

# Isabel Schnabel: Pulling together: fiscal and monetary policies in a low interest rate environment



SPEECH

## **Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Interparliamentary Conference on Stability, Economic Coordination and Governance in the European Union**

Frankfurt am Main, 12 October 2020

The title of this morning's session is intriguing in many ways: it speaks of a "new partnership" between monetary and fiscal policy and of the "requested" fiscal support.

The title suggests that the environment in which monetary policy operates may have changed in recent years – even well before the outbreak of the pandemic – and that this may have altered the way monetary and fiscal policies interact to deliver stable prices and sustainable growth.

And indeed, a few key numbers summarise how radically our world has changed. Over the past two decades, the ECB's main refinancing rate has declined from levels close to 5% to 0%. Consumer price inflation averaged 2.2% from 1999 to the eve of the global financial crisis in August 2008, but only 1.2% since then, well below our inflation aim of "below, but close to, 2%".

These developments raise important questions, especially as the same

developments have occurred in many other advanced economies. Many people are wondering why central banks, despite record low interest rates, have not been able to deliver inflation rates in line with their aim. A related question is what needs to be done to change this.

In my remarks this morning, I will not be able to give definitive answers to these fundamental questions. A deep analysis of these and other issues will be the subject of our monetary policy strategy review that the ECB's Governing Council has just resumed after the pandemic-induced pause.

But what I would like to offer is a way of thinking about the origins and implications of the current low interest rate environment and how it affects the conduct of both fiscal and monetary policy.

I will argue that it would be misleading to speak of a new "partnership" between fiscal and monetary policy. After all, partnership implies a degree of coordination that would be inconsistent with an independent central bank. But I will suggest that, in a low interest rate environment, there are strong complementarities between fiscal and monetary policy that can help lift the euro area economy out of the current low-growth, low-inflation trap.

## **The need for novel monetary policy measures**

Low interest rates have sparked a remarkable public debate. In many advanced economies, they have exposed central banks to severe criticism and have even called into question the paradigm of modern independent central banking.

In the euro area, the coincidence of low inflation and low interest rates has led to opposing views. For some, the ECB is doing too little too late to lift inflation. Others blame the ECB for "expropriating" savers and propping up "zombie" firms.<sup>[1]</sup>

There is an evolving understanding that some of these arguments may not properly reflect reality. In particular, it is increasingly appreciated that central banks have only a limited impact on the long-term trends that shape the interest rate environment in which the economy operates.

These trends are, by and large, determined by the willingness of households and firms to save and invest. In this context, central banks often point towards the "real equilibrium" interest rate that balances savings and investments.

And over the past few decades, slow-moving structural factors, such as lower trend productivity growth, an ageing society and global excess savings, have together led to a measurable decline in that interest rate.

Just as an example: annual productivity growth in the euro area in the 1980s was, on average, around 2%. Today it is less than half of that.

This decline in the real equilibrium interest rate has two broad consequences for the conduct of monetary policy.

The first is that ever-lower interest rates are needed to stimulate growth and investment. This is because monetary policy is only providing stimulus if the short-term policy rate – adjusted for inflation – is below the equilibrium rate. Current estimates suggest that the real short-term policy rate in the euro area needs to be negative for monetary policy to put upward pressure on prices.

The second consequence is that years of weak aggregate demand and price pressures have forced central banks worldwide to find additional instruments that could provide policy accommodation when their main policy rates were approaching zero.

In fact, the ECB has introduced a wide range of novel monetary policy tools in recent years, such as asset purchases and negative interest rates. There is a wealth of empirical evidence that suggests that these measures were not only necessary to fulfil our price stability mandate, but that they also had considerable positive effects on growth and employment in the euro area.<sup>[2]</sup>

## **The changed interaction between fiscal and monetary policy**

So, monetary policy has not become powerless in the wake of the fall in the real equilibrium interest rate. Nor have the side effects of our novel measures been as drastic as the public debate at times suggests.

For example, there is no evidence that purchases of government debt have undermined the disciplinary function of financial markets or created moral hazard.<sup>[3]</sup>

Lower interest rates did not lead governments to take on more debt. The primary balances for the vast majority of euro area countries improved after the start of our government bond purchases.

