

European issues

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November 1 : Christine Lagarde, President of the ECB with various types of resistance

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Everyone is expecting Christine Lagarde, everything is in place. On one side there will be flowers, and especially, for a year and a half at least, quite a detailed work programme, prepared beforehand by Mario Draghi. On the other, following a strange coalition, there will be resistance to impede its implementation as much as possible. Indeed, the difficulties experienced by the monetary policy in the euro area to reach a 2% inflation rate are not due to mistakes made by Mario Draghi. They are to blame on the very structure of the euro area's still fragile economy, and on services entangled in a sluggish world context and a monetary policy that has been allowed to drift along alone without budgetary support.

FIRST OBSERVATION: THE EURO AREA'S ECONOMY IS WEAKENING MORE THAN FORECASTS SHOW

In September over a year inflation had decelerated in the euro area [to 0.8%](#); forecasts are collapsing, whilst growth has been slacking off towards 0.8% year-on-year in the second quarter of 2019. "In comparison with the ECB's June macroeconomic forecasts, the GDP growth outlook has been revised downwards for 2019 and 2020," said M. Draghi on 12th September, as he presented the Council of Governor's decisions whose meeting had just been concluded. This is what drove him to state that not only must his policy of low rates be continued, but these must be stepped up. He added a firm, barely disguised, call addressed to the German and Dutch executives to accommodate their budgetary constraints. They can afford this, with their budgetary surpluses (1.7% and 1.5% of the GDP respectively), in the hope of one day having a less restricted [European budget](#) than the one which is now being prepared, to support its monetary support policy when recovery starts.

Hence the euro area's economic outlook is darkening, because the global perspectives are dimming too. At the inauguration of the annual IMF assembly and that of the World Bank which took place from 14th to 20th October, the [October economic report](#) is clear: "The global economy is in a synchronized slowdown and we are, once again, downgrading growth for 2019 to 3 percent, its slowest pace since the global financial

crisis. This is a serious contraction in comparison with the 3.8% of 2017, the year in which the world's economy was in synchronised recovery."

Mario Draghi is not wrong therefore when he regularly speaks of geopolitical uncertainties and international trade tensions. He is of course referring to relations between China and the USA, as well as Brexit, in the knowledge that Donald Trump's decisions also influence Iran, Syria and possibly soon Afghanistan, not forgetting domestic tensions that are disrupting many countries.

In fact, never in the last ten years has politics held so much sway over the economy, in other words against recovery, whilst we might have thought that the end of the major world economic crisis of 2007-2008 would have called for a concerted effort. But the contrary is happening, with the rise of geopolitical tension, therefore divisions, we are heading towards a global slowdown.

THEN, THERE IS MARIO DRAGHI'S ALMOST TESTAMENTARY MONETARY POLICY

It comprises three initiatives: the continued lowering of short-term rates, resuming the policy to reduce long-term rates, announcing that these decreases will continue. In effect this was the package presented after the [meeting of the ECB's Council of Governors on 12th September](#). It is a document that followed a long meeting and therefore comprises a certain

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"weight", if not to say, in the long run, it marks a certain commitment. Of course, this means support to business and undoubtedly a bid to further limit the impact of the global trend on the euro area.

These are the three initiatives:

- Further reduction of short-term rates: *"the interest rate on the deposit facility has been reduced by 10 base points, to -0.50%", with complementary measures, so that the banks can continue the mitigation measures and low rates policies without suffering too much.*
- Resuming the long-term rate reduction policy: *"Net purchasing will resume under the asset purchase programme, (APP), at a monthly pace of 20 billion € as of 1st November."*
- Announcing that he wants to extend this measure with reductions in rates and by the purchase of assets to achieve 2%. *"The ECB's key interest rates will remain at their present or lower levels until long-term inflation outlooks converge at a level that is sufficiently close to but lower than 2%."* Especially, regarding the purchase of treasury bills and private bonds, *"the Council of Governors plans to use this as long as necessary to reinforce the accommodative impact of its interest rates."*

In the central bankers' terms, "reducing rates" means undertaking an accommodative policy, "purchasing assets" means undertaking an unconventional monetary policy (unconventional, does not mean "heterodox"), "extending reductions over time", is the reinforced forward guidance, especially purchasing assets "for as long as is necessary" until inflation reaches 2%, is an open-ended initiative without any cap on time. It is the latter commitment which is the most powerful and the most controversial.

