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Draghi's Term as ECB President and the Challenges Ahead

Monetary Dialogue September 2019

Policy Department for Economic, Scientific and Quality of Life Policies
Directorate-General for Internal Policies
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Draghi's Term as ECB President and the Challenges Ahead

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Abstract

Mario Draghi took over as ECB President at a time of recession for the euro area economy and widespread concerns about whether the euro project could be sustained. The years since have seen an easing of fears of the euro breaking up and the economy recover without triggering inflation above its target level. As such, his presidency must be judged a success. Draghi's achievements go beyond the successful implementation of monetary policy. He also played a key role in encouraging Banking Union and other important institutional reforms. The new ECB President faces a difficult set of challenges. The ECB is not meeting its inflation target; inflation expectations are falling; and there are signs of economic weakness. Like Draghi, the next President will require strong communications, diplomatic and political skills to face these challenges successfully.

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EXECUTIVE SUMMARY

- Mario Draghi took over as ECB President at a time of recession for the euro area economy and widespread concerns about whether the euro project could be sustained.
- The years since have seen fears of the euro breaking up reduced and the economy recover without triggering inflation above its target level. As such, Draghi's presidency must be judged a success.
- Draghi's achievements go well beyond the successful implementation of monetary policy and have required skills that rise above just the technocratic ones we associate with a trained macroeconomist. His "whatever it takes" speech in July 2012 and the subsequent announcement of the OMT programme were sufficient to prompt financial markets to reverse course in their assessment of redenomination risk in the euro area.
- Draghi also played a key role in encouraging Banking Union, putting forward the case for greater centralisation in banking supervision and resolution and arguing for the ECB to take over as the single supervisor of the euro area's banks. The process of the ECB taking over as the single supervisor has helped with recapitalising the euro area's banks and with assuring investors that similar approaches are being taken across the euro area to supervisory issues and the treatment of bad loans.
- The new ECB President faces a difficult set of challenges. The ECB is not meeting its inflation target; inflation expectations are falling; and there are signs of economic weakness.
- Questions are being raised about whether the ECB is "out of ammunition" to address economic weakness and meet its inflation target. However, even with its traditional policy rate at zero, there is still room to provide further monetary stimulus.
- The deposit rate can be set to even more negative levels, perhaps with the introduction of "tiering" of reserves to offset the implications of negative rates on bank profitability.
- The Asset Purchase Programme can be restarted without triggering legal problems.
- Targeted Long-Term Refinancing Operations (TLTROs) can be made more generous to banks and more precisely targeted to meet some of the EU's other policy goals or to target the interest rates on the associated loans provided by the banks receiving TLTRO funds.
- The ECB should also clarify that its price stability goal is a 2 percent average inflation rate over a specified period of time.
- There are still many reforms of institutions and rules that can make the euro area economy function better, particularly during recessions. Draghi has been an effective voice in favour of these reforms and the ECB should continue playing an important role in this area.
- Draghi's designated successor, Christine Lagarde, has the communications, management, diplomatic and political skills to be an effective ECB President but Mario Draghi will be a hard act to follow.

1. INTRODUCTION

This paper reviews Mario Draghi's term as President of the European Central Bank and considers the challenges facing the ECB in the coming years.

Draghi became ECB President on 1 November 2011 at a time of a true crisis. In a briefing paper I wrote for the ECON Committee in September 2011, I noted that "*Mario Draghi faces an exceptionally difficult set of challenges*" and detailed a series of major problems.[1] The ECB had raised its policy interest rate from 1.25 to 1.5 percent in July 2012 but the evidence showed the euro area economy was heading for a "double dip" recession with unemployment rising again after a short period of recovery. The euro area's banks were suffering severe problems with bad debts and many were highly dependent on the Eurosystem for financing. Fears were growing that the sovereign debt problems that had already affected Greece and Ireland would possibly spread to larger Member States and there were concerns about whether the euro area had the necessary policy infrastructure to cope with these developments.

Taken together, these elements mean that Draghi took over during what many people believe was an existential crisis for the euro itself. Indeed, Google Trends show the peak period for searches for the term "euro crisis" occurred during November 2011.[2]

Faced with this set of initial conditions, it is assuredly the case that Mario Draghi's term as President of the ECB must be judged a success. The euro area economy has been expanding for a number of years and the unemployment rate is now close to its pre-crisis levels (see Figure 1). Contrary to fears in many quarters, the ECB's expansive monetary policy has not triggered inflationary pressures. Concern about banking and sovereign debt problems have also eased and a significant amount of institutional change has taken place in the euro area to help policy-makers cope better with future difficulties in these areas.

This success was not inevitable and Mario Draghi deserves personal credit for his role in producing this outcome. In the area of monetary policy, Draghi has clearly played the key role in pushing the generally conservative ECB Governing Council to adopt the kinds of aggressive monetary policy measures first adopted by central banks such as the Federal Reserve and then to go beyond other major central banks with a series of new initiatives that, taken together, exceed the amount of stimulus provided by other major central banks.

Draghi's achievements, however, go well beyond the successful implementation of monetary policy. Draghi has played a key role in major changes in the role of the ECB – most notably the introduction of the Outright Monetary Transactions tool and the ECB taking on the role of single supervisory mechanism for euro area banks – which have helped to reduce existential concerns about the euro and stabilise the banking system. He has also played an important and highly constructive role in working with Europe's political leaders to establish new institutional structures and continues to push for further changes that will make the euro area function more efficiently and reduce the chances of future crises. This role has required key diplomatic and political skills that go well beyond the traditional remit of a central banker.

Despite the successes of Draghi's term, his successor still faces a number of serious challenges. The ECB has consistently failed to meet its inflation target in recent years, measures of long-run inflation expectations are falling and there are signs of global economic weakness. This raises concerns about whether the ECB's has any further "monetary ammunition" to counter these forces. The ECB should

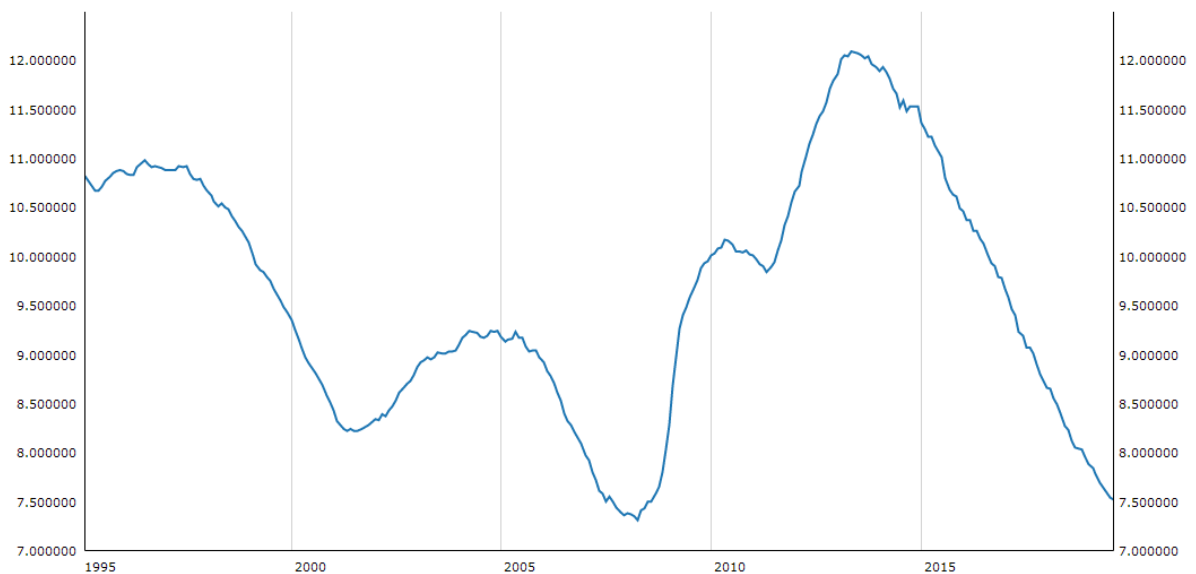
[1] See Whelan (2011).

