MARIO DRAGHI: THE MAESTRO AND HIS PARADOXES
REFLECTING ON EIGHT YEARS THAT CHANGED THE ECB AND THE EURO

SUMMARY

› Under Mario Draghi’s presidency, the monetary union was saved, deflation was avoided, unemployment fell, and the popular support for the euro rose to record highs despite growing political fragmentation.
› The ECB’s determination to fulfil its mandate, and its commitment to do whatever it takes within this mandate, provided the central bank with its greatest asset: its credibility. Meanwhile, the ECB has morphed into a modern central bank with a broad set of new tools, flexible enough to be recalibrated in the future.
› For all of this, we should be grateful to the outgoing president and hope that continuity will prevail under Christine Lagarde.
› At the same time, Mario Draghi will leave the ECB having apparently failed to bring inflation back to the 2% target and with a sense of unfinished business, if not frustration, as his final push for a more active fiscal policy remains uncertain.

Following his last press conference today, Mario Draghi will become the first president to leave the ECB without ever having raised interest rates. During his eight-year term, the ECB cut rates 8 times, made 10 QE announcements (including changes in size, duration and modalities of asset purchases) and 6 (T)LTRO announcements. The ECB purchased EUR2.6trn in public and private debt securities and the size of its balance sheet doubled.

Knowledge, courage and humility

In a recent speech in Milan, Mario Draghi focused on three qualities that make a good policymaker: knowledge, courage and humility, which happen to best describe his eight years of presidency. There is little doubt about Draghi’s economic knowledge, crisis-management experience, and political courage. As for humility, the President has always downplayed the idea that he saved the euro, when he actually did.

There will be much more to say about Mario Draghi’s legacy as Christine Lagarde takes over. His accomplishments are nothing short of extraordinary, and largely self-explanatory: he saved the euro from fragmentation and, possibly, implosion; he cemented the ECB’s credibility and determination to act in full respect of its mandate; he broke taboo after taboo, turning radical unconventional policy measures into standard, flexible tools. “The unconventional has become convention”, as Martin Sandbu put it.

We cannot emphasise enough the importance of this last point. Whenever Mario Draghi had strong convictions, he did whatever it took to force a decision even if the political price looked high and the Governing Council was divided. His political skills and solid reputation have helped him throughout the years as much as his economic and technical skills. His ‘whatever it takes’ speech in July 2012 may not have had the same effect without the backing of European policymakers he managed to secure.

That said, Draghi’s failures and paradoxes are more interesting to discuss, if only because that is where the disagreements and misunderstandings remain today.
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The Maestro’s greatest paradox

Mario Draghi may be one of the greatest policymakers in modern history, but he will leave the ECB with one of the worst track records in terms of inflation targeting, as opposed to Jean-Claude Trichet’s “impeccable” performance.

There is no debating the fact that the ECB stands far away from its inflation target: some 7% below a hypothetical 2% trend in absolute terms, as per the chart below. Of course, the ECB does not target the level of consumer prices, but if the symmetry of the mandate is to be stressed and strengthened, then so far it has been a failure. As an extreme illustration, for consumer prices to return to the 2% trend by the end of Christine Lagarde’s term in 2027, inflation would need to average 2.9% per year, for the next eight years. That is not going to happen.

EURO AREA: CONSUMER PRICES UNDER ECB’S PRESIDENTS

The lazy, yet correct, answer to this paradox is that the ECB did its best to fight disinflationary forces resulting from a series of economic shocks, but that it was left on its own by the inaction (or worse) of national governments and other European institutions. In other words, the ECB got unlucky and the counterfactual could have been much, much worse. And indeed, over the past few years we have never heard of a credible answer to the question Draghi asked in March 2016, after a very aggressive easing package was announced: “Suppose we had embraced what two years ago I used to call the “nein zu Allem” policy strategy, so do nothing. What would be the counterfactual? We deem that the counterfactual would have been a disastrous deflation.” Or, as we put it, TINCAD™: There Is No Credible Alternative to Draghi.

Moreover, there is no shortage of evidence suggesting that inflation has been dragged lower by global factors, and that the Phillips curve has become “flatter, non-linear or mis-specified in terms of the relevant economic slack”. In this context, Draghi’s legacy looks much more encouraging, especially as, scratching below the surface, a number of indicators of underlying inflation have gradually edged higher, including the ECB’s ‘super core’ inflation rate which rose to around 1.5% in September.
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The Maestro’s greatest achievements: from de-fragmentation to fiscal QE

The more constructive answer, looking forward to the future of monetary policy, is that Mario Draghi’s greatest legacy is to be found elsewhere, in a broader political sense.