Moreover, the sensitivities of euro area sovereign bond yields to macroeconomic news and risk remain far removed from the complacency that characterised financial markets in the run-up to the global financial crisis.

But the risk that non-standard policy tools may eventually create unintended adverse side effects becomes higher, the more intensively they are used and the longer they are maintained.

This is where the title of this morning's session comes in again: the lower nominal interest rates are, the larger are the benefits of using other policy domains more actively, in particular fiscal and structural policies.

The current pandemic crisis is a case in point.

The measures we have taken since March – most notably the asset purchases under the pandemic emergency purchase programme, or PEPP, and the liquidity provision to banks through targeted longer-term refinancing operations, or TLTROs, – have been crucial in allowing the financial sector to act as a backstop for the euro area economy.<sup>[4]</sup>

They prevented the health crisis from turning into a full-blown financial crisis at a time when markets started to panic and price action became highly destabilising, which could have had dire consequences for society as a whole.

But at times of significant uncertainty, private investment may not fill the gap left by the pandemic in spite of very favourable financing conditions. In these situations, monetary policy cannot unfold its full potential. Fiscal expansion is then indispensable in order to sustain demand and mitigate the long-term costs of the crisis.<sup>[5]</sup>

Strong complementarities reinforce the policy impact, working in both directions.

On the one hand, fiscal policy will be more effective when interest rates can be expected to remain low for a considerable period of time, like today. On the other hand, decisive fiscal action increases the effectiveness of monetary policy, especially in the presence of divergent developments across the euro area.

Indeed, the historic decision by European governments to tackle this crisis with a common fiscal response was not only a strong gesture of European solidarity, it has also been instrumental in stabilising financial markets and mitigating the risks of fragmentation, thereby supporting the transmission of our single monetary policy to all parts of the euro area.

These are not the times to worry that rising government debt today could undermine price stability tomorrow. On the contrary, using fiscal and structural policies more actively in the current environment will, if used wisely, support price stability and foster central bank independence.

The reason is that such policies may boost potential growth, reverse the decline in the real equilibrium interest rate and thereby increase monetary policy space in the future. This is why we applaud the clear focus of the Next Generation EU programme on digital and green investments, which promise to have the highest payoff for society.

To support these objectives, it is crucial to swiftly put the recovery fund into action and establish a sound and efficient governance structure that ensures that funds are channelled towards the most productive and sustainable projects.

Looking forward, governments will at some point need to make a credible commitment to regain fiscal space. But this should happen only once the economy has returned to a sustainable growth path. These efforts should be accompanied by a revision of the European fiscal framework: fiscal rules are too complicated, hard to enforce and procyclical.

Monetary policy, and with this I would like to conclude, will remain a stable and reliable source of support throughout the crisis. Our policy measures will continue to be geared towards ensuring that financial conditions remain consistent with a return of inflation towards our aim in the medium term, in line with our mandate.

Thank you.

---

## **Nagorno-Karabakh: Declaration by the High Representative on behalf of the European Union**



The EU welcomes the agreement reached on 10 October on a humanitarian ceasefire between Armenia and Azerbaijan. The EU urges the sides to strictly abide by this agreement and calls on all actors, including external parties, to refrain from any actions that may lead to further casualties. In this respect, we note with extreme concern the reports of continued military activities, including against civilian targets, as well as civilian casualties and urge the sides to ensure full respect of the agreement on the ground.

The EU calls upon the sides to engage in substantive negotiations without delay under the auspices of the OSCE Minsk Group Co-Chairs, without preconditions and on the basis of the agreed upon principles.

The EU continues to support the work of the OSCE Minsk Group Co-Chairs in seeking a negotiated political solution to the conflict and will remain engaged in efforts towards lasting peace in the region.

