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Mario Draghi: Charged to save the euro

By Lionel Barber and Ralph Atkins in Frankfurt

The new head of the ECB weighs his words and draws on Italy's prior experience of crises to illuminate how he will confront the eurozone's troubles

Mario Draghi was always the underdog in the race to win the top job at the European Central Bank. It did not matter that the former central bank governor, Treasury official and Goldman Sachs executive was far from the caricature happy-go-lucky Italian. Conventional wisdom dictated that only a German steeped in economic orthodoxy would succeed Jean-Claude Trichet, whose eight-year term as ECB president ended in October.

But in February everything changed. Axel Weber, Bundesbank president and Berlin's favoured candidate, resigned, swapping central banking for academia and then the private sector. Eurozone leaders fell back on Mr Draghi, a sober man with steady nerves that served him well in Rome's Byzantine politics. His crowning moment came when Bild, the mass circulation German tabloid, depicted him in a *Pickelhaube*, a Prussian spiked helmet.

The tabloid image was both an accolade and a warning. Only by steering an unwavering anti-inflation line based on strict budgetary discipline could Mr Draghi hope to maintain the support of the German people as guardian of their currency. Yet the new ECB president must now tackle a euro crisis that threatens 50 years of European integration. Little wonder, in his first interview since becoming president, Mr Draghi has the air of a man walking a political tightrope.

Sitting in his 35th-floor office in Frankfurt – barely changed from the Trichet era save a few memento photographs of his 20-plus years in public service – Mr Draghi, a fluent English speaker, weighs every word. In an hour-long discussion he avoids words such as crisis or emergency, preferring to talk about challenges and creating "trust", especially when discussing the ECB's pivotal role. While politicians beyond Germany demand that the ECB rescue the euro by expanding massively its government bond-buying programme, Mr Draghi argues instead for "a system where the citizens will go back to trusting each other and where governments are trusted on fiscal discipline and structural reforms".

These words implicitly recognise German-led demands that the ECB's actions stick to the letter of European treaties going back to Maastricht in 1992, which paved the way for the launch of the single currency seven years later. But how does Mr Draghi reconcile what many regard as the plodding political response to the crisis and the galloping demands of financial markets that are increasingly challenging the creditworthiness of sovereign borrowers, not simply Greece, Ireland or Portugal but now Italy and France, the heart of the eurozone?

Mr Draghi believes the recent summit in Brussels made useful progress. European leaders, he says, took a first step towards a eurozone fiscal "compact", with binding rules on public finances, backed by automatic sanctions. Just as important – but overshadowed by the controversy over Britain's veto of a European Union-wide treaty backing the fiscal compact – were the ECB's own bold measures a day earlier to aid stricken eurozone banks.

For the first time, the ECB is ready to offer banks three-year loans – in whatever quantity they require. The ECB also made it easier to borrow central bank funds by broadening the assets banks can use as collateral.

These measures, alongside two consecutive interest rate cuts, bear Mr Draghi's stamp. They significantly extend the "unlimited liquidity" policy started by Mr

Trichet. Some – including President Nicolas Sarkozy of France – appear to believe they are a device to encourage banks to buy sovereign bonds at cheap rates.

Mr Draghi disagrees. The main aim was to ease banks' funding difficulties and thus help small and medium-sized enterprises, the engines of growth and jobs. "What we are observing is that small and medium-sized banks are the ones having the biggest funding difficulties, and they are generally the ones who provide most of the financing for the SMEs."

Still, initial favourable market reaction has slipped into familiar disillusion. Critics say there is too much emphasis on fiscal austerity and not enough on breaking a vicious circle in which poor public finances, weak banks and a disastrous loss of competitiveness is plunging some eurozone countries into an economic slump.

Mr Draghi, marginally more forthcoming than the famously elliptical Mr Trichet, comes close to admitting official errors have been made. One was to press ahead earlier this month with fresh bank "stress tests" identifying further capital needs for Europe's lenders.

"Ideally, the sequence ought to have been different," he says. The EU could have waited until its new bail-out fund, the European Financial Stability Facility, was fully operational. "This would have had certainly a positive impact on sovereign bonds, and therefore a positive impact on the capital positions of the banks with sovereign bonds in their balance sheet." His concerns are striking as, before taking the top job at the ECB, he was active at the global level in strengthening bank regulation.

A second problem was German-led insistence on "private sector involvement" in government bail-outs – a euphemism for making investors take losses on bond holdings. Since the effect was to undermine investor confidence in the eurozone, was PSI in retrospect a strategic mistake?

A pregnant silence follows. A press aide shifts uncomfortably. Finally Mr Draghi refers to another "sequencing" slip. "Neither the EFSF was in place, nor were banks recapitalised before people started suggesting PSI . . . It was like letting a bank fail without having a proper mechanism for managing this failure as had happened with Lehman."

International Italian

Mario Draghi studied economics at university in Rome, where he was born in 1947, and became the first Italian to gain a doctorate from Massachusetts Institute of Technology.

He was a professor of economics in Italy and worked at the World Bank before taking over as director-general of the Italian Treasury in 1991.

He stayed for a decade, overseeing Italy's entry into the euro and earning the nickname "super Mario".

