THE BROOKINGS INSTITUTION

THE ECB AND THE EUROZONE:
A CONVERSATION WITH MARIO DRAGHI

Washington, D.C.

Thursday, October 9, 2014

PARTICIPANTS:

Welcome and Moderator:

DAVID WESSEL
Director, The Hutchins Center on Fiscal and Monetary Policy
Senior Fellow, Economic Studies
The Brookings Institution

Keynote Address:

MARIO DRAGHI
President
European Central Bank

Discussion:

STANLEY FISCHER
Vice Chairman of the Board of Governors
The Federal Reserve

MARIO DRAGHI
President
European Central Bank

DAVID WESSEL
Director, The Hutchins Center on Fiscal and Monetary Policy
Senior Fellow, Economic Studies
The Brookings Institution

* * * * *

P R O C E E D I N G S

MR. WESSEL: Good morning. I'm David Wessel. I'm the director of the Hutchins Center on Fiscal and Monetary Policy here at Brookings. We're a new enterprise devoted to improving the quality of fiscal and monetary policy and public understanding of it.

We had hoped that Ben Bernanke would be standing here, but, unfortunately, he's testifying this morning in Hank Greenberg's suit against the federal government in the Federal Court of Claims, so we can add one more thing to the very long list of things that we can blame on AIG. (Laughter)

We at Brookings are pleased to welcome Mario Draghi back to Brookings, where he was a trustee from 2003 until he became governor of the Bank of Italy in 2006. Mr. Draghi, of course, has been the president of the European Central Bank since November 2011.

Now, a lot of people say that Janet Yellen has a tough job, and she does, but Mario Draghi has a tougher one. He's making monetary policy for 18, soon to be 19 sovereign economies, each with its own fiscal policies, and some with, shall we say, extremely strong views about monetary policy. The Eurozone has and 11-1/2 percent unemployment rate and an inflation rate of just 0.3 percent over the last 12 months. The IMF this week put the odds of a Eurozone recession over the next year at 40 percent and the odds of deflation occurring at 30 percent.

But Mario Draghi is particularly well prepared for this. One chapter of the dissertation that he wrote at MIT 35 years ago discussed, and I'm quoting here: "The trade-off between policies that are optimal in the short run, but not in the long run and vice versa." And I suspect he's been cribbing from that thesis in his press conferences ever since.

Now, central bankers have always had a lot of power -- the power to move interest rates, to print money -- but the past few years have revealed to us the power of their words. And Mario Draghi offered us the clearest example, I think, in 2012, in July in London, where he defused an intensifying crisis of confidence in the Eurozone with two sentences. He said, "Within our mandate the ECB is ready to do whatever it takes to preserve the euro, and believe me, it will be enough," at which point the markets celebrated.

So I think that may prove to be the most successful central bank verbal intervention in history, but it taught us all that it's always wise to listen when Mario Draghi speaks, which we will now do. Mr. Draghi? (Applause)

MR. DRAGHI: Well, Dave, thank you for your kind words. Thanks for having me here. Brookings was always a place that I cherished being and enjoyed being a trustee, I enjoyed it very much. I miss it a lot now. And also thanks for having me here where I see friends of a lifetime, colleagues, and people I've shared continue sharing views on economics and other matters, so I have several reasons for being grateful for this invitation.

Ladies and gentlemen, as I was preparing these comments, I happened to reread John Maynard Keynes' open letter to President Franklin Delano Roosevelt, published in *The New York Times* in December 1933. And for those of you who have not read it, I strongly suggest reading it, it is a beautiful letter.

In it Keynes tells President Roosevelt that the administration is engaged simultaneously in recovery and reform and identifies a tension between the two. He worries especially about the risk that over-hasty reform impedes recovery. There are some parallels here for Europe, we are also engaged in reform and recovery, but in fact we face the opposite concern to that expressed by Keynes. Without reform, there can be no recovery.

In saying this I'm, of course, well aware of the argument that the reform is better achieved in good times. I do not however find this argument particularly compelling. First of all, too often has reform been postponed in bad times on that basis and then forgotten in good times.

Second, I'm uncertain there will be very good times ahead if we don't reform now. This is because the problems that we face in Europe are not just cyclical, but structural. Potential growth is too low to lift our economies out of high unemployment. It's also too low to allow us to overcome quickly the debt burden left from this crisis, and the period that preceded it. Thus, while stabilization policies that raise outward to us potential are necessary -- I'm not saying that they're not, but they're not enough.

We need to urgently raise that potential and that means reform. The third reason I'm skeptical that reform should wait for better times is the results we have achieved already. Europe has, in fact, been in the reform process for several years as many parts of our economy were broken during the crisis and needed to be repaired. We've taken many successful initiatives during what were, by any standards, bad times. And in several countries the first fruits of that endeavor are now becoming visible.

