.

L'Espresso: Some, including the minister Tremonti, believe that, when calculating national accounts, private debt should also be taken into account. Do you agree with this proposal?

Trichet: The Governing Council of the ECB considers that overall public debt outstanding is a criterion of the Treaty which is very important for the improved Stability and Growth Pact and should be reinforced. For the surveillance of macro policies, all features of a particular economy have to be taken into account.

L'Espresso: Mr. President, your term of office expires on 31 October. Two of whom – Mario Draghi and Axel Weber – are contending to be your successor. Who is your money on?

Trichet: It is an important decision and the huge responsibility for making it lies with the European Heads of State and Government.

L'Espresso: Could an Italian aspire to this position?

Let me mention Article 283 of the Treaty that requires: "The President, the Vice-President and the other members of the Executive Board of the ECB shall be appointed by the European Council from among persons of recognised standing and professional experience in monetary or banking matters." I repeat: it is a very important decision to be taken by the Heads of State and Government.

I am still learning – The legacy of Tommaso Padoa-Schioppa

Speech by Jean-Claude Trichet, President of the ECB, colloquium in honour of Tommaso Padoa-Schioppa, Bocconi University, Milan, 1 February 2011

Mr President of the Republic,

Dear Members of the family of Tommaso,

Dear Mario Monti, Dear Carlo Ciampi, Cher Jacques Delors,

Dear Romano Prodi, Dear Paul Volcker, Dear Mario Draghi,

Dear Friends from all over Europe and the world,

Ladies and Gentlemen,

"Aún aprendo" – "I am still learning". This is the name of a painting by the late Spanish painter Francisco Goya.

A beautiful, colourful souvenir with this very motto – "I am still learning" – is what Tommaso gave to his colleagues when he completed his seven-year mandate as a member of the Executive Board of the European Central Bank, in 2005. It was well chosen. For it encapsulates his own tireless search for knowledge and new ideas and in particular how Tommaso saw, and shaped, the world around him: central banking, the single currency and European unification.

Tommaso once told to me what his high school teachers advised him in his early youth: that he needed to decide what interests him most: whether to understand or whether to change the world. The choice of Tommaso was economics. And, because the subject of economics is human action, he thought that the call for action would prevail, in his motivations, over the enquiring spirit. I remain profoundly impressed by the remarkable capacity of Tommaso to combine practical activity with deep reflection and accurate analysis, without which action would be ineffective.

This has been his way to be in the world and to search for truth.

In 1998, Tommaso joined the European Central Bank (ECB) to serve a currency and an institution that few had believed would be created in time according to the Treaty. A currency and an institution he had contributed to design when he was a rapporteur of the Delors Committee. The institution was assigned the extraordinary mission to deliver to 11 and, soon after, 12 nations and 300 million Europeans a currency which would have the highest level of confidence and credibility from the start.

Over the course of his central banking career, Tommaso gradually developed a general paradigm of what he believed central banking involves. This paradigm is drawn from the evolution of modern central banks over the last 200 years. As the role of money – as a means of payment, a unit of account and a store of value – evolved over time, also what he called the *triadic* function of central banking evolved. In his view, ensuring price stability refers to money as a unit of account and a store of value; operating and supervising the payment system refers to money as a means of payment; and pursuing the stability of banks refers to money as a means of payment and a store of value. I would add that price stability is the primary goal, the primary mandate and that ensuring price stability is also a precondition for the other functions to be correctly exerted.

Tommaso's paradigm still provides a single and consistent order, in which the responsibilities of a central bank have their place. To each of these activities – from monetary policy to banknote printing, to market operations, financial stability, payment systems, relations with other public institutions, dialogue with the financial community and international cooperation – Tommaso has been assigned at different stages of his professional life.

In all these activities the central bank pursues and represents the public interest of a sound and credible currency, one that preserves its value over time.

And it is with great pride that I say today, in particular thanks to Tommaso's contribution, together with all members of the Executive Board, of the Governing Council and the staff of the ECB, that our primary mandate has been fulfilled: with an average inflation rate in the euro area over the past 12 years of 1.97%, the ECB governing council has delivered what 330 million Europeans expect – " *la difesa del risparmio*", " *die Währung zu sichern*", " *assurer la stabilité des prix*".

This remarkable track record has been delivered by a team of, today, 18 central banks (the ECB, as captain of the team, and the national central banks of the 17 euro area countries), which we call the Eurosystem. From the very beginning, Tommaso saw the challenge of making the full body of the Eurosystem an effective, continent-wide central bank, to make all its components act together, as I call it, as a true team, with a strong and dedicated team spirit.

It has not always been easy to draw the appropriate line between preserving the diversity of national traditions, cultures and institutional arrangements, which illustrate the richness of Europe, and being *European* in the definition of the policy missions and pursuing the public interest.

Tommaso was a central banker by profession, but he was also an advocate of a united Europe by deep personal conviction. European unification as a project which is economic in content and historically strategic.

On the one hand, the creation of a single market was a process. A process that could ultimately lead to the contradiction which Tommaso referred to as the "inconsistent quartet" – that free trade, free mobility of capital, a system of fixed exchange rates and autonomous national monetary policies were incompatible. One of the four would come under pressure and would have be surrendered in order to avoid inconsistency.

The single currency was the way to square the circle in merging all the independent national monetary policies.

One single money for one single market.

Tommaso saw the creation of the single currency as an ultimate integrative step, in the clearly defined policy field of monetary policy and was very aware of the responsibility given to the ECB to make this a success and a stepping stone for completing and achieving economic integration. The euro contained a strong commitment to move towards more economic integration.

One of the lessons of the present crisis is precisely the necessity to not only very strictly apply the governance of the fiscal policy that was enshrined in the Maastricht treaty and in the Stability and Growth Pact, but to reinforce very significantly this governance and to enlarge it to the surveillance of competitive indicators and macropolicies.

This is why I called, on behalf of the governing council of the ECB, for a quantum leap towards strengthening the institutional foundations of EMU and deepening economic union. The framework for economic governance needs to take into account that the euro area must operate, *de facto*, as a quasi-fiscal federation, in which the college of participating governments has the responsibility of exerting a very strong surveillance on national economic and fiscal policies.

Tommaso has always been very profoundly convinced that it was necessary to reinforce considerably the E letter in EMU in order for Economic Union (EU) to be fully commensurate to Monetary Union (MU). And the time to move is now.

We need, in particular, a stronger role of EU institutions, quasi-automaticity of the surveillance process, quasi-automaticity of sanctions, a much more effective enforcement. We need sound economic and fiscal policies to be performed individually by each nation and to be effectively and rigorously controlled by the peers, in each member's very own interest and in the interest of all.

When the sad news of Tommaso's passing away reached us, we were preparing the inaugural meeting of the European Systemic Risk Board (ESRB), which I have the honour to chair. Poor Tommaso passed away before we had the ESRB inaugural meeting on 20 January 2011. In commemorating Tommaso and his legacy, the ESRB deserves a particular mention because the reform of Europe's supervisory architecture was, like the single currency, one of his more profoundly held professional concerns.

