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The Honorable Mario Draghi
President, European Central Bank

<u>Questioners</u>

Bob Hormats:	Former Under Secretary of State for Economic Growth Energy in the Environment and now with Kissinger Associates
John Lipsky:	Distinguished Visiting Scholar at Johns Hopkins University and Former Acting Managing Director of the IMF

Introduction

Roger Ferguson

Thank you very much. So welcome to the 432nd meeting of The Economic Club of New York. I am Roger Ferguson, Chairman of the club which is now in its 106th year as the nation's leading nonpartisan forum for economic policy speeches. Throughout the long history of The Economic Club of New York we have had more than 1000 guest speakers appear before us establishing a strong traditional of excellence, which we will continue with today's speaker. Before introducing him I would like to begin by recognizing the 204 members of the Centennial Society who have contributed their support to the club to ensure its continuing financial stability. Thanks to all of you for helping to ensure that the club can continue to fulfill its mission well into its second century. I would also like to welcome the students who are with us and to thank Betsy Cohen and Jerry Speyer for making their attendance possible. Today we have students from Columbia University School of International and Public Affairs, from Fordham University and from The New School. So welcome to all of our students. Now, to our speaker. It is my honor today to introduce our speaker, Mario Draghi, President of the European Central Bank. Mr. Draghi chairs the ECB's Executive Committee Governing Council and General Council and he also serves as Chair of the European Systemic Risk Board. He is also chair of the Group of Governors and Heads of Supervision at the Bank for International Settlements. From 2006 to October of 2011 he served as Governor of the Bank of d'Italia as well as Chairman of the Financial Stability Board. He is a former Vice-Chairman and Managing Director of Goldman Sachs International, former Director General of the Italian Treasury and former Executive

Director of the World Bank. Mario was a Professor of Economics at the Universities of Trento, Padova and Venice and Florence. Dr. Draghi graduated from Sapienza University of Rome and received his PhD from the Massachusetts Institute of Technology. Mario the podium is yours.

Mario Draghi

President, European Central Bank

Well thank you, thank you so much for this warm welcome, for the honor of this invitation and for the pleasure of this invitation to be here amongst friends, colleagues, former teachers, friends of a lifetime, and be in this town that I love. I am delighted to be here with you and I would like to take the opportunity to talk about simply what is happening in Europe right now. The euro area as a whole is undergoing a process of fundamental reform. The overarching objective is to lay the foundation for recovery and more jobs, foster financial stability and fiscal sustainability and enhance international competitiveness for the benefits of all parts of the economy and the wider society.

Reform will be a lengthy process, but while it is far from complete, perhaps for the first time in many years 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 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.

So let me start with a quick review of the current situation and of the outlook for the economy. Recent data basically support our baseline outlook of a nascent economic recovery over the coming months. Following six quarters of negative output growth euro area GDP grows by .03 percent in the second quarter of this year. Taken together these data with the incoming information confirm the growth outlook that ECB staff produced last September and as a matter of fact has been produced all throughout this year. So we see this projection, this projection sees real GDP shrinking by 0.4 percent this year and positive growth rate of 1 percent for 2014. But as you can easily conclude from these numbers the pace of recovery is going to be subdued, uneven, and to some extent fragile, being exposed to many risks. It is uneven across countries for as long as is meaningful for us to look into the future.

The unemployment rate currently standing at 12.1 percent remains unacceptably high and the risks surrounding the outlook continue to be tilted on 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 percent

this year and next year 1.3 percent. 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 our quantitative definition of price stability, namely that inflation has to be close but below 2 percent.

That said, inflation expectations continue to be firmly anchored, in line with our aim of maintaining inflation rates at the level I said before. The risks to the outlook for price developments are, in spite of everything, still expected to be broadly balanced.

Finally, monitoring in particular credit dynamics remain weak. The annual growth rate of loans to the private sector has remained well in the negative territory and the pace of contraction of loan of the lending has actually accelerated over the recent period. Certainly weak loan dynamics can largely be explained by the current stage of the business cycle. We have to be attentive to alleviate structural and supply-side factor that may hamper credit provision.

The significant improvement in the funding situation of banks since the summer of 2012 has partly upset supply-side restrictions. But it will be some time before the more permissive funding conditions faced by many banks will be turned into an active spur for credit creation.

Against this background let's ask how should policy-makers respond to this still fragile

macroeconomic recovery. We need the three prong strategy.