What I would like to do today is to sketch out for you how structural reforms and other policy initiatives fit together to form a coherent strategy. What has been done so far to stabilize the euro area and what still needs to be done to achieve a sustained recovery.

Recovery strategy began with repairing money whose integrity had been challenged at the peak of the euro area crisis. The integrity of money means not only that money keeps its value over time, i.e., price stability. It also means that money is fungible across countries and across space. In this period, however, money, monetary and financial assets, government and corporate bonds, insurance products, and the reserve assets backing them and, above all, bank deposits stopped being freely exchangeable across the whole euro area.

In certain countries they became exchangeable almost exclusively within national borders. What was driving this process was the fear that assets held in the most fragile countries could be redenominated into currencies other than the euro. As is well known, that fear was shown to be unfounded when the ECB launched its OMT program, which successfully removed this threat to our monetary union. But this episode, nonetheless, caused significant damage to both the real and financial economy in the euro area.

It exposed the fragility of a system where the credit worthiness of sovereigns was the ultimate guarantor of national banking systems. This is where the European Banking Union came in. Banking Union means three things. It means a single supervisory framework that applies the same rules across the euro area. It means a single resolution framework, so that if a bank does still fail, it can be resolved in the same way everywhere, irrespective of the fiscal strength of its government.

And it means a system of deposit protection that provides depositors with equal confidence that their deposits are safe, regardless of the jurisdiction. We are now well advanced in creating such a system. The single supervisory mechanism will begin operating in November, I mean this November. A single resolution mechanism and fund will begin in 2016, and a harmonized approach to the level and funding of deposit guarantee schemes across the euro area has been agreed as the first step towards a single deposit guarantee scheme.

Different from the U.S., 80 percent of financial intermediation in Europe takes place through the banks, making bank lending essential for SME financing, for the transmission of our monetary policy, and for the allocation of resources in the wider economy. But the design of banking union alone, as ambitious as it is, will not be enough to repair the bank lending channel. Bank lending has also been held back by a wider process. The ongoing leveraging of the banking sector that is an unavoidable consequence of the previous credit bubble.

Policy cannot influence much the scale of that deleveraging, but it can influence its form, namely that it happens in a way where banks quickly disposed of unwanted assets and raised equity, thus moving into a position to again supply credit normally. In this context it was crucial that when the new European supervisor was agreed, it was also agreed to have an entrance exam before its introduction. A comprehensive assessment of banks state of health carried out by the ECB.

This was crucial not only because it would bolster confidence in the euro area banking sector, but also because the positive response it has elicited from banks and supervisors. Since the summer of 2013, when it was announced that the SSM, the Single Supervisory Mechanism, would be created, the banks that will fall under our direct supervision have strengthened their balance sheets by almost 200+ billion euros. This includes about 60 billion of gross equity issuance, 32 billion issuance of (inaudible), 26 billion of retained earnings, and then you have about 20 of asset sales, and about 21 of items, and 50 billion of other measures, so it's a quite significant strengthening of their balance sheets.

But a cleaned up banking sector will also be a smaller banking sector. And while we are seeing a corresponding large rise in corporate bond issuance, it is funding mostly large corporates and not SMEs, which account for two-thirds of private sector employment. We are, therefore, to avoid a situation where smaller firms face obstacles to excessive finance, our policies to repair the banking sector have to be accompanied by policies to develop capital markets.

That agenda is now being taken up in Europe. It was in part to support a more diversified financing mix that ECB argued early on in favor or redeveloping markets for Asset Based Securities, ABS, which provide a way for smaller, bank dependent firms and households to access finance from known bank investors. Together with the Bank of England we have been and remain closely involved in the work to promote a better functioning securitization market.

Looking further ahead, I'm pleased that the incoming president of the European Commission has proposed to build a genuine capital markets union in Europe, which would do for capital markets what the banking union will do for banks. As it will take time to develop a European capital market, in the meantime we have to operate in a financial system where, whether we like it or not, banks are dominant.

As such, the deleveraging of the banking sector has naturally effected our policy. In several countries where banks have been lowering their loan to deposit ratios and rebuilding their capital, they have not been in a position to pass on our low interest rates to their customers. Our monetary policy has, therefore, operated on two fronts.

On one side, engineering and appropriately expansionary stance in conditions of low inflation and substantial slack in the economy. On the other, repairing the transmission process of monetary policy so that this stance actually reaches firms and households.

On both fronts we have acted aggressively. We've progressively cut rates, going even into the negative territory so that they are now at a lower band and introduce forward guidance that rates will stay low for long. And we've facilitated the pass-through of these rates by banks, to widening the pool of eligible collateral they can use for our operations, extending the maturity of our loans up to three years, and intervening in the malfunctioning market segments.

