The Economic Club of New York

450th Meeting
108th Year

The Honorable Mario Draghi
President of the European Central Bank

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Questioners: Lord Mervyn King
Former Governor of the Bank of England

Robert Hormats, Vice Chairman
Kissinger Associates

Introduction

Chairman William C. Dudley

Welcome everybody. This is the 450th meeting of the Economic Club of New York in our 108th year. I'm Bill Dudley. I'm the Chair of the Club and also President of the Federal Reserve Bank of New York. The Economic Club is the nation's leading nonpartisan forum for economic policy speeches. More than 1,000 guest speakers have appeared before the club over the last century and established a very strong tradition of excellence. I want to recognize and thank the 229 members of the Centennial Society. These club members make an extraordinary contribution to ensure the financial stability of the club into its second century and their names are in your program.

So today we welcome back as a speaker, Mario Draghi, President of the European Central Bank. He also chairs the Executive Board, the Governing and General Councils, and the European Systemic Risk Board. He's a member of the Board of Directors of the Bank for International Settlements. And Mario comes to us directly from Frankfurt where just yesterday the ECB Governing Council met and made considerable news with some important new policy initiatives.

Prior to his current role, Mario served as Governor of the Bank of Italy and as Chairman of the Financial Stability Forum, later the Financial Stability Board. Mario received his PhD in Economics from the Massachusetts Institute of Technology where he studied with Stan Fischer –

Stan's here today – who is Vice Chair of the Federal Reserve System. Prior to taking the helm at the Bank of Italy, Mario was Vice Chairman and Managing Director at Goldman Sachs International. That's when our paths first crossed and I've found him over the years to be just a wonderful colleague, a man with great insight and a pleasure to work with. Mario, the floor is yours. (Applause)

The Honorable Mario Draghi

President of European Central Bank

Well, it's a great pleasure to be with you. Dear President Dudley, dear Bill, thank you very much for the invitation to speak here today.

Over the past years, central banks across advanced economies have provided unprecedented support to our economies and the results are being felt. Output has been put back on an upward path. Growth is strengthening. The output gap is gradually closing, as is the case in the euro area, or in some cases it is closed already. Insofar as monetary policy is intended as a macroeconomic stabilization policy, it is succeeding.

But our mandate is not phrased in terms of real growth. It is phrased in terms of price stability. And there, success is not achieved yet. Inflation remains low everywhere, lower than our objective requires. And medium- to long-term inflation expectations have been less steady for

some time, and also generally lower than our objectives.

To some extent, this apparent disconnect between real and nominal developments is an expression of lags in the transmission process. But it also has triggered suggestions that perhaps central banks are unable to fully control the trend in inflation – either because they lack the appropriate tools, or because inflation in any one economy is driven to a large extent by global factors outside their control.

I would dispute entirely the notion that we are powerless to reach our objective. The evidence at our disposal shows, on the contrary, that the instruments we are currently deploying are having the effect intended. With this in mind, in my remarks this morning I would like to review both the nature of global factors affecting inflation dynamics today, and the developments in core inflation that are more determined by domestic factors.

Whether low inflation stems from one or the other, the central bank can act proactively to counter risks to price stability and maintain the anchoring of inflation expectations. In the euro area we have proven that our monetary policy tools work and, with the right calibration – and I will insist on this word – have sufficient traction over the economy to deliver our medium-term mandate. And this was reflected in the Governing Council's decision yesterday to expand our monetary policy stance.

Over the last decade there has been a growing interest in the concept of global inflation. This is

the notion that, in a globalized world, inflation is becoming less responsive to domestic economic conditions, and is instead increasingly determined by global factors. Looking at the drivers of inflation across advanced economies today, we do indeed see a strong global component in low inflation. Decomposing inflation for the average OECD country, it is clear that since mid-2014 there has been a notable decline in domestic shocks driving disinflation, and a notable increase in global shocks. Those global shocks are, however, overwhelmingly associated with oil and commodity price falls.

As is well-known, global factors linked to oil and commodities should not, in principle, have any effect on price stability over the medium term. They may have a lasting impact on the price level, but not on the rate of change of prices. All things being equal, lower prices for oil should, over time, lead to higher prices elsewhere as disposable income increases and overall demand from consumption and investment rises.