[2] See https://trends.google.com/trends/explore?date=2006-01-01%202019-09-04&q=the%20euro%20crisis.

also continue putting forward proposals for institutional changes to improve the functioning of the euro area, to promote economic growth and to protect financial stability. So the new President has a full slate of work.

The rest of this paper is structured as follows. Section 2 reviews Mario Draghi's term as ECB President focusing on his contributions to averting the euro crisis, to the introduction of Banking Union and to implementing an appropriately aggressive monetary policy. Section 3 reviews the challenges relating to monetary policy facing the new ECB President and the set of policy options that are available. Section 4 reviews the remaining institutional changes that could be made to allow the euro area to work more smoothly during recessions and reduce the chances of a future crisis. Section 5 concludes with some comments about the role of ECB President and the preparedness of the designated next President, Christine Lagarde.

Figure 1: Euro Area Unemployment Rate



Source: ECB Statistical Data Warehouse.

2. DRAGHI'S ACHIEVEMENTS

In normal times, a central banker is judged against their macroeconomic stabilisation goals such as maintaining low inflation and minimising the scale of economic cycles. Draghi's period as ECB President was very far from a normal time and the achievements of the ECB during his presidency go well beyond the typical realms of monetary policy. I will discuss monetary policy below but will start with the ECB's role in easing the sovereign debt crisis, saving the euro and stabilising the euro area banking system.

2.1. Preserving the Euro

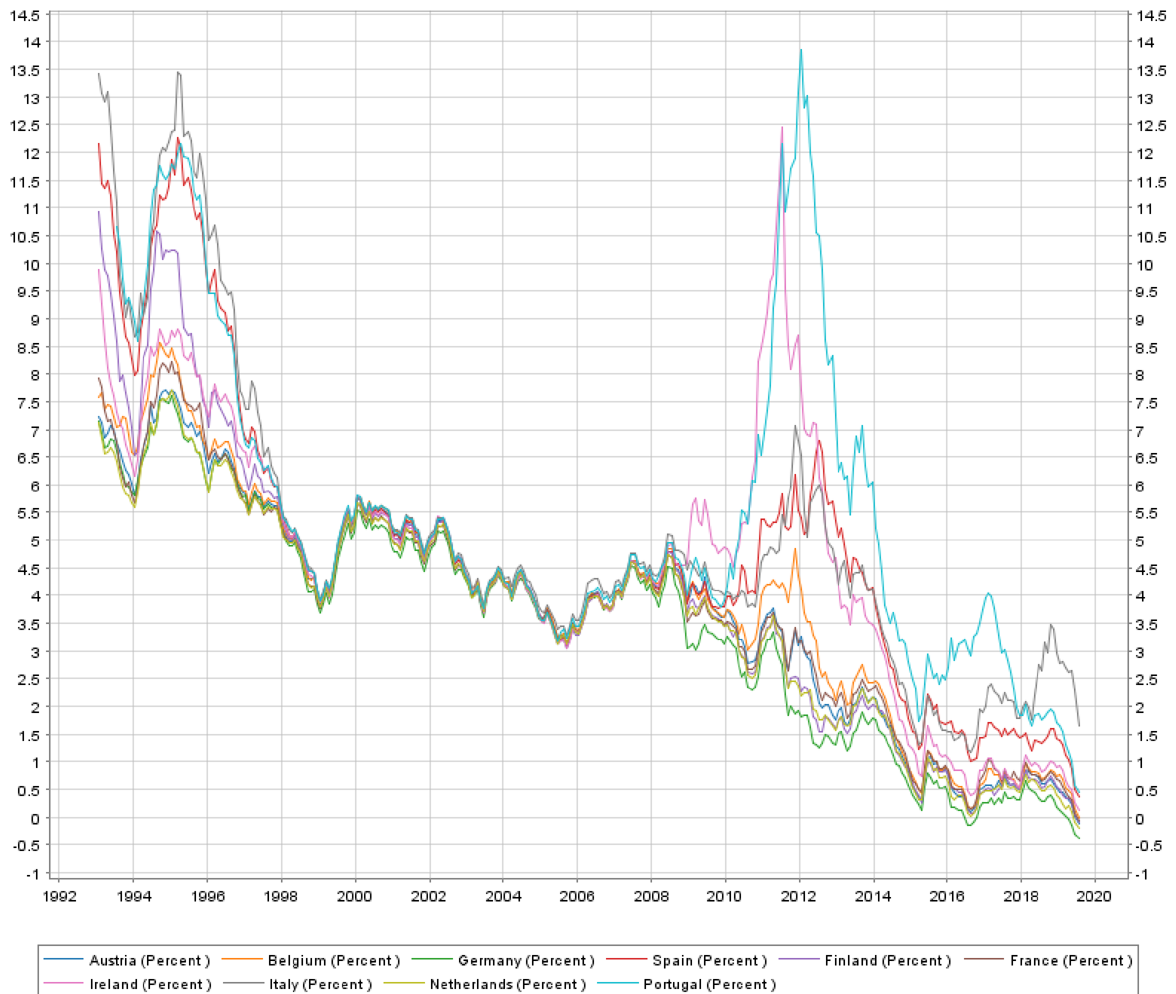
November 2011 was a time of great uncertainty about sovereign debt sustainability in the euro area. A restructuring deal for Greek sovereign debt had been agreed but it was unclear whether this was to be a once-off event or the first of a sequence of restructurings across different countries. Speculation about potential further sovereign defaults raised the cost of funding for countries such as Ireland, Portugal, Spain and Italy. (See Figure 2). Ireland and Portugal were already in EU-IMF programmes at this point but it was unclear whether there was a willingness or financial resources to fund either Spain or Italy if they lost access to the sovereign bond markets. Concerns about potential sovereign debt write-offs were also weighing on sentiment towards banks in these countries and many were struggling to maintain funding, with many relying heavily on short-term funding from the Eurosystem. This capital flight was mirrored in the expanding intra-Eurosystem balances ("TARGET balances") showing up on the balance sheets of Eurosystem central banks.

Taken together, these concerns represented a threat to the stability of the euro area and there was widespread speculation that one or more Member States might choose to leave the common currency. This risk further fuelled the cost of debt for governments and encouraged capital flight from banks.

Draghi's predecessor as ECB President, Jean-Claude Trichet did not handle problems related to sovereign debt well and his decisions may have worsened the crisis in Greece. Trichet's ECB intervened in the Greek sovereign debt crisis by buying Greek sovereign bonds but given the unsustainable nature of the debt burden, this ultimately did little to ease market concerns about a default. When negotiations over debt restructuring did occur, the ECB took a dogmatic anti-default approach, summarised by Trichet's comments at the July 2011 meeting: "*our message is - 'no credit event, no selective default – no default' It is as simple as that!*". The ECB's insistence on being treated as a senior creditor during the restructuring increased losses for private-sector holders and threatened the future of any ECB bond purchase scheme since investors would worry that the more bonds purchased by the Eurosystem, the more likely private investors were to lose out during a debt restructuring package.