Indeed, Europe has been confronted with the problem of asymmetry between economic development and institutional response also in the area of financial markets. While financial integration in the Single Market was progressing, regulation and supervision remained fragmented. Tommaso devoted a large part of his professional life to overcoming this fragmentation and making regulatory and supervisory structures commensurate with the realities of integrated European financial markets. He argued tirelessly in favour of a single rule book for financial institutions and was among the first to call for the establishment of supervisory authorities at EU level.

With the setting up of the European System of Financial Supervision, and three European Supervisory Authorities and the European Systemic Risk Board, we are a step closer to overcoming this asymmetry.

Our dear dear Tommaso, the militant of the European Union, the president of "Notre Europe", founded by Jacques Delors, used to quote Jean Monnet frequently. One of the quotations he loved - and that I love - is the following:

"Quand on est determiné sur l'objectif que l'on veut atteindre, il faut agir sans faire d'hypothèses sur les risques de ne pas aboutir. Aussi longtemps que vous ne l'avez pas essayé, vous ne pouvez pas dire qu'une chose est impossible".

Which I would translate – firstly, in Italian and then in English:

"Quando si è decisi sull'obiettivo che si vuole raggiungere, bisogna agire senza fare ipotesi sui rischi di insuccesso. Finché non avete tentato, non potete dire che qualcosa sia impossibile."

"When one is determined as regards the desired goal, one must act without making multiple hypotheses on the risks of failure. As long as you did not try it, you cannot state that the endeavour is impossible".

It is that very spirit of the founding fathers that Tommaso was always referring to. That very spirit of the founding fathers that is inspiring us today when we are drawing the lessons from the crisis.

Tommaso was not only a man of culture, a brilliant economist, a remarkable central banker, an important member of the Italian government, a true and visionary European. He was also an extraordinary and exemplary friend. The depth of his culture and his personal qualities helped him to establish exceptional and friendly relationship with his colleagues.

Je peux le dire en français, admirablement, car il parlait français mieux que les français, comme Jacques Delors le sait mieux que personne.

Merci Tommaso, notre ami si cher, notre ami si regretté, pour cette amitié profonde et pout tout ce que tu as fait au service de notre Union Européenne.

I thank you for your attention.

Interview with The Wall Street Journal

Interview with Jean-Claude Trichet, President of the European Central Bank, conducted by Brian Blackstone and Marcus Walker on 19 January 2011

WSJ: If 2008 and 2009 were years of crisis, and 2010 was a year of stabilization and recovery. How do you see 2011? What should Davos participants be focused on this year?

TRICHET: Since the start of the recovery, in the third quarter of 2009, the real economy has surprised up on the upside. This is encouraging. I see 2011 as a year of continuous hard work, to make the financial sector more resilient and to improve the soundness of fiscal policies. The crisis, which started in 2007 and intensified in September 2008 revealed the fragility of the financial sector first and then the relative vulnerability of public finances in the advanced economies.

WSJ: What worries you most?

Trichet: To consider that because we managed to avoid a depression and are now experiencing the recovery, we could lose momentum in the reforms that are still urgently needed. That is the main danger.

WSJ: This year austerity becomes pan-European. But a recent United Nations report said austerity risks a renewed economic downturn. Do you agree?

TRICHET: No, we do not. I do not buy the very simple reasoning that would suggest that pursuing sounder fiscal policy would hamper growth. On the contrary, I think that appropriate fiscal retrenchment in countries that need it is part of growth enhancement, because sustainable public finances makes a difference in terms of improving confidence of households, enterprises, investors and savers, which is decisive to foster growth and job creation.

WSJ: Does the U.S. have it wrong? It is engaging in even more fiscal stimulus.

TRICHET: It's not for me to give a lecture to other advanced economies. We have our own responsibilities. In our own case we strongly believe that fiscal soundness is confidence-enhancing and therefore part of a growth-enhancing strategy.

WSJ: In your recent ECB press conference you made repeated references to the July 2008 rate hike and said the ECB is never pre-committed not to move interest rates. Were your remarks over-interpreted as hawkish?

TRICHET: I have nothing to add to what I have said last Thursday (ECB press conference on 13 January). You have to place my remarks in the context of the first 12 years of the euro, during which we delivered price stability in line with our definition: less than 2%, close to 2%. When you look at the yearly average since the setting up of the euro it is 1.97%, better than had been done in any such period of time in the previous 50 years. You don't get this result by chance. We are profoundly attached to our mandate. And that explains the solid the anchoring of our inflation expectations, which we see as one of our major assets because it helps avoiding second round effects when we have oil price increases in particular. Clearly, in particular on the side of energy and commodity prices we have a number of developments that we will continue to monitor closely.

WSJ: Tighter monetary policy would have the biggest impact on countries like Spain, Greece and Ireland where private debt is linked to Euribor. Can you understand why those peripheral countries are concerned about this hawkish shift?

TRICHET: I also said in my last press conference that the present interest rates were appropriate. In any case all countries in the euro area have an immense stake in the solid anchoring of inflation expectations because medium and long-term interest rates incorporate future inflation expectations.

WSJ: Inflation is being driven by energy and commodity prices and higher value-added taxes in some countries. Is the ECB's focus on headline inflation misplaced? Does the Fed have it right by focusing more on core inflation?

TRICHET: In the U.S. the Fed considers that core inflation is a good predictor for future headline inflation. In our case we consider that core inflation is not necessarily a good predictor for future headline inflation. That being said all central banks, in periods like this where you have inflationary threats that are coming from commodities, have to go through the hump and be very careful that there are no second-round effects. This is what we are doing.

WSJ: When you hiked rates in 2008 there were signs of those second-round effects. Do you see evidence they are starting to take hold in Germany or elsewhere?

TRICHET: At this stage, we do not see this. And everybody knows we would not let second-round effects materialize. We will continue to deliver price stability.

WSJ: Could the ECB raise interest rates while still maintaining nonstandard measures including unlimited loans to banks?

TRICHET: It is our doctrine since the beginning of the turbulence that interest rates on the one hand and non-standard measures on the other hand are decoupled. We design the monetary policy stance; we decide interest rates to deliver price stability in the medium term. Non-standard measures are there to help restoring a better functioning of monetary policy transmission. We are disconnecting both measures. We can move interest rates on the one hand, and we can move non-standard measures on the other hand independently.

WSJ: Euro member states are working on comprehensive measures to address the debt crisis. What elements should be in that package?

TRICHET: These decisions are the responsibility of governments. We have in particular a very strong message, which is that we need a “quantum leap” in the strengthening of governance of economic and fiscal policies.

WSJ: When you spoke of a quantum leap last year, you referred to quasi-automatic sanctions on excessive deficits. Governments so far haven’t come along. What makes you optimistic that you can still get your point of view adopted by governments?

