Luiss
School of European Political Economy

Taking stock of Christine Lagarde's challenges at the ECB

Lorenzo Codogno and Mara Monti

Policy Brief 2/2020

LUISS

January 14, 2020

LUISS School of European Political Economy

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Taking stock of Christine Lagarde's challenges at the ECB

Lorenzo Codogno and Mara Monti

- Christine Lagarde's challenges at the helm of the ECB remain daunting, despite smooth sailing during her first press conference and a notably different communication style.
- Issues will emerge from different sources, not least the ECB's problematic relationship with the political actors, but the new president appears well prepared to address them as they arise.

Christine Lagarde's reign at the European Central Bank (ECB) has heralded a shift not in the monetary policy field, but mainly in terms of communication, at least judging by her first press conference in December. She is not Mario Draghi or Jean-Claude Trichet, her predecessors, and she wants to affirm her own different style as president. "Each and every president has his or her own style of communicating. I know some of you are keen to compare and rate or rank. I will have my own style. As I've said before, don't over-interpret, don't second-guess, don't cross-reference. I'm going to be myself and therefore probably different." What a brilliant start for the president of a Governing Council formed by her and 23 men!

Lorenzo Codogno is Visiting Professor in Practice at the LSE's European Institute and founder and chief economist of his own consulting vehicle, LC Macro Advisors Ltd. Prior to joining LSE, Lorenzo Codogno was chief economist and director-general at the Treasury Department of the Italian Ministry of Economy and Finance (May 2006-February 2015). Throughout this period, he was head of the Italian delegation at the Economic Policy Committee of the European Union, which he chaired from Jan 2010 to Dec 2011, thus attending Ecofin/Eurogroup meetings with ministers. He joined the Ministry from Bank of America where he had worked over the previous 11 years. He was managing director, senior economist and co-head of European Economics based in London. Before that, he worked at the research department of Unicredit in Milan.

Mara Monti is Visiting Fellow at the LSE's European Institute and a journalist at Il Sole 24 Ore, Italy's leading financial/economic newspaper, based in Milan. She completed an MSc (Econ) in Politics of the World Economy at LSE career in journalism, specialising in the financial sector. Over the past 16 years, she has been part of the financial team at Il Sole 24 Ore, writing extensively on financial issues, sovereign crisis and monetary policy issues. Prior to joining Il Sole 24 Ore, Mara worked as editor-in-chief for international news agency Dow Jones Telerate in Milan. She wrote several books investigating the bankruptcy crisis of the past ten years and probing into financial scandals.

She bypassed attempts to label her as a dove or a hawk, suggesting an owl instead, due to its perceived wisdom. "Once and for all, I'm neither dove nor hawk and my ambition is to be this owl that is often associated with a little bit of wisdom. I'm not full of vanity but I will certainly try to bring the best out of the members of my Governing Council in order to arrive at monetary policy decisions and use of instruments that will be as consensual as possible."

Lagarde will favour a more collegial decision-making process to address the divisions that came to the surface in September after the decision to confirm the Asset Purchase Programme. She will possibly even allow public voting by Governing Council members. Currently, there is an informal voting system, which tends to achieve unanimity, but is not public. Still, Draghi supposedly resisted such a change. Those who sit on the Governing Council de facto represent their central bank and country, although in principle they should not. Country weights and rotation logics strictly drive even the appointments at the Executive Board. Thus, allowing Governing Council members to vote formally and make their vote public may be unduly risky, as it may exacerbate country divisions.

Lagarde's bold start was also a way to deflect criticism for not having a central banking background, although she was previously Managing Director of the International Monetary Fund and Finance Minister in the French government. Actually, her background should prove a great asset given today's need to table a dialogue with euro area policymakers while maintaining the ECB's independence and monetary dominance.

Indeed, the role of the ECB, its policies, its independence and relationship with political actors may be challenged, as has already happened in many other countries/areas. Tensions inside Europe have not gone away. Brexit has bolstered support for populist parties and potential splits within and in the immediate surroundings of the monetary union. In Spain, the far-right Vox party has called for a 'Spaxit'. In Poland, apparently, the populist government is considering whether to follow the same path as the UK and exit the European Union.