First, the ECB managed to restore the transmission of monetary policy via credit easing measures resulting in a de facto recalibration of the ECB’s monetary stance towards the periphery (see Chart 10). This was justified by the mandate, again, as the rising financial fragmentation in peripheral countries was jeopardizing the ECB’s broader objective.

Second, the ECB went beyond de-fragmentation, embracing a more active use of its balance sheet and, eventually, getting closer to what we called ‘fiscal QE’ via open-ended asset purchases. Draghi will leave behind a cost of borrowing – for sovereign states and private agents alike – that is unlikely to be an issue for the foreseeable future. There might be episodes of volatility, idiosyncratic crises and populist bursts, but on average, borrowing costs have fallen to record low levels, making national Treasury management easier and more sustainable in most, if not all cases.

Today the spread between nominal GDP growth and the average sovereign bond yields is positive in most euro area countries, including in Italy, suggesting that national governments can run primary budget deficits and still reduce their debt-to-GDP ratios over time. It is arguably more complicated than that in practice, but the quasi-fiscal effects of the ECB’s unconventional policies should not be underestimated in how they boost tax revenues and reduce public debt overhang over time.

EURO AREA: DIFFERENCE BETWEEN NOMINAL GDP GROWTH AND SOVEREIGN BOND YIELDS

Waiting for the euro to graduate into a real bee

The above achievements are likely to have far-reaching and lasting consequences for the euro. Mario Draghi has kept repeating that that the ECB can do more, with no limits within its mandate. Meanwhile he has been moving political lines towards fiscal easing, telling politicians that if they do not like what they see on the monetary side, they must get their acts together because there could be more to come if they don’t.
If and when fiscal policy becomes more supportive of growth, the ultra-loose financial conditions secured by the ECB’s latest package, including open-ended asset purchases and forward guidance on steroids, could be the difference that finally obliges Europe to lead the way with a more efficient and politically acceptable policy mix.

In a nutshell, Mario Draghi managed to transform the ECB into a modern central bank with an innovative and flexible toolkit at its disposal. For his mission to be completed, on top of reaching the inflation target, the euro needs to graduate from a “bumblebee” into “a real bee”. This graduation will be outside the ECB’s direct control, instead depending on the political appetite to complete the monetary union with a full banking and capital market union, a safe asset, a real budget capacity, if not a fiscal union. In a recent interview, the President said that he was “optimistic”, and so should we be.

As far as the ECB is concerned, Christine Lagarde’s biggest challenge will be to preserve Mario Draghi’s legacy and the institution’s credibility in what are likely to be turbulent times, starting with a comprehensive review of the ECB’s strategy.

Que será, será
Whatever will be, will be
The future’s not ours to see
Que seré, seré

Farewell to you Mr. President. Thank you on behalf of 340 million citizens. And be proud, be very proud!

MARIO DRAGHI AND WOLFGANG SCHÄUBLE

Source: Getty Image
MARIO DRAGHI: THE MAESTRO AND HIS PARADOXES
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Draghi’s Greatest Hits

During his eight-year terms, Mario Draghi presided over 77 Governing Council meetings, attended 35 hearings at the European Parliament, gave 150 speeches and 27 interviews (focusing on interventions recorded on the ECB’s website). We highlight below his greatest moments, on a purely subjective basis.

ECB: MARIO DRAGHI’S SPEECHES AND INTERVENTIONS

2011-2012: the courage to act

▷ 3 November 2011: first press conference, first rate cut (link)

“Continuity, credibility and consistency are of the essence.”

“I have great admiration for the tradition of the Bundesbank. […] As for the future, let me do my work and we will have periodic checks as to whether I am in sync with this tradition or deviating from it.”

“We are independent and make our own judgement.”

▷ 8 December 2011: second press conference, second rate cut, first LTRO (link)

“The answer to the first question is “no”. The answer to the second question is “no”. And the answer to the third question is “we never pre-commit”. So, it is two “noes” and one “never pre-commit”.”

“It was a lively discussion – and one should not abuse the word “lively”, because we are central bank governors after all! Opinions were divided, not in terms of the substance but in terms of the timing. It was a majority decision.”

▷ 26 July 2012: Verbatim of the remarks (link)

“Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.”
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6 September 2012: press conference, OMT announcement (link)

“Well, it was not unanimous. There was one dissenting view. We do not disclose the details of our work. It is up to you to guess.”

“I am what I am, really.”

29 October 2012: interview with Der Spiegel (link)

“If we do not resolve the euro crisis, we will all pay the price. And if we do resolve it, we will all benefit, particularly German taxpayers and savers.”

“We couldn’t just sit back and do nothing.”