TRICHET: There are a number of elements that are important: the reinforcement of sanctions; the reinforcement of the independent diagnosis that would be made by Commission. It's a set of quantum leaps, including the quasi-automaticity of the start of the corrective procedures and of the sanctions, which in our view is extremely important. Governance is now discussed by the European Council and the European Parliament. The Parliament has in the past always demonstrated a remarkable capacity to capture what is essential for Europe. So, the involvement of the Parliament is very important.

WSJ: Last year, governments made a watery compromise on sanctions, weaker than the European Commission's proposals. Should governments rethink that compromise?

TRICHET: Even the initial proposals from the Commission seemed to us too timid. Our position has not changed.

WSJ: You have called for maximum flexibility for the European Financial Stability Facility. There is discussion whether EFSF should take over all or part of the bond buying program from the ECB. If that were to happen, would you be relieved?

TRICHET: As I said, they have to improve the stabilization fund in both quality and quantity. By quality I mean having a tool that is as flexible as possible.

WSJ: You have said bond purchases are meant to ensure the transmission of monetary policy. If EFSF buys bonds, wouldn't that take a monetary function away from the ECB and give it to a fiscal authority?

TRICHET: As all our non-standard measures, the securities purchase is indeed meant to help restoring a better transmission mechanism of our monetary policy. It is clear that if markets are functioning better more generally then we have less problems in the transmission of monetary policy. In any case, the main tool to improve the situation is to restore the credibility of individual governments themselves.

WSJ: Should countries be able to borrow money from the EFSF for bank recapitalization without having to apply for a full bailout?

TRICHET: These are the responsibilities of the governments. We are asking to demonstrate full responsibility for economic and financial stability through a quantum leap as regards the economic governance in the euro area, a quantum leap in conditionality and greater flexibility in their utilization of the mechanism.

WSJ: You have said there is a sense of urgency to improve the EFSF. Governments appear to have put off any changes until March at the earliest. Do you think leaders are showing a sufficient sense of urgency?

TRICHET: Since the beginning of the turbulence, I have said we needed to demonstrate -all of us, all authorities - a solid sense of direction, a sense of responsibility and the awareness of the necessity to be ahead of the curve and not behind the curve. I maintain that.

WSJ: What do you think the risk is that this wrenching process will cause the breakup of the euro or its membership?

TRICHET: Of course the euro is there and will be there in the future. I do not comment on what I consider absurd hypotheses. I am used to such questions from the very beginning of the euro. The paradox is that, years ago, the question was about Germany supposed to be at that time the “sick man of Europe”. I was responding that Germany was

doing hard work that its economy was catching up on competitiveness. Now the same hard work has to be done by those that were growing rapidly over the past years but at the same time had lost their competitiveness. One has to accept that within a vast economy that has the size of the euro area, with 331 million people, there are economic differences. For instance when I look on both sides of the Atlantic I see that the differences between the fastest and slowest-growing U.S. states, it is more or less of the same order of magnitude as between countries in the euro area, for instance between Oklahoma and Nevada, 13 % differences in growth in 2009; between Slovakia and Ireland more than 9 % in growth in 2008.

WSJ: The U.S. copes with these differences through labor mobility and a federal budget. Does the euro zone ultimately need a big federal budget?

TRICHET: The quantum leap we are asking for in surveillance of fiscal policy has to be the equivalent, in our own institutional framework, of what a federation could do. And we should not overestimate labor mobility in the U.S. and underestimate it in Europe. If I take the U.S. state with the highest unemployment and the state with the lowest, I am not that far from what we observe in the euro area, for instance in 2009 between 18% and Spain, 3,7 % in Netherlands, and between 13,6 % in Michigan, and 4,3 % in North Dakota, 4.3%.

WSJ: Should senior bondholders of bank debt be forced to accept haircuts in the event of a bailout, as proposed by the European Commission?

TRICHET. This is not a European concept. This is a global concept, which is discussed in particular at the level of the Financial Stability Board and of the Basel Committee It is particularly important for so-called systemic financial institutions. Very careful analysis is required on the various possible options – additional capital buffers, contingent capital, bailing in financial instruments, etc. I would say for us it is still a work in progress. In any case I don't imagine we could have a different solution in Europe than in other advanced economies.

WSJ: What can be done to improve the euro zone's growth potential?

TRICHET: The growth potential of Europe and the euro area could be significantly higher if all European countries had implemented the structural reforms of the so-called Lisbon Agenda. Now the Europeans are again committed to bold structural reforms. Two avenues seem particularly decisive amongst many others. I would insist on the full opening of a real single market in services. When we created the single market we were an industrialized economy and services were not particularly dominant. Now we are an advanced economy and services are playing a dominant part, and we still have resistance to a real single market in services. This could give a boost to European growth potential. The second point is labor market reform where we need significantly more flexibility in a number of economies.

WSJ: This is your last year as ECB president. How important is it that the choosing of your successor by governments be a smooth process?

TRICHET: I have very hard work until the end of October and I expect to exert, with all my colleagues, my impressive, inspiring and profound responsibilities until the last day. As regards my succession I have full confidence in the heads of state and government. It is their responsibility.

WSJ: What has surprised you, both good and bad, over the last 12 years of the euro? What do you think the euro zone will look like in 2015?

TRICHET: I will not say that I was myself surprised because I have been deeply involved in the negotiation of the Maastricht Treaty and the setting up of the euro. But I guess that a number of external observers are very positively surprised to see that price stability with the euro has been, over 12 years, better than with the previous national currencies and that as many as 17 countries and 331 million peoples are in the euro area since the beginning of 2011. But this is not time for complacency. As all of the advanced economies we have to draw – without any complacency – all the lessons from the present global crisis, in particular in terms of governance.

WSJ: The Fed is doing more quantitative easing, while the ECB warns of inflation risks even though both regions are recovering in a broadly similar fashion. Are Fed and ECB policies diverging, and does it pose a risk to global financial stability?

TRICHET: On both sides of the Atlantic we have each of us our responsibilities that are very important. We are placed in different economies, particularly in terms of the financing of the economy, and of the nature of the shocks we have to cope with. But we are united in purpose: to deliver price stability in medium term and to solidly anchor inflation expectations.

Interview with BILD

Interview by Jean-Claude Trichet, President of the European Central Bank (ECB), conducted by Oliver Santen, published 15 January 2011

BILD: Mr Trichet, in one word, how would you describe the state of the euro today?

Trichet: If you allow me two words: credible and stable.

BILD: Will the euro crisis get worse this year?

Trichet: Let me be very clear: this is not a crisis of the euro. Rather, what we have is a crisis related to the public finances of a number of euro area countries. All governments have to put their finances in order, and above all those governments and countries which have lived well beyond their means in the past.

BILD: How are the euro area countries ever to reduce the debt, now totalling €7 trillion?