In light of this, central banks typically choose to “look through”, as we say, through such global forces until their effect on inflation fades out or until prices reverse. As oil and commodity price swings have opposing effects on output and inflation, monetary policy usually does not want to overreact and reinforce the effect on growth in either direction.

But falls in oil and commodity prices can have a more lasting impact in inflation – and hence become relevant for monetary policy – if they feed into core inflation. That can happen under

two circumstances. The first is if price falls are symptomatic of a weakening global demand, rather than a boost to global supply. Then, lower oil prices might be accompanied by declining net exports, which could in turn cause firms to cut back on investment and drag down core inflation. This blunts the growth-bolstering effect of lower commodity prices. Imported inflation might also be depressed as foreign producers cut prices in reaction to weakening global growth.

The second circumstance is if there is a succession of supply shocks that keep inflation low for a long period of time and cause firms and households to revise down their inflation expectations. In that situation, low oil and commodity prices can have second-round effects as lower expectations feed into wage bargaining and price setting, thereby affecting core inflation. Then, the effect of supply shocks becomes more similar to demand shocks.

In both cases, central banks end up facing a situation not of a benign supply shock, but rather of an adverse demand shock that, if left unaddressed, could derail price stability over the medium term. And that would call for a more forceful monetary policy response. Importantly, there were signs in the past that such circumstances were present in the euro area.

Estimating the relative contributions of supply and demand in oil and commodity price dynamics is always complex, but combining evidence from several different sources, both effects appear to have been at play. While supply shocks explain an important part of oil prices over the last year, adverse demand shocks have also increased driven by the slowdown at the global level.

In that context, we have also seen that, while the euro depreciation is contributing to higher import prices in euro, export price inflation in our main trading partners has remained depressed, contributing to weak producer price pressures. This, in turn, has weighed on the recovery of industrial goods inflation, which is sensitive to global inflation and makes up around a quarter of the consumption basket in the euro area.

At the same time, a succession of oil price shocks over recent years has led to a prolonged period of low inflation in the euro area which, at times, has been reflected in declines in measures of inflation expectations. Against that backdrop, we have seen a higher risk that a continued period of low inflation could start to have second-round effects and feed into core inflation.

In sum, while in general the forces driving global disinflation are ones that should not, over the medium term, affect central banks' ability to deliver their objectives, in the euro area the risks were higher that they might not wash out over time, and might instead feed into core inflation. For that reason, they became relevant to our monetary policy.

These global factors, however, have by no means been the only force driving disinflation in the euro area. If we decompose inflation in the euro area and in the United States, a striking difference is that, at least until the start of this year, domestic factors explain a much more important part of our disinflationary trend. This stronger role for domestic forces in the euro area

has contributed to core inflation diverging from other advanced economies. And in the case of the euro area, core inflation has hovered around 1% since early 2013.

The ECB's objective is headline inflation, and there are good reasons for this, not least to keep purchasing power stable. Headline inflation is also a good predictor, a better predictor of short-term inflation developments. But core inflation has to be taken into account because it's more closely linked to medium-term inflation trends. In fact, our staff analysis shows that core inflation is a better predictor of medium-term headline inflation than headline itself. So persistently low core inflation is another risk to our mandate.

So why have domestic factors affected inflation more in the euro area? The main reason is that, from 2011 onwards, the euro area experienced a sovereign debt crisis and a double-dip recession, while other advanced economies recovered. That led to a very prolonged downturn, which was associated with a decline in employment, depressed wage growth, and low business and consumer confidence. Disinflation in this period is well explained by the existence of a very wide output gap. The divergence in core inflation between the euro area and other advanced economies, in other words, is a story of domestic economic weakness.

This has particularly been reflected in weak services inflation, which is more strongly determined by the domestic economy and domestic wage pressures than other inflation components. And with services making up 44%, about 44%, of the consumption basket, that

obviously creates a strong drag on overall inflation. Services are also a very important input into manufacturing, and therefore, they spill over into the price of domestic industrial goods.