---

## **Philip R. Lane: Interview with Wall Street Journal**



## INTERVIEW

# **Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Tom Fairless on 8 October**

11 October 2020

**What's your latest thinking on the economic outlook for the eurozone? Do you see the risk of a double-dip recession?**

The usual language we use for how the economy is performing is not so helpful this year. When the economy was locked down in March and April there was a really big drop in activity, but it was an enforced drop. We published on 1 May a set of simulations, and broadly the baseline there has been working. The baseline had a big drop in the second quarter and an elastic bounceback in the third quarter, and that has worked out. The narrative was that the fourth quarter would not be a dip, but it would be a slowdown.

What is true is that the next phase is going to be tougher. We think that about half of the drop has already been recovered. We also think there is going to be more in the fourth quarter. By the end of the year, the European economy is going to be still about 5 percentage points below its end-2019 level. That's a lot less than the 15 percentage points the economy was down in the second quarter, but a 5 percentage point drop is still a lot. Our baseline is still a lot of recovery in the fourth quarter, a lot of recovery next year, with the elimination of the whole gap in 2022. But the situation now does feel different because it's no longer just reliant on the elasticity of reopening the economy. It does rely on whether there are going to be more localised lockdowns, which are happening to some extent. And it does depend on what is going to be the behaviour of consumers and investors, and what is fiscal policy going to look like.

We had in our baseline that there would be temporary outbreaks and temporary resurgences, because the nature of the pandemic is that you do get waves. It's not too surprising that there's some pick-up in the virus right now. The big question, and this is why there is so much uncertainty, is: how quickly can the current dynamic, with rising cases, be stabilised.

The approach to addressing the virus is now much more surgical. It tends to be shutting down the entertainment sector and restaurants, but not shutting down factories, not shutting down schools and so on. If it's shown that you can control the virus with serious but not universal restrictions, then that's more or less in line with our baseline. If it turns out we have to really disrupt the economy more materially in order to control the pandemic, then that's more of a negative development.

**A lot of businesses have been disrupted for six months, is there some damage that the economy has sustained from that that we're likely to see going forward?**

This is one of the big issues. It relates to the very extensive fiscal support. The loss of revenue for many firms has been offset to some extent because some of their cost base, in particular the wage bill, has been partly taken over by the state. And then you have the ability to obtain liquidity because of credit guarantee schemes that have been quite important as well. All of that makes more sense when the period of lost revenue is relatively contained.

The question whether there is longer-lasting damage to the economy is part of the uncertainty that remains. If it turns out that most of the economy can operate as normal most of the time, there is less fear of long-term damage than if there is going to be more extensive interruption of activity. But you definitely have sectors like travel, tourism, the entertainment sector, where there is probably quite a lot of damage. The dominant issue here is not at macro level, how the whole economy and aggregate productivity might be affected, but for those sectors that are the most vulnerable to the crisis, definitely a lot of support will be needed for them.

**Do you see the risk of a wave of job cuts?**

So far there hasn't been a huge amount of permanent job losses. There's been short-time working and a lot of retention of workers, or in some cases they may become unemployed and be rehired. Going back to the deterioration of the lockdown and the interruption to travel and tourism, there is a reasonable concern about whether firms will survive and whether people's job prospects will be damaged. We do think that is one reason why the savings rate is not going to return to normal super quickly, because it makes sense in that environment to have some precautionary savings. The fear of losing your job, which in conditions of uncertainty is going to be elevated, is a real issue.

Probably the most important thing to say about our view of the economy is that there is a high degree of uncertainty. We publish not just our baseline but also mild and severe scenarios and each of those scenarios is self-validating. If good news emerges that the pandemic can be contained, that

there is better treatment, ultimately a vaccine, then the good news takes hold and that uncertainty will fade and there are a lot of savings in bank accounts that can go back into the economy. Alternatively, if bad news arrives then the support for consumption and investment will be a lot weaker. So the uncertainty is a fundamental characteristic of what we have right now.

**Do you see signs of a K-shaped recovery in which some classes of workers will do better than others?**

That correlates quite strongly with the sectors. We know that the sectors most affected are labour-intensive service sectors like restaurants, hotels, travel, tourism. Those sectors employ a lot of younger people and these are overall not the best paid sectors in the economy. That can feed into macro outcomes because those classes of workers, by and large, have a much higher consumption propensity than those that are higher paid, who will have more of a savings margin. This is why it's so important that the fiscal measures to support the categories of workers in the sectors more exposed to the pandemic are maintained.