First, monetary policy has to remain consistently supportive of the baseline outlook and mitigate the risk 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 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, especially in the euro area. Hence we must establish conditions that align incentives of individual financial institutions with those of the society.

Let me start with monetary policy. As you know, our treaty clearly gives priority to price stability as our primary objective. Within this disciplining framework we tailor our policy response to the challenges that we face. In response to the events of the last six years we have

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, the first time in three years. And we counteracted and removed unwarranted fears of a breakup of the euro area last year.

In July of 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 affect, the governing council adopted explicit communication of 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 the present or lower level for an extended period of time.

This expectation is based on our assessment that the subdued inflation outlook will extend in the medium term given the broad based weakness in the real economy and subdued monetary dynamics. What was the rationale for adopting our forward guidance, our type of 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. Another-words the adoption of forward guidance does not imply that we have 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 money market conditions return to the levels observed in early summer.

Second, our forward guidance is specifically tailored to the ECB's mandate and our monetary policy strategy. The path of the policy rates remains conditional on the outlook for inflation and it would be reviewed over time against our analytical framework. This means that we assess whether the medium-term outlook for inflation remains subdued against two types of metrics. First, economic indicators pointing to persistent slack in the real economy. Second monitor 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 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 the path that does not add to downside risk for the recovery. Thus, our monetary policy stance will continue to be geared towards maintaining the accommodative stance and providing support for the economic recovery. But preserving, as I said before, preserving monetary accommodation is not sufficient in itself for the recovery to 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 countries. 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 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, the European Union fiscal rules were weakly enforced and as such incapable of promoting prudent fiscal policies at times of favorable economic conditions. So between year 2000 and year 2007. Second there was no mechanism to prevent and correct macroeconomic imbalances within the EU. The result was an incentive vacuum.

Rather than exploiting the advantages of monetary union for modernizing their domestic economies, several countries simply delayed all the necessary adjustments. And the elimination of exchange rate fluctuations and the leveling-off of the spreads in sovereign borrowing costs that preceded the crisis deactivated the market forces that previously had disciplined macroeconomic policies at the country level.

European policy makers are now addressing these issues. Due to a recent strengthening of the EU fiscal rules, Member States now face strong incentives to adopt sound budgetary policies.

Namely there are provisions that are being inserted in the National Constitutions to the extent that budgets must be balanced.

Moreover a new Macroeconomic Imbalances Procedure has been established at the European Union level. It does require governments to adopt competitiveness enhancing policies and tackle

potential sources of financial instability in their economies. Reflecting the 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 the right direction has started. Euro area countries have cut their fiscal deficit ratios by half since the peak in 2009. Excluding interest payments euro area member countries on the 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 US or Japan, which last year still recorded primary deficits of 6 percent and 8 percent of GDP respectively.

We are also seeing some noteworthy improvements in competitiveness and external positions. The countries under full EU and IMF programs like Spain, like Portugal, like Ireland, like Greece have seen their unit labor costs fall by more than 10 percent since 2008 relative to the euro area average. Their current accounts have improved by around 8 percent of GDP since then.

In short, there is progress towards more solid economic fundamentals in the euro area. But of course it is necessary that the current momentum of reform be maintained to reach greater stability.

Finally, a sustainable recovery requires healthy financial institutions. We see 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 euro's of fresh capital and another €275 billion had been injected by governments. All in all this amounts to more than 5 percent of euro area GDP. As a result the average Core Tier 1 ratio of the largest euro area banks currently stands well above 11 percent and the majority of euro area banks already comply with the minimum capital requirement of the fully implemented Basel III framework.

Furthermore, in countries under financial assistance which are the countries I mentioned before, under financial assistant programs, Spain especially problematic legacy assets have been removed from banks' balance sheets to ensure they will no longer curb banks' lending to profitable business.

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. And I think that is the most important one, we need to create full transparency about the risks that are present in banks' balance sheets. And second we need to align investor's incentives with the society.

A comprehensive balance sheet assessment will be a crucial preparatory step before we begin our new supervisory task in the fall of next year. This will serve to strengthen transparency and to mitigate the risk of the possible emergence in the early days of operations of the new supervisory mechanism. There is going to be a major exercise of a balance sheet assessment, the objective of which must be to convince the private sector that it pays to put money in the banking industry. I think that is the key objective, so for this reason transparency is the main consideration that we have to keep in mind.

