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Mario *the* Magician

By Wolfgang Münchau

He will either succeed or fail spectacularly.

The reign of Alan Greenspan at the Federal Reserve has taught us not to make judgments about a central banker's performance in real time. The adulation the Maestro enjoyed in the late 1990s and early 2000s stands in depressing contrast to a much more muted consensus judgment today. Zhou Enlai got it right: It really is too early to judge the impact of the French revolution.

In that spirit, I can say that it is certainly too early to pass judgment on Mario Draghi, the president of the European Central Bank. My own hunch is that his tenure will end up being seen either as a great success, or as a great failure, but probably nothing in between.

He is serving a single eight-year term, of which less than half has passed. The highlight of the last three and a half years has been a pledge to do "whatever it takes" to save the euro. The concrete embodiment of this pledge was a scheme to provide *ex ante* unlimited central bank purchases of distressed government debt—conditioned on good behavior by member states. It goes by the official name of Outright Monetary Transactions.

OMT was a big deal. The architecture of the eurozone had, and still has, many flaws. But one flaw is now fixed. Thanks to Draghi's single-handed intervention, there is now a lender-of-last-resort backstop. It has by far been the most important institutional development since the outbreak of the eurozone crisis. EU leaders could not get themselves to agree to a fiscal union, let alone a political union. They could not agree to issue joint sovereign debt instruments, or transform existing debt into joint and several

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eurobonds. They set up a firefighting fund, and tidied up some of the rules. But the one real big innovation came from the ECB. Draghi transformed the ECB into a central bank in the spirit of Walter Bagehot.

This was a huge gamble for various reasons. Overtly, it seemed to contradict a clause in European law that the ECB must never monetize government debt. That is the view taken by Germany's constitutional court, the Bundesbank, and the economic and legal establishment. The Germans have been jealously guarding the no-bailout rules and anti-debt monetization rules as the holy grail of the monetary union.

The second reason was the outcome of the gamble was uncertain. I was among those who were not convinced at the time that it would work. It was probably Draghi's biggest intellectual achievement—having correctly calculated the effects of OMT on the behavior of investors. As of now OMT is just a promise. It was never put into legislation, despite initial promises to the contrary. It has never been used. Call it magic, or a phantom program, it is the closest I have ever seen anything approaching the proverbial free lunch in economics. Without monetizing a single cent of European debt, Draghi turned the sentiment in the eurozone's bond market from depression into euphoria.

Whatever may happen to the euro in the future, thanks to Draghi the euro will probably not perish due to a speculative attack in the bond market. This does not mean that the crisis is over, or indeed that the euro is a sustainable currency. But saving the euro from a premature death has been Draghi's historic accomplishment.

What got him to do it? Was it his period at Goldman Sachs, where he worked before he was drafted back to run the Bank of Italy? I doubt it. Draghi spent his formative years at the World Bank, and later, from 1991 onwards, as chief of the Italian treasury. It was there where he learned the skills he has been applying at the ECB. He learned not only to survive in a political snake pit, but also to weather some of the tightest moments in Italian financial history, especially the 1992 episode when Italy was forced to leave the exchange rate mechanism of the European monetary system. Italy came within a whisker of defaulting, and it was thanks to Draghi and his colleagues at the Tesoro that this cataclysm was avoided.

Draghi has been able to save the euro because he has done a similar thing before. He saved the Italian lira. I have never met a central banker with a deeper technical and intuitive understanding of financial markets than Draghi. Nor have I ever met such a political central banker. He yields to nobody in upholding the independence of the central bank, yet unlike many of the technicians at the helm of Europe's national central banks, he understands that the central bank constitutes part of the institutional framework collectively known as government. And he understand that monetary policy is part of a wider framework of economic policy. Independent does not mean apolitical.

Draghi's experience and his cool, clear-headed approach are obviously suited to an acute crisis. But is this still the right approach for the post-crisis situation? The main challenge of the post-crisis period has been the management of a credit crunch accompanied by a gradual fall in inflation, which has been hovering firmly below 1 percent since November 2013. Draghi and his colleagues at the ECB did not see this coming. Nor did they expect the low inflation rates to be so sticky.

As I was writing this article in late May, the ECB was moving towards a series of monetary policy decisions at its governing council meeting in early June. In the months before, Draghi tried his best using verbal intervention—open-mouth interventions as some critics have put it. He said countless times that the ECB stands ready to act, only to announce the same thing the next

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week. He and his colleagues would repeat the line that negative interest rates or asset purchases were acceptable instruments of monetary policy in principle. But they kept on deferring.

After he decided to overrule German objections to the OMT, Draghi concluded that he needed to co-opt the Germans into any decision to ease monetary policy further. In January, the German constitutional court passed a preliminary ruling that was highly critical of his OMT program. Draghi decided that he did not want to alienate the German establishment opinion any further by adopting negative interest rates, let alone a large program of asset purchases, against the vote of the Bundesbank.

Draghi's Challenge: *ECB President* **Mario Draghi** *needs to organize a majority in the ECB governing council, which consists of the ECB's six executive directors, and eighteen national central bank governors. Front row (l–r):* **Patrick Honohan, Benoît Cœuré, Sabine Lautenschläger, Mario Draghi, Vítor Constâncio, Yves Mersch.** *Middle row:* **Carlos Costa, Luc Coene, Christian Noyer, Jens Weidmann, Jozef Makúch, Josef Bonnici.** *Back row:* **Boštjan Jazbec, Erkki Liikanen, Ardo Hansson, George A. Provopoulos, Gaston Reinesch, Ilmars Rimševics, Klaas Knot, Peter Praet.** *Not shown:* **Panicos O. Demetriades, Luis M. Linde, Ewald Nowotny,** *and* **Ignazio Visco.**

He has finely tuned political instincts. But monetary policy works differently than a lender-of-last-resort pledge. While a central banker's verbal thunder can wrong-foot a speculator, it is not a suitable instrument to steer inflation expectations. When they come unhinged—as they probably have done in the eurozone—a central bank must act, not talk. To get through this particular crisis, the ECB president does not require the political and tactical skills of a Machiavelli, but the economic skills of a Modigliani. Draghi now has to solve an acute problem of monetary policy itself. On this point, the judgment of his presidency is still open.

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He faces two genuine difficulties. The first is to organize a majority in the governing council, which consists of the ECB's six executive directors and eighteen national central bank governors. The second task is intellectual: to understand at a deep level the forces behind the fall in inflation rates. Core inflation in the eurozone—headline inflation without volatile items such as energy, food, and alcohol—fell to below 2 percent over five years ago. It never recovered, but with each shock, it edged downward a little further. Even the ECB's own forecasts, which have consistently proved too optimistic, tell us that inflation will not return to the ECB's target of a headline inflation rate of "close to but below 2 percent" in the medium term.

Draghi's activism when confronted with a bond market crisis stands in contrast to his conservatism in the pursuit of classic monetary policy. He dismisses the experience of Japan, at least in public. He discounts the theory of secular stagnation, recently revived by Larry Summers. Or maybe he does see the danger, but realizes that this time he cannot promise to do whatever it takes to get inflation back up to the target rate.

It is probably fair to say that the risk of a secular stagnation is sufficiently large that a rational central bank would want to pay some insurance to avoid it. Draghi said that if inflation rates remained low for longer than estimated, the ECB would consider quantitative easing. But with each delay, QE becomes costlier and less effective.

History will judge whether Draghi gets this call right or not. If he is right, and eurozone inflation recovers gradually, he will go down as the central banker who made two improbably correct calls. But if secular stagnation strikes, posterity will treat OMT as a footnote. And it will remember the monetary policy record instead. ◆