

## CIO Viewpoint

## Ciao Mario Draghi, Bienvenue Christine Lagarde

### Investment Solutions

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**Mario Draghi signed off as president of the European Central Bank last week with a warning that the eurozone faces persistent “prominent downside risk” and with a defiant defence of the “irreversible” euro. He can take some credit for the latter, thanks to an unorthodox and largely successful tenure. His successor, Christine Lagarde, will need to channel some of that energy to meet some very different challenges.**

Mr Draghi began his eight years at the bank by reversing the rate hikes of his predecessor, Jean-Claude Trichet, but his term is most readily defined by three simple words. Uttered during a speech in London in 2012, the promise that the ECB would do “whatever it takes” was a full stop to a moment of fear in markets, when the debt position of countries like Italy and Spain seemed like it might topple the euro zone itself.

Within weeks the central bank explained what those words meant: an offer to buy the bonds of distressed countries if they met certain criteria, known as the Outright Money Transactions (OMT) programme. It was never used, but it underpinned the European financial system at one of its most fragile times.

This was the power of transparent and decisive communication to the market, part of the Italian’s achievement in moving ECB philosophy away from the traditions of the Bundesbank and towards the more open approach of the US Federal Reserve. He then followed the Fed’s lead in 2015 when the ECB embarked on its own quantitative easing programme, amassing EUR 2.5 trn in assets. The programme ended in December 2018, but was restarted last month as the eurozone economy continued to slow.

### Growth struggles

In fact, the measures unveiled this September encapsulate the innovations Draghi has introduced. Alongside renewed asset purchases, the ECB delivered a deposit rate cut, a tiered reserves system to shield banks from the impact of negative rates, and more generous terms on the “TLTRO” loans first unveiled in 2016 and which are offered to banks willing to lend in the real economy.

There is doubt, however, about the potential for any direct impact on growth or inflation, both of which have remained stubbornly low – second quarter eurozone GDP growth was just 0.2% and annual inflation slowed to 0.8% in September. With the ECB deposit rate already at rock bottom and credit growth so healthy that some countries have sought to prevent excesses, some observers feel the strategy has run its course. It was no surprise that Draghi’s final intervention served to highlight tensions among ECB board members.



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### Key takeaways

- Mario Draghi leaves the ECB having changed its philosophy and opened up the central bank up to unorthodox, and largely effective, monetary policy. It may well have saved the eurozone.
- His replacement, Christine Lagarde, will need all her political experience to forge a new mandate for the bank. Her tenure will require a coordination between fiscal and monetary policy.
- Growth in the eurozone remains fragile, and the ECB’s ability to act is sharply diminished. The economy needs investment, but recovery is also dependent on a meaningful resolution to the US-China trade dispute and to Brexit.

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The criticism has been very sharp in Germany, where Draghi's measures are depicted as an extravagance that favours borrowers over savers and pensioners. Low rates also favour exporters as they benefit from a weaker euro while hurting banks, who are unable to pass negative rates on to clients.

### **Social consequences**

And the criticism that unorthodox policy has created inequalities cuts deeper than that too. The ECB may have kept Europe clear of recession, but it also delivered a flood of cheap money that has subsidised anyone holding financial assets over the last eight years.

This has aggravated existing wealth inequality and has helped to foster the rise of populist politics, in Europe as it has elsewhere. That clearly has social consequences, which policymakers will need to address. It also has a more direct influence on markets through the rise of protectionism and lingering tensions between the world's major trading blocs.

In other words, Draghi may well have saved the eurozone, but it wasn't without a cost. Right now, there is very little left in the ECB's arsenal, and Christine Lagarde will be left to cope with the results of its largesse, without resorting to the same. She will also have to smooth over the disagreements at the ECB's Frankfurt headquarters, which broke into the open after the September meeting.

Ms Lagarde is not an economist, but as the former IMF chief and French finance minister, she is a consummate politician. That may be an advantage, as crisis management gives way to more subtlety. Lagarde is known for maintaining tight control of events in her remit. She even described in an interview with CBS last week how she discreetly avoids drinking wine while at important events. She will need that same sober, careful approach as she convinces European leaders to add meaningful fiscal stimulus to the monetary policy mix that shepherded the eurozone through the last decade.

### **A new toolbox**

Simply put, governments now need to put their money to work – through investments in infrastructure, education and in research & development activities – in order to generate growth that allows rates to rise again. Negative rates worked in a moment of crisis, but it is doubtful that they have a lasting place in the policy toolbox for the Lagarde era.

What will be needed is a more nuanced form of quantitative easing, alongside new monetary tools that encourage both financial and social returns. Lagarde has already flagged up one potential innovation, suggesting eurozone countries pool their bonds in a single combined debt instrument that gives the region a larger safe-asset offering to investors.

There will be other headwinds too. Brexit is likely to make growth more difficult across the continent, but the eurozone is even more vulnerable to the ebb and flow of the US-China trade dispute. It was no coincidence Lagarde used the US TV interview to make a powerful plea for the “big men” to sit down and make rapid progress towards a solution. It may even be that her deep political experience can help influence the outcome.

Mario Draghi was a skilful politician himself. He built consensus around controversial issues and secured support for dramatic interventions. He even won a round of applause from the press corps as he bowed out. Christine Lagarde will be hoping to achieve the same, but in her case it will more likely be for helping the ECB to step back from its role as saviour. Her job is to help build a new and united fiscal and monetary policy framework that makes room for eurozone countries to revive their economies while addressing inequality.

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