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The ECB's policy under the presidency of Mario Draghi: a curse or a blessing for Europe?

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The paper discusses the monetary policy of the European Central Bank (ECB) under the presidency of Mario Draghi. It first shows the serious mistakes made under his predecessor, Jean-Claude Trichet, during which period the ECB destabilized rather than stabilized. Draghi, on the other hand, embarked on a more expansive course immediately after taking office, thereby securing the existence of the euro in a very threatening situation. In 2014, he then identified the deflationary risks for the eurozone at an early stage and successfully countered them with massive bond purchases. The undesirable developments for the financial system and especially the banks predicted by his critics, who are to be found primarily among German economists, have not materialized.

Keywords: *European Central Bank, Mario Draghi, monetary policy*

JEL codes: *E52, E58*

1 A CONTROVERSIAL PRESIDENCY

Mario Draghi was the third President of the European Central Bank (ECB) after Wim Duisenberg (1998–2003) and Jean Claude Trichet (2003–2011). In contrast to the presidency of his predecessors, Draghi's term of office is highly controversial. In Germany in particular, there has been growing criticism of his policy of negative interest rates and extensive bond purchases. It culminated in a letter of anger from the President of the German Savings Banks and Giro Association, Helmut Schleweis, published in the *Bild* tabloid on 14 August 2019. In his tantrum, he blamed Draghi for gradually changing the lives of millions in Germany but also in Europe not for the better but for the worse. After the ECB's decision to lower interest rates further and to resume the asset purchases on 12 September 2019, *Bild* presented a picture of Draghi showing him as 'Graf Draghila' who sucks the German savings account dry.¹

In this paper, I will show that this criticism is unjustified. While Trichet made serious mistakes during his presidency, Draghi managed to save the eurozone from collapsing under a perfect storm. He subsequently diagnosed deflationary risks at an early stage and, with an expansionary monetary policy, he ensured a revival of economic growth and a fall in unemployment. The adverse side effects of this therapy, as predicted by his critics, are still not apparent today.

1. See <https://www.bild.de/bild-plus/geld/wirtschaft/politik-inland/ezb-leitzins-schlecht-fuersparerer-frau-merkel-stoppen-sie-endlich-den-minus-zins-64669942,view=conversionToLogin.bild.html>.

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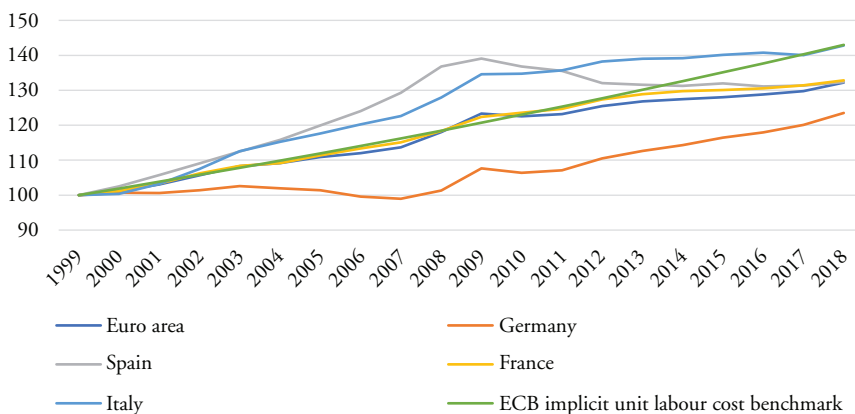
2 THE POLICY FAILURES OF JEAN-CLAUDE TRICHET

On the occasion of the tenth anniversary of the euro in June 2008, the ECB published an anniversary bulletin, which assessed the first ten years of the euro as an enormously successful period:

In this 10th anniversary edition we show that the euro has already brought several gains, including price stability and low interest rates. These benefits are supporting other positive developments, which are unfolding gradually but persistently, including more trade in goods and services, and more financial integration, which in turn is spurring financial deepening and modernisation. There is also a remarkable degree of resilience in a complex international environment. In our view, these achievements lend great support to meeting all present and future challenges for the euro area, and also support the adaptation of national economies. (ECB 2008: 15–16)