Now, as the banking sector is progressively cleaned up and the leveraging process reaches its conclusion, banks will have new balance sheet capacity to lend and our monetary policy will become even more effective. And I expect credit to pick up soon, next year.

In this context the ECB has recently launched a series of measures to make its stance more expansionary and add more stimulus to the euro area economy. Most important here is our new package of credit easy measures. This package includes the so-called Targeted Long-Term Refinancing Operations, otherwise called TLTRO, which have a built in incentive mechanism to encourage loans to firms and it includes new programs to purchase outright high quality ABS and cover bonds, which will provide market incentives for banks to originate more saleable securities and, thus, more loans to collateralize them.

These measures also fulfill a broader objective. They allow us to continue to steer policy while interest rates are at a lower bound. They help us steer expectations about the future path of interests rates by underpinning our forward guidance. And with our asset purchase program -- this is a pretty important point -- we are transitioning from a monetary policy framework predominately founded on passive provision of central bank credit to a more active and controlled management of our balance sheet. We expect our measures to have a sizeable impact on our balance sheet and, ultimately, through their impact on all channels of monetary transmission, on inflation.

Let me be clear on this. We are accountable to the European people for delivering price stability, which today means lifting inflation from its excessively low level, and we will do exactly that. The governing council has repeated many times, even as it was adopting new measures it is unanimous in its commitment to take additional unconventional measures to address the risks of a too prolonged period of low inflation.

This means that we are ready to alter the size and the composition of our unconventional interventions and, therefore, of our balance sheet, as required. But alongside monetary policy, fiscal policy is needed as well, but for fiscal policy to be able to perform its stabilization role, governments must have fiscal space and the sustainability of public finances must be unquestioned.

During the crisis, those two conditions were no longer met. Reactivating fiscal policy has therefore had to be achieved in stages. First and foremost was repairing confidence in public finances, both through committed structure of fiscal consolidation and through strengthening the institutional framework for fiscal governance. Much has been achieved in this respect. Governments have consolidated budgets, they have established medium-term credibility by strengthening the fiscal rules and this has been one driver of their falling borrowing cost. One driver.

So, to now call into question not just the letter, but also the spirit of fiscal governance framework would be self-defeating. If this were to again cast out over fiscal sustainability, it would create a risk that borrowing costs and enhance fiscal policies turn procyclical once more.

The whole point of fiscal governance framework is indeed to generate confidence and certainty not just in financial markets, but also among consumers, entrepreneurs, and -- which is very important in our monetary union -- between governments themselves.

Any perception that the spirit of this governance framework is being breeched effectively undermines the basic assumption behind our being together in a monetary union. That is to say, we can coordinate our policies in a way that generates confidence to our citizens. If confidence in public finance is assured, the next stage -- and that's where we are now -- is to exploit the available fiscal space so that fiscal policy can work with, rather than against, monetary policy in supporting aggregate demand.

The aggregate fiscal stance must be supportive of aggregate demand in the current cyclical position and this can and should be achieved within the existing rules. Against this background, for governments and European institutions that have fiscal space, then of course it makes sense to us it, especially for those without fiscal space, fiscal policy can still support demand by altering the composition of the budget, in particular by simultaneously cutting distortionary taxes -- let's not forget that this is a part of the world where the taxes are the highest -- in particular by simultaneously cutting distortionary taxes and unproductive expenditure.

And for all there is the option to regenerate fiscal space, not just by tightening the budget, but by expanding their source of revenue. Higher potential output raises future government revenues and, if credible, can restore some margin for maneuvering.

This is where structural reform should enter the picture, and such reform would not only enable fiscal policy, but also make monetary policy more effective by allowing the private sector to take advantage of the conditions created by it. I said several times that we can produce the easiest credit conditions, but if some young entrepreneur needs nine months or one year before he can get a permit to open a new shop, he certainly won't apply for credit. And once he opens a new shop, he's been overburdened by taxation. He certainly sees no advantage, no benefit from having this credit.

What I'm saying in short is that all our efforts to support aggregate demand would be more effective if accompanied by policies to boost aggregate supply. And this brings me back to where I started, to the need to raise potential growth. Put simply, I cannot see any way out of this crisis unless we create more confidence in the future potential of our economies. Demand-side policies can play a part in this by forestalling the so-called (inaudible), a situation where workers are unemployed for too long and lose their skills. The quicker we can return the economy to potential, the less potential we lose.

But such policies cannot alone provide the jolt to medium-term growth prospects that necessary for a self-sustaining recovery, which is a recovery based on private sector investment. For investment to grow sustainably over the median term, the right fundamental conditions need to be in place. Namely, a rising workforce and a rising productivity. For many European countries there is scope to increase labor participation rates over time, but given demographic trends, raising structural growth will have to take place primarily through productivity.