The key question is how much influence anti-establishment parties will have in the European Parliament and EU countries, and in which way this could affect the appointments, and thus policies, at the ECB. It is a crucial question because the head of each National Central Bank, appointed nationally, sits on the ECB's Governing Council.

For instance, in Austria, the Eurosceptics played a crucial role in the appointment of Robert Holzmann as Oesterreichische Nationalbank's governor. The two ruling parties at the time, Chancellor Sebastian Kurz's conservatives and the far-right Eurosceptic Freedom Party, chose him. It happened just before a scandal stripped Kurz's coalition of his partners. The issue of whether national governors will remain free from political interference once appointed remains an open one.

Within the Executive Board there are also many changes due to a number of expiring mandates, thereby potentially creating discontinuity in policies. With the departure of Benoît Cœuré at the end of last year, two out of the six members of the old Executive Board now remain. Yves Mersch is the only long-standing member (since December 2012 and he will stay until December 2020), while Luis De Guindos joined in June 2018.

The core of the new presidency will be a strategic review. Lagarde has said that implementing a strategic review some 16 years after the previous one is "nothing unusual or extraordinary". The Governing Council's goal is to complete it before the end of 2020. She has made it clear that it will be comprehensive, as "it will turn each and every stone". It will reach out not just to the usual quarters but also to the European Parliament, academics and civil society, with "no preconceived landing zone". It will also cover technological and climate change, inequality, and how businesses are affected by monetary policy. It will re-examine the appropriateness of each monetary policy instrument, although the framework for doing this "is not yet fully agreed".

The launch of the strategic review could potentially mark a significant departure from the previous presidency, as Draghi reluctantly accepted calls by Finnish Governor Olli Rehn and others to open the Pandora's box of the ECB's monetary policy strategy. Rehn said: "In my view, a review of monetary policy strategy is a sound way to prepare for these longer-term challenges. I'm glad this option is now discussed, and assume that the ECB will conduct a review at an opportune time, in the relatively near future." The strategy was reviewed previously in 2003, and Otmar Issing, the then Chief Economist, was very much in the driving seat. At that time, the exercise was mostly restricted to ECB staff.

Probably the most critical part of the discussion will be about the inflation target. The definition of price stability is entirely in the remit of the Governing Council, i.e. there is no formal need for a policy review. The introduction of an 'inflation aim' in Draghi's introductory statement on 25 July last year was already a change in the definition of price stability: "If the medium-term inflation outlook continues to fall short of our aim, the Governing Council is determined to act, in line with its commitment to symmetry in the inflation aim." Therefore, the issue is whether the strategy review will confirm the shift in the definition of price stability more explicitly with a formal endorsement, and whether it can even go beyond that. The shift, however, has faced staunch opposition within the board and outside. Six former central bankers, including Otmar Issing, wrote a memorandum saying that:

"In October 1998, the Governing Council announced its definition of price stability as an average annual increase in the price level for the euro area of below 2%. The Council did not change this definition in the 2003 evaluation of its monetary policy strategy at all. In the past few years, the ECB has de facto altered the initial definition of price stability by considering an inflation rate for example of 1.5% as unacceptable. For years now, the ECB has failed to meet its self-imposed

target of raising the euro area inflation rate to a level of below, but close to, 2%, which in the ECB's interpretation seems to be a "point target". The ECB essentially justified in 2014 its ultra-loose policy by the threat of deflation. However, there has never been any danger of a deflationary spiral, and the ECB itself has seen less and less of a threat for some time. This weakens its logic in aiming for a higher inflation rate. The ECB's monetary policy is therefore based on a wrong diagnosis. The frequently used argument that the ECB would be violating its mandate with low inflation rates is simply inaccurate. The Maastricht Treaty enshrines this mandate, according to which the primary objective of the ECB is to maintain price stability. Current considerations on defining the 2% threshold as a symmetrical inflation target represent a clear departure from a policy focused on price stability. This is particularly true if "symmetry" is understood in the sense that, after years of undershooting the 2% mark, a similar period of time should be spent allowing for an overshooting of the 2% inflation rate. And, incidentally, how, after years of unsuccessful "inflationary policy", does the ECB intend to convince the public and the markets that it will succeed in stopping inflation at a certain level in good time?"