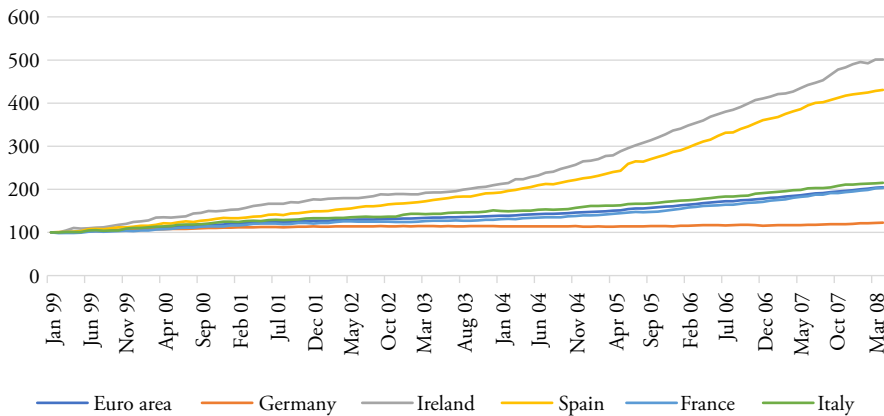
Looking back, the overall positive assessment in the report is more than astonishing. The first severe problems in the euro area banking system had already become apparent by the end of July 2007 with the collapse of the German IKB Bank. But this was only the first visible symptom of deeper-seated imbalances that had developed among the member states during the first ten years of the euro.

A central cause of these tensions was the policy of wage moderation pursued in Germany since the late 1990s. It resulted in German unit labor costs remaining virtually constant from 1999 onwards (Figure 1), which was destabilizing the whole euro area. For the orderly functioning of a monetary union, the unit labor costs of member states should have developed in line with the central bank's inflation target. The ECB defined price stability as an inflation rate of 'below, but close to 2%.' At the same time, wage increases in the peripheral countries (Greece, Ireland, Spain) exceeded this benchmark increase of unit labor costs. On average, the ECB was thus able to achieve its inflation target, but at the price of destabilizing real interest-rate effects. In the peripheral countries with above-average inflation rates, the real interest rate was too low; in Germany, it was too high.



Source: AMECO database.

Figure 1 Unit labour costs (1999 = 100)



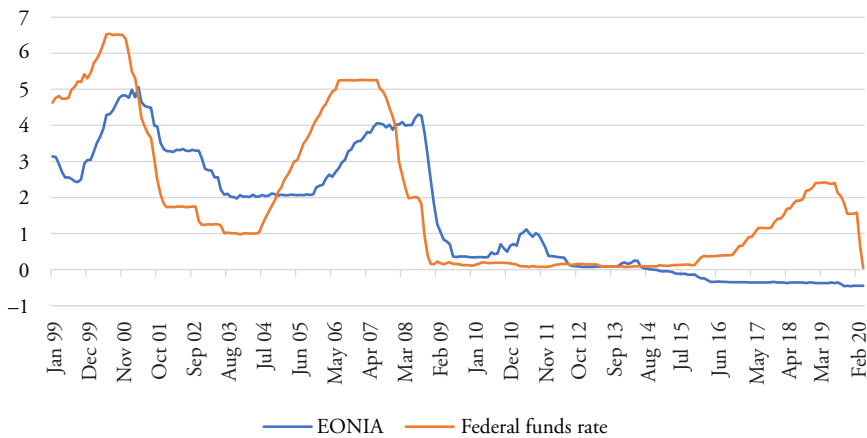
Source: ECB, Statistical Data Warehouse.

Figure 2 Bank loans to the private sector (January 1999 = 100)

The low real interest rates in the peripheral countries fueled a construction boom and excessive bank lending. The credit volume in Spain, for example, quadrupled between 1999 and 2008; in Ireland, it even quintupled (Figure 2). High domestic demand in the peripheral countries led to a strong import demand and to deep deficits in the peripheral countries' current-account balances. German banks mainly financed these current-account deficits. Given the German economy, which was virtually stagnant in the first half of the 2000s due to wage developments, they were happy to lend to banks in the euro area.