Now this balance sheet assessment is formed by three components; a risk assessment, an asset quality review and finally a stress test. To be as transparent as possible we envisage a process which is going to be run not only by national supervisors but by for actors; the ECB from Frankfort, the National Supervisors, also other National Supervisors will be part of the joint

inspection teams and finally third party private sector advisors.

So the three elements, risk assessment, asset quality review and a stress test, will ensure a comprehensive assessment that will identify the remaining risks on banks' balance sheets. To strengthen incentives the institutional architecture will also be augmented. I have spoken so far about the single supervisory mechanism, the single supervisory in the euro area but there is also going to be a single resolution mechanism, like equivalent to your FDIC. As a first step to overcome in the existing problem, harmonized rules and procedures for bank recovery and resolution are being developed at a European level. This new way of European rules should be implemented at the national level quickly. 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.

So there will be a single resolution mechanism that will execute bank resolution in a timely and impartial manner and formulates its decisions from a clear, encompassing European perspective.

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

Let me conclude. As I said 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 process in the future. Yet, we should also not exaggerate the euro area's challenges. For example, while the unemployment rate has increased more in the euro area than in the United States during the crisis, the employment rate in the US has fallen further than in euro area which makes the two figures hardly comparable.

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

Thank you for your attention. (Applause)

Question and Answer Session

ROGER FERGUSON: Thank you very much Mario for that very comprehensive and insightful speech. I'd now like to introduce the two members who will conduct our question and answer session. Bob Hormats the former Under Secretary of State for Economic Growth Energy in the

Environment and now with Kissinger Associates. And John Lipsky a distinguished visiting scholar at Johns Hopkins University and the former Acting Managing Director of the IMF. If you in the audience have any questions you can email them to questions@econclubny.org. That is questions@econclubny.org and our President Jan Hopkins will read them. Bob you have the first question.

BOB HORMATS: Thank you very much. Welcome Mario to the New York Economic Club and welcome back to New York. I would be remiss if I did not begin on the note that everyone is talking about, predicted in Washington, but throughout the country, and that is the ongoing debate over the government shut down and the debt ceiling. As you know these issues have enormous impact, not only on the American economy, but on the global economy. Therefore, I would request from your perspective if you could take a look at this from an international point of view and particularly what the implications would be if Washington failed to reach an agreement on a constructive and sustainable solution to this problem. Not one that simply kicks the can down the road or leads to a default in the current environment, but one that just is simply not able to address the kind of fundamental challenges that we face as a country on broader fiscal policy issues. What would the global impact be? And the second is, what do global markets in other countries look to the United States to do to strengthen our long-term fiscal sustainability? As you know, this debate has been swirling for some time around the debt issue, the deficit issue, not just in the immediate sense but over the next 10 to 15 years. The CBO has just done a report on that. So I would be interested in your thoughts on what happens to global markets if this is

not dealt with in an effective way in the near term, but also what kinds of measures the United States needs to do to put herself on a more sustainable basis and renew confidence in the dollar and in the US financial markets.

THE HONORABLE MARIO DRAGHI: Thanks Bob. I am not sure I am actually the best person to answer this question. (Laughter) So I hope you forgive any naive statement on my side.

BOB HORMATS: ... in Washington, Mario, so please proceed.

THE HONORABLE MARIO DRAGHI: First let me say .... let me give you just an outside perspective. As I said as someone who is not especially informed about this issue. I think the world still does not believe that the United States will not find a way out of this. There is complete misbelief that finally some agreement will be found. So that is the first part. Second, there are two types of ... at least two types of situations that we have to keep in mind. First is, an agreement is found but late and there may be an accident in between. Clearly the markets response will depend on what type of accident. Whether it is ....it depends very much on what sort of nonpayment happens. And there are different consequences on the markets depending on whether its bonds or its not bonds. The second situation is one where this standoff lasts several months or several weeks. In that case, it is probably safe to say that this could cause severe

damage to the US economy and to the world economy. So that is the answer. Now I can comment on the last part, namely what sort of agreement is more likely to be found. It is quite clear that long-standing agreements will contain an element of stability for both the US economy and the world economy and it is also quite obvious that if you have a short-term agreement, will be less stable. Will produce less stability. But I think this is in a sense must be clear to all of you. The key thing now is where an agreement will be found or away out will be achieved. On the second question, what do you ask governments should do to ensure long term fiscal sustainability. I think it is again a very, very complicated question. But, it is quite clear the financial crisis has produced a debt and a deficit level that is not sustainable through time. It is also quite clear that fiscal retrenchment, fiscal consolidation, has different speeds in different parts of the world. In Europe it has been very fast. In some cases it was absolutely necessary and I can say more about this later, to do it fast. And has produced a contraction. In some cases a severe contraction. In the US the consolidation is proceeding and the other way to get out of the situation which is unsustainable is to grow more. So to grow is equally important as to consolidate. And I am confident that this is well understood here. Thank you.

