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Action on the addicts

FT interview Italy's Mario Draghi is aiming for a eurozone 'unpolluted' by banks hooked on emergency liquidity – but sees much remedial work as up to governments, write **Ralph Atkins, Lionel Barber** and **Tony Barber**

Mario Draghi has been here before. In the early 1990s, his native Italy was gripped by crisis. The public sector deficit had soared to more than 10 per cent of economic output, inflation was nearly in double digits too, and home-grown terrorism was still a threat. "It was a situation which was certainly worse than one could ever imagine today," he recalls.

Then director-general of Italy's Treasury, Mr Draghi helped implement a strict fiscal austerity plan drawn up by the government of Giuliano Amato, prime minister, which led to Europe's largest privatisation programme. A catastrophe was successfully averted.

Twenty years later, as governor of Banca d'Italia, the country's central bank, Mr Draghi's message is that – with the right approach, focused on bold action by national governments – the crisis afflicting the eurozone is surmountable too, in spite of its dazzling intensity. "The euro is not in question," he insists at the start of an interview with the Financial Times. "The euro is one of the pillars of European economic integration and all countries, all individual countries, have greatly benefited from that."

Mr Draghi's comments are important not just because he is an influential member of the European Central Bank's governing council. He also chairs the Financial Stability Board, a panel of global regulators charged with redrawing the rules of the financial system, and he is seen as a possible successor to Jean-Claude Trichet, whose term as ECB president expires next October. In a year's time, he could have one of the highest profiles in global economic policymaking.

In Europe, this year's crisis has exposed flaws in the workings of the continent's 16-country monetary union. The problems have been exacerbated by bickering and delays when it came to launching rescue mechanisms and bail-outs for countries such as Greece and Ireland, and by sloppy communication. Angela Merkel, Germany's chancellor, infuriated other eurozone policymakers by insisting on discussing how private investors could help pay for future European Union bail-outs – which only added to financial markets' nervousness. Borrowing costs for countries such as Ireland and Portugal have rocketed; investors have fretted about the financial stability of Spain – and even Italy.

$60bn

Italy's rough monthly need for debt financing in the early 1990s

But Mr Draghi echoes Mr Trichet's argument that, for the eurozone, "the aggregate fiscal position is actually sounder than in other parts of the world" and bond markets in general are functioning well. "What we are talking about are problems in individual countries – not the aggregate."

Even among policymakers at the ECB, which inherited the instincts of Germany's ultra-cautious Bundesbank, his position is conservative. Italy's central bank governor seems clear that solving the crisis in the long term will depend on addressing the core causes rather than on rescue mechanisms. Back in the early 1990s, he points out, Italy faced having to issue new debt or refinance debt worth $60bn or so a month – figures that dwarf the current financing needs of today's problem eurozone countries. "We did not go to the International Monetary Fund; there was no EU rescue mechanism."

Admittedly, Italy was boosted by the effects of a currency devaluation, which lifted exports. However, this only contributed in part. Flexible exchange rates also "make your [interest rate] spreads go up much more because you have to embody exchange rate uncertainty".

This week Giulio Tremonti, Italy's finance minister, and Jean-Claude Juncker, Luxembourg's prime minister, proposed another "mechanism" – the issuing of joint euro government bonds – as a way of resolving the present crisis. Mr Draghi suggests that not only does such an idea present legal problems but that it would also not solve the underlying causes of the crisis. "My personal experience has demonstrated that a country can go through a crisis without any help and make it." But, he adds: "It is hard to think of how a mechanism could correct basic structural misalignments, where there ought to be a national response."

When governments show sufficient resolve in putting public finances on a sustainable path, Mr Draghi argues, financial markets take note. "If communication is crisp, if policy action is firm and if the commitment is perceived as persistent, markets are certainly not going to be hostile to that."

Given his insistence that the initiative lies with governments, it is little surprise that Mr Draghi sees only a limited role for the ECB. Actions taken by the bank have become increasingly controversial this year, especially in Germany. In May, when the eurozone crisis was at its most intense, the ECB broke a taboo and intervened in government bond markets in an attempt to calm nerves. In recent days, it has stepped up such purchases, in spite of warnings by Axel Weber, Bundesbank president, that the blurring of monetary and fiscal policies risks undermining the ECB's credibility in the fight against inflation.

Mr Draghi says he is "very careful in stating the terms under which these purchases could be undertaken because I'm only too aware that we could easily cross the line and lose everything we have, lose independence, and basically violate the [European Union] treaty".

