Mario Draghi leaves a transformed central bank behind him

Dr. Jürgen Callies, Head of Research, MEAG

31 October 2019 will mark the end of an era; that of Mario Draghi, the third President of the European Central Bank (ECB) since the introduction of the euro. Draghi still leaves a dynamic and focused impression, so why not extend his presidency? The reason lies in the fundamental principles for the governance of the ECB. When the ECB was founded, its President was given a tenure of eight years – which is long in an international comparison. But as an offset no extension of the term was provided for. This was designed to guarantee independence, and has proven to be a wise decision in times of rising populism worldwide and the increasing exploitation of the central bank for political purposes. In any case, Mario Draghi was more of a formative figure for the ECB than is predecessors Duisenberg and Trichet.

Mario Draghi took over the helm of the ECB when it was in troubled waters. The Lehman/subprime crisis of 2008/2009 had triggered off the biggest global recession since the Great Depression almost 80 years before. And even though things appeared to have stabilised to some degree by 2011, structural aberrations had come about within the Eurozone, leading to enormous economic upheavals and dramatically heightened risk premiums for government bonds, initially in Greece, Ireland and Portugal, but then followed soon after by Italy and Spain. In a debt restructuring for Greece alone, the private sector had foregone its rights to around 100 billion euros.

Looking back at this phase, there is no doubt that Mario Draghi saved the European single currency at that time. The weakness in the monetary union – which the German Bundesbank had criticised even before the introduction of the euro – had manifested itself all too clearly: without a political and fiscal union, uncertainty, sluggishness and disunity hampered the mastering of the crisis. Also the substantial debt waiver for Greece by private creditors did not result in a noteworthy easing of the situation; the risk premiums for ten-year sovereigns in the rest of the European periphery took on fully unsustainable proportions (more than 10 % in Portugal and over 4 % in Italy). A resounding statement from Draghi at an investment conference one day before the opening ceremony of the 2012 London Olympics initiated the turnaround: "Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough." At the time he had been in office less than a year. The "Whatever it takes" subdued the speculative attacks on the capital markets and made it clear that there would be no repeat of the ERM debacle of 1992 (when market forces pushed the

pound sterling out of the European Exchange Rate Mechanism). The reversal was triggered, and Mario Draghi can justifiably claim the title of saviour of the euro.
In many other aspects, Mario Draghi's list of accomplishments is a mixed bag, but there is no question that he shaped – or, perhaps more aptly, transformed – the European Central Bank.

1) The ECB's measure of success now seems to be based more on the well-being of the capital markets and economic growth than on monetary stability in the traditional German sense. During Draghi's presidency, a broad range of money market sectors enjoyed a far better performance than during the eras of Duisenberg and Trichet, while economic growth in the Eurozone remained below average during this time. Small savers, who are largely dependent on money-market investments like cheque and savings accounts, had to accept real losses.
2) Strategic considerations at the ECB now appear to take a back seat to tactical management. More emphasis is now placed on the element of surprise on the capital markets and the containment of possible or expected crises than on other fundamental questions like the disturbance of relative prices, whether future crises will be able to be controlled or the redistribution effects of central bank policy. Draghi has ensured that the capital markets are continuously supported. He has supplied the banking system with sufficient liquidity and kept refinancing options for companies (and countries!) very inexpensive. But in contrast to the US Fed, Draghi did not achieve or only tried the (occasional) interest rate turnaround . He temporary has stopped the market-impacting buying of securities from increasing further, but he didn't even stop the practice as such. He accepted as collateral damage that speculative bubbles would occur, e.g. in selected housing markets or in government bonds that were considered to be particularly safe, and in doing so he purchased present-day successes with future losses.
3) The fixation on a self-defined, adjusted inflation target robs the central bank of its freedoms to act, and forces it into a long-term low-interest-rate policy. But instead of being satisfied with an inflation rate well below 2%, the ECB has its sights set on one that is below, but very close to 2% and is even discussing by shifting this to an “on average 2% target”. Now that may not sound like much of a difference, but in view of the history of the Eurozone, it looks like an almost hopeless undertaking. After all, in the past, an inflation rate of almost 2% has virtually only ever been achieved or exceeded when the oil price was rising fast. So in targeting the 2%, the central bank fails to include inflation-curbing structural factors at work such as demography and digitalisation in its considerations, and signalises low interest rates for some time to come. At the same time this policy leads, for instance, to so-called "zombie companies" – companies that under normal circumstances could not survive – being able to

be very cheaply refinanced and remain in the market, kept alive by a "hunt for yield". This means that scant resources are channelled into comparatively unproductive usages, reducing the potential for growth and inflation.

4) A central bank policy that puts its faith in a monetary transmission mechanism powered with the fuel of prospering asset markets accepts the risk of collateral damage that encourages political radicalisation due to serious interventions in the redistribution of income and wealth. For example, the shift in the distribution of wealth toward greater inequality (small savers lose, investors in risky assets win, debt is rewarded), leads to burdens caused by skyrocketing prices for real property and the rent increases that go with that, and reductions in the returns of life insurance policies.

5) Draghi established the ECB as an efficient institution that expanded the scope of its power (banking supervision), helping it become a strong partner to the political sector. The extra time that the ECB freed up for heavily indebted European countries was only partially used – its power to demand such reforms are limited. This distancing from concentrating only on the traditional business of an central bank, the expansion of its power and making (economic) political demands have moved the coordinates of central bank policy towards those of a political institution. In the longer term, however, this could endanger its autonomy. The number of former finance ministers on the management and advisory boards will be a good indication of this.

Mario Draghi will always remain in memory as the man who saved the euro. The slogan "Whatever it takes" is today used in various versions and different contexts, its connection to Draghi will be lost over time. The better his successors work, the easier it will also become to forget the burden that he loaded onto them by transforming the ECB. He hasn't left them – starting with Christine Lagarde – an easy task.