JOHN LIPSKY: Thank you. Congratulations on the thoughtful address and more broadly congratulations on the wonderful job you and your colleagues in Frankfurt and around the European Central Banks have done meeting the challenges. I think the size of this audience reflects the interest here in the European project, but also recent events have underscored our interest in the success of the European Economic Monitor Union and I hope you can convey that

back home. I think when you get to Washington you will find another hot topic, the conduct of unconventional monetary policy and you can see the recent events here in the United States and our markets underscore that as well. The implementation of unconventional policy has involved the implementation of new and more instruments and in the case of the ECB beyond the traditional discount and repo facilities and the long-term repurchase operations, the OMT, Outright Monetary Transactions, the ELA and now more recently forward guidance. How do you decide how to implement this mix of instruments given the traditional idea that you should match instruments to targets. How do you decide which of these instruments to use? And has the proliferation of instruments made it more difficult to gauge the stance and overall impact of monetary policy? And finally how do you meet the challenges of effectively communicating this much more complex array of monetary instruments?

THE HONORABLE MARIO DRAGHI: Thanks John. Well thank you for your kind words. These days, one doesn't happen to be flattered that often. Thanks. The three instruments you mentioned, the long-term refinancing operations that we started at the end of 2011 and for the first time this means that for the first time the ECB was opening what we call a fixed rate full allotment, namely a credit line. Policy rates without any penalty for all the banks that would apply. It was a three year horizon. ECB had done it for at most one year with a horizon of one year. Now that addressed a specific problem which was the fragmentation of the financial markets of the euro area. By the end of 2011 when the data of credit and money, any credit data was showing a dramatic drop. It all started really midyear but it became dramatically visible by

November and December. So that is why in two months we cut rates twice and we did the LTRO's. We are convinced that in so doing we avoided major accidents in the banking system. The reason was frankly all other source of funding had dried up. The policies were vastly migrating to safe haven places like Germany from the rest of the European Union. So that helped to cope with that objective at least. I think we have reached the objective. It worked. It worked also in terms of rates, volatility, stock markets, any index had a positive reaction. But it didn't last. Three months down the road the euro area was seen at risk. There were many people, many investors, also on this side of the Atlantic which were believing the euro would not survive. They had taken significant positions on the short side. So the OMT, the response that the ECB within its mandate would do whatever it takes to preserve the euro. So it was a positive commitment to the objective, the immediate objective, of course, to defy, to destroy self fulfilling expectations of disruptive scenarios for the euro. It was a positive commitment to a higher, I would say political objective, to make sure that the euro is irreversible. And it worked. Now, we in a much more stable situation we saw interest going .... by the way between July 2012 and a month ago, we saw interest rates further going down all over, fragmentation gradually being reduced. By the way fragmentation on the funding side is by and large disappeared as far as deposits are concerned. What we do every month, every month we look at how deposits in the banking system grow in different parts of the euro area. Then we calculate a dispersion index. And this index is now at the same level it was at 2007. So as far as that component of funding, fragmentation is gone. But on the lending side we still have problems. So the last thing we want is a short-term money market rates start behaving in a way that will

threaten our recovery. That is why we issued our specific peculiar forward guidance. It is different. It is different from the one you have here. It is different from the one the Bank of England has. Certainly very different from what Japan has. Why is that? Well, we are simpler folks. That is the answer. I will tell you why. Because we don't buy assets. We don't buy government bonds. We don't buy guilds. Our interest rates have not reached, as I was saying in the statement before, have not reached the zero level of the lower bond. So there was the different situation. Our mandate was clear. It speaks only to price stability. So the issue was then, are we going to be quantitative or qualitative? Again, being in the specific institutional context we thought ... well there were many reasons for being qualitative but especially that the world is such an uncertain place that we wouldn't feel like binding ourselves to a specific figure and the thing that we say is that basically our medium-term outlook about inflation has to be such and such for our forward guidance to remain in place, which is what it is today, namely subdued and weak. The intention was not to change our reaction function. Our intention was to clarify our reaction function. So the question is, did it work? There are various metrics. One is were we successful at keeping interest rates at the level we want to keep the short-term interest rates and the answer was yes for some time. Then they fluctuated but still in a corridor that is by and large acceptable. The second point is that the forward guidance has been clearly successful in reducing the volatility. The third is that it's been clearly successful in reducing the sensitivity of interest rates to news that have nothing to do with the fundamentals of the euro area economy. I mean if the euro area economy recovers, you would expect an increase in interest rates, but if it doesn't then you would not. So all in all we will stay with that.