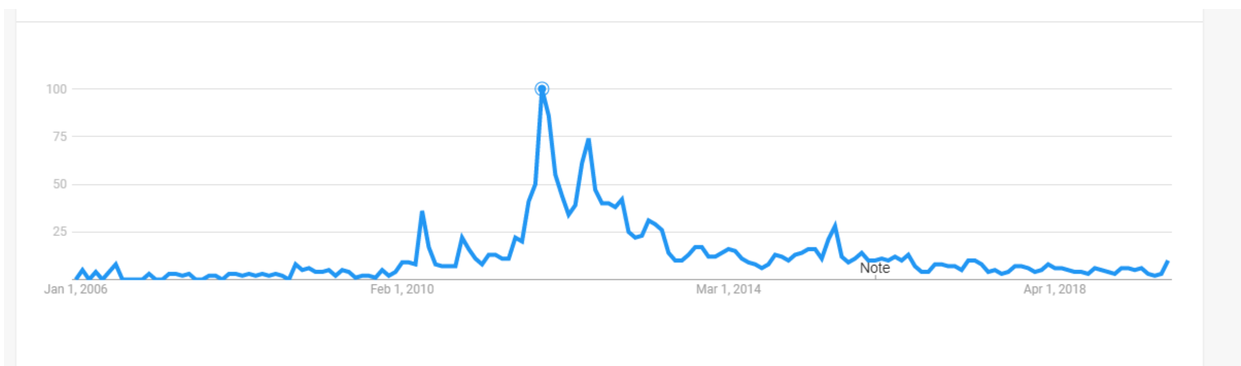
In under a year, Draghi's ECB had, via actions and words, done enough to ease the worst of the euro crisis. On 8 December 2011, the ECB announced the introduction of long-term refinancing operations provided credit to banks over a three-year maturity as well as a number of measures to increase the availability of collateral to allow banks to secure more credit from the Eurosystem. These measures provided stable funding to many banks that had been previously been under pressure with their liquidity planning (the previous maximum length operations had been one year in length). They also provided a substantial amount of liquidity to financial markets, much of which was used to purchase sovereign bonds, thus helping to ease some of the pressures on sovereign yields.

Figure 2: Long-Term Sovereign Bond Rates in Selected Euro Area Countries



Source: ECB Statistical Data Warehouse.

Figure 3: Index of Number of Google Searches for "The Euro Crisis" (Peak = 100)



Source: Google Trends.

By summer 2012, however, the LTROs were seen as having been a temporary "sticking plaster" that left the fundamentals of the euro crisis unchanged. With many euro area economies back in recession and widespread austerity measures proving politically unpopular, questions about the future of the euro were multiplying and these uncertainties were reflecting in surging yields on sovereign bonds in many countries (See Figure 2). Perhaps the key moment of Draghi's regime was his short speech in London on 26 July 2012. The key phrases were "*Within our mandate, the ECB is ready to do whatever it takes to preserve the euro. And believe me, it will be enough*."

On its own, this could have meant many things but its serious tone convinced many in financial markets that the ECB was willing to take action to prevent sovereign spreads in euro area countries from spiralling out of control. This was followed by a concrete announcement on 2 August 2012 of new policy instrument, "Outright Monetary Transactions" (OMT). This programme could be applied to make secondary market purchases of sovereign bonds of a Member State with the goal of "*safeguarding an appropriate monetary policy transmission and the singleness of the monetary policy*." Implementation of OMT was dependent on the relevant Member State adopting an ESM-sponsored macroeconomic adjustment programme or a precautionary programme. Importantly, and crucially deviating from Jean Claude Trichet's position, the ECB accepted that bonds purchased via the OMT programme would receive the same treatment as other creditors.

While OMT has not yet been implemented for any Member State, the combination Draghi's commitment to preserve the euro with a concrete ECB "bazooka" programme of potential bond purchases was sufficient to prompt financial markets to reverse course in their assessment of sovereign default and redenomination risk in the euro area: Draghi (2019) noted recently that the announcement "*acted as a circuit breaker*" for speculation about redenomination risks. Spreads tightened rapidly over the rest of to 2012 and continued doing so through 2015. Today, sovereign bond spreads are neither as close together as they were prior to the global financial crisis nor as far apart as they were in summer 2012. This probably reflects a fair assessment: default risk remains a possibility but concerns about the demise of the euro are relatively low at present.

2.2. Banking Union

One of the key fault lines in the design of EMU that was exposed during the global financial crisis was the inadequacy of the legal rules governing the banking sector in the euro area. Deposit insurance schemes that were in place prior to the crisis were insufficient to reassure depositors once the crisis hit. With little experience of bank failures in the modern era, few Euro Area states had well-designed bank resolution legislation. Most would have had to rely on normal liquidation procedures to enforce losses on creditors and did not have agencies with FDIC-style powers to arrange, for example, purchase and assumption deals. And while Basel-style banking regulations were enshrined in European law, transposing and applying regulatory standards took place at a national level as did micro-prudential banking supervision. There appear to have been important differences across Member States in prudential supervisory culture and the interpretation of issues like classification of non-performing loans. There were also many agreed "national discretions" in setting and implementing regulations.

These problems interacted with existing sovereign debt and banking weaknesses to make the euro's crisis more intense. Difficulties in resolving banks placed more fiscal pressures on states and national differences in supervisory cultures reduced the transparency of bank balance sheets and fuelled further mis-trust of banks in euro area economies under strain.

Given these problems, the ECB under Draghi should receive considerable credit for its role in encouraging the various elements of Banking Union that have come into place. Reviewing the development of Banking Union proposals, it is clear Draghi's ECB played a key role in pushing this

project along. During early 2012, a number of members of the ECB Executive Board made statements in support of centralising banking supervision and resolution in the euro area.[3] In April 2012, at an appearance before the ECON Committee, Draghi also came out in support of increased centralisation in this area.[4] By June 2012, the euro area summit statement backed the establishment of a Single Supervisory Mechanism (SSM) "involving the ECB". The process of ECB taking over its SSM duties occurred over a relatively short period of time. The SSM legislation was passed in October 2013 and the ECB took over as the single supervisor on 4 November 2014.

The ECB taking over as the supervisor of the euro area's banks has had a positive impact on the stability of the banking sector. Prior to becoming the single supervisor, the ECB insisted on a comprehensive assessment of the banks it was taking over, documenting various capital shortfalls that needed to be made up. This helped to establish the scale of "legacy losses" in various banks. European investors can also now be assured that similar approaches are being taken across the euro area to supervisory issues and the treatment of bad loans.

With Banking Union in place, it is possible to take this achievement for granted and to forget the important role played by Mario Draghi in bringing it about. However, it was not inevitable that banking supervision would be centralised at a euro area level. Financial regulation rules are made at an EU level and it was not clear that EU states outside the euro, in particular the UK, would accept this kind of centralisation. There were also strong national vested interests among bankers and regulators objecting to this development. And previous expert advice had warned against this approach: The 2009 de Larosiere report rejected the creation of a single supervisor as too complex a task and it explicitly rejected a role for the ECB in micro-prudential supervision. In light of these difficulties, Mario Draghi's diplomatic and political skills appear to have played a key role in the establishment of the SSM specifically and Banking Union more generally.

2.3. Monetary Policy

In relation to monetary policy, generally seen as the core area of responsibility for central banks, Mario Draghi has overseen an aggressive and innovative expansionary approach to policy which ultimately must be judged a success. Draghi took over the ECB presidency at a time when the euro area economy was slumping and unemployment had started increasing again having briefly stabilised during 2010/11. The ECB's monetary policy has helped the euro area economy recover and the unemployment rate is now close to its pre-crisis levels. It has achieved this without threatening price stability. Indeed, increasingly the concern about ECB monetary policy is its failure to get inflation up to its target level.