Governments in the euro area know well what they need to do to achieve this objective. They don’t need our advice, they simply need to implement their specific national structural reforms and the more vigorously they do this, the more credible an increase in growth potential will become, the more quickly business and consumer confidence will return to the euro area.

The European level also has a role to play in creating an environment that supports productivity growth. For example, there are few European companies that are world leaders in the digital economy. Completing the single market in all of its forms, digital, capital, services, would promote the financing of a number of these firms and create a business environment that encourages investment in the adoption of new technologies.

I've provided you with a description of the many ongoing reforms and policy steps that in combination will lift the European economy out of what has already been too long a crisis. The issue is not really whether policies to support demand should proceed or follow policies to support supply. Reform and recovery are not to be weighed against each other. The whole range of policies I've described aim simultaneously at raising output towards its potential and at raising this potential.

This combination of policies is complex, but it's not complicated. Each of the steps involved is well understood. The issue now is not diagnosis, it's delivery, it's commitment, and it's timing. I see you're looking at your watch, speaking of time. (Laughter)

I recently said of monetary policy that at the current juncture, the risks of doing too little, exceed the risks of doing too much. If we want a stronger and more inclusive recovery, the same applies to doing too little reform. Thanks. (Applause)

MR. WESSEL: Thank you very much for those remarks, Mr. Draghi. You've delivered as I knew you would a three part recipe for growth. I'm sure that I agree with you that it's not complicated, but it does seem at least coherent.

I'm very pleased to welcome to the stage Stanley Fischer, the vice chairman of the Federal Reserve, not only because of his decades of wisdom and experience -- I once referred to him in a column as venerable, but he called me and complained because he said it made him sound old (Laughter) -- but also because he was one of Mario Draghi's professors at MIT back in the 1970s. And although he wasn't on Mario Draghi's thesis committee, in the Acknowledgements Mr. Draghi singled out Stanley Fischer for what he called "constructive criticism and substantial suggestions." So we thought that by inviting Stan Fischer to join us today, he might continue this tradition of constructive criticism and substantial suggestions. (Laughter) So with that as your goal, Mr. Fischer, I'd like to start with you.

The classic case for a central bank independence is that if we let the politicians run monetary policy, they'll be shortsighted and we'll get more inflation later. But both in Europe and in the U.S. right now it seems to be the opposite, that the central banks are worried about too little inflation and they are running into political resistance -- perhaps more in Europe than here -- into pursuing their objectives.

So, I'm trying to figure out, what do you make of this? And to what extent are political constraints on central banks interfering with the goal, as Mr. Draghi put it, of delivering price stability which these day means more, rather than less, inflation?

MR. FISCHER: Well, thanks for inviting me, David. And I'd like to start by seconding David's proposed candidate for the most powerful sentence ever uttered by a central banker. He said two sentences. I thought it was comma, but you say period between those two statements.

I don't think anybody has ever changed the atmosphere of an entire continent in the way that Mario did and for as long as he did, as well. With regard to your question, the people who wrote on the independence of central banking grew up when inflation was the problem. I think of the models that we had then as being a way of analyzing the problem then.

The fundamental problem was the one that Mario's thesis chapter related to, how do you deal with policies in a democracy when the short-run and the long-run implications of the policies are different? And the short-run ones are easier to implement.

I think if we were doing it now we would be able to produce a very coherent model which would talk about the long-term impacts of not dealing with the recession because it's difficult and the longer-term benefits of actually getting on and dealing with it quickly -- and I think you could turn that model around to say that you have a non-political body in the middle to implement policies which are well understood to be more important -- to be significant for the long-run, with possible short-run controversial aspects or negative aspects, as the case may be.

So I don't see it as a huge contradiction that we now have to ask central banks to deal with the opposite situation than the one which was originally used at a formal level to develop a model of central bank independence.

MR. WESSEL: Do you feel constrained by the politics in executing the mandate of the European Central Bank?

MR. DRAGHI: Before I answer this question, let me say one thing about this repeated reference to my dissertation. I'm kind of surprised because when I wrote that stuff I was pretty clear, quite convinced that it would have nothing to do with reality. (Laughter) That's something I just wanted to say.

MR. FISCHER: That's why I had to quote it out of context. (Laughter)

MR. DRAGHI: No, no, I would say this also on behalf of my colleagues at the governing council, we are there in our personal independent capacity and if I have to see and go back to my personal experience, as president before, as a member of the governing council, I would say that politics has not been a constraint on our decision making.

Certainly we come from different parts of Europe and our information set, when we decide our policies, contains the realities where we live and therefore inspires different, I would say, backgrounds and different views about policy making. But I can't really find a single, individual instances of members of the governing council that say what they say because they have their national interests in mind.

