

Economy

What legacy will Mario Draghi leave to the ECB?

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Bruno Cavalier - Chief Economist
bruno.cavalier@oddo-bhf.com
+33 (0)1 44 51 81 35

Fabien Bossy - Economist
fabien.bossy@oddo-bhf.com
+33 (0)1 44 51 85 38

<https://www.oddosecurities.com>

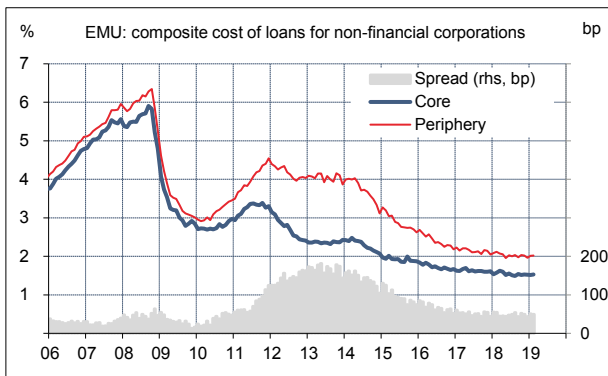
Mario Draghi has only five meetings of the ECB's Monetary Policy Committee left to chair before the end of his term on 31 October. His successor will be appointed by the European Council, probably this summer, partly in light of 'political' factors, as the position of President of the ECB is seen as a trophy. Many claim that it is now Germany's turn. Should this prove to be the case, it would certainly raise the question of Mario Draghi's legacy, namely the ECB's total commitment to defending the integrity of the Eurozone. Could the ECB now revert to its original condition, i.e. an annexe to the Bundesbank?

Tun, was immer nötig ist (Whatever it takes)

Mario Draghi took up his duties as head of the ECB on 1 November 2011. At the next meeting on 3 November, the Governing Council unanimously voted in favour of a modest rate cut (-25bp). Likewise at the next meeting. Even though these decisions cancelled the monetary tightening that had taken place earlier under Jean-Claude Trichet's presidency¹, they were not presented at that time as a correction of an error but rather as the normal monetary policy response to the marked deterioration in economic conditions. **Draghi's Copernican revolution only began the following summer at a time when the intertwining of banking risk and sovereign risk was such that it called into question the euro's very existence. On 26 July 2012, everyone remembers, Mario Draghi pledged to do "whatever it takes" to save the euro. All the decisions made by the ECB over the past seven years (ZIRP, NIRP, QE, TLTRO), with their positives and negatives, are the result of this commitment.**

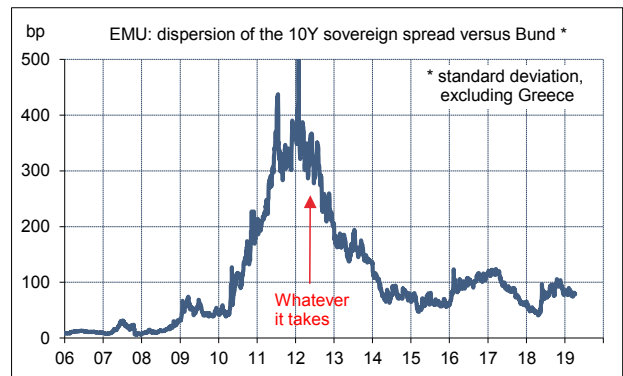
Even if most EU countries are now experiencing tensions over Europe, the integrity of the Eurozone is no longer seriously called into question for the foreseeable future, neither by the capital markets nor by the most Eurosceptic politicians. The fragmentation of corporate lending conditions, which had been exceptional from 2012 to 2015, has been largely reabsorbed (see chart lhs). The dispersion of government borrowing rates has also fallen considerably (chart rhs). In light of these positive results, the undesirable effects resulting from the monetary policy, such as pressure on banks' margins, although real are nonetheless secondary issues. **It is doubtful whether European banks earnings would have been better than they are at present had the eurozone imploded, had Italy or Spain defaulted, or had the businesses of peripheral member states been deprived of normal financing conditions.**

EMU: credit conditions for businesses



Sources: Thomson Reuters, Bloomberg, Oddo BHF Securities

EMU: financing conditions for member states



¹ As Governor of the Bank of Italy, Draghi had never stood out for positions diverging from Jean-Claude Trichet's.

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About a year ago, the end of Mario Draghi's mandate looked like the beginning of a normalisation of the ECB's policy, based on the sequential and gradual model that had been tested by the Fed: an end to asset purchases, followed by an exiting of the low interest rate policy, then returning policy rates to a neutral level, then shrinking the central bank's balance sheet.

The deterioration of economic conditions in the Eurozone and the absence of a rise in inflation towards the target 2% in the medium term have prompted the Governing Council to review its initial intentions. The ECB ended its asset purchase programme in December 2018, but the first hike in policy rates is at best envisaged for 2020, and everything else is postponed accordingly. **It is not under Mario Draghi's mandate that the ECB will initiate a normalisation of its monetary policy. This gives rise to two questions: who will succeed him? Will the next ECB president be free to conduct monetary policy as he/she sees fit?**

The choice of ECB president, and of the other members of the Executive Board, has always been a partly political decision reflecting the balance of power in the Eurozone. It is not written anywhere in the Treaties but it is acknowledged that a balance has to be struck between small and big countries, between the north and the south.