After a spell at Goldman Sachs, Mr Draghi became governor of the Banca d'Italia in 2006 and for five years chaired the Financial Stability Board, responsible for drawing up much of the global response to the financial crisis.

But he remains adamant: "There is no trade-off between fiscal austerity, and growth and competitiveness." While tax rises and public spending cuts will hurt economic activity in the short term, markets should respond positively to lower budget deficits as long as two conditions are met: first, national economic policies must be designed to boost growth and job creation, and second, "it is necessary to have the right euro area designs . . . so that confidence is fully restored".

Few German conservatives – or indeed the UK's current coalition government, for whose policies Mr Draghi has warm words – would dispute this restatement of economic orthodoxy. Mr Draghi cites Italy's experience in the early 1990s, when he was director-general of the country's Treasury and public finances had spun out of control. Then there was no option of help from an EFSF-style rescue fund nor the International Monetary Fund.

An important lesson, he says, is that exchange rate devaluation – an option for Italy then, but not for struggling eurozone countries today – was double-edged. "It brought a temporary respite to the economy, so that exports could grow, but it also widened sovereign bond spreads because the exchange rate risk came on top of sovereign risk."

But what if the eurozone broke up, allowing devaluations outside the single currency straitjacket? Not so long ago, politicians and central bankers would have considered such a question impertinent, if not irrelevant. But Mr Draghi, like others, is ready to break the taboo.

Even if it were possible for countries to leave the eurozone, it "wouldn't help"; currency devaluation would lead to inflation "and at the end of that road, the country would have to undertake the same reforms . . . but in a much weaker position". Nor would it be in the interests of remaining eurozone countries. "You would have a substantial breach of the existing [EU] treaty. And when one starts with this you never know how it ends, really."

Many market observers argue that the unlimited firepower of the ECB is the only weapon able to calm the markets and save the euro. Mr Draghi favours a big firewall to protect stricken sovereigns but this should be provided by the EFSF not the ECB.

"The delay in making the EFSF operational has increased the resources necessary to stabilise markets. Why? Because anything that affects credibility has an immediate effect on the markets. A process that is fast, credible and robust needs less resources."

On a positive note Mr Draghi points out that last week's summit restated a €500bn lending capacity for the EU's rescue funds and agreed a further €200bn could be provided for the IMF – providing confirmation of the firepower for shoring up the eurozone.

Two other points were overlooked, he adds. First, the EFSF's resources would be reviewed as early as March – a hint that they could be increased. Second, the ECB had agreed to act as "agent" for the EFSF in market operations – speeding its full launch.

This raises questions about the future of the ECB's own "securities markets programme" in which it buys government bonds to relieve market tensions and drive down borrowing costs. The ECB's hopes that the eurozone rescue fund would take over that role have been dashed by delays and worries about the rescue fund's firepower.

"We have not discussed a precise scenario for the SMP," Mr Draghi says. "As I often said, the SMP is neither eternal nor infinite."

Across Europe, politicians have argued that in fact the programme needs to be stepped up dramatically. The obstacle, Mr Draghi argues, is the EU ban on "monetary financing" – central bank funding of governments. This reflects German fears about a repeat of 1920s hyperinflation driven by central banks running the money printing presses. "We have to act within the treaty," he says.

It is a sometimes legalistic – at times, even theological – debate. But behind Mr Draghi's comments is also a widely-held view at the ECB that if it had massively expanded bond purchases a year ago, governments – including Italy – would not have made any progress towards implementing economic reform, or agreeing tougher fiscal rules.

Under Mr Trichet, the SMP was undermined by public criticism from the Bundesbank's Mr Weber. Because the ECB's governing council was split in public, the central bank had to spend more to convince financial markets of its intentions.

Ultimately central banks have unlimited financial firepower – they can after all simply print money. The ECB could simply announce that it would intervene in the bond markets to stop yields going above a certain level. If the central bank was sufficiently credible, financial markets would not test the limits and the ECB would end up spending little, or so the argument goes. (The Swiss National Bank has taken similar steps to stop its currency appreciating.)

Mr Draghi appears unimpressed. Any extra cost countries pay to borrow is typically a result of their own financial health and policies. "Monetary policy cannot do everything," he says. One possible worry is that by pegging an interest rate, and pledging to buy unlimited amounts of bonds if necessary to defend the peg, the ECB would lose control of money supply.

He is also reluctant to discuss whether the prospect of a eurozone recession might force the ECB into "quantitative easing" – large scale government bond purchases aimed at boosting economic growth. "The important thing," Mr Draghi says, "is to restore the trust of the people – citizens as well as investors – in our continent. We won't achieve that by destroying the credibility of the ECB. This is really, in a sense, the undertone of all of our conversation today."

As the interview draws to a close, Mr Draghi is reminded of the huge volume of European bank and state refinancing in 2012. Some €300bn of eurozone government debt has to be refinanced in the first quarter. Global growth will also slow, he warns, although he stops short of forecasting a world recession, "and uncertainty has risen".

Mr Draghi is obviously hedging his options. Those who know him, however, suggest that this is a pragmatist who listens to advice – preferably crisp – thinks through his options and settles on a course from which he is loath to budge. As he prepares for a break over Christmas, he will doubtless be working out how to reconcile the conflicting demands of the politicians and the markets. He does not have much time. For 2012 may well mark the moment when the euro's fate is settled.