And, all in all, I think the ECB has been quite successful at basically shielding itself from the politicians all over Europe. In this sense, to work in a 18, soon 19, member council is an advantage, with respect to working with one country only because you have 18 different governments that can shout at you. (Laughter) So it's less --

MR. WESSEL: It's easier to ignore one of them, is that the point?

MR. DRAGHI: A little more sparse, exactly. Perhaps it's the only benefit, but -- (Laughter)

MR. WESSEL: Mr. Draghi, you referred to the ECB's balance sheet in your remarks and the ECB's balance was close to 3 trillion euros at one point, and now it's closer to 2 trillion euros, and you've talked about why you want to increase it, but I wonder if you could explain what is the importance of the size of the balance sheet at a time when you're at the zero lower bound? And what exactly do you mean when you say that there's some sea change here between passive provision of credit and a more active and controlled management of the balance sheet?

MR. DRAGHI: Well, let me say briefly this one thing. Our mandate, our objective, is price stability, which in our definition means bringing back the inflation rate to below, but close to 2 percent. And, in a sense, the corollary of this is to be able to have our monetary policy transmission channels repaired so that our monetary policy is transmitted and achieves this objective.

When a central bank reaches its lower bound, the only instrument that it's left with is the size of the balance sheet, the size and, perhaps to a lesser extent, the composition of the balance sheet and that's why we now are in that area. But given our institutional set-up, the size of our balance sheet is mostly determined by our lending to the banking system against collateral. In this sense, one could say that the size is passively determined from our side, at least from out viewpoint, by the demand from the banks and, ultimately, by the economy to which the banks give credit.

So, what we've been doing purchasing ABS now is to gradually move it into a more active control of the size of our balance sheet, and that's what I meant in that sense. Sometimes, when we talk about size of balance sheet, they are used to the Fed. The Fed came out with almost precise figures in several stages, basically, but they were precise figures.

Now this effort is a little more difficult for us now precisely because a good chunk of our balance sheet is still passively determined and so that's why I could only give ballpark figures. But, also, I always add what I actually said in the speech, that if this were not enough, we are ready to move even further into an active -- even more active control of our balance sheet size.

MR. WESSEL: Mr. Fischer, what lessons do you think Europe should learn from the experiments with quantitative easing here and in Japan?

MR. FISCHER: Well, I think the European Central Bank, at least, has learned the main lesson, which is that monetary policy lives even when you're at the zero lower bound and it's been pretty effective, in fact, and that's what the research results show and it's also, I think, what the evidence of our eyes show. It's not exactly derived from what central banks have been doing, but the fact that fiscal policy also matters, particular in recessions, which we learn each crisis. When we're in the middle we invent theories of why it doesn't matter and then a crisis comes along and you discover that it does matter again.

That was a point that Mario emphasized and I'm not sure if I'm allowed to pose a question, but I will. Mario, the emphasis on fiscal policy is undoubtedly correct, but you've had examples in which European governments really not only didn't cooperate, they went the exact opposite way, and I'm thinking of course of the fact that

France and Germany both violated the terms of the Maastricht Treaty a decade ago when it came to their policies versus sticking by Maastricht, they went with their policies.

What is it now that makes you hope that this time will be different? And I'll add a footnote question, why didn't you talk about infrastructure as one of the critical things that should be -- I know you only had X words, but --

MR. DRAGHI: Well, to the second point, in a sense, I hinted at that when I said that productive investment, investment that could raise the potential output is needed. And so that is -- infrastructure phase is one way of doing it. Often we think about infrastructure as bridges and roads, but in Europe, probably, it's something else that's needed. It's digital investments in the digital economy and, in some countries, education is also important because it's not by chance that if you -- a small digression: The countries that have the highest percentage of youth unemployment are countries that have in common two features.

One is that they have in place a legal system that strongly discriminates against young people, against the new entrants in a variety of ways. And the second thing they have in common is that they rank among the last, as far as the performance of their educational systems are concerned, in the OECD ranks. So that is infrastructure investment, as well, to some extent so that's important.

I would add one thing, if I can, about what we learned from the experience in U.S. and Japan as far as QE goes. I must say, we learned several things, one thing we learned for example is that when you reach the lower bound, the yield curve tends to steepen, so long-time interest rates go up and that's why the Fed originally did QE on the long-term maturities to lower interest rates.

Now, in our case, without QE, we lowered the interest rate on the deposit facility in the negative territory and that caused the long-term rates to go down so, in a sense, we got the same effects without QE. But we learned many other things from the experience, especially in Japan. First of all, QE is not effective unless you have a well defined deflation objective, and that's very important.

Second point is, QE is effective mostly if, like the Fed did, it's concentrated on those activities that are closer to the credit easing component of the financial assets. And the Fed bought a residential mortgage-backed securities and we start buying now the ABS. These two things.