**Will the jobs that have been washed away in this crisis come back, or do you expect a shift in the European economy toward new sectors and types of jobs?**

In terms of the return of tourism – going back to restaurants and so on – once we're past the pandemic, I don't see a reason why those sectors wouldn't fully recover. In fact, you could argue that after a long period of time of not having the same level of entertainment, not having the same level of tourism, there will be maybe more of a strong bounceback after the pandemic. For business travel, and the balance between working from home or the office, maybe there's going to be more long-term consequences. But maybe some of that was going to happen anyway and it's just been accelerated by the pandemic. And the acceleration of digitisation that we've seen may well be good for productivity over the longer term.

**What risks do you see to the economic outlook? How concerning is the exchange rate of the euro?**

The single biggest risk is that the pandemic is not controlled, and/or it takes longer than is currently expected to find good treatments and a vaccine. That outranks any other risk by some distance. What we haven't seen in this crisis is the amplification of the crisis by financial instability and credit crunch issues and so on. The fact that there has been a good degree of policy responsiveness this year, it's important to maintain that, because we would have had worse outcomes this year without a good deal of policy support. And I think that's going to remain true until the pandemic is really vanquished.

The most important driver of inflation dynamics is the amount of slack in the economy. When we're operating, in the second quarter, at 15 percentage points below 2019 levels, only half of that has been offset by now, and we'll have a 5 percentage point gap by the end of 2020, that is by far the biggest issue for inflation. On top of that we have had the movement in oil prices, and in addition to that the exchange rate does matter. So the exchange rate is



important for the European economy, there is no doubt about that. But there's a lot going on at the moment and it's important not to put that at the centre of policymaking, because it's not. The exchange rate does matter, but it's only one of the issues that we think about. It's there, but it's only one of many factors. It's also not so much that the central bank is looking at the exchange rate per se, it's the implications for the European economy and for inflation.

The exchange rate is one issue, but the fact that there's been a significant recovery in the Chinese economy is quite important. The fact that, by and large, the world economy is looking better than it did a few months ago is quite important. The fact that there's been a lot of policy support, not just in the advanced economies but also in the emerging economies, is important. The fact that European manufacturing, by and large, is open, is busy now, is important. So the exchange rate is important but the bigger global issue is the state of global demand, and that has recovered maybe better than expected.

### **Is the exchange rate a problem at its current level?**

Again, it's not the level. What enters the dynamic calculations is the movement in the exchange rate. That's really what matters. And in turn it's the implications of that, not on a month-by-month basis but over the next couple of years. So it's something we're looking at, but there's so much going on in the world right now, it's just one of many factors. And compared with the core issue, which is the pandemic itself, it in no way ranks in the same category as that.

### **Given that inflation is so low and there's a large amount of slack in the economy, are investors correct to assume that, all else equal, the ECB will announce another round of bond purchases?**

We understand why inflation is slightly negative right now. It's clear that there are some purely temporary factors behind it. In Germany, for instance, there has been a temporary VAT cut. That has quite a big impact on the price level, but that is going to be reversed on 1 January. Another factor is that the European economy will operate on average this year at 8 percentage points below the 2019 level. That's a huge amount of slack, so it's not surprising that we have very low or slightly negative inflation in these months.

But for next year we are projecting the economy to grow by 5 percent. The European economy doesn't normally grow by 5 percent, so we know there's going to be a lot of reduction in slack next year. And this is why we do think that inflation is going to climb. What is true is that the current inflation level remains far away from our goal. We don't think that is a satisfactory inflation outlook.

But a lot is going on this autumn – in terms of the pandemic and in terms of fiscal policy. When we made our September forecast we didn't know what the budget plans for 2021 were going to be. There's going to be a lot of budgets announced in the next few weeks. Then we will know more about how much fiscal support there will be for the economy in 2021. We also have to see in these

weeks what's happening with the exchange rate, and with oil prices. We're going to get a lot of information.