From this perspective, the economic and financial situation of the euro area was already extremely fragile in the summer of 2008. How little the ECB's top management was aware of these problems is shown not only by the utterly uncritical anniversary bulletin but also by the ECB's decision to raise its key interest rate (the so-called 'main refinancing rate') from 4.00 percent to 4.25 percent on 9 July 2008. This decision is in complete contradiction to the policy of the US Federal Reserve. Following the outbreak of the global financial crisis (GFC) in the summer of 2007, the Federal Reserve had already implemented an initial interest-rate cut (the federal funds rate) from 5.25 percent to 4.75 percent in September 2007. With further interest-rate steps, it then lowered its key interest rate to 2.00 percent by April 2008. The differing interest-rate policies are reflected in the overnight rates; the federal funds rate for the US dollar and the EONIA (European Overnight Index Average) rate for the euro (Figure 3).

So while the US Federal Reserve did everything possible to stabilize the banking system from the very outbreak of the financial crisis, the ECB even increased the pressure on the banks. Even after the Lehman insolvency, which occurred on 15 September 2008, the ECB did not change course. Regardless of the crisis-ridden escalation in the financial system, the ECB maintained its refinancing policy for the banking system: an auction procedure in which the banks had to quote a refinancing interest rate for liquidity. This rate had to be equal to or higher than the ECB's key interest rate. Because of the drying up of the interbank market, this procedure resulted in very high bid rates. As a result, on 8 October 2008, more than three weeks after the Lehman insolvency, the banks in the euro area had to pay a record average refinancing rate of 4.99 percent. It was not until 15 October that the ECB switched to refinancing at a fixed interest rate, reducing the refinancing rate to 3.75 percent.



Source: Federal Reserve Bank of St. Louis and Deutsche Bundesbank.

Figure 3 Federal funds rate and EONIA rate

Severe errors in interest-rate policy continued even after the outbreak of the euro crisis at the beginning of the 2010s. In the middle of the crisis, the ECB decided to raise its key interest rate from 1.00 percent to 1.25 percent with effect from 13 April 2011 and again from 1.25 percent to 1.50 percent with effect from 13 July 2011. It took the departure of Trichet to correct this misguided interest policy. At his first press conference as ECB President, on 3 November 2011, Mario Draghi announced a rate cut from 1.50 percent to 1.25 percent.

The failure of the entire interest-rate policy under Trichet is shown not least by the fact that the US Federal Reserve had already brought its key interest rate up to the zero lower bound on 16 December 2008. At the ECB, even under Draghi, this was only reached on 10 September 2014.

Besides, in the Trichet era, the ECB did not implement a comprehensive quantitative easing program. Again, this stands in stark contrast to the policy of the Federal Reserve which started an extensive bond purchase program in 2009. It was not until 2015 that the ECB was able to commit itself to a similarly strong program of quantitative easing.

Overall, under Trichet's reign, the ECB seems neither to have realized the emerging imbalances between the member states in the pre-crisis phase nor did it actively stabilize the banking system and the whole macroeconomy of the euro area after that. Instead, it made the situation of the banks even more difficult with its completely misguided interest-rate policy.

3 MARIO DRAGHI'S PARADIGM CHANGE FOR THE ECB'S MONETARY POLICY

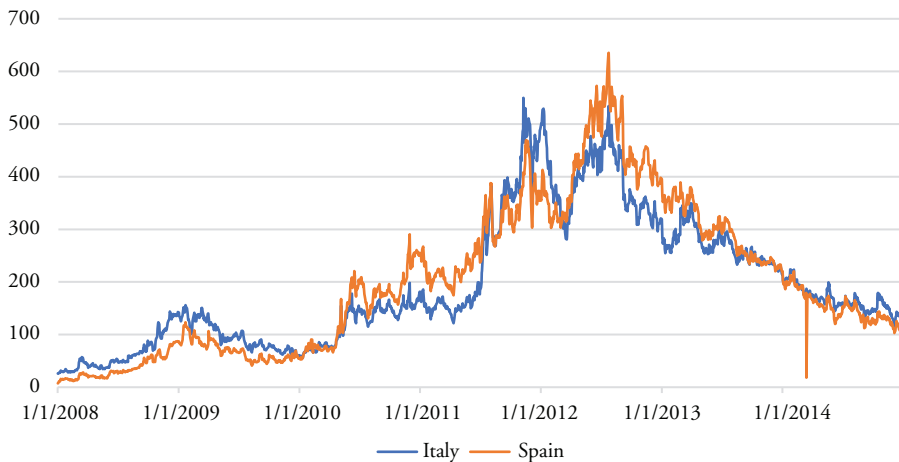
Mario Draghi's assumption of office marked a paradigm change in the policy of the ECB. After the decision to lower interest rates, the ECB announced on 8 December 2011 extensive longer-term refinancing operations at a favorable interest rate. These measures were referred to by financial market participants as 'Dicke Berta' (Big Berta), the nickname for a particularly effective German gun in World War I. Italian and Spanish banks, in particular, used this

facility to purchase domestic government bonds. In effect, these measures constituted an indirect form of quantitative easing.