The need for monetary policy to be innovative was largely forced on Draghi's ECB by economic events. A few months prior to the beginning of Draghi's term, the ECB had raised the interest rates on its Main Refinancing Operation (MRO) to 1.5 percent and was planning further increases. By the time Draghi took over the economy was weakening. Draghi's ECB Governing Council cut its policy rate on his ninth day in office and never raised them during his term. (See Figure 4)

With interest rates already low, the ECB has had to introduce a wide range of new tools and approaches to implementing monetary policy. Most of these approaches have been copied from what has been done elsewhere but they have combined in recent years to resemble an expansionary monetary policy package that exceeds what has been implemented elsewhere.

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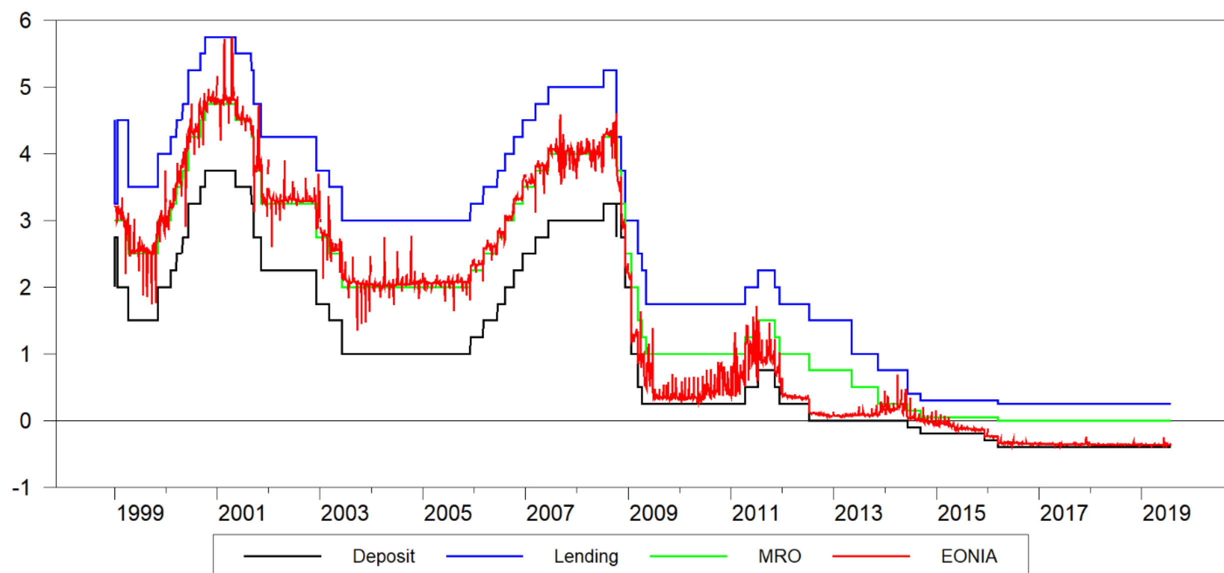
[3] See for example, this report in the Financial Times from March 2012 https://www.ft.com/content/d01b8d14-7a88-11e1-8ae6-00144feab49a.

[4] See http://www.europarl.europa.eu/document/activities/cont/201205/20120502ATT44349/20120502ATT44349EN.pdf.

Figure 4: EONIA and the ECB's Policy Rates



Source: ECB Statistical Data Warehouse.

The key innovations to ECB monetary policy under Mario Draghi have been:

1. Forward Guidance: During Trichet's presidency, questions about the path of future policy were often met with the mantra of "*we do not pre-commit*". However, in a world where long-term interest rates have a key influence on the economy, communicating a commitment to keep interest rates low for a long period in order to reduce these longer rates, can be a powerful tool to influence the economy. The ECB began using forms of forward guidance in July 2013 and this is now a standard part of its toolkit.

2. LTROs and TLTROs: Large long-term refinancing operations have also become an important tool for the ECB to influence the banking sector and the economy. Following the initial LTROs of late 2011 and early 2012 which stabilised the liquidity situation of euro area banks and contributed to lowering sovereign yields, the ECB introduced Targeted LTROs (TLTROs) in June 2014. These provide funding to banks contingent on passing the credit on to the real economy. Recent versions of the TLTRO have made the interest rate on the loans more attractive the more lending is provided to non-financial corporations and households.

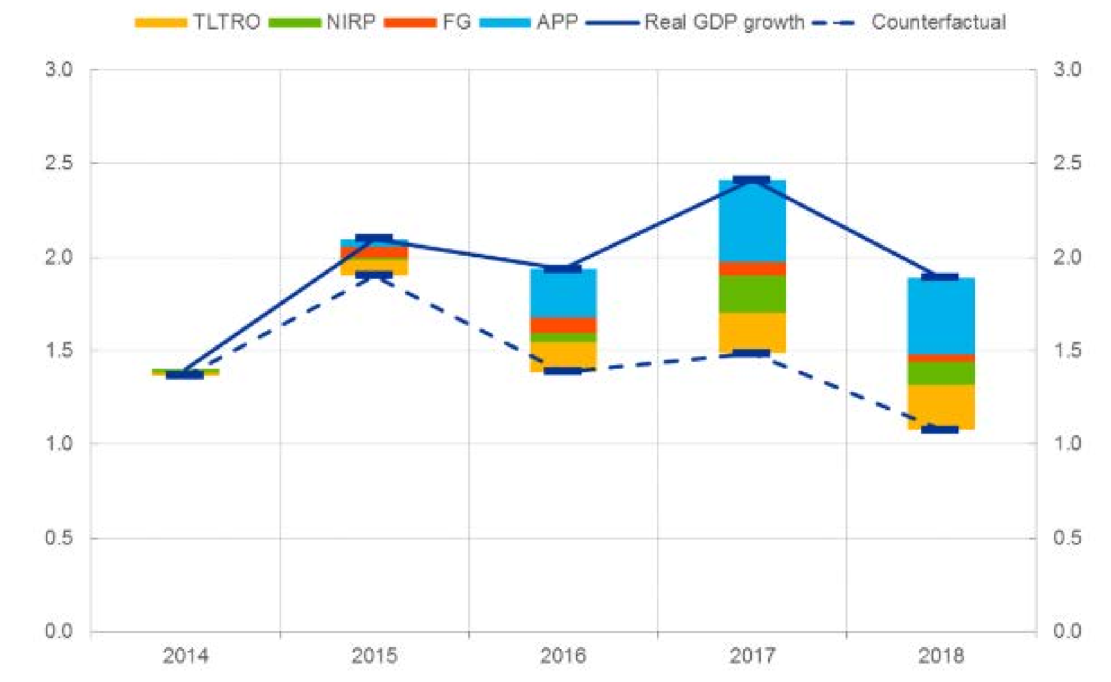
3. Negative Deposit Rates: Contrary to the traditional idea of a zero bound on interest rates, the ECB has been able to move its deposit rate into negative territory, starting in June 2014 at minus 10 basis points and gradually moving this rate down to minus 40 points since March 2016. This has provided an incentive for banks to use their reserves to make loans to the real economy.

4. Asset Purchase Programmes: The ECB declined to follow the Fed and Bank of England in pursuing Quantitative Easing (QE) programmes during the global financial crisis. However, it introduced a large Asset Purchase Programme (APP) in late 2015 and purchased EUR 2.65 billion in assets in the period up to the end of 2018, paying for these assets via credits to "reserve accounts" that commercial banks hold with the Eurosystem. Combined with the negative deposit rate applied to these reserves, this

provides an incentive for banks to make positive interest rate loans rather than losing money by keeping it deposited with the Eurosystem.[5]

As described in an excellent and comprehensive recent speech by ECB Chief Economist, Philip Lane, taken together, these four elements work as a package to provide a significant stimulus to the economy: They act to reduce sovereign bond yields, reduce private sector borrowing rates and encourage banks to lend to firms and households. Lane presented ECB staff calculations for the impact of these four policies on GDP growth and inflation. These calculations are repeated here as Figures 5 and 6. They suggest the ECB's unconventional policies have had a significant impact on GDP growth and have prevented inflation from falling even further below its target level.