Some of those factors may represent negative developments, but some factors may be positive. There's a lot of two-sided uncertainty, but we know some of that uncertainty will be resolved this autumn. We will know the fiscal plans, we will know more about the pandemic. So I think it's true to say that we would like to see a stronger momentum in inflation. Meeting by meeting we will have to make that call: where do we think inflation is going? Because if the outlook remains at 1.3 percent, that is far away from our goal.

**So that does suggest that, all else equal, you would need to do more stimulus?**

That depends on the incoming data. It is clear that 1.3 percent is not our goal. More than usually the incoming data will tell us a lot. Right now, there's a lot to learn in these weeks. It was always clear that there was going to be a pivot in the recovery, because the initial bounceback was mechanical in the third quarter. Now, the pace of the recovery will depend on the pandemic dynamics, on the behaviour of households in terms of consumption, on the behaviour of firms in terms of investment. It becomes more of a question of economic analysis. It really is a unique period of uncertainty. But along some dimensions the uncertainty will diminish in the autumn because we'll know more about the outlook for 2021.

**So December's meeting could be important?**

I wouldn't focus on any one meeting. It's not the case that we only look at the formal projection rounds.

**Major central banks have avoided cutting interest rates deeper into negative territory, or cutting below zero. Does that show a certain scepticism towards negative interest rates?**

We still think that the pandemic will be mostly a temporary shock. We do think that the impact of the pandemic on GDP will be mostly gone by 2022. So there's maybe an 18-month horizon compared to now. Any interest rate cut typically lasts for a long time. Typically, it's not just that you cut the overnight rate, but that the market infers that the rate cut will be there for a long time, so the whole yield curve moves.

When you have an expectation of a strong movement in the economy over a relatively short period of time, then the implications of a short-term rate cut in the yield curve are going to be less, because the conditions that might cause you to cut rates now are less likely to persist for so long. The value of a rate cut is still there and we look at it all the time. It's perpetually looked at. We reject the idea that we are at the lower bound. We think, overall, a rate cut would still be working the way other rate cuts have worked. The economics of a rate cut remain. We think the rate cuts up to now, including last September's, have worked in the way intended; they pass through into lower lending rates, into more credit volumes and so on. In terms of effectiveness, we think the asset purchases have a bigger impact on

the yield curve now. But the option of going lower remains part of our policy guidance.

**Is the ECB's strategy review likely to come to a similar conclusion to the Federal Reserve, which recently indicated it will target an average inflation rate of 2 percent?**

All advanced economy central banks have a high degree of commonality in the issues they face, especially: how do you conduct monetary policy when the underlying global equilibrium real rate,  $r^*$ , has trended downwards? In addition, we all – to different degrees – are below where we would like to be in terms of the inflation rate. One of the issues is whether the sustained period of low inflation might get locked into inflation expectations.

In terms of our monetary policy strategy review, it's important that our medium-term orientation is to get inflation back to where we think it should be. For us to be back at around 2 percent, that's not going to happen this year or next year. So then a key question is: how do you anchor expectations? One version of how you might anchor expectations is the new formulation of the Fed. But there's a whole family of different ways of doing this.

Our current forward guidance has a lot of guidance there. The main concern raised with us is: please tell me you're committed, that your monetary policy is committed to get inflation back towards the aim. Our monetary policy today, even before the strategy review, says that we're not going to tighten the interest rate until we see inflation robustly converge to the aim. In other words, we need to see a lot of evidence that the inflation outlook is in the neighbourhood of the aim. And we have a second condition: that we've seen that robust convergence reflected in realised inflation dynamics. It's not just that we're forecasting two years from now that inflation is going to pick up, but that we've already seen a good pickup in underlying inflation.

So there's a lot of similarity between our current forward guidance and that family of policies which all say: we're not going to have knee-jerk policy tightening, we're going to make sure that inflation is in the neighbourhood of where we want it to be before we tighten.