Trichet: This year, the budget deficit in the euro area will be half as high as that in the United States or Japan. Virtually all advanced economies face acute fiscal problems. This is something that is often forgotten. That being said, this is no time for any complacency. Let me repeat: the ECB expects the governments in the euro area to make enormous efforts to bring down their debt. Some countries have to get their debt under control again.

BILD: Can you understand that many Germans are afraid of inflation?

Trichet: The Germans are right to be fiercely against inflation. Inflation hurts in particular the poorest. Price stability is a precondition for growth. But the Germans and the European citizens do not need to be afraid: We have delivered and we will deliver price stability.

BILD: Inflation in Europe rose to 2.2% in December, the highest rate for two years.

Trichet: We are always concerned if inflation rises and are following developments very closely. But the figures for December can be accounted for, above all, by rising energy prices.

Let me say something about the longer-term figures. In the last 12 years the average rate of inflation in the euro area has been 1.97 %, and in Germany only 1.5 %. Those are better figures than at any time in the 50 years before the euro was introduced. In Germany, inflation was 2.2 % in the 1990s, 2.8% in the 1980s and even higher in the 1970s. These figures speak for themselves.

BILD: But why does nearly everybody have the impression that the euro has made life more expensive?

Trichet: That may have been the case ten years ago. I do not believe that this perception is shared today by a significant number of fellow citizens. The ECB has ensured that the euro is a credible and stable store of value.

BILD: Why then do you think that one in two Germans wants the Deutsche Mark back?

Trichet: Once again: The euro has ensured stable prices. In the last 12 years the price level has been more stable in the Federal Republic than over the previous 50 years. The Germans, too, are aware of how valuable it is.

BILD: Why are you in favour of an enhancement of the rescue umbrella?

Trichet: Governments need an effective mechanism, which is supportive to ensure financial stability.

BILD: Germany is the biggest contributor to the rescue of the euro. Are we Europe's paymaster?

Trichet: Germany is a very important country in Europe. The measures to combat the debt crisis are borne jointly by the Member States. Germany is an important anchor for Europe, not only on account of its economic size, but also and above all owing to its own creditworthiness, its sound fiscal policy and its competitiveness.

BILD: Why does Europe not just let default countries go bankrupt?

Trichet: First, I would say: debts should be repaid. It is the rule of law. Now, the International Monetary Fund has been around for many years to help marshalling adjustments in countries with difficulties, in order for them to recover their creditworthiness and honour their commitments. Europe is in line with this approach, for the sake of the financial stability of the euro area as a whole.

BILD: Many experts believe that Greece's bankruptcy is unavoidable.

Trichet: The Greek government has taken measures within a strong programme negotiated with the European Commission and the International Monetary Fund. We expect Greece to implement these measures to the letter. Compliance with the announced adjustment programme is checked every three months.

BILD: After Ireland, will other countries be taken under the EU rescue umbrella?

Trichet: We are asking all countries to bring their fiscal house in order. This is the best way for them to win back their creditworthiness.

BILD: Have the right lessons been learned from the financial crisis?

Trichet: We are on the road to far-reaching changes in the international financial system, and it is important that these changes are made. Together with the international community we are working hard to ensure that banking rules are changed. Much has already been done, but a great deal also remains to be done.

BILD: Will the euro still exist in 20 years' time?

Trichet: Of course, there is no doubt about that.

BILD: Will more than the current 17 countries then have the currency?

Trichet: Today, 331 million people in 17 countries use the euro. The rules for joining the euro area must be applied strictly. That is the main thing: provided strict application of the rules, the euro area is open, as the entry of Estonia demonstrates.

BILD: Mr Trichet, your term of office ends in October. Do you already have your eye on a suitable successor?

Trichet: That is not up to me. Rather, it is the responsibility of the Heads of State or Government.

BILD: A German at the head of the ECB would surely not be a bad thing for the euro.

Trichet: This decision is a very important responsibility of the Heads of State and Government!

BILD: What are you particularly proud of in the seven years you have been in office so far?

Trichet: The ECB has a clear primary mandate, which is to ensure price stability in the euro area. We have delivered and we will continue to deliver. And all members of the Executive Board of the ECB, all colleagues of the Governing Council of the ECB can be very proud of that. Let me add: peace and friendship between the European nations are essential for the stability and prosperity of our continent. I have devoted my life to bring the friendship between France and Germany to the benefit of Europe as a whole.

Economic and Monetary Union: What we have achieved and what we must do next

Speech by Jean-Claude Trichet, President of the ECB, Klausurtagung der CSU Landesgruppe, Wildbad Kreuth, 7 January 2011

Sehr geehrte Damen und Herren,

ich danke Ihnen sehr herzlich für die Einladung zu Ihrer Klausurtagung in Wildbad Kreuth. Ich wünsche Ihnen und Ihren Angehörigen ein gesundes und friedvolles Jahr 2011.

Das vergangene Jahr hat uns alle vor besondere Herausforderungen gestellt, und ich freue mich, mit Ihnen über die Herausforderungen im laufenden Jahr zu sprechen.

Lassen Sie mich vorab meine zentrale Botschaft wie folgt zusammenfassen. Wir haben in der EU eine Wirtschafts- *und* Währungsunion. Wie dieser Name besagt, beruht die Union auf zwei Säulen: einer wirtschaftspolitischen Säule und einer währungspolitischen Säule.

Für die währungspolitische Säule stehen die Europäische Zentralbank, ihre Unabhängigkeit und ihre eindeutige Ausrichtung auf Preisstabilität. Preisstabilität im Sinne einer durchschnittlichen jährlichen Inflationsrate auf mittlere Frist von knapp unter 2% ist gewährleistet.

Der Euro ist eine stabile Währung, so stabil wie seine stabilsten Vorgängerwährungen, einschließlich der D-Mark. Und dies gilt für ein Währungsgebiet, das nunmehr 331 Millionen Menschen umfasst. Preisstabilität für diesen großen Währungsraum gesichert zu haben, und sie allen Indikatoren entsprechend auch für die absehbare Zukunft gesichert zu wissen – das ist die entscheidende Errungenschaft der währungspolitischen Säule in der Wirtschafts- und Währungsunion.

Die zweite Säule ist die Wirtschaftspolitik. Für diese Säule stehen der Stabilitäts- und Wachstumspakt, die Ausrichtung der allgemeinen Wirtschaftspolitik und die effektive gegenseitige Überwachung der Finanz- und Wirtschaftspolitik.

Leider hat diese zweite Säule erhebliche Defizite offenbart. Der Stabilitäts- und Wachstumspakt ist zunächst aufgeweicht und dann verletzt worden, die allgemeine Wirtschaftspolitik ist nicht in allen Ländern auf Stabilität ausgerichtet gewesen, und die gegenseitige Überwachung war oftmals nicht effektiv.