Now what about today? Well, if we look at the situation today, we do see some improvements as the economic recovery takes hold. As domestic demand strengthens, inflation has risen from its trough. In recent months, the share of items in the consumption basket with an inflation rate below 1% has fallen slightly, but crucially, the share with an inflation rate below 0% has fallen significantly. So we think that, thanks to our monetary policy actions, the risk of deflation in the euro area is firmly off the table.

Yet despite these positive signs, the trend in services inflation continues to be relatively weak. Whereas disinflationary pressures on industrial goods can be partly offset by the exchange rate, higher services inflation depends entirely on stronger wage growth. All measures of wage growth, however, are stuck well below their historical averages. And though the euro area unemployment rate is declining – down now almost 1.5 percentage points from its 2013 peak – a great deal of slack still remains in the labor market.

Indeed, if unemployment continues to decline at its current pace, it may take years before the euro area returns to its pre-crisis unemployment rates. And as we have seen in the UK and the US, even at that point, there may still be a substantial time lag before a tight labor market translates into higher wages. This suggests that, for core services inflation to rise over the

medium term, we will need to see a faster closing of the output gap in the euro area and a quicker return towards full employment.

So, putting the picture together, we've seen two factors that could endanger medium-term price stability in our area and warrant a monetary policy response. First, a global environment of volatile oil and commodity prices that could feed into expectations. Second, a domestic environment where persistent slack continues to constrain price pressures.

But as we've shown, even with interest rates at zero, we have an array of conventional and unconventional measures to deliver that response. Since the summer of last year, we cut our policy rates into negative territory, launched a credit easing package, began purchasing private and public sector securities under what we call the asset purchase program. And a large body of evidence has accrued in that time that our instruments are indeed powerful. And that evidence has allowed us to refine further our understanding of the amount of stimulus required to bring inflation back to 2% without undue delay.

For example, since we launched our credit easing package in June 2014, the composite lending rates – we have this index across the euro area – this composite lending rates index for firms has declined by more than 80 basis points for the euro area as a whole, and by about 140 basis points in the stressed economies. That is a formidable pass-through. Our estimates suggest that we would have needed to reduce – if we could reduce interest rates, we would have to reduce

interest rates by 100 basis points to achieve the same effect on bank lending rates.

So improving financing conditions have also fed into improving macroeconomic conditions. Our measures will add almost 1% to GDP between 2015 and 2017. And we are also seeing an effect on smaller firms that are typically harder for monetary policy to reach. In our most recent survey on smaller firms in the euro area, for instance, we saw for the first time since 2009 that the net percentage of small firms registering an improvement in business activity has turned positive, for all size subgroups.

Crucially, our measures are also gradually feeding through into inflation. Inflation would likely have been negative this year were it not for our measures. And according to our estimates, in the absence of our measures, it would be at least half of a percentage point lower and between 1/4 and 1/3 of a percentage point lower in 2017.

So, in assessing how to respond to the risks to price stability, the question we faced was not whether our tools worked – indeed, they are probably the dominant force spurring the recovery we see today. It was whether, in light of the evolution of those risks, the calibration of our policy was still sufficient.

And this is the question that the Governing Council addressed yesterday. On the real side of the economy, our assessment was that the recovery is ongoing and the economy remains resilient to

volatility in the global economy. Domestic demand is replacing foreign demand as the engine of growth, and our outlook for the coming years is broadly unchanged. On the nominal side, however, we perceived that the downside risks to the inflation outlook had increased, especially given the continued declines in oil prices and the large output gap – the two causes that I mentioned before. Without further monetary policy action, the date when inflation returns to our objective would once more have been pushed back.

The Governing Council therefore decided that, to secure the path of inflation back towards 2%, the calibration of our existing monetary policy measures needed to be adjusted. Specifically, we decided to lower the interest rate on the deposit facility by 10 basis points so that now it's -0.30% and to extend our asset purchase program. The monthly purchases of €60 billion under this program are now intended to run until the end of March 2017, rather than finishing in September 2016. Or even beyond, if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its aim of achieving inflation rates below, but close to 2% over the medium term. We will also reinvest the principal payments on the securities purchased under our program as they mature, for as long as necessary.