BOB HORMATS: Mario you have spoken eloquently here and in many speeches in the past on the importance of structural reforms in Europe regarding product and labor markets to improve competitiveness, increasing adjustment capabilities and achieving higher growth rates. And as you have pointed out in your speech today, some improvements have actually taken place in fact in some countries, considerable improvements have taken place with respect to reducing current account deficits, some are now in surplus. Major changes in the positive realm. I wonder if you could dig a little bit deeper and identify what the future priorities should be. You have talked about the need to keep up the momentum, could you be a little bit more specific about what areas do you think need to be focused on in the future to sustain momentum and particularly what types of measures have proved so far to be most successful or most promising, because different countries as you have correctly pointed out have instituted different kinds of reforms. Which are those that seem to be the most promising and most successful. And are countries in Europe learning from one another to try to figure out what works and what doesn't under in some cases very similar circumstances, others obviously differ from one to the other, but where are we going, what should the priorities be and where do you see the most room for optimism in this area.

THE HONORABLE MARIO DRAGHI: Thanks Bob. Let me just step back and go to say 2009 in just the aftermath of the most virulent period of the crisis. In many governments of the so called stressed countries in the euro area, what happened was that budget deficit levels and debt

levels were unsustainable. And markets were clearly saying so. So the governments in power at that time had to face a very urgent situation and they had to go fast about repairing these budgets. When you have to decide very fast on how to fix your budget, the easiest things that everybody does is basically raise taxes. Taxes were raised significantly everywhere, in a part of the world where taxes are already very high. So that some countries reached something like 50 percent and plus of GDP in terms of tax incidence on the economy. The second thing was to cut investment expenditure, capital expenditure because that is easy. Simply cancel investments. Now all of this produced a recession. No wonder. Now there is more time and what countries now ought to think about is just the other way around namely cut taxes, bring them back to sort of what used to be normal historical levels, to recreate the incentive for private investment, and also cut expenditure. Now when you go to cut expenditure, I think you know very well in this country, it is the same thing probably, it is not easy because you have to change legislation which has been used often for many, many years. That is where the structural reforms come into place. There is a broad range of structural reforms that can be done by the public sector in as far as government expenditure is concerned. Some countries need a new pension reform, other countries need different much better control over their some of then are federal, and they have no .... well they have very little control over their single region budget, so they have to enforce that. Each country has its own menu. Then, you have the reforms that simply free the individual initiative for the individual entrepreneurship and these are reforms that deal with competition especially in the product markets. You need to wait six months, nine months, before you can open a shop, so you know, you give up. If you have to bear a substantial cost for having a license, if it is too

high, you give up, and so on and so forth. Second, structural reforms that would directly affect the labor market. The labor market situation is a special one because what happened is ...well first of all if you look at the labor market in Europe now and you see that in some countries they had....most of them had a serious crisis comparable, most of them had higher levels of unemployment but in some of them you have a very high level of youth unemployment on top of having a high level of unemployment. And you ask why? The reasons are by and large two. In the early part of the year 2000 these countries had wanted to make their labor markets more flexible but they didn't' want to hurt the people who were already working. So they wanted to introduce flexibility leaving everything else constant. So what they did was to introduce flexibility only for the young entrants. That translated into these young people being hired only with short-term, very short-term contracts, three, six months, even one month in one country. This situation went on and on and on until the crisis struck. Then, of course, the first jobs to be cut were these people. So you have millions of young unemployed. The second reason is basically that in some countries you have educational systems that simply do not produce the skills necessary for these young people to find a job. That is an even, if I may say, more serious and longer-term problem. So the labor market has to be addressed by all countries in their different ways. There are countries like Spain for example who have started to reform the labor market and you can see that it works because, for example, the unit labor cost in Spain had dropped much more than in other countries. In some countries, for example, in spite of having 13 or 14 percent unemployment, you still see nominal wages going up more than the European average. Which means basically you have lots of people unemployed and the ones who are

protected getting higher and higher wages. So you see that there is clearly need to address this issue.