Die Entwicklungen im letzten Jahr sind eng mit den Schwachstellen der wirtschaftspolitischen Säule verzahnt. Daher ist die grundlegende Herausforderung für dieses Jahr, die wirtschafts- und finanzpolitische Säule so zu stärken, dass sie trägt. Dies erfordert einen Quantensprung in der Gestaltung und Implementierung des Stabilitäts- und Wachstumspakts, und eine stabilitätsorientierte allgemeine Wirtschaftspolitik aller Länder. Wirtschaftliche Schwächen und Wettbewerbsverluste müssen rechtzeitig korrigiert werden.

Dazu müssen die Mitgliedstaaten erkennen, dass der Euro nicht nur eine gemeinsame Geldpolitik bedeutet, sondern auch eine stabilitätsorientierte Ausrichtung der jeweiligen, nationalen Finanz- und Wirtschaftspolitik erfordert. Diese Erkenntnis muss konsequent in der Praxis umgesetzt werden. Die derzeitigen Vorschläge dazu gehen nach Auffassung der EZB nicht weit genug und ein ambitionierteres Vorgehen ist hier angemessen.

Soweit die Zusammenfassung meiner Botschaft heute.

Ich bitte Sie, mir zu gestatten in Englisch fortzufahren.

Behind us lies a year of remarkable changes, but also remarkable achievements. After the worst recession in decades, economic growth has resumed in Europe. The German economy, in particular, has fared much better than many had anticipated. And with more than 60% of German exports staying within the EU, rising demand from other European countries has made a significant contribution to that recovery.

But 2010 was also a year of great challenges. The euro area economy was severely tested by developments related to the weakened standing of several sovereigns. In response, Europe's leaders chose to take some tough and courageous decisions. None were easy, but they were necessary and they are beginning to pay off.

In 2011 we must strengthen our efforts even more. We need to see further significant progress on the reduction of excessive fiscal deficits. And we have to build and implement an effective rigorous framework for economic governance in the euro area.

Current proposals go some way towards repairing the institutional shortcomings that the recent past has exposed. Vulnerabilities will be detected and made public earlier. There will be less discretion in applying and enforcing macroeconomic and fiscal discipline in Member States.

But Europe cannot afford to rest halfway – we need to be more ambitious. The proposals that we have seen in Brussels do not go far enough in the ECB's view. As I have said before, we need to make a quantum leap in our economic governance. We must achieve a framework where each and every country respects the principle that a successful

economic and monetary union is based on sound macro policies. There must be a binding code of conduct for all parties concerned.

* * *

Today I would like to share with you my views on how, together, we can fulfil that duty, building on the notable achievements and stable foundations of our single monetary policy.

The credibility of the ECB rests on its independence, the transparency of its strategy and the consistency of its words and actions. I will also argue that the euro area's new surveillance framework should be built on these three principles – of independence, transparency and consistency of words and deeds.

The achievement of price stability in the euro area

The Treaty assigns to the European Central Bank (ECB) the single objective of price stability. The ECB has provided a clear definition of this objective, as annual inflation in the euro area of below 2%, but close to 2%, over the medium term.

Since its establishment in the summer of 1998 the ECB has worked hard to fulfil this objective. The results are very clear. We have seen 12 years of low inflation and low interest rates. The average annual inflation rate in the euro area has been 1.97%. It is the best result in terms of price stability for any large euro area country over the past 50 years.

So the ECB has performed its duty. As a result, millions of European citizens have seen their purchasing power and the value of their savings preserved.

Speaking before the *CSU*, I would like to recall the concern expressed by Franz-Josef Strauss back in 1978. In connection with the establishment of a European Monetary System, he had warned *"Europa darf keine Inflationsgemeinschaft werden!"* Ich sage Ihnen heute: Europa ist keine Inflationsgemeinschaft geworden. Und wird es nicht werden.

Indeed, in Germany, the inflation rate has been even lower than the euro area average over the past 12 years: 1.5% per year on average between 1999 and 2010. By comparison, the average annual rate of inflation in Germany in the 1990s prior to the introduction of the euro was 2.2%. In the 1980s, it was 2.8% and in the 1970s, 4.9%.

The steady course of monetary policy in the euro area has also contributed substantially to stabilising medium to long-term inflation expectations at a level consistent with price stability. This is a remarkable accomplishment, especially given the numerous economic and financial shocks we have had to face since the ECB came into being.

These achievements have not come at the expense of employment. On the contrary, since Economic and Monetary Union began, employment in the euro area has risen by over 14 million, compared with close to 8 million in the United States. And these achievements have not come at the expense of growth either. Adjusted for population growth differences, growth in the euro area has been almost the same as in the United States over the past decade, at about 1% per year in terms of GDP per capita growth.

The euro is now well established as a credible currency, of which citizens can be proud. This is important for all the Member States of our union, both individually and collectively, as we together face the challenges of the global economy.

Responding to the crisis: bold actions in line with steadfast policy orientation

None of these achievements happened by accident. They were only possible because our actions were enshrined in our medium-term oriented monetary policy strategy.

The financial crisis has changed neither our strategy, nor our objective. The ECB's response to the crisis has always been in line with both our strategy and our medium-term objective of price stability.

But we did broaden the range of our tools to adapt monetary policy to the challenges of the crisis. What we did was to insure euro area banks against present and future liquidity shortfalls. Banks are the backbone of our financial system. 70% of firms' external financing comes from banks. They finance a very large share of the investments made in Europe. Jeopardising banks' ability to lend to companies would have meant jeopardising the jobs of millions of Europeans.

Because of the crucial role of banks in the real economy, we decided to provide liquidity in unlimited volumes and with longer maturities to banks. In parallel, we reduced the interest rate at which they can borrow to a historical low of 1%.

And we launched a programme to purchase euro-denominated covered bonds, i.e. Pfandbriefe, issued in the euro area. The aim was to jump-start this market, which had suffered considerably in the crisis and which is so important for Europe. Overall, the Eurosystem – the ECB and the national central banks – purchased EUR 60 billion of Pfandbriefe across the euro area. This has provided an important contribution to revitalising this market after the crisis. We will hold the bonds to maturity and the profits will be distributed to our shareholders.

Because of these and a number of other important steps, fears of a "Kreditklemme" have not materialised. Our bank lending surveys show that lending in the euro area – even in the middle of the crisis – was not significantly constrained by supply-side factors.

That being said, monetary policy responsibility can not substitute for government irresponsibility. Excessive government borrowing by some Member States led to a seizing-up of the market for government paper. This market plays a central role in our financial system and constitutes a crucial element in the transmission of monetary policy to the real economy. Fire sales of government bonds imply a sharp deterioration in banks' funding conditions.

Confronted with a serious dysfunction in important segments of financial markets, the Governing Council of the ECB decided to intervene. The reason for the decision was certainly not to finance debt-laden Member States, but to address some severe malfunctioning of markets, so as to help ensure a better functioning of the transmission of monetary policy to all euro area economies. Let me stress solemnly that our monetary policy stance is itself designed to deliver price stability over the medium term.

In any case, we told all governments that they had to correct drastically their fiscal policies. This was not new. It has been our constant message to executive branches: governments must restore fiscal sustainability without delay. This brings me to the second part of my remarks.