2013-2014: new guidance and negative thinking

25 June 2013: speech in Berlin, “Stable Euro, Strong Europe” (link)

“In a speech here in Berlin just 18 months ago, I quoted Erhard’s famous dictum: ‘Die soziale Marktwirtschaft ist ohne eine konsequente Politik der Preisstabilität nicht denkbar’.”

2 January 2014: interview with Der Spiegel (link)

“In Latin you say: "Repetita iuvant -- to repeat is beneficial". The fewer changes made in a country, the more often I repeat my messages. And it works.”

[about Jens Weidmann] “I would rather speak of convergence than of conflict. Our positions have clearly moved closer to each other and cooperation has improved.”

24 April 2014: speech in Amsterdam, “Monetary policy communication in turbulent time” (link)

“We have also further simplified our reaction function by laying out some contingencies that would warrant a monetary policy reaction. These are, first, an unwarranted tightening of monetary policy stance (from developments in short-term money markets, global bond markets or foreign exchange markets) that could be tackled through more conventional measures. Second, a further impairment in the transmission of our stance, in particular via the bank lending channel, for which a targeted LTRO or an ABS purchase programme might be the right response. Third, a worsening of the medium-term outlook for inflation, which would warrant a more broad-based asset purchase programme.”

8 May 2014: press conference (link)

“We never pre-commit – well, that I think finished a long time ago.”

5 June 2014: press conference, introduction of a negative deposit rate (link)

“I would say that for all the practical purposes, we have reached the lower bound. However, this doesn’t exclude some little technical adjustments and which could lead to some lower interest rates in one or the other or both parts of the corridor. But from all practical purposes, I would consider having reached the lower bound today.”
FLASH NOTE

PICTET WEALTH MANAGEMENT

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24 October 2019

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› 22 August 2014: speech in Jackson Hole, “Unemployment in the euro area” (link)

“Over the month of August financial markets have indicated that inflation expectations exhibited significant declines at all horizons. The 5year/5year swap rate declined by 15 basis points to just below 2% - this is the metric that we usually use for defining medium term inflation.”

“The risks of “doing too little” – i.e. that cyclical unemployment becomes structural – outweigh those of “doing too much” – that is, excessive upward wage and price pressures.”

“In parallel it may be useful to have a discussion on the overall fiscal stance of the euro area. Stronger coordination among the different national fiscal stances should in principle allow us to achieve a more growth-friendly overall fiscal stance for the euro area.”

› 24 September 2014: interview with Europe 1 (link)

[In French] “Plus d’Europe, plus d’Europe, plus d’Europe.”

› 27 November 2014: speech in Helsinki, “Stability and Prosperity in Monetary Union” (link)

“It would be natural to reflect further on whether we have done enough to preserve at all times the ability to use fiscal policy counter-cyclically. But it is also clear that… this could only take place in the context of a decisive step towards closer Fiscal Union.”

2015-2016: breaking taboos

› 22 January 2015: press conference, APP announcement (link)

“It’s the first time that we’ll have the accounts be published of this meeting, and so we have also worked out some qualifiers to indicate how the meeting proceeded.”

“The measure of this asset purchase programme exceeds what, well it doesn’t exceed really, it’s in the ballgame.”

“I have some jokes that I could make at this point in time, but I’ll just re-read the statement if you want, because that’s really what we can say today, and I’d just rather avoid jokes on this. I mean, the overall situation of inflation, inflation developments, doesn’t allow us to make these jokes.”

“Some people voted against lower interest rates way back at the end of November 2013. We did OMT. We did the LTROs. We did TLTROs. And somehow this runaway inflation hasn’t come yet. What I’m saying is that certainly the jury’s still out. Also, for the people who say that there will be inflation, yes, when, please? Tell me, within what?”

› 23 March 2015: Hearing at the European Parliament (link)

[Responding to a MP accusing the ECB of blackmailing Greece] “Let me disagree with you about almost about everything you said.”
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› 22 October 2015: press conference (link)

[introductory statement] “The Governing Council is willing and able to act by using all the instruments available within its mandate if warranted in order to maintain an appropriate degree of monetary accommodation.”

› 20 November 2015: speech in Frankfurt, “Monetary Policy: Past, Present and Future” (link)

“If we decide that the current trajectory of our policy is not sufficient to achieve our objective, we will do what we must to raise inflation as quickly as possible. That is what our price stability mandate requires of us.”

› 4 December 2015: speech in New York (link)

“There cannot be any limit to how far we are willing to deploy our instruments, within our mandate, and to achieve our mandate.”

“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.”

› 21 January 2016: press conference (link)

“We don’t give up.”

› 10 March 2016: press conference, QE expansion, CSPP, TLTRO-II (link)

“The Governing Council is symmetric in the definition of the objective of price stability over the medium term.”

“So it was all in all, I would say, a very reassuring discussion, very positive, very constructive.”