THEN THERE IS A GROUP RALLYING VARIOUS TYPES OF RESISTANCE, WHICH ARE NOW ALMOST PUBLIC

The biggest of these is the oldest. It reflects hostile sensitivity to budgetary deficits, which is even greater

against the ECB's purchase of treasury bills. Jens Weidman, President of the Bundesbank, the German Central Bank (Buba), who leads this group, which also includes Klaas Knot, the President of De Nederlandsche Bank (DNB) and Robert Holzmann, President of the Austrian National Bank (OeNB) believes that *quantitative easing* is leading to the monetary financing of public deficits, if it is not already that. And this is forbidden by the Treaties.

Jens Weidman demonstrated this as he sued the ECB's policy at the Constitutional Court in Karlsruhe. The latter took the cases of the OMT (Outright Monetary Transactions) and Quantitative Easing Programmes (QE) to the European Court of Justice. In June 2015 the Court validated the OMT programme and in October 2018 that of QE: it approved the steps taken by the ECB, (notably by limiting the ECB's purchases of public bond emissions of each State by one third).

Resuming the purchase of treasury bills and especially in an open-ended manner – is too much! This group deems then *"that the arguments in support of resuming the purchase of net assets are not robust enough"*, according to the report from the meeting on 12th September, published on 10th October. Strong resistance undoubtedly triggered aggressive signals that have spread since then. They are not targeted against Mario Draghi, who has known about this for many years, but against the person who is to replace him on 1st November, Christine Lagarde, as a warning of what they are thinking.

A second sensitivity links the concern about budgetary orthodoxy to questions about the weakening of the banking system ensuing excessively low rates. They undermine profitability. This is possibly why Sabine Lautenschläger, the only woman on the ECB's Board, will resign from her post as ECB Board as of 31st October (the day Mario Draghi leaves!). Undoubtedly, she is "orthodox" but might also be worried about what is happening in the German banking system, not just at the Deutsche Bank and the Commerzbank but also in the regional establishments (Landesbanken). They are monitored by the Buba, but are strongly influenced by local policies, about which we can be legitimately concerned.

Do longer lower rates mean even weaker banks? We might think that we are talking about Italian banks benefiting from undue support, but this is not the case. The German banks' cost-to-income ratio is 81.8%, i.e. the highest level in the euro area. It lies at 73.4% in France and 64.8% in Italy[1]. All banks have to adapt to this monetary policy, but also and especially to lower growth and lower inflation which are global – firstly the German and then the French banks.

The third group which is more complicated to explain, lies from the reticence of Benoît Coeuré, of the ECB's Board and François Villeroy de Galhau, Governor of the Banque de France (who spoke his mind more directly). In their opinion the purchase of assets is "an instrument of last resort" the use of which has been too hasty. And also, why shouldn't these rates on public debt, which have become so low or negative be considered as incentives to discourage efforts to reform? France is quite a good example. The lowering of the public debt rate offers the "saving" of at least 4 to 5 billion € in public spending, which especially reduces the need to decrease the deficit, which benefits from this by increasing!

RISE IN RISKS ARE A CONCERN EVERYWHERE, FOR THOSE WHO SUPPORT MARIO DRAGHI AND OUTSIDE THE EURO AREA

"The (assets purchasing) instrument is not as efficient any more with the present rates" suggested some members of the ECB Council on 12th September. In particular, these excessively low rates can lead to perverse effects in the long term. They lead to weaknesses which might worry banks which have too much invested in overly risky loans, weaken them in the event of a problem and on the other hand give rise to various bubbles. The risk of the "Draghi Policy" has weakened the euro area, since the ECB no longer has any munition to respond in the event of difficulties, since a further reduction in its rates has become almost impossible.