The ECB is not underwriting government borrowing. Instead it is correcting dysfunctional financial markets, says Mr Draghi. It is perhaps no coincidence – given he will need Berlin's backing if he is to succeed Mr Trichet – that Mr Draghi quotes Germany's Otmar Issing, the hawkish former ECB chief economist, as arguing that spreads between the interest rates on debt from eurozone governments should reflect their differing financial positions. Before the crisis investors made little distinction between the bonds of eurozone countries, effectively seeing little difference between, say, Germany and Greece.

That situation has changed dramatically. The problem is that "these

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repricing processes don't actually function in harmonious, well-ordered ways. You often have overshooting... It could happen that these excessive oscillations result in permanent damage unless they are countered."

Properly functioning bond markets are needed to ensure that ECB interest rate decisions are transmitted to the broader economy. Buying up government debt, as the bank is doing now, is not about providing cheap funding to governments. It is about keeping control of the mechanics of interest rate policy and ensuring that markets work properly. "When the ECB operates in these markets, it is not doing monetary financing - it is actually doing monetary policy," he says. But he emphasises: "What the ECB is doing is temporary and closely linked to the dysfunctionality of certain markets."

Using similar reasoning, Mr Draghi says the ECB must look at how it might deal with "addicted" banks - those institutions reliant on the unlimited liquidity the ECB has provided since the collapse of Lehman Brothers, the US investment bank, in September 2008. The number of "addicts" unable to obtain alternative funding is not clear, but data on ECB liquidity usage suggest they are a source of widespread concern at the bank's Frankfurt headquarters.

"Sooner or later", Mr Draghi explains, the ECB will want to return to the system of auctioning liquidity. The risk is that addicted banks will then send interest rates artificially higher because they will be desperate to obtain funds - again interfering with monetary policy. Analysts have suggested a possible two-tier ECB liquidity system, with special provisions for addicted banks. Without revealing details, Mr Draghi says that "concrete proposals" are being discussed. "We want to make absolutely sure that our monetary policy is not going to be polluted by the addicted banks' demand."

As FSB chairman - and previously a senior executive at Goldman Sachs, the US investment bank, from 2002 to 2005 - Mr Draghi has particular insights into the banking system. On the global level, he says, "we have to have a change in culture". This has started "but has to continue". In the past, there was a "severe misalignment of incentives" and a miscalculation of risks involved in credit products, with the people making the mistakes "paying themselves in an overly generous fashion".

But on the eurozone, throughout an hour-long discussion, his emphasis remains on government action. Mr Draghi hints that he would support a greater degree of fiscal union to complement the monetary union - but admits he does not know what would be possible.

"You start with a bunch of countries that share a common currency and think that everything else could stay the same," he says. "Then, they discover that it cannot stay the same and then establish rules and try to bind themselves into behaving uniformly through rules. Then, if they discover the rules are not enough, they have to decide how to strengthen policy co-ordination and possibly to introduce new rules to bind themselves in an even tighter fashion."

The EU is making "good progress" in this direction, he says, but the question about the bloc's ultimate destination is one to be decided by politicians, not by central bankers. "Would countries be willing to give up national sovereignty over their budgets? Would countries be ready to worry about other countries' problems, and tax their citizens to solve these problems?"

For now, the EU is still struggling to contain the financial crisis. Mr Draghi, however, remains cautiously upbeat. He draws inspiration from his Italian journey two decades ago and from Germany's experience following the launch of monetary union in 1999, which left the country with an overvalued exchange rate. "Germany's recent restructuring and its reaction to the crisis is a role model for a variety of reasons."

But given the intensity of the eurozone crisis, and the scale of fiscal and economic problems faced by countries such as Greece, is it reasonable to expect a German-style turnround that would shift sentiment in the financial markets?

Again Mr Draghi looks back to the turbulent times in the early 1990s. "In all these crises, the first time you look at them you see a financial profile which seems very difficult to cope with. People focus their attention on deadlines, spreads, interest rates and all this. I think the reality shows that if you give enough time to a country, but expect it to be firm and serious in its national response, the country makes it through the crisis and wins," he says. "The idea that you could quickly resolve a financial crisis... makes no sense to me."

The other reality is that three and a half years since the financial crisis erupted, policymakers need to brace themselves for further shocks. Battles have been fought but it is too soon for a cessation of hostilities, let alone a declaration of victory. As Mr Draghi says: "It's a long war."

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