Sound fiscal policies: a pre-condition for monetary union

After one of the most difficult years for our still young common currency, it is time to turn the page. It is time for each and every Member State to live up to its responsibilities. And it is time to strengthen the code of conduct for national governments, notably the Stability and Growth Pact, of which I will not hesitate to say that Theo Waigel is the founding father.

We know that for several years fiscal policies in some countries have breached both the letter and the spirit of the Pact. The problems that hit some European bond markets last year were a visible and tangible testimony of fiscal misconduct.

The watering-down of the Pact in 2004 and 2005 by Europe's largest economies was a quieter event, but it was no less grave. In that period, Member States chose to change the rules rather than their policies. The ECB voiced its "grave concerns" at the time.

Today, governments have no choice but to change their policies. And they must substantially reinforce the Stability and Growth Pact.

And it is not only fiscal policies that need to be brought back onto the path of virtue. In several countries, macroeconomic policies more generally need to be aligned with best practice.

Germany went through some painful years of macroeconomic adjustment. Not so long ago it was called the sick man of Europe. Since then, relative unit labour costs have been improved, labour market barriers have been lowered and employment has risen.

Today, the German economy is highly competitive with increasing domestic demand. But because some economies were less courageous in pushing forward necessary structural reforms, the competitive gap between countries in the euro area has widened.

The primary symptoms of a widening competitive gap are unit labour costs, inflation differentials and mounting current account imbalances. Their long-term damage could take the form of persistent differentials in output growth, income and welfare.

We can see the primary symptoms. We are now poised to avert the long-term damage and ensure a smooth long-term functioning of the euro area.

The need for a rigorous and credible surveillance framework

So the period ahead is about two things: fiscal consolidation and measures to strengthen the growth potential of our economies. Both must be monitored by a rigorous and credible surveillance framework.

Currently there is an open and frank exchange of views about the concrete design of the new surveillance framework.

Let me give you a little more detail about the ECB's views on such a framework.

For fiscal policies three elements are indispensable:

- shorter deadlines under excessive deficit procedures;
- quasi-automatic application of sanctions;
- and ambitious targets for the reduction of public debt towards the 60% of GDP ceiling.

The severity of the breach should determine the severity of the sanction. Country missions, fines, reduced access to EU funds, and other pecuniary consequences are necessary.

We should be inflexible in applying sanctions if rules are breached. In limiting the power of discretion, we will strengthen the power of the Pact. Decisions are what we need for sanctions to be credible. Only then will they give national policy-makers the right incentives. This is why we are calling for quasi-automaticity.

There should be greater focus than before on government debt levels, more automaticity, along with improved national fiscal rules and better statistical data.

The second area of policy slippage concerns macroeconomic policies. In a monetary union, national developments in prices and costs have to take account of the fact that it is a union of monetary stability. Therefore, national price and cost developments that are significantly higher than the union average entail significant losses over time in competitiveness.

Competitiveness losses cannot be sustained forever, and adjustments in unsustainable economic policies have to be made. Fiscal and structural policies need to keep domestic demand in line with rates of sustainable growth and price stability.

For monitoring *macroeconomic* policies we have to build a new framework from scratch. Here is what we propose:

- a limited number of clearly defined quantitative indicators to identify undesirable developments;
- transparency about the procedures and the sanctions;
- and a set of reliable statistical data, interpreted and acted on by independent arbiters.

We have advocated that a specific scoreboard should be designed for euro area countries. A detailed and self-contained scoreboard offers a concrete basis for assessment.

Credibility of our analysis is key. But credibility is not a right, it has to be earned.

The credibility of the ECB rests on our independence, the transparency of our strategy and the consistency of our words and deeds. Likewise, Europe's new surveillance framework should be built on these three principles – of independence in the assessment of the fiscal situation as well as of the soundness of macroeconomic policies; transparency of the procedures; and consistency of words and deeds.

Conclusions

Let me draw to a close with a few words on the ECB's role in the crisis. As I have explained, the institutional model of the ECB has proved its worth by delivering price stability over the first 12 years of the euro's existence. This is fully in line with our primary mandate according to the Maastricht Treaty.

As I frequently said, all institutions, whether European or national, must be up to their responsibilities. The ECB is responsible for monetary union, in full independence. The national governments, individually and collectively, duly enlightened by the Commission, are responsible for the Economic Union. The European governments have to fulfil their duties in full. They must face up with the present difficulties by implementing rigorously their national adjustment programmes and by considerably reinforcing their collective governance of Economic Union. We all have to be guided by a clear sense of direction towards the consolidation of EMU and the strengthening of European unity. In an international

environment which comprehends so many hard challenges and so many opportunities Europe must be ahead of the curve and not behind the curve.

Europa heute steht für Frieden, Freiheit und Wohlstand. Die Gründerväter der Europäischen Union wären zu Recht stolz auf die Errungenschaften, die gemeinsam in den vergangenen 60 Jahren erreicht worden sind. Lassen Sie uns auf diesen Errungenschaften aufbauen.

Ich danke Ihnen für Ihre Aufmerksamkeit.

Thank you for your attention.

Introductory remarks at the International Club of Economic Journalists

Jean-Claude Trichet, President of the European Central Bank, Frankfurt am Main, 13 December 2010

Ladies and Gentlemen,

It is a true pleasure for me to participate in the meeting co-organised with the International Club of Frankfurt Economic Journalists. I vividly remember the interesting discussions we had in December 2008. At the time, I took the opportunity to discuss the changes in central banking communication. Today, I would like to focus on the current situation regarding Economic and Monetary Union.

Let me start by quoting from a famous speech that, according to the ancient Greek historian Thucydides, the Athenian statesman and leader Pericles delivered to his fellow citizens during the Peloponnesian War more than 2400 years ago:

"Our constitution does not copy the laws of neighbouring states; we are rather a pattern to others than imitators ourselves. Its administration favours the many instead of the few; this is why it is called a democracy." [1]

As democracy in Periclean Athens 2400 years ago, the construction of Europe does not have established institutional patterns to copy. The European Union and the euro area are shaping new forms of cooperation and integration between sovereign states. The founding fathers of Economic and Monetary Union (EMU) built the European house from its foundations. They could count neither on guidelines nor on predetermined rules. We are still progressing. An ambitious agenda lies in front of the European Leaders. It is a visionary agenda, and despite all the current challenges it is being pursued with determination.

Serious work is currently under way to underpin macroeconomic and financial stability in the euro area. We all know that it calls for determination, resolve and a solid sense of direction.

For what concerns monetary policy, you can rest assured that the European Central Bank will continue to deliver the most efficient policy response and retain the posture of 'credible alertness' that was adopted since the outbreak of the financial turmoil back in August 2007. This posture includes both standard monetary policy, which is implemented through interest rate changes, and non-standard policies, which are implemented, in essence, through special liquidity operations and interventions in some bond markets.