And this needs just two words to understand, to appreciate the importance of the overall re-calibration of our asset purchase program. One should consider that the extension of our net purchases to at least March 2017 and the decision to reinvest the principal payments on maturing securities for as long as necessary will add about €680 billion – some 6.5% of the euro area GDP

– in liquidity to the system by 2019, relative to the situation that would have prevailed under the previous policies, the policies which were enforced until the day before yesterday. This, of course, will strengthen our forward guidance on interest rates and ensure that liquidity will remain very supportive in the long term.

There was very broad support among the members of the Council for recalibrating our instruments to put inflation trends back on the path towards 2% that we envisaged when we launched our purchase program. There was also very broad agreement with the extent of the re-calibration, which was based on technical work carried out by the staff of the whole Euro system in our committees. The analysis we did before the inception of our asset purchases, and the evidence accumulated since, give us confidence that the additional measures announced yesterday provide material upward pressure on price dynamics to reach our objective as initially intended.

Arguably, the only difference between our current situation and a more traditional situation is that our monetary policy stance is not determined primarily on the basis of just one tool – namely interest rates – but on the basis of an array of tools, which include also the pace of asset purchases, and forward guidance on both interest rates and asset purchases.

But similar to the times when we steered policy primarily through interest rates, we are continuously monitoring economic and financing conditions, on which our policy action is

always conditional. If these developments change in directions that make it necessary to respond again, we are of course ready at any time to adjust this array of tools to secure the return of inflation to our objective without undue delay.

There is no particular limit to how we can deploy any of our tools. And in this context it is important to recall that we operate under a clear framework of monetary, what we call monetary dominance. We are ultimately driven by our mandate of maintaining price stability. Indeed, it is inevitable that unconventional policy settings, ranging from negative interest rates to purchase of a broad range of assets, can have unintended consequences on allocation and distribution. In the selection of our policy tools, we aim to minimize the extent of such distortions, which is why, for instance, we have so far focused our asset purchases as much as possible in the most liquid asset classes.

But there is no doubt that if we had to intensify the use of our instruments to ensure that we achieve our price stability mandate, we would. There cannot be any limit to how far we are willing to deploy our instruments, within our mandate, and to achieve our mandate. And indeed the European Court of Justice has stated that the ECB must be allowed “broad discretion” when it “prepares and implements an open market operations program.”

I can say therefore with confidence – and without any complacency – that we will secure the return of inflation to 2% without undue delay, because we are currently deploying tools that we

believe will achieve this, and because we can, in any case, deploy our tools further if that proves necessary. Thank you. (Applause)

QUESTION AND ANSWER PERIOD

CHAIRMAN WILLIAM C. DUDLEY: So we're going to take a minute to prepare the stage for questions from two members, Mervyn King, Lord King, Former Governor of the Bank of England, and Robert Hormats, now Vice Chairman of Kissinger Associates. So if you two could make your way to the stage, we'll get the stage set up and begin that conversation.

We'd like to begin the conversation. Lord King, if you could pose the first question to President Draghi.

LORD MERVYN KING: Ladies and gentlemen, if we could possibly start the session. I know that many of you will want to hear more from Mario. But let me first welcome you to New York, Mario. I know that for you it's literally a flying visit and everyone here is very grateful to you for coming. Just over three years ago, in London, you made that magic phrase, "We'll do whatever it takes, and believe me, it will be enough." And it had tremendous effects, a great success. Yesterday didn't seem to have quite the same effect. (Laughter)

THE HONORABLE MARIO DRAGHI: Well, it was not the same words.

LORD MERVYN KING: Why do you think the market reaction was presumably to move the exchange rate in a direction that you wouldn't have approved of? And are you concerned about that?

THE HONORABLE MARIO DRAGHI: Well, as I was saying before, they were not the same words. Let me just say how the whole, the whole story developed really. It started in the last Governing Council, so about a month and a half ago, and we made an assessment about; we decided to make an assessment of whether our monetary policy stance was adequate. And so we basically decided that by December we would decide what to do. And we did one thing, basically we asked all the economies of the 19 central banks in the euro area and the economies of the ECB, who actually meet in specific committees to reflect on this. The assessment was, first, that some things were actually improving, as I just said. On the real side, the recovery is continuing, though the levels of growth are still low. But it's continuing, it's gradually improving. It's driven mostly by consumption and the drivers of this recovery are our monetary policy, oil prices, and a certain stance of the fiscal policy which is between being neutral and mildly expansionary. However, on the inflation side, we still see a very subdued dynamics. The inflation projections that were delivered in December, yesterday, had a minor downward revision for 2016. But this is one of many downward revisions, one of a series of downward revisions. And these projections actually already contained the improvements in the markets until, say mid-October, mid-November, and so that was a factor. And right after the cutoff date of these projections, we also