And the third important thing, again going back to the Japanese experience, is that the health of the banking system is crucial, though without that QE would not be effective. Any monetary policy, actually, would not be effective.

MR. WESSEL: Those are good answers, but to the question that Stan asked you.

MR. DRAGHI: Stan asked -- oh, I'm sorry. Can you say it again?

MR. FISCHER: The question was, in essence, are the European governments -- have they learned enough to now want to use --

MR. DRAGHI: Oh, yeah.

MR. FISCHER: -- fiscal policy as you suggested?

MR. DRAGHI: Well, it's a very difficult question because you're really asking me to say what I think of what they think. (Laughter)

Let me try to answer in a different way. A lot is being said about what are the incentives that policy makers, governments, have in their policy making? And often our monetary policy, at least in some parts of the euro area is judged to have lessened, decreased, incentives to governments to act.

It seems to me that now all of these governments have a very powerful incentive to do the right things. And that is, if they don't do the right things, they will disappear forever from the political scene because they will not be reelected. When you have unemployment rates at 25 percent, when you have millions and millions of youth unemployed, that's the most powerful incentive to do the right things. So I'm, to some extent, more optimistic as far as their response capacity today then I would have been in 2002 when the situation was much less critical.

MR. WESSEL: So one way of describing the recipe that you laid out is to use Prime Minister Abe view of three arrows. So there's the monetary arrow, there's the fiscal arrow, and there's structural reform.

MR. DRAGHI: Yes.

MR. WESSEL: I want to ask you about the first and the second. On the second, so you said it's important that the fiscal stance be supportive of aggregate demand in the current cyclical situation, is it?

MR. DRAGHI: We judge it to be, by and large, neutral now. The euro area countries went through a wide, front-loaded fiscal consolidation starting in 2010, which became front-loaded because of the confidence crisis, because of the change in the risk structure that followed the sovereign debt crisis. When for the first time it was accepted that sovereigns could fail, that changed completely the risk structure and forced these countries to go through a very painful front-loaded fiscal consolidation.

Now a lot of this has been achieved now and the sense is that, by and large, it's neutral. In other words, we don't see much head winds in the near future. It can be done more -- more can be done.

MR. WESSEL: Right. Mr. Fischer, is neutral the right fiscal stance for Europe now?

MR. FISCHER: Well, what Mario says is much better than what was there before, so that's clear. (Laughter)

MR. WESSEL: In the right direction.

MR. FISCHER: It's a move in the right direction and he made it clear in his speech that he hopes they'll move further and that would be, by and large -- not only by and large, that would be better.

MR. WESSEL: And on the monetary stance. I understand what you're saying when you say with a great deal of evidence that you've done a lot of things, negative rates, and LTROs and TLTROs, you're producing acronyms even faster than the Federal Reserve did during the crisis and that's a substantial accomplishment.

MR. FISCHER: Do you know how much each one cost? (Laughter)

MR. WESSEL: But in the end, as you point out, it's all about whether you're achieving you objective. So, given the inflation rate in Europe now, given the size of the output gap, given inflation expectations, do you worry about the risks that the ECB is just a little behind the curve? It was a lot, but it wasn't enough?

MR. DRAGHI: No, I think the various decisions that we've taken -- of course, I'm a biased observer in this, so take that for what it's worth. But I think the decisions that the ECB has taken have already had, but continue to have a powerful impact on our economies.

The key thing here is really to finish with this comprehensive assessment of our banking system. We've already seen signs that the credit flows are stabilizing. We are seeing signs that there are marginal improvements in the unemployment in the labor market, but we have not seen -- actually, on the other side we see signs that our modest recovery is losing momentum. And as far as our actions are concerned, I think we did a log. It will continue -- we'll continue doing it. We have to.

We know that the lags in monetary policy are long and variable, so we can only judge from the perspective of the medium-term assessment of our actions. And on that ground, we see inflation rate gradually rising to 2 percent by 2016 or 2017. But it's going to be a very gradual rise and the longer it takes, the bigger will be the risk.

MR. WESSEL: Stan took the liberty of asking you a question, do you want to return the favor?

MR. DRAGHI: No, thanks. (Laughter)

MR. WESSEL: Is there anything else you'd like to ask Mr. Draghi before I turn to the audience?

MR. FISCHER: No, I'd like to say one thing. We should look back at where we were and where Europe was, and the progress that has been made. A few years ago I think the common view in a room like this on this side of the Atlantic would be, the banking union isn't going work. They don't have the capacity, they'll never get it done, et cetera. It's coming into sight. There will be difficulties, it will be done.