Since the ECB was created, Germany has never gained the top position. The first person to occupy the position, Wim Duisenberg² of the Netherlands, was a compromise choice. He was given the job based on a promise that he would stand down mid-mandate to make way for France's Jean-Claude Trichet, who incidentally was very German in his monetary policy views. Italy's Mario Draghi only really emerged after the resignation in February 2011 of Bundesbank president Axel Weber, who at the time was considered the favourite³. It is now said to be Germany's turn, in the person of Jens Weidmann. A press campaign is underway to promote his candidacy⁴. The selection process this year is more complex than usual since, besides the ECB president, new presidents will have to be chosen for the Commission and the Council. There will therefore be horse-trading between countries. Moreover, on the Executive Board, a replacement will have to be found for France's Benoît Coeuré, who reaches the end of his term on 31 December 2018. And if Jens Weidmann is appointed, another position will have to be found for Sabine Lautenschläger, a fellow German. (We leave to one side the question of the low representation of women on the ECB's Governing Council).

The pros and cons of a Jens Weidmann candidacy are worth examining.

- His main claim to the position as ECB president is his nationality (German) and role (head of the Bundesbank). If Jens Weidmann were a different nationality or just a good German academic, he would not be considered. It is therefore impossible not to view his candidacy as an attempt to rein in the ECB after the "Draghi years".
- Jens Weidmann's negatives stem from his behaviour during the euro crisis: his dogmatic approach to interpreting the ECB's mandate, his rigidity in the face of unprecedented financial shocks, his tenacious refusal to admit an error of analysis, his almost systematic opposition to the rest of the Governing Council. In September 2012, Jens Weidmann was the only Council member to oppose the creation of OMTs, a programme that was intended to enable the ECB's conditional involvement in bank or sovereign rescues if necessary. This tool was never used but the announcement of its creation, coming at a crucial moment, restored confidence and reactivated monetary policy transmission channels. Under his presidency, the Bundesbank has contested the legality of various measures, such as QE, before ultimately being ruled against by the European Court of Justice. Jens Weidmann's attitude in these years had two other harmful consequences. First, it delayed action by the ECB. QE on sovereign debt was not launched until 2015. It may legitimately be thought that if this tool had been employed sooner, the ECB might not have introduced a negative deposit rate. Second, Jens Weidmann helped fuel public suspicion in Germany regarding the ECB, whose actions are often presented as a transfer from Germany to the rest of the Eurozone⁵. Only in Germany, for example, did the muddled debate over Target-2 take on such importance.

No one would dream of questioning Mario Draghi's decisive role in the design and adoption of monetary measures over the last few years, but it is not all down to the decision of one individual. These choices have all been very largely endorsed

² At the time, it was said that the real "boss" at the ECB was the German chief economist, Otmar Issing, who designed the ECB's monetary strategy according to a model largely based on the Bundesbank.

³ Axel Weber disagreed with the ECB's intervention on the sovereign debt markets as part of the SMP (Securities Market Programme).

⁴ See the 4 April 2019 edition of the WSJ, "A first German ECB chief: It looks increasingly likely". Moreover, last week Jens Weidmann co-signed an article with the governor of the Banque de France in the French and German press calling for a genuine capital markets union – something that Mario Draghi has continually called for in the last few years.

⁵ For a criticism of this argument by a German economist, see Fratzscher (2018), "The Germany Illusion", Oxford University Press



by the Council. **Draghi's contribution is particularly apparent in the change of interpretation in the remit of the ECB (the mandate itself is unchanged).** The Council has paid more attention than in the past to core inflation (as opposed to total inflation), to credit aggregates (rather than monetary aggregates), and recognises that support for the real economy through an enduringly accommodative policy is a necessary condition (albeit an insufficient one) to get inflation in line with its target. **All in all, the ECB is much more aligned with the standards seen in the other main central banks, particularly the Fed. It is unlikely that this evolution could be called into question just by the choice of a new president.**

Moreover, some of the decisions being adopted now have a time horizon that extends well beyond the end of Draghi's term. This is true of the forward guidance on policy rates, the policy of reinvesting assets coming to maturity, the implementation of new long-term bank refinancing operations (TLTRO-III), and also, potentially, for the means of compensating for the impact of negative rates in the banking sector. When the ECB embarked on the negative interest rate adventure in 2014 (at -0.1%), it was an emergency way of fighting the deflation risk, as German opposition to QE was strong. No one imagined that the deposit rate would still be negative five years later, at a lower level (-0.4%) and with no prospect of quickly exiting this state of affairs. **As things stand, the cost of this "NIRP tax" equates to close to € 8bn per year for European banks,** with 30% for Germany, 25% for France, 21% for Benelux, and less than 5% for Italy and Spain. **This represents a distortion on two fronts: for the system as a whole (undermining banks' earnings) and for the way the cost is borne between countries (to the advantage of Southern European countries).** Several ECB officials have suggested that a compensation system could be examined and, provided it does not create more distortion than it resolves, potentially put in place. The decision is not expected imminently. The option put forward most frequently would be to exempt banks from this NIRP tax on a portion of their excess reserves, as it is done by the Swiss central bank.

If a tier-based regime for taxing bank reserves were put in place, the result would be a much less pronounced need to raise policy rates to "help" banks (this is a constant claim by the banking lobby, particularly in Germany). In a worst-case scenario, with the economic situation continuing to deteriorate, it would even open up the prospect of further rate cuts. **In conclusion, normalising monetary policy would become less urgent, including for a more conventional ECB president than Draghi, as Jens Weidmann could prove to be.** Could this be a way of tying the hands of Draghi's successor ...



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