The list of these perverse effects is impressive:

- Business zombification: if rates are too low, businesses that are not very profitable and unable to service their debts long-term, so-called zombies, will

subsist and become the norm. In order to survive their debt will continue to grow. A day will come when the banks will be afraid, even before the rates rise. They will try to escape, but it will be impossible. They will then see their losses with those holding bonds and stocks. [According to a study by the Banque de France](#) in 2014 in France around 18% of new loans to SMEs and 10% of those granted to large companies were done at particularly low rates, which corresponded to around 2 to 3% of all impaired loans. This does not endanger the French banking system even if zombification is spreading. The [study by France Stratégie](#) (in French only) estimates that in 2015, more than 4% of productive capital is "trapped" and more than 5% of workforce is "under threat". Worse still work in 2016 estimated that in 2013 the share of zombies in the Portuguese, Spanish and Italian debt respectively lay at 50%, 40% and 30%. Here we are talking about a systemic situation. The question is whether the ECB has any responsibility in this process which might lead to the "State zombification" to quote some of its bitterest critics!"

- Excessive business debt : in France for example, lending is clearly growing faster than the GDP, which forced the [High Council for Financial Security](#) to ask the banks to provide more equity, to oblige them to rein in lending to businesses and to guarantee them ... just in case.

- Stock bubbles: if the rates are low, weighing on the profitability of savings, the abundant liquidity created by this policy means there is a quest for higher yields in the stock markets (dividends provide 3% profitability on the CAC40), therefore at greater risk. And households will fall into long and extremely long-term debt in terms of purchasing housing, whose price per square metre will increase.

Of course, the combination of these factors increases the euro area's vulnerability. But this is not just affecting the euro area, but all of the economies which "employ quantitative easing".

The IMF has just published an article by [Tobias Adrian and Fabio Natalucci](#) on its blog, which establishes

1. source : Statista

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that the easing of financial conditions comes at a cost: *"it encourages investors looking for higher yields to take more risks, so that the threats which hang over financial stability and growth remain high in the mid-term."* This vulnerability can especially be found amongst fund managers and pension funds, then in financial businesses, followed by insurance companies, banks, households and States. The authors calculate that risk taking, gauged by "speculative" more than that "at risk" debt could rise to 80% of the GDP in China, 60% in Spain, 50% in France, 40% in the UK, 35% in the US, 20% in Japan and 15% in Germany by 2021. As always in these areas, hypotheses are important, but the results are of consequence: 40% of the debt of these eight countries would be zombified! As for stocks, the bubble would lie at 8% in the US and rise over the 3% mark in the euro area the risk therefore lies with the banks.

MOREOVER, THE WEAKNESS OF INFLATION IS THE MAIN UNKNOWN: WAGES ARE RISING BUT NOT INFLATION!

WHAT IS HAPPENING? WHAT IS NOT WORKING?

There is still no sign of 2% inflation on the horizon, rather the opposite. The basic criticism made by the opponents of Mario Draghi's monetary policy and the concern of those who are against it, comes from the failure to reach the 2% inflation mark. In return, if we might put it like that, perverse effects are increasing and therefore so are the vulnerabilities, resistance, as well as the social and banking tension that go with it. The logic of Mario Draghi's approach has been understood fulfilling his mandate of "inflation close to 2% mid-term", but there is concern about the growing cost of the long term. This is why he lowered rates to dissuade people from saving (and to encourage investments on the stock market), to spread loans, then investment, then employment, wages and *in fine* inflation, in a bid to attenuate costs to the banks. But there is no inflation: where did the error in analysis, the break in the chain, occur?

IF SALARIES ARE RISING BUT NOT PRICES, THIS MEANS THAT PROFITS ARE MAKING UP FOR THIS!