But the monetary easing orchestrated by Draghi proved insufficient to stabilize the euro area. In the first half of 2012, tensions in the euro area increased. Financial market participants increasingly questioned the existence of the monetary union, which led to Italy and Spain having to pay very high risk premia for their bonds (Figure 4). With Italy's already high level of public debt, a vicious circle had developed. European politicians were not willing to provide an active contribution to stabilizing the situation. Especially, the German government was opposed to all proposals for joint liability.² In this life-threatening situation for the euro, Mario Draghi succeeded in turning the situation around with his famous speech in London on 26 July 2012.

And so we view this, and I do not think we are unbiased observers, we think the euro is irreversible. And it's not an empty word now, because I preceded saying exactly what actions have been made, are being made to make it irreversible. But there is another message I want to tell you. Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough.³

This statement was endorsed on 6 September 2012 by the ECB's decision on the modalities for undertaking outright monetary operations. The success of this purely verbal intervention was enormous. Without any market intervention by the ECB, risk premiums



Source: Datastream.

Figure 4 Risk premia for Spanish and Italian government bonds vis-à-vis German bunds (Basis points)

2. For example, in its annual report 2011–2012, the German Council of Economic Experts proposed a 'debt redemption pact' (Bofinger et al. 2011).

3. Verbatim of the remarks made by Mario Draghi. Speech by Mario Draghi, President of the European Central Bank at the Global Investment Conference in London, 26 July 2012, URL: <https://www.ecb.europa.eu/press/key/date/2012/html/sp120726.en.html>.

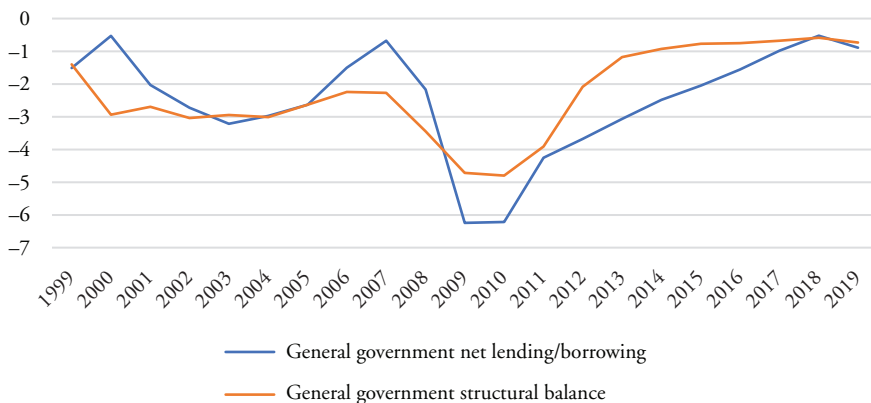
on long-term government bonds of peripheral countries, which had risen steadily until then, immediately declined. Over time, they decreased significantly. Mario Draghi thus succeeded in turning the market assessment from a bad equilibrium, that is, the expectation that the euro area would break up, to a good equilibrium, that is, the expectation that monetary union would remain stable.

The fundamentally transformed monetary environment enabled the peripheral countries to turn their fiscal policy around. Until Mario Draghi's intervention, they were under massive pressure from the financial markets to pursue consolidation at any price. German economists, in particular, welcome this 'market discipline' (Feld et al. 2015). But the inappropriate fiscal restriction led to a recession in the euro area in 2012 and 2013 and pushed the already high unemployment rate even higher. In the new equilibrium, the peripheral countries were able to avoid destabilizing fiscal policy measures. If one takes the structural budget balance of the euro area as an indicator for discretionary fiscal policy, the austerity policy ended in 2013; the structural budget balance of the euro area has remained almost constant since then (Figure 5).

The success of the changing macroeconomic environment was not long in coming. Economic growth picked up again and the unemployment rate declined. By the end of 2019, the unemployment rate had come down almost to the pre-crisis low reached in 2008.