Figure 5: Effect of ECB Unconventional Policies on Euro Area GDP Growth

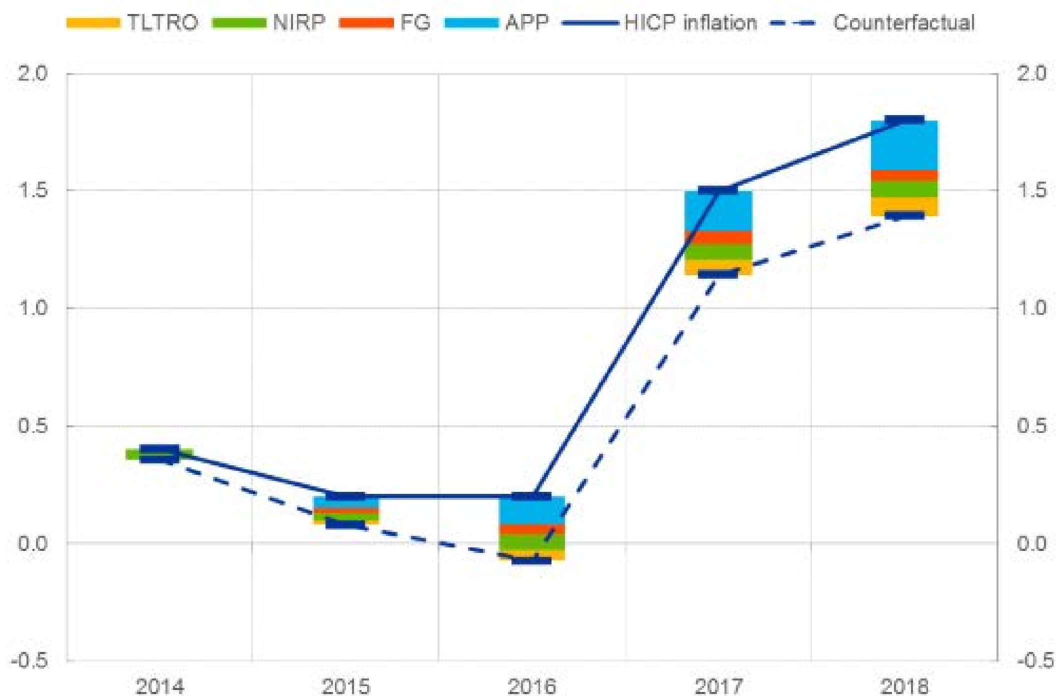


Source: Lane (2019).

Note: NIRP = Negative Interest Rate Policy, FG = Forward Guidance.

[5] That said, Ryan and Whelan (2019) document that while many banks are actively working to reduce their deposits with the Eurosystem, the main channel for this appears to be purchasing securities.

Figure 6: Effect of ECB Unconventional Policies on Euro Area Inflation



Source: Lane (2019).

Note: NIRP = Negative Interest Rate Policy, FG = Forward Guidance.

What role can we ascribe to Mario Draghi in the implementation of these policies? The ECB Governing Council is relatively secretive about its decision-making, albeit that the innovation of published "accounts" of the meetings (without attributing statements to individuals) has improved transparency somewhat. Still, it can be hard to appreciate fully the role played during and before key meetings by the ECB President. My sense, however, is that Draghi has played a crucial role in building the necessary consensus required to get the Governing Council to adopt this sequence of unconventional policies.

In a June 2014 briefing paper, I noted that, relative to other central banks, the ECB had been slower to cut interest rates to near zero after the global financial crisis and more reluctant to adopt unconventional measures despite the euro area economy performing worse than international comparators and inflation generally being below target. However, over the subsequent five years, the ECB adopted a significant package of unconventional measures. My sense now is that Mario Draghi had to use all of his diplomatic skills and powers of persuasion to push the many conservative "hawkish" members of the Governing Council to accept the need for new monetary policy measures. As we will discuss below, while Draghi's ECB has not solved all of the problems facing the Governing Council, it has developed a much larger set of tools that his successor can use to influence the economy.

Draghi has also played a crucial role in in implementing monetary policy via his effective communication at post-Governing-Council press conferences and other public appearances, including those at the ECON Committee. Many of these policies such as the APP or the OMT tool have been questioned as possibly running counter to the European Treaty. Draghi's clear and firm explanations of their legality and the roles they are playing in helping the ECB to meet its mandate have played an important role in their effectiveness.

3. MONETARY POLICY CHALLENGES AND POLICY OPTIONS

Despite Mario Draghi's successes in keeping the euro together and implementing an effective monetary policy that has helped the euro area economy recover from crises, the new ECB President faces a number of serious challenges and may, like Draghi, have to consider new and innovative ways of implementing monetary policy if the ECB is to achieve its goals.

3.1. Challenges

While the ECB's monetary stimulus has helped the euro area economy to recover, this recovery has not stimulated inflation sufficiently to move it back towards the ECB's target of "close to but below 2 percent." It is worth emphasising the extent to which the ECB has now fallen short of this target. The black line in Figure 7 shows the level of the Harmonised Index of Consumer Prices (HICP) starting from November 2011, Mario Draghi's first month as ECB President. The blue line shows how the HICP would have evolved if it had increased at a steady inflation rate of 1.85 percent (a figure I am using as a substitute for the ECB not actually declaring its inflation target). The figure shows a steady widening in the gap between these two series, with the gap in August 2019 standing at about 6 percent. In other words, the cumulative shortfall in the price level now stands at the equivalent of over three years of the target-level inflation.

Given the ECB's failure to meet its own inflation target, it is not surprising that inflation expectations are gradually becoming "de-anchored" from the ECB's target level. Figure 8 shows three measures of the average level of inflation expected over the next five years by the participants in the ECB's Survey of Professional Forecasters.[6] Each of these measures are at their lowest ever, with the mean of the overall probability distribution provided by the forecasters now down to just 1.62 percent. Figure 9 shows that under 3 percent of participants expect inflation to exceed 2 percent over the coming five years.

A further cause for concern is the evidence of an economic slowdown. Many short-term indicators suggest the euro area economy is weakening, most notably in the manufacturing sector, and there are wider concerns for the health of the global economy as trade disputes threaten to cause disruption. The possibility of a no-deal Brexit also looms over the euro area economy in the coming months, with the likelihood being that the dislocations created by such a shock will tend to be front-loaded as businesses trading with the UK are hit hard at first before gradually adjusting to the shock over time.

In addition to shorter-term problems, the euro area has serious longer-term supply-side issues. Research suggests that the maximum long-term growth capacity of the euro area economy is significantly below where was in previous decades due to declining work-age populations and weak productivity growth.[7] As discussed in Whelan (2018), it appears likely that this reduction in potential output growth has also reduced the "equilibrium" real interest that stabilises the economy. This suggests that extremely low policy rates and unconventional measures may be with us for the foreseeable future.