had another data on inflation which was again slightly weaker than expected. So given this broad description of reality, what the committees did was to propose a package, a package of measures which is the one you've seen. This package was basically endorsed by the board and presented, proposed to the Governing Council. And the Governing Council approved this package with a very, very large majority. So basically there isn't any story behind it, as I've seen actually written in some places over the last two days. What this package says is what I mentioned during the speech, it was a re-calibration of our monetary stance, which incidentally is the word I used in a speech I gave just before the last Governing Council in Frankfurt. It was not a revolution. It was not a novel monetary policy change. So that is basically the story. And we consider the package that's been proposed by the committees as exactly the right one. It was clearly, as the markets have abundantly demonstrated, it was not a package that was meant to address market expectations. It was a package that was meant to address the reaching of our objectives of inflation. I think that is to be kept in mind. So the process was pretty robust. The approval process was, as I said before, a large majority of the Governing Council supported it. It was based on a board proposal. So again there were, if I may say, some of the commentaries I've seen in the last two days, dwelt on the presence of some dissenters, and what this could imply, as far as our future monetary policy is concerned. Like all central banks, we have some who dissent. But certainly, I mean I think if there is one who has shown that unanimity is not a constraint to our monetary policy decisions, it's me. (Laughter) So I would say the, I would say the bottom line of what I'm saying is QE is there to stay. And if needed, it could be re-calibrated, and like, by the way, any other of our instruments, like it happens to all monetary policies

everywhere in the world. So let me, in the end, say one particular thing about our main, what's becoming the main policy instrument today – namely our balance sheet. Often people ask what's the maximum expansion in your balance sheet. Well, the balance sheet of a central bank is a monetary policy instrument. As such, it should be utilized to the extent that it's necessary to achieve the objective that our mandate asks us to achieve – namely an inflation rate that is below but close to 2%. There isn't any specific limit in this, in using this. So as a conclusion, I think we have the power to act. We have the determination to act. We have the commitment to act.

LORD MERVYN KING: Thank you. Your words just now, and also in your speech this morning which, if I remember correctly, towards the end you said there can be no limit to the extent to which the balance sheet can be used to meet our mandate. That's the key thing – meeting the mandate. Was that deliberately designed to try to offset some of the reaction yesterday?

THE HONORABLE MARIO DRAGHI: The speech today? (Laughter) No, not really. Well, of course...(Laughter)....Let me say this. That's why I said not really, and of course, because it has two parts. And it's actually…it's a well-designed speech because it gives the whole thinking process before. I know I am a biased observer, of course, so take it for whatever it matters. But the first half is an explanation of why we react with our monetary policy to shocks that seem to have nothing to do with monetary policy, like oil price shocks for example. The second part, which is more closely linked to our recent decisions, of course, takes into account what we did

and it's been a fantastic opportunity for clarifying our objectives, our mandate, the process whereby we reach these decisions, and give to you here in New York City a sense of how the European Central Bank in Frankfurt, a far, distant place, actually works.

LORD MERVYN KING: It was an extremely clear speech and many central bank speeches are not clear. Yours today was admirably clear. But if one, I'm sure some of the older members of the audience will wonder why central banks today seem to be so concerned that inflation is so low. It's still positive, but it's very close to zero. Is there a risk that central banks are ignoring other aspects of what is happening in the economy and could this rebound? And then when inflation does start to pick up, we'll be back in the world that we grew up in, in which inflation was clearly too high and the role of central banks was continuously to try to bring it down?