“Suppose we had not acted at all. Suppose we had embraced what two years ago I used to call the “nein zu Allem” policy strategy, so do nothing. What would be the counterfactual? And of course, we deem that the counterfactual would have been a disastrous deflation.”

› 21 April 2016: press conference (link)

[following Schäuble’s “be very proud” attack]

“We obey the law, not the politicians, because we are independent, as stated by the law.”

› 8 December 2016: press conference (link)

“Tapering has not been discussed today.” (repeated six times)
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2017-2018: the courage not to act

› 27 June 2017: speech in Sintra, “Accompanying the economic recovery” (link)

“All the signs now point to a strengthening and broadening recovery in the euro area. Deflationary forces have been replaced by reflationary ones.”

› 26 October 2017: press conference (link)

“In any event it was not discussed and so this is not tapering; it’s just a downsize.”

› 25 January 2018: press conference (link)

“Now, can we declare victory? The answer is no, not yet.”

› 14 March 2018: ECB Watchers conference (link)

“Monetary policy will remain patient, persistent and prudent.”

› 19 June 2018: speech in Sintra, “Monetary policy in the euro area” (link)

“In short, monetary policy in the euro area will remain patient, persistent and prudent.”

2019: the final straw

› 22 February 2019: speech in Bologna, “Sovereignty in a globalised world” (link)

“This tension between economic integration and political cooperation is fuelled by a powerful belief that there is an inherent trade-off between EU membership and the ability of countries to exercise sovereignty. […] But this belief is wrong. It is wrong because it conflates independence with sovereignty.”

“Independence does not guarantee sovereignty.”

› 27 March 2019: ECB Watchers conference (link)

“We need to reflect on possible measures that can preserve the favourable implications of negative rates for the economy, while mitigating the side effects, if any.”

› 18 June 2019: speech in Sintra, “Twenty Years of the ECB’s monetary policy” (link)

“In the absence of improvement, such that the sustained return of inflation to our aim is threatened, additional stimulus will be required.”

“The limits we establish on our tools are specific to the contingencies we face.”

› 12 September 2019: press conference, open-ended QE, tiering, forward guidance and TLTRO-III easing (link)

[following Draghi’s longest answer ever to the first question of the press conference]

“I think I will stop here.”
“If fiscal policy had been in place, or would be put in place, the side effects of our monetary policy would be much less, the action of our decisions today would be much faster and therefore the need to keep in place some of these measures would be less.”

“I’m sorry the answer is that I can’t tell you the numbers, we never did it, we’re not going to do it, just to let you know that there was no need to take a vote as I said because there was such a significant majority.”

› 30 September 2019: interview with the FT (link)

“Have we done enough? Yes, we have done enough -- and we can do more. But more to the point what is missing? The answer is fiscal policy. That’s the big difference between Europe and the US.”

“To have a stronger EMU we need a common eurozone budget. Clearly the political debate on that still has a long way to go. But I am optimistic.”

“People have understood the benefits of the single currency. Trust is going up. The opponents of the euro have not succeeded.”

› 11 October 2019: speech in Milan, “Policymaking, responsibility and uncertainty” (link)

“Central bank independence does not preclude communication with governments when it is clear that mutually aligned policies would deliver a faster return to price stability. It only imposes limits on what such alignment could entail. Specifically, it means that alignment between policies, where needed, must serve the objective of monetary stability and should not work to the detriment of it.”

› 24 October 2019: final press conference

“Unfortunately, everything that has happened since September has shown abundantly that the Governing Council’s determination to act was justified.”

“How do I feel? I feel like someone who tried to comply with the mandate, the best possible way.”
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CHART 1: ECB POLICY RATES

CHART 2: ECB’S BALANCE SHEET

CHART 3: EURO AREA HEADLINE, CORE AND SUPER CORE INFLATION RATES

CHART 4: EURO AREA UNEMPLOYMENT RATE
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CHART 5: 10-YEAR SOVEREIGN BOND SPREADS

CHART 6: INTEREST RATES ON BANK LOANS TO SME

CHART 7: 5Y5Y INFLATION SWAPS

CHART 8: ECB SPF INFLATION EXPECTATIONS
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CHART 9: SPREAD BETWEEN 2019 NOMINAL GDP GROWTH AND 6-10Y AVERAGE BOND YIELDS

Source: PWM - AA&MR, European Commission, Bloomberg

CHART 10: ECB POLICY RATE AND SIMPLE TAYLOR RULES FOR CORE AND PERIPHERAL COUNTRIES

Source: PWM - AA&MR, ECB, Eurostat, OECD (basic Taylor rule using the unemployment rate gap, OECD’s NAIRU estimates, and headline inflation for illustration purposes)
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