**Mario Draghi suggested that the ECB's policy target was symmetrical. Is that accepted by the Governing Council?**

How can you doubt that? We have emphasised this in our introductory statement for at least over a year now. All the action we've taken since 2014 was in order to respond to inflation that was dropping below the target. There would be asymmetry if anyone was concerned that the ECB would quickly suppress inflation that went above the aim but tolerate below-target inflation so long as it was above zero and below two.

But the evidence shows that we've been very symmetric, that we've done a lot since 2014 to respond to the fact that inflation has been too low. So in that sense it is a symmetric target. Part of the strategy review is how else can we communicate and have a better common understanding of what is meant by symmetry. So we say we're symmetric, and I think the record shows we've been

symmetric. But to fully understand what that means will be part of the strategy review.

**Investors seem to perceive that the Fed might be more aggressive than the ECB in pursuing its target.**

Anyone who pays attention to our policies and forward guidance knows that we will not tighten policy without inflation solidly appearing in the data. I do not see that the ECB has a structurally tighter orientation for monetary policy.

**European nations like Spain and Italy have very high and rising public debt. Does the level of debt still matter? Should governments aim to reduce their debts at some point?**

It's important to make a sharp distinction between sovereign debt and other types of debt in the economy. We've seen the damage that can occur when an economy is made very vulnerable by debt. But a lot of those examples have both high sovereign debt and large external debt. It's important to make a distinction between that example and what we have now in Europe. We see an increase in public debt, but we are not seeing economies running a high current account deficit.

The eurozone as a whole is running a current account surplus. Simultaneously, household savings are extremely high at the moment. The fact that the sovereign may have increased its debt is macroeconomically necessary given the situation. But also in terms of the longer-term consequences, it's a very different scenario to having a lot of sovereign debt twinned with a lot of net external debt.

Under current conditions it's important that fiscal policy is active and responds to the needs of the economy. We think the maximum hit to the economy is this year, but there will still be below-normal operations next year. So it's important to have a lot of fiscal support next year, but it's going to be obviously directionally less than this year. But a lot of these measures are temporary in nature. We have had problems in the past because the fiscal deficit was structural in nature and you needed to have a lot of adjustment, spending cuts and tax rises, to close it. In the current context a lot of the work will be done by the recovery in the economy.

This pandemic might last for a sustained period, but it is temporary. Once this is over, debt ratios will be a lot higher in Europe. And at that point it will be important to think about what kind of policy frameworks will not only stabilise the debt ratio but also bring it down over time. Because one other lesson from this crisis is that it shows the value of fiscal space. If you want to have a suitably countercyclical fiscal policy when shocks happen, you have to create some room in the good years, when the European economy has recovered. So we will want to see debt ratios come down to some extent. That message has to be there. The calculation of what that looks like, I think, can wait.

It is also worth taking into account that the trend interest rate has come

down, because of the policy support we have put in place and also the cyclical slump in investment demand combined with cyclically high savings ratios. There's also a cyclical component to the low interest rate environment. Governments can take advantage of the fact that the trend interest rate is lower than it was 20 years ago. It's still important that the debt ratio comes down, but a growing economy can do a lot.

**Do you think the 60% debt-to-GDP level outlined in the EU Treaty is still important?**

It's in the EU treaty. In economic terms, the most important issue is having debt ratios come to a safe level over time. The calculation of that level will depend on the country and will probably also depend on the time horizon you're looking at. Debt ratios over time should return to a safe level, but let me emphasise that the dominant interpretation of "safe" should be "macroeconomically safe". This means governments can respond to another shock with countercyclical measures. There would be macroeconomic risk in leaving debt ratios at too high a level.

**Is there a risk that the ECB finds it can't change its policies in future because government debt ratios are so high?**

Right now we have this accommodative monetary policy, because we think the European economy is operating below potential and it needs monetary support to recover. We have signalled the conditions needed for our policy to tighten once the economy has recovered. Essentially, the conditions under which we would tighten policy are driven by the inflation outlook.

That's an important signal to governments. The interest rate policy is crystal clear and if the conditions in respect of inflation warrant a tightening of policy, that's what the ECB is going to do. Those are conditions where the European economy is doing well, where the slack has disappeared, where there's a high degree of confidence. Under those conditions the fiscal conditions will look very different in terms of the ability to revise fiscal policies.