THE HONORABLE MARIO DRAGHI: Well, you're actually asking three questions. The first is why do we have an objective of 2% or less, or close to 2%, and rather not say 1% and you know there are many, many reasons. This was basically accepted, it became conventional wisdom in the early, I think the late 90s after the Japanese experience. And so now it's been, by the way, incidentally it's never a good practice to downgrade your targets when you're not able to achieve the previous one. When we talk about credibility, I think that's a winning argument for not doing it, but there are also more serious arguments for not doing it. The second point is when you say aren't central banks ignoring some aspects of...that could, I mean if you kind of meant to ask this question, the answer to that is certainly our monetary policies cannot achieve

everything. And I'll be more specific. Monetary policies help to achieve a cyclical recovery, but to have, to transform this cyclical recovery into a long-term, sustainable structural recovery one needs, countries need many more actions by the governments. First and foremost, these famous structural reforms. And each country, of course, has its own list. Let's not forget, when we talk about unemployment, and now we know that in the euro area the unemployment level is very high, but even before the crisis, it was high. It was 9% in 2009. So it means that there are some structural causes to the unemployment rate that we have in Europe. It's not only a cyclical factor. We certainly have to address that, but there must be other actions by the governments to address that. The same thing with competition in the service sector, in the product sector. So the agenda of structural reforms is fundamental to achieve a full objective. Now, your third question was, now I forgot...

LORD MERVYN KING: What is puzzling, in a way, is that we're in a world that's so different from before in which we are trying to keep inflation up, push inflation up, rather than the battle we had before which was to push inflation down. Is there a risk...?

THE HONORABLE MARIO DRAGHI: Oh, yes, oh, yes, right, your third question is like those sorts of magicians that they play with strange formulas and all of a sudden there is something that comes out of bottle, a genie, and then you never put it back. First of all, frankly if you ask this question now, my first answer would be it's a high class problem. So we are so distant from that world now. Second, we have, we have all the instruments to address this problem. For

example, the decision we've taken yesterday about the repurchase, about repurchasing bonds that come to maturing so that rather than maturing them and draining liquidity from the market, they will stay on our balance sheet for quite a long time, being long-term bonds, was actually meant to avoid a fall in liquidity that would happen. And there are very powerful factors in the euro area that would actually cause this fall in liquidity even without our policy action. So we have to counter them to make sure the liquidity condition will stay quite ample for a long time. So even, I mean if we were to experience inflationary pressures as we would have called them in the 70s, we would – one, the first thing we would do is simply let things go without addressing them. But we have also plenty of instruments to do that, to drain this liquidity.

ROBERT HORMATS: Mario, first of all, thank you for a terrific speech which really does clarify to an American audience some of the thoughts that went into your decisions of yesterday. I'd like to ask you to elaborate on a theme you touched on and you've discussed in many speeches previously, and that is these structural reforms. It seems to me that one of the difficulties that markets tend to have these days is an over-reliance on what central banks do or what they expect them to do with very little emphasis on what governments are not doing, that they should be doing in order to deal with these structural problems – the unemployment problem obviously is one. Improving the competitive environment which is, of course, a big EU issue. I wonder if you could take a few moments and comment to a greater extent on some of these fundamental changes or if there's a risk that over-reliance on central bank policy in itself will give policymakers in capitals or in Brussels a way of avoiding some of these more important

structural issues because they simply say, let the central banks do it, and we don't really have to take the tough political decisions that are needed.

THE HONORABLE MARIO DRAGHI: Well, first, we've experienced in the last, during the crisis time actually, that the effectiveness of our monetary policy was seriously hampered by the lack of certain structural reforms. Let me mention one of them – the state of health of the banking system. Banks were giving very generous liquidity lines at the beginning of 2012, what we call LTROs, Long-Term Refinancing Operations – namely €1 trillion was extended with a maturity of three years and very favorable interest rate conditions at that time. And it was a good decision. It was important because it avoided massive bank failures which were possible at that time. But we frankly would have expected much more transmission of all this money into actual credit to the real economy, and we've seen very little. We've seen very little for the reason that these banks were unhealthy. And so we needed what was actually a very important structural reform – namely completely overhaul the supervisory system in the euro area and we did it creating one single supervisor located in Frankfurt and, therefore, independent from national vested interests, and basically revisiting deeply many of the sort of rules and procedures used in carrying out this supervision. And the amount of capital that the euro area banks raised as a response to this, I can't remember the number but it was very significant. But even more significant was that after that, credit recovered, and is still recovering now. So that is one structural reform that actually improved the transmission of our monetary policy. Without that, there was no transmission. So we lowered interest rates. There was no lower lending rate. That is