JOHN LIPSKY: As you have mentioned and as is underscored in the IMF's World Economic Outlook and Global Financial Stability Report that were both published earlier this week that the banking system, weakness, capital weakness, fragmentation and corporate debt overhangs in the Eurozone are leading to higher borrowing costs for corporate borrowers, adding to systemic fragility and helping to induce the de-leveraging and the decline in bank lending that you discussed. And that the IMF agrees with your analysis that progress on banking union is central to strengthening the financial sector, especially in the banking sector in the Eurozone economy where as we all know bank lending is dramatically more important as a relative source of funding than for example in the US economy. You have described a very important set of actions that will be forthcoming in the next few months, the risk assessment, the asset quality review, and the stress test. And in the near term that is going to produce potentially a need for even further capital raising on the part of some institutions. Now there has been a broad agreement that where capital needs to be raised it should come first from retained earnings, second from private sources, third from national governments and fourth from the new European Stabilization Mechanisms, bank recapitalization facility. Who is going to have the power to decide what banks are going to have to do and which source of capital they will have to make use of. Is it going to be the ECB as a new single supervisor, national governments or the European Commission or who?

THE HONORABLE MARIO DRAGHI: Now you are absolutely right. I just have to correct you on only one small point. The ESN, the European Stability Mechanism will not be able to recapitalize banks directly until the single supervisory mechanism will be in place. So it is very unlikely that they could actually finance anything at this stage or at the end of next year. But other than that, your description is absolutely right, and that is why the Asset-Quality Review is so important. The banks will .... some banks may have to raise capital. I have no idea whether to expect major disasters or not. Certainly what is positive is that in view of this exercise, ahead of this exercise, all banks and supervisors, national supervisors actually reacting very, very strongly everywhere. Either convincing banks to raise more capital, forcing a very high level of provisions in many parts of the area. So it is quite.... this is quite good because it is conducive to a better situation. Certainly we will have to see exactly how things stand and that is why these four actors' participation to the exercise is so important. Because transparency is the key thing and by and large people outside Europe are convinced that if there is no more transparency it is very unlikely that they can actually invest in the banking system. Now, what are the prospects for raising capital? From what we see today the situation is not bad. We have seen in the last month and a half we have seen several banks capable of raising capital. So the market prospects are way better than they were on the occasion of the last stress test two years ago. Also, the sovereign bond market by and large is more stable than it was two years ago. Whose going to decide this? There are two different assessments. The supervisor of the ECB will be responsible for the assessment of whether a certain bank is viable or it is not viable. And then there will be

another authority which will decide what to do. They can decide to sell, merge, close, liquidate, resolve, different actions. Supposed it is not viable, in this process, as you said, first ordinary capital will be exhausted and then a series of creditors according to a pecking order which has been defined by the European Commission as a law. The rules of the ___ have been defined by the European level. Then at the end of this, and I insisted a lot in having a precise commitment by the national governments to have in place the, say national backstops of public money. Not with the idea that it is going to be necessary. Maybe it is not necessary but it is absolutely important to let markets and people know that in case it were necessary, it is there. It is also frankly, it says something about the... I would say the clarity of our exercise because people might think if there is no backstop money then the exercise would be more lenient in order to avoid, to use taxpayers' money. This commitment which is by the way enshrined in a solemn sentence by the European leaders is now sort of going down to a more operational level and very likely in the next few weeks we will have a precise statement about that. So who is going to decide whether to use public money in the end is the national government because the single resolution authority will not be in place very likely by the time we finish with this exercise. But the rules are I would say overall consistent because they have been fixed at the European level by legislation.

ROGER FERGUSON: Thank you very much. (Applause) So thank you Mario, thank you Bob and thank you John for that stimulating question and answer session. Before lunch is served I would like to remind you that we have two breakfasts next week, one October 15, you will hear

from Dr. Kim, Governor of the Bank of Korea and then on the 17th of October from Richard Fisher, the President of the Federal Reserve Bank of Dallas and we look forward to seeing you at both of those events. So now please enjoy your lunch and thank you again for coming today. Thank you very much.