**What do you think will happen to the ECB's bond holdings? Could these bonds be held for decades?**

We've set out the conditions under which these portfolios will be rolled off. It's not the case that there's a commitment to perpetually hold onto them. We've said that when the inflation outlook allows it, they will be rolled off.

With the asset purchase programme, we've said that we'll have net purchases until shortly before the period when we might tighten policy and the end of reinvestment will be dated after that. The pandemic emergency purchase programme (PEPP) is an exceptional measure, so how long we hold onto those assets could be different. We've said we'll maintain the portfolio until the end of 2022, and that we will not let the roll-off of that portfolio interfere with our monetary policy. So that is saying that you do have to be careful about how you roll the portfolio off over time. But it's also clear

that the PEPP is a temporary measure. If the monetary conditions allow it, these portfolios will be rolled off. This is fundamental to protecting our independence.

**How could this crisis affect labour productivity in the eurozone? Is there a risk that the ECB's policies will help to keep afloat unviable "zombie" companies?**

Increased digitalisation accelerates new ways of working, and that effect is non-trivial. At the ECB, we've found our ability to do business with less travel cost is there. So I think that productivity gain is real. There has been a critique that the European economy has been doing too little by way of public investment. Now, through this very innovative scheme – the EU recovery fund – that will, we think, have a significant impact on productivity, especially for those countries that are the biggest net recipients.

It's also very important to remember the counterfactual. Easy monetary and fiscal policies are important to protect productivity. The worst impact on productivity would materialise if we allowed unnecessary recessionary forces, if we allowed that through a lack of monetary and fiscal support, a lack of demand. Then a lot of firms would go under that shouldn't have to.

It is also worth keeping in mind that, over the last five to six years, the ECB and European supervisors have made a lot of progress on resolving non-performing loans, which have historically been the biggest concern in terms of zombie companies. When you think about low interest rates, we think the number of firms that would not survive if the interest rate were higher is quantitatively visible but small. So when you quantify it we don't think that low interest rates as such are a big source of zombie dynamics.

And even if it's true that some firms are kept alive by low interest rates, the costs of raising interest rates so that such firms would be shut down, the cost of doing that would far exceed any benefit in terms of cutting off those firms.

**There seems to be a lot more job creation in the United States than in Europe during this recovery – is that a concern?**

One basic difference in how the US and European economies operate is reallocation within the firm versus reallocation across firms. In the United States, new entrants bring new technologies and then the existing firms shut down. That's one way to operate the economy. A different way is adjustment within the firm. To switch for example from on the street to online retail, is that taking place by existing employees switching jobs?

**Do you see a case for a bigger role for the state in the European economy?**

At the very early stage of the discovery process for certain industries, I think there's a strong case for more public research and development. The logic of the public sector making big bets on the private sector is not untroubled, historically. But you can see the case for having a degree of resilience in supply chains, for example in response to changing energy

prices. But that doesn't mean that the supply chain needs to be national in nature. The EU is an example where the states, rather than having national solutions, work together.

---

## Isabel Schnabel: The ECB's independence in times of mounting public debt



INTERVIEW

### **Contribution by Isabel Schnabel, Member of the Executive Board of the ECB, Frankfurter Allgemeine Zeitung**

10 October 2020

The pandemic is driving up government debt throughout the world. In the euro area, it is set to exceed 100% of GDP, a level that is, however, still below that of many advanced economies. In Germany especially, many observers are concerned about this development. They consider it a threat to the independence of the European Central Bank (ECB), fearing that “fiscal dominance” may induce it to deviate from its monetary policy objectives, endangering price stability. The purchases of sovereign bonds, which began in 2015 and were stepped up amid the pandemic, are sometimes even described as monetary financing, which is prohibited under the European Treaties.

These criticisms don't stand up to the facts. Neither is the ECB pursuing a policy of "financial repression" – it is not keeping interest rates low to make it easier for governments to finance their debt – nor have its asset purchases disabled the price discovery mechanism in financial markets. The ECB gears its monetary policy to its price stability mandate, not to the indebtedness of Member States.