one example. Another example is when you don't have, when you have a system of, sort of taxation that is too high and not well designed. Just put yourself in the shoes of a very young entrepreneur, and for him, his credit will be freely available, but it takes nine months for him to get a permit to start his new business. And as soon as he gets the permit, he has to pay high tax. So he has no incentive to go to the bank and borrow money. That's another example of lacking of structural reforms that would hamper the transmission of our monetary policy to the real economy. And our example is if the judiciary system of a country doesn't work, and it takes, say eight years on average to repossess a collateral given by a debtor, to a bank it's quite clear that this both paralyzes the bank for all this time because it freezes capital and paralyzes the debtor which is unable to do anything else. So these are all examples, and then of course we go into the taxation regimes especially. I think this is a key issue in Europe because, you know, in many countries in Europe the level of government expansion and taxation is way above 50%. So we often speak about growth-friendly fiscal consolidation. That means basically we are in favor of lower budget deficit, but not in the way that it was actually achieved during the crisis by some governments that, pressed by markets to consolidate their budget deficits, they simply raised taxes like crazy. And that, of course, worsened the recession in which these economies were. And in some cases actually increased the deficit. So that's one response. The second part of your question is, isn't the fact that easy money with low interest rates removes the incentive that governments might have in undertaking structural reforms. This is an argument that I heard many times in one country of the euro zone which particularly dislikes low interest rates and easy money. (Laughter) Now, I mean I don't agree with this. I think that the level of interest

rates in the financial markets don't have any strong relationship; don't carry any strong relationship, with the willingness by the governments to undertake structural reforms. First, when we talk about structural reforms we often talk about labor market reforms, judiciary, education, healthcare, change the political system, the electoral system. Do you think that any of these five things are really linked to interest rates? That governments really think, well, maybe tomorrow I start changing my judiciary because the interest rates are too high? I think they have no relationship. Second, when by chance governments actually have reacted to the pressure of financial markets – and they did in 2012, 2011, '12, '13 – they didn't do structural reforms. They actually increased taxes like crazy, as I was saying before. And they forgot completely about doing structural reforms that need social consensus. That is the key thing. Third, factual evidence shows that the labor market reforms that have taken place in Spain and in Italy actually took place way after interest rates had been low for quite a time. So there isn't any obvious relationship between the two.

ROBERT HORMATS: Could I ask you to probe a little bit on the exchange rate issue? Because you made a very interesting point in your speech that as a result of the actions that the ECB has taken, a lot of the improvement in economic activity in Europe has been domestic. The question then is to what degree the exchange rate movement has had a positive effect? In addition to the additional improvements in the domestic environment, how do you assess the exchange rate environment in terms of its ability to boost both inflation and growth in Europe? And if that environment were to change, how would that change the environment for making monetary

policy?

THE HONORABLE MARIO DRAGHI: Well, you know, a standard sentence that I always say is that the exchange rate is not a policy target, but it's important for growth and price stability. So we view the exchange – when we decide our monetary policy, we don't have in mind the exchange rate level. But the exchange rate is a vehicle of transmission to the price level of our monetary policy decisions, so to this extent, it is important. But ultimately, and by the way right now you know, and we've discussed, we know that we are on a divergent monetary policy path and this certainly has consequence on the exchange rate as well as we were in the same divergent monetary policy path in 2011 and 2012 and that had opposite effects on the exchange rate. But these two episodes, two examples, show that the major monetary policy jurisdictions, since they're also bound by their national mandate, don't look so much at the exchange rate, but at internal price, or in the case of the Fed, also the full employment situation. So that's the way we will work on that, look at that.

CHAIRMAN WILLIAM C. DUDLEY: I think we're going to have to leave it there. Thank you Bob. Thank you Mervyn. And thank you Mario for a very clear, candid, and thoughtful – you set a very high bar for us central bankers in terms of communications – well done. Thank you. (Applause) I want to wish everyone a great holiday season. We'll be back; the Economic Club of New York will be back in January with two member events. And Chair Janet Yellen will be coming to speak to us in the spring. So enjoy your lunch. Thank you. (Applause)