At various stages people here were confident that the European Monetary Union would at least start losing members, if not collapse. It hasn't happened, they're gaining members. And what Europe is trying to do is undertake a very long-term project in a relatively short time. I think this process of creating a national economy took the United States 150 years. Well, the clock moves more rapidly these days, but they're still trying to do a whole lot of things together and they're doing better than most of us would have said at each stage, when they began the next stage. And I hope that continues to be true.

MR. WESSEL: Thank you.

MR. DRAGHI: Thank you.

MR. WESSEL: We will have time for a few questions and there's a mic here. Maybe I can start with Don Cohn over here? The mic isn't on, Don, so I'll repeat the question.

MR. COHN: (inaudible) saying more about its reaction function than how things might move forward. That would be a way, perhaps of effecting expectations without taking some of the negative aspects of putting stuff on your balance sheet?

MR. WESSEL: Before you respond, so the question's from Don Cohn of Brookings, a former vice chair of the Federal Reserve, and he asks, wasn't there more that the ECB could do with forward guidance. They've found this phrase "extended period," which I don't know where they got that from, and he suggested that maybe that would strengthen the monetary policy?

MR. DRAGHI: Yes, Don, you're right. I should have mentioned forward guidance. I should have said that the balance sheet size is the instrument only after we've exhausted the forward guidance potentials. We've discussed this quite extensively. Let me step back, the difference between our forward guidance and the Fed or the Bank of England's forward guidance is that we are qualitative. We don't have precise thresholds or precise horizons. It's qualitative.

We say that interest rates will stay at the present level or lower, and now we say it will stay at this level for a long period of time. We have several reasons for having done that and having rejected, in a sense, or chosen this route rather than the other one.

First of all, we are aware that it's harder to communicate at the beginning, but it's also easier to get out at the end. Second -- I use a kind of joke, we would say we are simpler folks. That's basically it.

No, but in our complex situation, simplicity has some benefits, but the point of fact is that basically, we got exactly the same results in terms of expectations as if we had the different forward guidance, much more nuanced and much more precise. We now have the lower long-term interest rates lower than in the U.S. We've flattened our yield curve, we see the only interest rates often negative, so all the spreads against different assets have shrunk enormously. And when we look at market expectations, the first hike in interest rate is foreseen by 2017, though it's basically -- at some point we discussed this, but then in the last -- we kind of stopped discussing it because we saw that we could get all of the benefits.

MR. WESSEL: Marty Felstine, next to you?

MR. FELSTINE: Thanks, Marty Feldstein, Harvard. Many of us in the United States worry about financial stability issues. The Fed has recently asked Stan to be responsible for a committee to deal with that. What about the ECB, is there concerns about that, given the abnormally low interest rates in Europe, and so on?

MR. DRAGHI: We certainly take these concerns very seriously and we recently had a discussion on this in the last meeting, if I remember, at the BIS in Basel. There are two components that are, in a sense, at the basis of financial risk. One is the risk premier and volatility, they are abnormally low, according to historical standards, and the other is leverage.

And we see the first, but we don't see the second so much, but I have to be quite careful here. We don't see leverage increasing in the banking system, as such. We know little about leverage increases outside the banking system and so as far as the regulated sector -- also, we shouldn't forget the actually much more powerful regulation of the banking system that is in place today.

So, for what we can see, we don't actually see a pervasive systemic financial stability risk coming up. There is a lot we don't see, at the same time. We have to say that. At the same time, we may have localized race in, for example, in some housing sectors in certain countries, but these are quite local, they're not systemic, and they should be tackled with the sort of local instruments.

SPEAKER: Mr. Fischer, how big are the risks you see in Europe and the U.S. to financial stability of this extended period of very low rates?

MR. FISCHER: Well, the main big fact that's mentioned about the risks of financial instability relates to high prices of assets. Actually, if interest rates are at zero, assets should have high prices, assets that earn income. So I think we're making a mistake by comparing things with what they were when interest rates were much higher. It does mean that when interest rates have gone up a lot, asset values could decline unless the structural measures that Mario's talked about have come into play by then.

The Fed has identified a few places where there's concern at present. The really bad financial crisis -- financial instabilities -- by and large, have occurred, more often than not, in the residential housing or in the housing and construction sector. We're very far from that at present. You can see a few places where there are some problems.

MR. WESSEL: Martin Wolf, right here.

MR. WOLFF: Martin Wolf, *the Financial Times*. I'm going to challenge you as follows, I'm going to argue -- or (inaudible) response, that Keynes, of course, was right. And it's just two components of this. On the structure reform mantra, first, I'd like your comment on what you think is going on in Germany. There's no doubt Germany has very substantial reforms. The labor market works extremely well, the transmission of the credit system is superb, interest rates are incredibly low, and the country's demand is really remarkably weak and inflation is also very close to 1 percent. So what's going on there? That would suggest that reform is not a necessary condition for recovery. Why isn't your policy working there?