Why is a change in the definition of price stability so important? After many years of underperformance relative to the current definition of price stability of "below but close to 2%", the ECB would be forced to react if inflation starts to exceed 2%. Average inflation was 1.2% during Draghi's eight-year mandate. A symmetric target would call for an overshoot for a sufficiently long period to allow for a modification in economic agents' behaviour and market expectations. Making the target symmetric would not make any difference for today's policy, but it would be hugely significant in the future. The policy strategy review will also encompass an assessment of the effectiveness and appropriateness of the main policy tools, an exercise that will also be vital for future policies.

On top of that, unorthodox policies are increasingly less effective when it comes to propping up inflation and increasingly risky for financial stability. The November Financial Stability Report of the ECB was unusually hawkish, de facto pointing to the trade-offs that the ECB is facing. "Signs of excessive financial risk-taking, including for some non-bank financial institutions, highly leveraged corporates and real estate sectors, requires monitoring and targeted macroprudential policy actions." Furthermore, "The euro area banking sector has increased its resilience in recent years. But slow progress in improving underlying profitability and renewed cyclical headwinds may hamper banks' ability to respond to downside risks to growth. [...] A more active use of macroprudential instruments, including the countercyclical capital buffer, could mitigate some of the risks to euro area financial stability in some countries."

Some businesses may be sustainable only because of the low-interest-rate environment, and there may be mispricing in asset prices amid the robust risk appetite and valuation reliance on low rates and re-leveraging in the private sector. The ECB increasingly perceives these side effects as a high price to pay in the attempt to prop up inflation by continuing the ultra-expansionary policy, despite the risk of de-anchoring inflation expectations.

The tradeoffs between achieving price stability and maintaining financial stability are even stronger than in the past. Unusually accommodative policies across the globe have inevitably increased the risks of misallocation of resources and credit events. There is no obvious metric by which we can say that the ECB is more concerned today about financial stability than in the past. However, surveillance work on the banks seems to be increasingly focused on the need to build up sufficiently large capital buffers to withstand the next crisis without significant hurdles in an era in which there are many structural challenges to the banks' business model. This debate will become even louder in the future.

On 12 December, Lagarde's premiere at the ECB press conference showed a line of continuity in policies with Draghi's era: interest rates and policies were left unchanged, with forward guidance and even the overall language pretty close to that used at the previous press conference by Mario Draghi, with no hints at future policy shifts at least for now. Moreover, the strategic review has increased the bar for any possible near-term adjustment. Many potential changes are brewing in the background, however. It is no longer about hawks versus doves; it is about structural versus cyclical, and the best policy strategy and tools for the future.

Fiscal imbalances and the ever-increasing public debt remain key issues, especially in Southern European countries. Accommodative monetary policy from the ECB makes borrowing cheaper for European governments, but it does not solve the structural problems and the fiscal imbalances or the ongoing global underlying phenomena such as trade wars. Sound economic policy and fiscal consolidation at the national level are still necessary, as well as economic reforms.

Despite unanswered questions about monetary policy, recovery and prosperity in the euro area ultimately depend more on the decisions of policymakers concerning structural reforms, the flexibility and resilience of domestic economies as well as the future shape of European integration. Draghi, before his departure, called for help from the fiscal side and for a Fiscal Union, claiming that monetary policy alone is not sufficient. How can the need for fiscal expansion to complement monetary policy in supporting aggregate demand be adequately combined with addressing public debt dynamics and structural impediments?

Many parts are thus in motion, and navigating this magmatic world will not be easy for President Lagarde.