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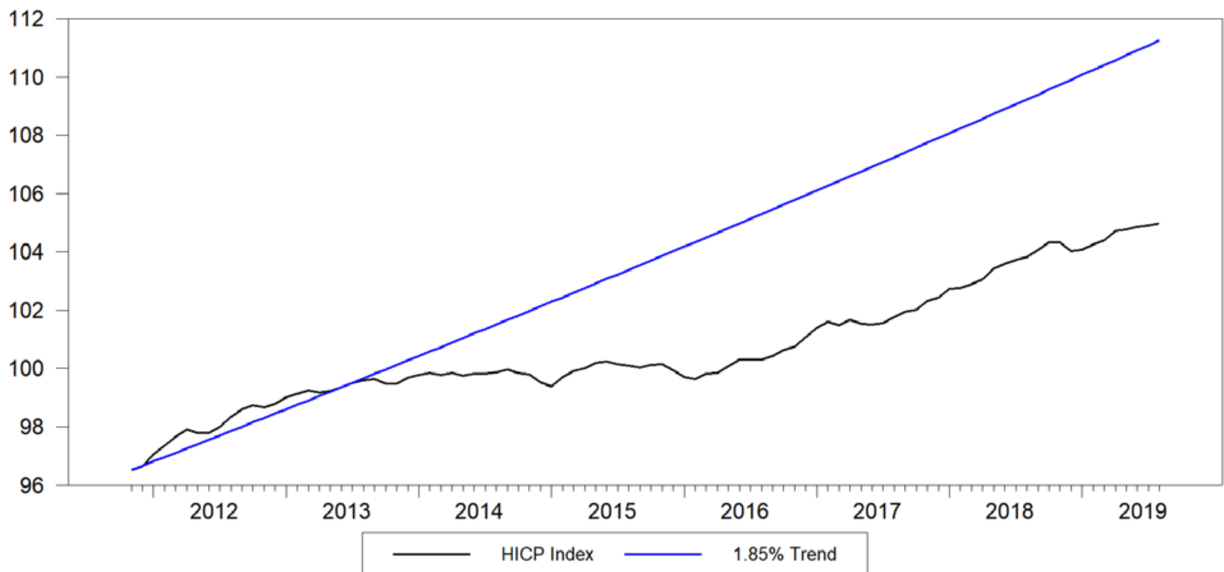
[6] Available at https://www.ecb.europa.eu/stats/ecb_surveys/survey_of_professional_forecasters/html/index.en.html.

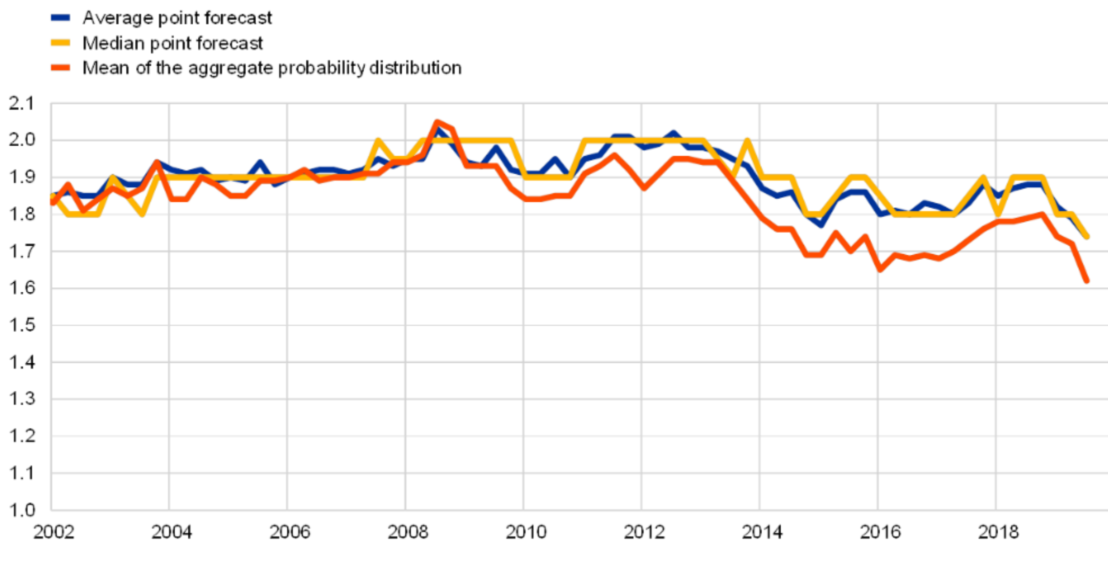
[7] See McQuinn and Whelan (2018).

Figure 7: The HICP Index Relative to a 1.85% Trend Since November 2011



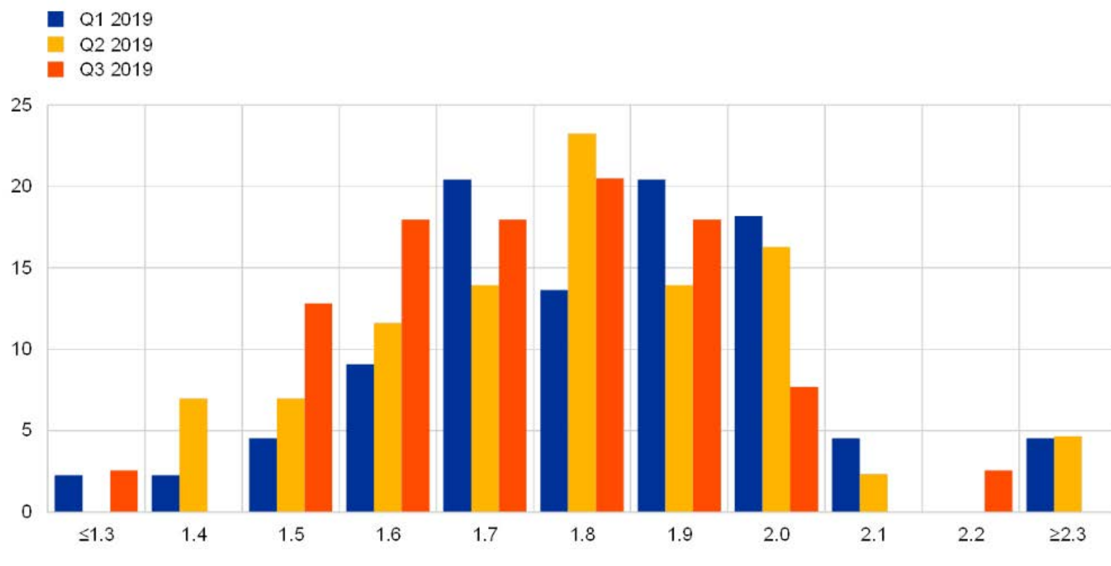
Source: Author's calculations based on data from ECB SDW.

Figure 8: Five-Year Inflation Expectations from the Survey of Professional Forecaster



Source: ECB.

Figure 9: Distribution of Point Estimates of Five-Year Inflation Expectations from the Survey of Professional Forecaster



Source: ECB.

3.2. Monetary Policy Options

The ECB's traditional "policy rate", the MRO rate is zero. This may suggest there is not much the ECB Governing Council can do to counteract economic weakness and restore inflation towards its target level. However, recent experience has shown that even with its traditional policy rate at zero, there is still room for manoeuvre to provide further monetary stimulus. Here I list some options that can be considered.

More Negative Deposit Rates: In the past, economists used to discuss "the zero lower bound" on interest rates. They reasoned that people would not be willing to invest their money in negative interest rate deposit accounts or bonds because cash was available as a superior zero interest rate option. However, when considering the transmission of monetary policy via financial institutions, it turns out that zero is not a particularly special number. Due to the ECB's asset purchases, European banks have almost EUR 2 trillion on deposit with the Eurosystem. These banks have decided they are willing to accept a 40 basis points annual charge for having money safely on deposit with the ECB rather than withdraw this money as cash and store it in warehouses. The latter option has security and hazard risks and would require paying for insurance in case, for example, a warehouse containing large amounts of cash burned down. Indeed, evidence elsewhere suggests deposit rates can be set lower than minus 40 basis points. The current rate in Switzerland is minus 80 basis points and this has still not triggered a run to cash.