We might think that the "Draghian logic" is one of cost pressure: wages increase, followed by prices to maintain margins. Except if competition is fierce, in the euro area and outside. Except if the digitisation of work, technologies and other disruptions are weighing on prices. Except if the wages that are rising are rather more those of technicians, computer scientists and AI specialists, whose innovations are compressing the wages of others and whose programmes weigh on all prices! Except if the euro is rising. Except if oil prices are low! Except if previous low inflation is weighing on increases and the claims that follow, even in extremely unionized sectors such as the German mechanical industry. Except if geopolitical uncertainties ...

The result in the service economies, our economies, where the wage-price link should be direct, since gains in productivity are less, is that profits adjust downwards. This is weighing on innovations which would enable an increase in business's pricing power, notably in industry. The service economy is the more sluggish, changing its prices at a slower pace and is under direct attack, as we can see in the crisis of its networks: banks, insurances, distribution. It has fewer means, due to its margins, to innovate and restructure. In brief, it is zombifying.

CHRISTINE LAGARDE, BETWEEN A DIFFICULT DISCOURSE AND DIFFICULT REQUESTS

The criticism made regarding Mario Draghi's monetary policy is unfounded. The worst of them deem that it has a "pro-Italian" bias. Italy certainly has some serious economic, banking, budgetary, social and political problems. Firstly, it is on the brink of recession, but with a foreign surplus (2.3% of the GDP) resulting from wage compression: inflation lies at 0.3%. Investment is recovering slowly but within an excessively weak network of exporting SME's, whereby the weight of the public debt (135% of the GDP) has now become a Damocles Sword. The budgetary deficit lies at 2.2% of the GDP, the lowest percentage since 2007, helped

rather more by low rates than the economy. This will take time: an increase in long-term rates would be fatal. But it would be dramatic in Greece, Portugal, Spain, Belgium and in France also. Recovery has been slow and consequently inflation more so – more than had been forecast in Italy and elsewhere.

In fact, Mario Draghi's monetary policy is the victim of the ECB's isolation: the decrease in rates makes wages rise to the detriment of profits, because it is no longer facilitated by German, Dutch, euro area and EIB budgetary support. The simple reduction of rates alone has been effective but is leading to more negative than positive effects. Mario Draghi makes the list to explain the failure of his policy, if we are expecting 2% simply thanks to a reduction in rates, especially in a world which is decelerating! He is requesting patience, perseverance and especially budgetary support.

Christine Lagarde should honestly wonder what is happening rather than listing our failings. Why is the rise in wages in a service economy, which is especially being challenged by new technologies, is not making prices rise, and therefore the margins? On the contrary, why is it weighing on them, on innovations and the capacity to improve services, to upscale and therefore increase prices?

Christine Lagarde's first (difficult) narrative will therefore be to ask truthful questions about the service economies. They are under pressure, not innovative enough, more some sort of knowledge importers from

elsewhere. They provoke disruptions, rather than being co-creators of change. Their means are not organised, not collaborative enough and financed from the sidelines!

The second narrative, which is just as problematic, is certainly that patience is vital to move forward, but this will not be enough. Without support, not just from the Germans, the Dutch, the EIB, etc. but also without a sizeable euro area budget, with Eurobonds, it will be a difficult game to win. In this context the name of economist Isabel Schnabel is increasingly being quoted by Berlin to take over from Sabine Lautenschläger. This might help. A professor she has constantly defended the ECB, a scapegoat in her opinion. Hence, she published a [tweet](#) on 13th September indicating "*How scary that German politicians from various sides even try to benefit from such moods!*" This is clear.

The 2% inflation rate that the ECB is not achieving, is the demonstration of the limits to euro area cooperation in moving forward on monetary issues. The rationale of an "ever closer Union" lies there: the monetary policy alone shows what can be done, with its limits, and what remains to be done. Christine Lagarde is therefore expected! To continue Mario Draghi's work by showing politicians what their responsibilities are. Welcome!

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