The ECB's Governing Council has demonstrated a strong ability to preserve price stability during one of the most challenging period of modern monetary history, a period that could have led to a repeat of the Great Depression of the 1930s.

Not surprisingly all advanced economies, being stressed by the worst financial and economic crisis since World War II, are called to reflect on the weaknesses of their economic and financial structures and on the appropriate reforms to redress their medium and long term macroeconomic and macro-financial strategies. This is the case in the United States. This is the case in Japan. It is the case in the European Union and in the Euro area as well.

My plan for tonight is precisely to assess the institutional framework of the Euro area by highlighting the origin of the tensions we are currently experiencing and the plausible solutions that would help to restore market confidence and consolidate the building blocks of EMU.

As its name suggests, “Economic and Monetary Union” has two attributes: one is “Economic” and one is “Monetary.” The Monetary attribute of our Union refers to the ECB, its mandate and its independence. The “Economic” aspect of our Union comprises the fiscal regime enshrined in the Stability and Growth Pact; the national frameworks of economic policy, including macroeconomic policy and financial supervision; and the system of mutual surveillance.

The developments we are currently witnessing in Europe’s economy have to do with its “Economic” functions. They have essentially three origins: unsound fiscal policies in a number of member states; inappropriate macroeconomic and supervisory policies in a number of member states; and overall an inadequate system of surveillance. This is the triangle that lies behind the current situation. And let me make this very clear: the triangle does not include monetary policy.

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The “Monetary” side: Price stability in the euro area

The “M” side of the EMU is relatively straightforward to assess. The Treaty assigns the ECB the primary responsibility for maintaining price stability in the euro area over the medium term. We now have almost 12 years of experience with the euro: this is a sufficiently long span of time to provide an evaluation of how successful the ECB has been in delivering on its mandate.

You all know that from the outset the ECB has set itself a very clear numerical benchmark, which is a public and transparent yardstick. The ECB’s Governing Council has defined price stability to be an annual rate of inflation in the euro area of below 2% over the medium terms. The Governing Council has also declared that, in pursuing its mandate, it aims – within that range of values – at an inflation rate over the medium terms close to 2%.

Let me emphasize that the track record is solid. Over the first 12 years of existence of the euro, the average annual inflation rate in the euro area has been 1.97%. This is the best result in the euro area for at least 50 years and despite the number of economic and political shocks we had to face since we began, in 1999, with a new institution, a new currency and a new framework for monetary policy-making. It has been achieved in an environment of positive growth that in per capita terms was virtually the same as in the United States. It has been achieved in an environment of employment growth with employment rising by over 14 million. And it has been achieved for an entire continent of 330 million people.

Furthermore, over the same period, inflation expectations have generally been aligned with our definition of price stability. Even at the height of the financial crisis, in a situation of high uncertainty, inflation expectations have remained anchored. Today, as witnessed by the October reading of the Consensus Forecast, as well as of the Survey of Professional Forecasters and Euro zone Barometer, they remain anchored, with both readings at 1.9% at a 5 years horizon. The more recent Eurosystem staff economic projections – that spans a shorter time horizon - also reflect the stability of inflation looking forward.

Our monetary policy strategy has communicated a clear sense of direction. The sustained anchoring of expectations has made it possible for the ECB to ease its policy stance in response to the crisis without entering pre-commitments about the future path of the policy rate. Our definition of price stability has guided our citizens in their economic decisions and has acted as a built-in stabiliser in the deepest phases of the crisis.

The “Economic” side: sound and sustainable fiscal policy

Let me now turn to the main contention of my remarks: the tensions we are experiencing today in the Euro area sovereign debt markets find their deep causes in the countries’ policy slippages of the past years. These slippages are all concentrated on the “E” side of EMU. First, fiscal policies in some countries have not been aligned with the requirements laid out in the Stability and Growth Pact. Second macroeconomic policies in some Euro area countries were not fully consistent with the participation in a monetary union that is founded on price stability.

To be sure, looking at the euro area as an aggregate, and comparing the euro area with its major global partners, the fiscal problem appear relatively modest. Next year, the average Euro area budget deficit will be in the order of 4.6%. By 2012 it is expected to decline further to 3.9% (Source EC Autumn 2010 economic forecast). These expected numbers are about half the corresponding expected figures for the US and Japan. The problem, the source of the current tensions clearly reside with national fiscal developments, notably localised in those countries that have not done enough to correct imbalances or to prepare for difficult times, when times were still good.

We know that for several years, fiscal policies in some European countries have breached both the letter and the spirit of the Stability and Growth Pact. The Pact calls for budgets that are close to balance or in surplus over the cycle, deficits always below 3% of GDP and a public debt level of below 60% of GDP. When a few years ago it became clear that in some important countries fiscal policies would not be able to meet the rules of the Stability and Growth Pact, it was not

the policies that were changed but the Pact. This was clearly a dark moment in the history of European policy decision making.

In 2004 and 2005, the governments of the three largest Member economies coalesced to try and dismantle the Stability and Growth Pact. It was a very fierce battle at the time, and the ECB publicly voiced its grave concerns.

The recent crisis has demonstrated that growing underlying macroeconomic imbalances can also destabilise fiscal policies and place a country on an unsustainable trajectory. A boom-bust cycle can mask a fiscal problem for a long time and suddenly expose the problem when it turns. High fiscal elasticities tend to curb budget deficits – and even produce overall surpluses – when asset price run-ups boost revenues from financial and housing transactions. The same elasticities, however, will send the budget into distress when the boom reverses.

The second area of policy slippage concerns macroeconomic policies. Here what stands clearly in front of the policymakers is the sustained increase in unit labour costs whose growth in some member countries has consistently outpaced both domestic inflation and euro-area average union labour costs. Such competitiveness losses cannot be sustained forever, and catching-up phenomena can only explain a limited part of the process. Sooner or later adjustments in unsustainable economic policies have to be made. Fiscal and structural policies need to keep domestic demand in line with rates of sustainable growth and price stability.

Reinforced fiscal surveillance, for all its critical importance, is not enough. We need to scrutinise more closely the macroeconomic policies. We need reinforced macroeconomic surveillance. You know that the monitoring of fiscal and macroeconomic policies in the European Union and the Euro area is performed by peer group fora: the Eurogroup and Ecofin meetings of finance ministers. The European Commission typically supports the activity of these fora. Of course, effective monitoring requires adherence by members to the policy framework, it requires peer pressure and consequences to deal with deviant behaviour, and it requires reliable statistics.

Europe's economy: the current challenges and the way ahead

Let me come to the third part of my remarks: what is expected of national governments and of European Union institutions?