One concern that was raised when Sweden introduced negative deposit rates was that, after a certain point, rate reductions stopped passing through to financial markets. Thus far, however, that has not been the experience in the euro area. Figure 4 above shows that the EONIA measure of short-term market interest rates has followed the deposit rate very closely in recent years.

A final concern about making deposit rates more negative is that these rates act as a form of tax on the banking sector and this could raise the cost of borrowing for firms and households. I think these concerns are somewhat overblown because the size of this charge is small compared with the overall

size of the banking sector. For example, a charge of 40 basis points on EUR 2 trillion of deposits with the Eurosystem results in an annual charge to the banking sector of EUR 8 billion, which compares with total consolidated assets of almost EUR 29 000 billion.

Nevertheless, these negative effects on the banking sector can be easily offset by introducing a system of "tiered reserves" as has been implemented by the Bank of Japan and other central banks with negative interest rates. This would provide compensation for the some of the money that banks have deposited with the Eurosystem before imposing a charge after a bank's deposits rise above a certain level. For monetary policy transmission, what matters is the marginal cost of keeping deposits with the Eurosystem rather than the average level, so this policy could reverse the damaging effects of negative deposit rates on bank profitability without reducing the policy's effectiveness in determining market interest rates. In his speech at the ECB's conference in Sintra in June, Draghi commented that "*Further cuts in policy interest rates and mitigating measures to contain any side effects remain part of our tools*." I interpret this as implying that cuts to the deposit rate and the introduction of tiered reserves is likely to be introduced soon.

Further Asset Purchases: Another policy option is to announce a further round of asset purchases. One complicating factor for such a decision is that the Governing Council has previously set limits on how the amount of sovereign bonds it would buy from national governments and these limits—33 percent for each issuer as well a 33 percent limit for each specific bond issued—are in some cases being reached. These limits are designed to prevent the Eurosystem from becoming a "blocking minority" if a country proposes a debt restructuring which its bondholders then vote on. There are concerns that failure to use a blocking minority to prevent debt restructuring could be viewed as illegal monetary financing.

My judgement is that these concerns should not prevent a further round of asset purchases. This is for a number of reasons.

First, in relation to legal concerns, it should be noted that the ECB's OMT programme was judged legal by the European Court of Justice despite a clear declaration that the ECB would be treated the same as other creditors and without any commitment to put issuer limits in place or block debt restructuring. Indeed, if issuer limits of this sort were to be considered a major issue, then the Eurosystem's acquisitions via the Public Sector Purchase Programme (PSPP) would have attracted concern among market participants and commenters suggesting that OMT purchases would be severely limited (or possibly could not be activated at all) in some countries. To my knowledge, this has yet to be raised as a major concern. Given these points, I believe the self-imposed issuer limits could be raised, perhaps to a threshold of just below 50 percent. Mario Draghi's comment in Sintra in June that "*the limits we establish on our tools are specific to the contingencies we face*" clearly suggests this is the kind of action he can support.

Second, it should also be noted that the specific mode of purchase the Eurosystem uses for the PSPP raises questions about whether debt restructuring would really constitute monetary financing. If, for example, the Banca d'Italia were to agree to restructure its holdings of Italian government bonds, then the Italian government as a whole is not better off. The central government's debt has been reduced but the central bank's asset holdings have been reduced and this reduces the payments from these assets back to central government. The Banca d'Italia would also still have longer-term liabilities due to the credits to commercial bank deposit accounts that it used to purchase the bonds or Intra-Eurosystem liabilities relating to funds earned from bond sales being transferred to banks elsewhere in the Eurosystem.

Third, while issuer limits are being reached in some cases, the total amount of sovereign bonds purchased is well below the 33 percent limit, so there are many bonds left that can be bought even under these limits by moving away from a purchasing rule based purely on capital keys.[8]

Finally, there are large amounts of corporate bonds that are available for the Eurosystem to purchase, particularly with net issuance currently being strong due to low borrowing costs and the ECB could also consider starting an equity purchase programme, which could boost stock prices.

These considerations suggest there is room for a further round of asset purchases, with no technical reasons why the programme could not be as large as the EUR 50 billion per month over a period of about 18 months.

Modified TLTROs: Another policy the ECB could consider is a modified version of its TLTRO designed to be more expansive than its predecessors. The most recent TLTRO allows banks to get loans from the ECB at interest rates as low as ten basis points above the deposit rate (which would currently mean a minus 30 basis point interest rate) provided they meet requirements to expand their loan books. Specifically, TLTRO3 would provide loans at this interest rate to banks that increased a benchmarked stock of eligible loans by 2.5% between September 2019 and March 2021. It would be possible to supplement this scheme with a more generous rate reduction dependent on a higher rate of increase in credit.

Other more radical options should be considered. For example, TLTROs could provide banks with deeply discounted negative interest rate loans under condition that they then make loans at zero interest rates to selected types of businesses. Such a programme could even be targeted at helping the EU achieve success in other areas of policy. For example, negative rate TLTRO loans could be provided to agencies to promote outcomes related to the "European Green Deal".

Another option would be a programme targeted at mortgage lending. Mortgage lending is currently not incentivised by TLTRO, presumably because of the maturity mis-match between TLTRO loans and mortgage terms. However, a longer-term TLTRO could be designed to offset these concerns, perhaps with a qualifier that any additional mortgage lending induced by such a programme be consistent with national macro-prudential policies. For example, if a country's designated macro-prudential authorities are putting in place measures to cool their housing markets, then such a policy may not be welcome.

A Clarified and Modified Inflation Target: The European Treaty gives the ECB and national central banks a primary goal of price stability but does not define what price stability means. Prior to the introduction of the euro, the ECB Governing Council defined price stability as inflation within a range of zero to 2 percent over the medium term. A review of the monetary policy strategy in 2003 saw this definition refined to clarify that the ECB would aim for an inflation rate of close to but below 2 percent.

Incoming ECB President Lagarde has signalled her support for a broad review of the ECB's monetary strategy and this would provide an opportunity for a further revision of the definition of price stability with a view to raising inflationary expectations. The simplest revision would be to announce an actual inflation target. Rather than putting a number on "close to but below 2 percent" (like my guess of 1.85 percent above) the simplest thing would be to announce that the ECB's target inflation rate is 2 percent. It's a simple number, easy for the public to understand and can be used as an "anchor" rate for longer-term inflation expectations.

[8] See, for instance, the calculations in Bruegel (2018).

A more complex issue is the question of "symmetry" relative to an inflation target. Draghi's Sintra speech argued that the ECB has "clarified" that it treats its inflation goal in a symmetric manner, commenting that "*our medium-term orientation implies that inflation can deviate from our aim in both directions, so long as the path of inflation converges back towards that focal point over the medium-term policy horizon*." Unfortunately, the credibility of this position has been undermined by the fact that other members of the Governing Council disagree with him. Bundesbank President, Jens Weidmann, has recently said "*Regarding our definition of price stability, the current formulation of the target is not symmetric in my view*".[9]

The reason there is room for disagreement and confusion here is that the ECB's own definition of price stability is insufficiently clear on this question. I recommend the Governing Council adopt the proposal of Grégory Claeys, Maria Demertzis and Jan Mazza (2018) to define price stability as inflation of around 2 percent "on average" over a long period, perhaps corresponding to a full business cycle. With such a definition in place, it would be clear (for instance from the calculations shown above in Figure 7) that inflation could be above 2 percent for a number of years in the future without the ECB failing to meet its price stability goal. And there would be no room for "hawks" on the Governing Council to disagree with this assessment.