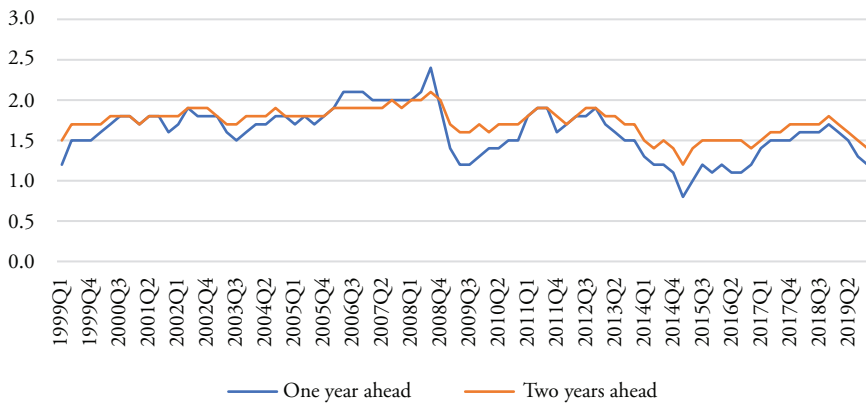
Mario Draghi's third key strategic move was the announcement of large bond purchases in autumn 2014. This decision was prompted by a marked decline in the euro area inflation rate and inflation expectations in the euro area (Figure 6). As key interest rates had reached the zero interest rate threshold at that time, there was a risk of a slide into deflation. Given the still-high levels of corporate and private debt, 'debt deflation' (Fisher 1933) would have posed threats to the euro area financial system. Draghi, therefore, opted for a proactive policy in the form of an extensive asset purchase program.

All in all, if one assesses the ECB's policy under the presidency of Mario Draghi by its mandate of price stability, it was definitively not too expansionary. From 2011 to 2019, the average euro area inflation rate was 1.1 percent, which is below but not close to 2 percent. As the effects of monetary policy have long lags, one also has to ask whether there might be risks for price stability in the future. But according to the most recent



Source: IMF, World Economic Outlook Database, October 2019.

Figure 5 Euro area fiscal balance (percent of GDP)



Source: ECB; Survey of Professional Forecasters.

Figure 6 Survey of Professional Forecasters: inflation forecasts for the euro area

Survey of Professional Forecasters, even for the longer term no increase of the inflation rate is expected (Figure 1).

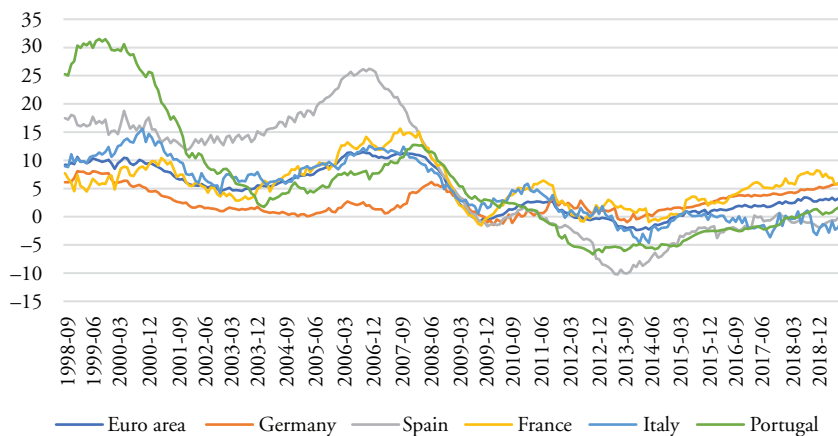
4 RISKS AND SIDE EFFECTS OF THE ECB'S POLICY

This positive assessment leads to the question of the risks and side effects of the ECB's monetary policy conducted under the aegis of Mario Draghi. German economists, in particular, warned of the supposed adverse consequences of Draghi's policies soon after he took office. As Appendix 1 shows, year after year, the majority of the Council had asked the ECB for a departure from its expansionary monetary policy. It justified this in particular by citing threats to financial stability and monetary stability. It is worth noting that economists from other countries did not share such fears. For instance, the Council wrote in its Annual Report 2016/17 (p. 184): 'In light of the macroeconomic developments, the extent of the ECB's quantitative easing and the resulting low interest rates are neither appropriate for the euro area nor Germany.'