And the second question, which is linked to that is, if you push it hard, when people talk structural reform in Europe, they basically mean labor market reform. And in countries -- you can respond to that --

MR. DRAGHI: Go ahead.

MR. WOLF: -- like your own, I would suggest that will massively increase consumer uncertainty because they all think, in addition to all the young workers who are not getting any jobs, all the old workers who do have a job think they're going to lose their jobs. That's not going to encourage them to consume. Keynes was right.

MR. DRAGHI: The first question, let me say what I read in the speech. Against this background for governments that have fiscal space, then of course it makes sense to use it. So, you decide to which country this sentence applies. (Laughter)

MR. WOLF: I wanted you to say it. (Laughter)

MR. WESSEL: We can arrange for flags to come on the screen here. (Laughter)

MR. DRAGHI: On the second question, no, I wouldn't agree. I wouldn't agree that in the present situation a more flexible labor market would actually cause massive firings of people. You know, the problem is that what happened in the early 2000s in some countries, including my own, was that in order to make the labor market more flexible the new contracts were made incredibly flexible, so that you could work with horizons which in Spain were as short as one month.

Imagine people working for five, six, seven years with one month contracts? The average land thing in Italy could have been a little longer, certainly. So that by itself produced an enormous amount of uncertainty and depressed demand by these young people. As the crisis struck, these were the people which were eliminated immediately.

So the reform of the labor market here consists in various parts and one of which is to make easier for companies to hire young people. Not necessarily, it makes it also easier to fire, but not much easier, not much easier. So I don't see that danger as far as Italy is concerned. Also because Italy has been in a recession so long now that if they want to fire, they did fire whatever -- so there's no obstacle to -- there's such a slack in the economy, and it's such a huge unemployment that whatever the companies want -- the employers want to do, they already did it.

MR. WESSEL: One more question. Steve Liesman?

MR. LEESMAN: Two questions, real quick. For the vice chairman, what effect does weakness in Europe and the strength of the dollar have on your outlook for monetary policy?

And for President Draghi, why is there no balance sheet target? Would a balance sheet target be an effective -- do you think you do not have a target because so much of your balance sheet is passive, you don't feel like you could hit it?

MR. WESSEL: Do you want to start, please?

MR. FISCHER: Yeah, sure. We make decisions on the basis of what we think is going to happen to the two variables in which we're interested. Inflation, which by law we have to deal with -- which is inflation and unemployment or employment. And we have to take into account the impact on aggregate demand of the factors that affect aggregate demand, and the exchange rate will, to some extent, effect aggregate demand. So that is the channel through which the exchange rate will affect our decisions. It won't be a separate factor. We'll be judging what's happening to their output and to inflation and acting on that basis.

And, by the way, there are some very good things happening in the balance of payments of the United States, much of it due to the change in our international energy balance. So I don't want to start estimating how much impact it will have. It is, as you noticed yesterday, something we talked about at the last meeting and I'm sure we'll talk about it at the next meeting and then we'll make our decisions on the basis of the two variables, which we have to focus on.

MR. WESSEL: Mr. Draghi?

MR. DRAGHI: Well, in a sense, your question is like a question about forward guidance. I said that at some point it will try to stir -- we expect to stir the budget, the balance sheet size, towards the size that it had at the beginning of 2012. That is a fairly vague statement and that's the ballpark of figures that we see today as roughly adequate to produce a certain effect on inflation.

But as you said, the way we're using to expand our balance sheets are still, to a great extent, passive-based. Namely, based on some other party's decisions. So to commit to a precise figure now means that we will be in control 100 percent of this size, which we are not. We are gradually moving towards that situation. And we're moving, we're doing the first steps and we'll continue moving.

But the key thing I think one should put more attention on -- not so much on the ultimate objective, but on the commitment that, if we were to realize, to assess that our action is not producing the effects that we want to produce, we will take further measures. And we will further move into a more active control of our balance sheet.

MR. WESSEL: With that, I want to thank Mario Draghi for spending time with us today and Stan Fischer for both answering and asking good questions.

MR. DRAGHI: Thank you.

MR. FISCHER: Thank you. (Applause)

* * * * *

CERTIFICATE OF NOTARY PUBLIC

I, Carleton J. Anderson, III do hereby certify that the forgoing electronic file when originally transmitted was reduced to text at my direction; that said transcript is a true record of the proceedings therein referenced; that I am neither counsel for, related to, nor employed by any of the parties to the action in which these proceedings were taken; and, furthermore, that I am neither a relative or employee of any attorney or counsel employed by the parties hereto, nor financially or otherwise interested in the outcome of this action.

Carleton J. Anderson, III

) Signature and Seal on File)

Notary Public in and for the Commonwealth of Virginia

Commission No. 351998

Expires: November 30, 2016