There are also strong arguments for reconsidering 2 percent as an inflation target and instead considering a higher rate. There are no results from academic economics suggesting 2 percent is somehow an "optimal" inflation rate—its emergence as a consensus among modern central banks seems to be a convention rather than based on evidence. However, we have seen that central banks that pursue a 2 percent target tend to end up with zero interest rates and unconventional policies once their economy goes into recession. A predictable price level that grows at a steady 4 percent rate could possibly be still viewed as a form of price stability while allowing the ECB to have more room for manoeuvre during recessions. I don't expect the next strategy review to consider this option but over the longer-run it should be one of the available options.

Adopting a clear and symmetric 2 percent target is not guaranteed to raise inflation. After all, the ECB is not meeting its current definition of its inflation target, so why would the public believe it if it revised the target to a higher average level? Still, the current approach is unclear and allows some to interpret the ECB has having an asymmetric approach that tolerates inflation below 2 percent more than inflation above that level. A clarification that this is not the case would not hurt and may help.

Helicopter Drops? A final issue worth noting is the possibility of the Eurosystem implementing a more radical option of direct provision of money to the private sector, known sometimes as "helicopter drops" or "QE for the people". A number of academics and commentators have called for this as a more effective approach to monetary stimulus than asset purchase programmes and Mario Draghi commented in March 2016 that it was "an interesting concept".

While I have no objection to such an approach in theory, it seems unlikely to be practical and may well be inconsistent with the European Treaty. The practical problems become obvious as soon as you start trying to turn this idea into a plan. Who does the central bank give this "free money" to? The ECB does not have a register of everyone living in the euro area or a list of bank accounts that could be credited. It seems most likely such a programme would have to work through national governments identifying people to receive the free money but this would look a lot like pure monetary financing.

[9] See https://uk.reuters.com/article/uk-germany-ecb-economy/ecbs-weidmann-sees-no-need-for-economic-stimulus-newspaper-idUKKCN1VE0FF.

Eurosystem operating procedures would also mean that if successful, an operation of this sort could have long-run costs for the taxpayer. Like QE programmes, a programme of this sort would result in an expansion of the amount of money that commercial banks have on deposit with the Eurosystem and, under normal conditions, these deposits are compensated with interest income. The Eurosystem would just incur additional longer-term costs from this programme without obtaining additional assets to cover these costs. This means that, at least under current Eurosystem operational procedures, "free money" programmes wouldn't turn out to be completely free for the public.

So while Draghi is correct that this as an interesting concept, it's not one we are ever likely to see implemented in the euro area.

4. FURTHER INSTITUTIONAL CHANGES

A consistent theme of Mario Draghi's public communications in recent years has been that the euro area is over-reliant on monetary policy and there need to be institutional reforms to allow other instruments to be deployed to promote economic stability.

I have written at length about the various institutional reforms that are possible (Whelan, 2019) so I won't repeat that analysis at length here. However, it should be noted that there are a whole series of reforms to allow for a more effective application of fiscal policy in the euro area. These include simplification of the EU's fiscal rules and adapting the European Commission's methodology for estimating potential output which induces pro-cyclicality. They also include taking steps to develop some level of joint fiscal capacity across the euro area. There have been lots of ideas for how such joint capacity should work and the French and German governments have developed a limited joint proposal that would see an increase eurozone budget that could play some role in stabilising national economies. So the principal has been accepted by the governments of the two largest euro area countries. It is now a case of getting broader political agreement.

There are a number of areas where Banking Union could be strengthened and the links between banks and sovereigns further weakened. These include a common euro area deposit insurance scheme, a joint fiscal backstop for the Single Resolution Fund, the removal of zero risk-weighting for EU sovereign bonds and the imposition of limits on bank holdings of bonds issued by their own national governments.

The ECB can introduce some reforms of its own to improve procedures for dealing with banks in distress. The ECB should simplify its procedures relating to emergency liquidity assistance (ELA). Since ECB is now the supervisor for all of euro area banks, it could be argued that decisions about emergency liquidity should be taken at a central level and profits or losses from these operations should be shared. ECB should also announce procedures for providing a dedicated lending facility for financial institutions undergoing (or recovering from) a resolution process.

Finally, the ECB should continue to argue for growth-enhancing structural reforms to be implemented by national governments. I would stress, however, that the ECB should be willing to include reforms to allow higher levels of net immigration into the EU as part of such a package. As documented in, for example, McQuinn and Whelan (2018), declining work-age populations are projected to be a major drag on the potential growth rate of the euro area in the coming decades. A rational economic case should be made for the economic benefits to Europe of higher levels of immigration and the ECB is well positioned as an independent body to make this argument.

5. CONCLUSIONS

While official confirmation will not occur until October, it is safe to assume that Christine Lagarde will be taking over from Mario Draghi as ECB President in November. Despite Mario Draghi's considerable achievements, Lagarde will face a full slate of difficult issues to deal with in the coming years. There is no doubt that Mario Draghi will be a hard act to follow and questions have been raised by some about whether Lagarde is well prepared for the tasks that lie ahead. Compared with Draghi—who has a PhD in Economics from MIT and a long career in economic policy spheres—Lagarde's background as a lawyer and politician may seem like less appropriate preparation for a major job in central banking.

A closer examination of what the role of ECB President has become and of Lagarde's qualities and experience suggest she is well qualified. In this paper, I have stressed that the job Draghi has done as ECB President has involved many skills that go well beyond the technocratic abilities you would associate with a typical MIT PhD-trained economist.[10] Draghi has had to be an excellent communicator to explain to his colleagues, to financial markets, to MEPs and to the public why new courses of action have had to be taken. He has also had to be a diplomat and politician, persuading members of the Governing Council to take new approaches to monetary policy and working with Europe's leaders to design improved economic policy structures for the euro area.

Judged against this background, Lagarde's skills and qualifications seem a good fit. She is a first-rate public speaker and an experienced political operator. While she may not be a qualified economist, she has access to a world-class economics staff at the ECB, including an outstanding chief economist on the Executive Board. Moreover, as the discussion in this paper illustrates, legal issues are raised with almost every potential new initiative the ECB considers, so a legal background is valuable. Finally, the ECB presidency requires management of a huge complex organisation but one could argue the IMF is even larger and more complex. So, on balance, Lagarde's qualifications make her an excellent fit for this role.

Lagarde has already indicated she sees room for further monetary policy stimulus if necessary.[11] It seems likely that she will play a key role in arguing for some or all of the policies outlined above in Section 3. I will note that this paper was completed prior to the Governing Council meeting of September 12 and it is possible that a new package of monetary policy measures along the lines mentioned here may be introduced at that meeting or the at Draghi's final meeting in October. Even if this is the case, defending (and then perhaps expanding) on such a package will require hard work and a lot of diplomacy.

[10] I say this as someone who, like Draghi, holds a PhD in economics from MIT!

[11] See https://www.reuters.com/article/us-ecb-policy-lagarde-idUSKCN1VJ1RF.

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Mario Draghi took over as ECB President at a time of recession for the euro area economy and widespread concerns about whether the euro project could be sustained. The years since have seen an easing of fears of the euro breaking up and the economy recover without triggering inflation above its target level. As such, his presidency must be judged a success. Draghi's achievements go beyond the successful implementation of monetary policy. He also played a key role in encouraging Banking Union and other important institutional reforms. The new ECB President faces a difficult set of challenges. The ECB is not meeting its inflation target; inflation expectations are falling; and there are signs of economic weakness. Like Draghi, the next President will require strong communications, diplomatic and political skills to face these challenges successfully.

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