The Centre for Economic Policy Research (CEPR) then conducted a survey among European economists to see whether they shared this view. The survey showed that only 15 percent of those questioned agreed with the Council's view (Den Haan et al. 2016).

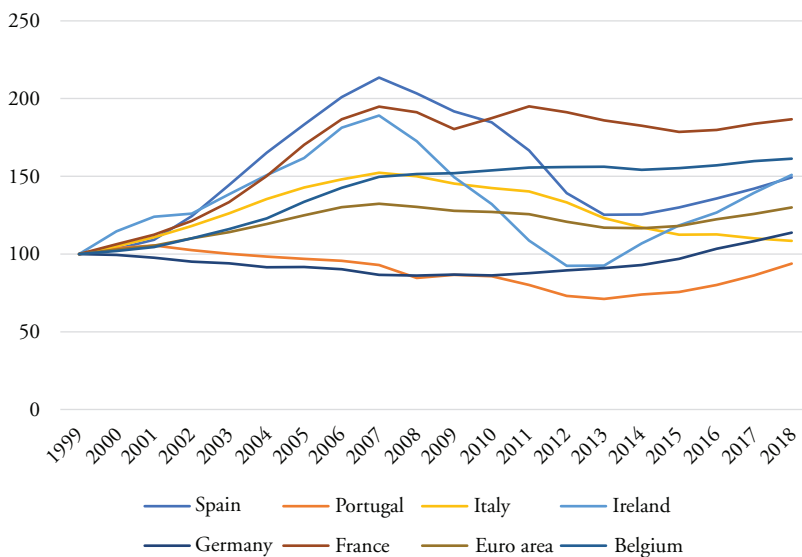
Potential adverse side effects for the stability of the financial system of the euro area have been a central concern, especially for German economists. A key lesson from the period before the GFC is the destabilizing power of excessive credit creation by banks. As a consequence, economists are now paying much more attention to credit cycles (Borio 2012). But even after a prolonged period of very low and even negative interest rates, credit growth in the euro area has remained rather moderate, especially if one compares it with the developments before 2009 (Figure 7).

The same applies to the situation in the real-estate sector. In the period before the GFC, real house prices skyrocketed in some euro area countries, especially in Spain, Ireland, and France. More than a decade later, average real house prices in the euro area are still below the peak which was reached in 2007 (Figure 8). The data also show that the fears of an overheating



Source: ECB, Statistical Data Warehouse.

Figure 7 Growth rate of bank loans to the private sector



Source: OECD Data, Housing Prices, URL: <https://data.oecd.org/price/housing-prices.htm>.

Figure 8 Real house prices in the euro area (1999 = 100)

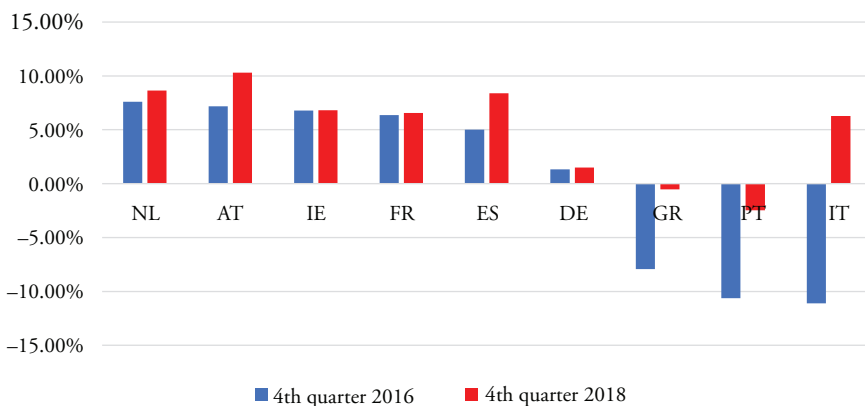
in the German real-estate market are not warranted. In the period of the German wage moderation which caused a stagnant domestic demand, German house prices were lagging behind the developments in other euro area member states. The substantial increases in German house prices since 2010 can, therefore, be regarded, at least partially, as a catching-up process.

Another primary concern of ECB critics is the risk of Mario Draghi's monetary policy for the stability of the banking system. But as a chart in the recent report of the German Council of Economic Experts shows, the return on equity of significant banks⁴ in the euro area has improved considerably during the period of very low/negative interest rates (Figure 9). It also shows that the significant banks in Germany are suffering from structural problems that are not related to the ECB's monetary policy.