Starting from fiscal policies, in some countries there remain significant concerns about the sustainability of their own fiscal positions. It is not possible to procrastinate further the solution to these problems and fiscal authorities need to act in order to strengthen public confidence in sound public finances, thereby reducing risk premia in interest rates and supporting sustainable growth over the medium term. More generally, all euro area governments should step up consolidation efforts in a way that is credible and lays the foundation for sustainable long-term growth. To this end, it is essential that countries pursue credible multi-year consolidation plans and fully implement the planned consolidation measures. Positive fiscal developments that may emerge, reflecting factors such as a more favourable than expected economic environment, should be exploited to make faster progress with fiscal consolidation. In their 2011 budgets, countries need to specify the necessary fiscal adjustment measures in detail, while standing ready to correct any slippages from the fiscal objectives announced.

In this context, let me express the appreciation of the Governing Council for the economic and financial adjustment programme which was recently agreed by the Irish government with the European Commission, in liaison with the ECB, and the International Monetary Fund. I am sure that the programme is suited to bring about a sustainable stabilisation of the Irish economy and sooth the tensions in financial markets that are associated with the Irish fiscal problems and the reorganisation of its banking sector. Furthermore, by addressing in a decisive manner the economic and financial causes underlying current market concerns the programme will also contribute to restoring confidence and safeguarding financial stability in the euro area as a whole.

Equally important is that **s**tructural reforms are rapidly implemented that enhance the prospects for higher sustainable growth especially in those countries that have accumulated over the past years significant loss of competitiveness or are suffering from high fiscal and external deficits. Removing labour market rigidities and increasing product market competition - particularly in the services sectors - would further support the adjustment process of these economies. Measures working in this direction will also facilitate the restructuring of the economy and foster innovation, productivity growth, which ultimately leads to sustainable long-term economic growth. At the current stage it cannot be stresses enough how important it is that the banking sector of the euro area be appropriately restructured. By repairing their own balance sheets, implementing sound and effective risk management strategies the banks in the euro area will increase their resilience to domestic and external shocks, which would allow them to make their contribution to sustainable growth and financial stability.

Finally, let me state clearly – also on behalf of the Governing Council of the ECB – that we are not completely satisfied of the proposals put forward by the Commission and the European Council Task Force that should aim at strengthening the system of economic governance in Europe. These proposals in our view do not yet represent the quantum leap in economic governance that is needed to be fully commensurate with the monetary union we have created.

Most important, we need to strengthen in particular two areas of the economic and financial structure in the EU. The first area is the surveillance on domestic fiscal policies with a view to preventing excessive deficits and unsustainable public debt. The second one is the adoption of a mutual surveillance framework on macroeconomic policies in the euro area focussing on those countries which experience sustained losses of competitiveness and large current account deficits as these countries face the greatest sustainability challenges.

To be specific, I think that for these two broad areas, one can highlight six main lines of reform that the ECB deems it is necessary to purse further. Starting from the fiscal policy side, I am convinced that, as far as the euro area is concerned, one should:

1. The deadlines for action on the side of governments under excessive deficit procedures should be shortened, and the system of sanctions should operate much earlier in the EDP process. In the past lenient applications of the rules were exploited by short-sighted policymakers for irresponsible delays in adjustments and laid the premises for the current situation.
2. Sanctions should be applied in a way that is quasi-automatic and based on clearly defined criteria and with less discretion over outcomes. This will mean, first to diversify the spectrum of possible financial and non-financial enforcement mechanisms. Among the financial mechanisms, I include fines, deposits and reduced access to EU funds. Under the non-financial mechanisms, I include country missions, recommended adjustment programmes, possible limitations of voting rights for Member State in persistence violation. Quasi-automaticity will also imply the limitation of the scope for discretional intervention at the political level, for example by implementing to the maximum possible extent the “reversal of voting majorities” at the European Council.
3. Place more ambitious targets for the reduction of public debt towards the 60% ceiling. We should assign the debt criterion the importance it is given in the Treaty by combining a clear and sufficiently ambitious rule on public debt reduction with the prescriptions on deficit developments that are typically the exclusive focus of EDP procedures.

For what concerns the mutual surveillance framework, three other main lines of reform are necessary in our opinion:

1. The design of a transparent procedure that clearly specifies the sanctions in case of breach of sustainability rules. Identification of Member States with vulnerabilities should be done on the basis of clear and undisputable quantitative indicators which should not be left to the sole discretion of the Commission. We have advocated that a specific scoreboard should be designed for euro area Member States which would trigger a quasi-automatic in-depth analysis and reinforced monitoring. A detailed and self-contained scoreboard offers a concrete basis for assessment. Furthermore, it restricts the scope open to countries to arbitrage across indicators and monitoring dimensions.
2. The procedure should be transparent in order to give the possibility to the general public and to market participants to appreciate the evolution of the process, from the stage at which macroeconomic imbalances are detected and assessed, to the stage at which recommendations for corrective actions are issued. Transparency in this case reinforces – rather than weakens – the teeth of the procedures.
3. The increase in the quality and independence of the economic analysis that underpins the surveillance exercises. It is important that the Commission is permitted to assess not only national budgets, but also the individual budgetary measures taken by Member States and have the right - in liaison with the ECB - to carry out missions to Member States in order to assess the budgetary situation. Ancillary to this last point, we need to bring the reliability of statistical data to the highest possible level.

It is my opinion that in order to pursue these lines of reform we need to give the Commissioner himself and the Commission services charged with conducting macroeconomic and fiscal surveillance for the euro area the highest degree of independence possible within the Commission, ideally supported by a body of “wise persons” providing external assessments.

Let me conclude with an example that demonstrates that in Europe policymakers can make bold steps when and where necessary. I am referring to the recent decisions of the European Council and the European Parliament to create the European Systemic Risk Board - or ESRB -, which I shall have the honour to chair.

This new European body will be part of the new European System of Financial Supervision and its function will be to provide macro-prudential oversight of the EU financial system. It will bring together the governors of the national central banks, the new European Supervisory Agencies, the Commission and the national supervisory authorities of all 27 member states.

The establishment of the ESRB will be a landmark event in how Europe deals preventively with systemic risk. It will complete the European construction in the direction of adding safeguards that will stabilise the financial system and make Europe’s economy more stable and resilient in the medium terms. Furthermore, it will facilitate multilateral dialogue

and cooperation in the field of macro prudential oversight with similar institutions in other countries, including the US and the newly created Financial Stability Oversight Council (FSOC).

Conclusion

The ECB has, I trust, been living up to its responsibility and delivered what had been promised to our people: a stable currency that has promoted economic growth and job creation. This has not been an easy journey and we had to drive on rocky roads and absorb various shocks, including food and oil price gyrations as well as the consequences of the terrible terrorist attacks in the US. Over these years, the euro has always been a force for stability and it remains so also in what is now a more than three-year period of economic and financial instability.

In Europe, as in all other major advanced economies, we are now called to react to the challenges posed by the crisis. Changes are needed in the euro area involving both our economic models and surveillance frameworks. Taking into account the lessons to be drawn from the global crisis in terms of functioning of the Economic Union, it appears of the essence to pursue greater cooperation and greater cohesion through a economic governance that will be considerably reinforced. We must keep our sense of direction: towards more European unity and more responsible European unity.

Thank you for your attention.