A similar misjudgment is an often-repeated argument that very low interest rates cause a *zombification* of banks and the corporate sector. Data from the Bank for International Settlements, which are available only until 2016, show that the share of zombie firms (that is, firms that are unable to cover debt-servicing costs from current profits over an extended period) is much higher in Anglo-Saxon countries (Figure 10). In addition, in euro area member states, the zombie share has declined with the reduction of interest rates.

In the German debate, the ECB is criticized above for expropriating the German saver. This argument is perhaps the most narrow-minded perspective for the assessment of a European institution. In fact, nominal interest rates on savings accounts have declined significantly during the presidency of Draghi. But for the return of savers not only does the nominal interest rate matter but also the inflation rate, which can be regarded as a hidden tax on savings. The Bundesbank provides data for the real return on German savings accounts since 1967 (Figure 11).

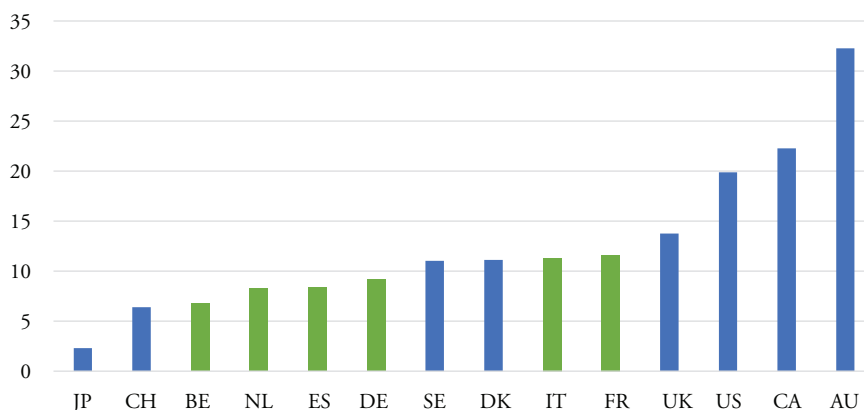
For the period, where the Deutsche mark was the currency for Germany, that is, until December 1998, the average real return on savings accounts was -0.004 percent. This can be explained by the fact that in the 1970s and 1980s, the German inflation rate reached peaks of more than 7 percent. In the period when Draghi was president, the real return was -0.7 percent which is not a qualitative difference. In other words, this critique of the



Source: German Council of Economic Experts, Annual Report 2019/20: chart 57.

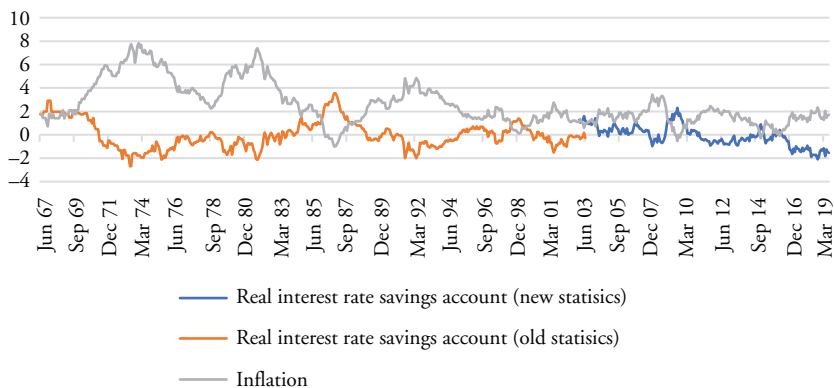
Figure 9 Return on equity of significant banks in the euro area

4. Banks supervised by the Single Supervisory Mechanism (SSM).



Source: BIS, Quarterly Review, September 2018.

Figure 10 Share of zombie firms in 2016 (broad definition)



Source: Deutsche Bundesbank, Zeitreihendatenbank.

Figure 11 Real interest rate on German savings accounts

ECB is the result of money illusion. Upon closer scrutiny, one can show that the simple act of saving does not generate any real returns as it simply redistributes money balances from the corporate sector to the household sector (Bofinger 2020a).

5 SUMMARY

When Mario Draghi assumed the presidency of the ECB, the euro area was in a perfect storm. This situation had been caused not least by serious mistakes in the ECB's interest-rate policy under the aegis of Jean-Claude Trichet. With a courageous and professional approach, Draghi

succeeded in stopping the centrifugal forces that threatened the very existence of the euro area in the summer of 2012. The change in monetary policy paradigm that he brought about enabled the peripheral countries of the euro area to pursue a more cautious consolidation policy. As a result, the recession was overcome, and unemployment, which was very high in some cases, was gradually reduced. With foresight, Draghi decided in autumn 2014 to counter the emerging deflationary risks with a broad-based bond-purchase program.

The decisive criterion for assessing ECB policy is the mandate of price stability. The ECB – in principle like most other central banks – has chosen to define price stability as an inflation rate of ‘below but close to 2 percent.’ With a realized average inflation rate of 1.1 percent in the years 2011 to 2019, Draghi cannot be accused of having been too expansionary. Inflation forecasts for the coming years do not indicate that there will be any fundamental change in the price trend.

The side effects on the stability of the financial system and the profitability of the banks, which have been feared for many years, especially in the German debate, are not apparent. For example, the growth rates of credit aggregates are currently much lower than in the phase before the financial crisis. Finally, the argument often heard in the German debate, that Draghi's policy is dispossessing German savers, is not very convincing. The long-term average shows that the real interest rate on German savings deposits has never been positive.

At best, Draghi can be criticized for failing to communicate the ECB's policy and the underlying strategy more effectively. The two-pillar strategy developed by the ECB back in 1998 was misconceived from the outset (Bofinger 1999). It is therefore positive that Christine Lagarde announced a fundamental review of the ECB's strategy at her first press conference as President of the ECB (Bofinger 2020b).

But, all in all, in contrast to critiques from Germany, one can say that Mario Draghi has changed the lives of millions of people in Europe for the better. It was a blessing for Europe.

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APPENDIX 1 ASSESSMENT OF THE ECB'S MONETARY POLICY IN THE ANNUAL REPORTS OF THE GERMAN COUNCIL OF ECONOMIC EXPERTS (MAJORITY POSITION)

GCEE Annual Report 2013/14 item 191 'Projections based on the latest inflation and growth forecasts indicate that we will see the first interest-rate hike in 2014. Application of the original Taylor rule to the euro area also suggests that the current policy of low interest rates should be abandoned fairly soon.'

GCEE Annual Report 2014/15 item 13 'Against this backdrop the ECB slashed interest rates to almost zero and introduced comprehensive quantitative easing measures. However, this policy poses a risk to the euro area's long-term economic performance. Firstly, low interest rates tempt the financial sector to take excessive risks. And, secondly, the ECB's asset purchase programmes could cause governments to scale back their reform and consolidation efforts.'

GCEE Annual Report 2014/15 chapter 4, executive summary 'The GCEE is of the view that although the risk of deflation is currently fairly low, there are also moderate risks to the longer-term performance of the economy that should not be neglected. The ECB should therefore avoid any further massive expansion of its balance sheet unless there are observable signs or specific forecasts of deflation emerging in the euro area.'

GCEE Annual Report 2015/16 items 11 and 12 'Simple interest rate rules, such as the Taylor Rule or a rule that explains past ECB interest rate decisions quite well, suggest that monetary policy should be tightened given the current economic outlook. While the risk of deflation is currently low, there are risks for the development of the economy in the longer term. ... In addition, monetary policy is leading to a build-up of risks to financial stability which could pave the way for a new financial crisis.'

GCEE Annual Report 2016/17 item 10 'In light of the macroeconomic developments, the extent of the ECB's quantitative easing and the resulting low interest rates are neither appropriate for the euro area nor Germany.'

GCEE Annual Report 2016/17 item 376 'This means that the current negative short, medium and long-term interest rates are in no way consistent with the economic situation in Germany. These negative rates are contributing to various exceptional, and in some cases dangerous developments.'

GCEE Annual Report 2017/18 chapter 4, executive summary 'Interest rate reaction functions suggest that the ECB should tighten its monetary policy considerably in order to reflect macroeconomic developments. Risks to financial stability also support a monetary policy normalisation.'

GCEE Annual Report 2018/19, executive summary 'There is a danger that the change of course in monetary policy will come too late. Inflation might rise faster, and we could see a further increase in the misallocation of credit, investment and resources and in the risks to financial stability.'