The euro has been built on the principle of "monetary dominance": the ECB's objectives are solely determined by its mandate as defined in the European Treaties. This principle is buttressed by far-reaching political independence, the prohibition of monetary financing of public debt and a comprehensive fiscal framework.

Is the rising public debt jeopardising this independence? Empirical research refutes this idea. There is no evidence of a systematic feedback loop from sovereign debt developments to monetary policy decisions.

The public debt ratio in the euro area is notably lower than it would have been in the absence of the bond purchases. However, this primarily reflects the positive effects of monetary policy measures on economic growth, whereas the impact through lower interest rate expenses has been comparatively small. Without the measures taken since March, growth up to the end of 2022 would be around 1.3 percentage points lower. By contrast, history shows that financial repression would dampen economic growth.

Moreover, a monetary financing of public debt would be expected to raise inflation expectations – as was the case in the 1970s. The ECB is faced with the opposite scenario: expectations remain well below our inflation aim of below, but close to, 2%.

Also, in financial markets, yields in the euro area continue to noticeably react to risk factors. The risk premium on Italian sovereign bonds is higher today than when purchases started in 2015, and risk premia soared significantly during the political turbulence in 2018. The market's price discovery mechanism continues to function primarily because most of the government bonds remain in the hands of investors other than the Eurosystem. And this has not changed during the pandemic.

Nevertheless, financial markets can be gripped by panic, as was the case, for instance, when the pandemic first spread. Self-fulfilling price spirals then endanger the stability of financial markets. In such situations, central banks must act quickly to restore trust. Through generous liquidity provision, the market can find its way back to a "good" equilibrium and can again function smoothly.

But would it not make sense to take on less public debt today to protect the ECB's independence in the longer term? In fact, the opposite is true, as the interaction between monetary and fiscal policy has changed in the low interest rate environment.

Many central banks have seen their room for manoeuvre curtailed over the past few years. As policy rates are already very low, monetary policy must



increasingly turn to “unconventional” measures, such as asset purchases, to fulfil its mandate. This is primarily caused by structural changes to the economy, an ageing society, global excess savings and low productivity growth. These factors have led to a marked decline in the euro area’s real equilibrium interest rate – the rate that balances investment and savings.

In this environment, fiscal policy gains importance. The decisive fiscal policy intervention in the coronavirus (COVID-19) crisis strengthens the effectiveness of monetary policy and mitigates the long-term costs of the pandemic. With targeted, forward-looking investment, not least under the umbrella of the EU Recovery Fund, governments can foster sustainable growth, increase long-term competitiveness and facilitate the necessary reduction of the debt ratio once the crisis has been overcome. This would also afford the ECB more room for manoeuvre in the future, which would even strengthen its independence.

*This contribution first appeared as an opinion piece in Frankfurter Allgemeine Zeitung on 10 October 2020.*

---

## **Forward look: 12 – 25 October 2020**



Overview of the main topics and events at the Council of EU and European Council.

The indicated format of each meeting (physical or virtual) are subject to change.

### **Foreign Affairs Council, 12 October**

The Foreign Affairs Council will exchange views on Russia and on EU relations with the Latin America and the Caribbean region, and be informed about current affairs.

### **General Affairs Council, 13 October**

Ministers will take stock on the EU-UK negotiations and will discuss European Council conclusions for the meeting on 15-16 October.

### **Video conference of employment, social affairs and equality ministers, 13 October**

Employment and Social Policy ministers will hold two debates: ‘Worker participation and support for workers in restructuring’ and ‘Equal participation of women and men in the labour market’.

## **European Council, 15 and 16 October**

EU leaders will discuss relations with the United Kingdom, climate change and relations with Africa.

## **Agriculture and Fisheries Council, 19 and 20 October 2020**

Ministers will seek to adopt the Council's general approach on the post-2020 CAP reform package, conclusions on the farm to fork strategy and reach a political agreement on next year's fishing opportunities in the Baltic Sea.

## **Environment Council, 23 October 2020**

Ministers will discuss the European climate law as well as biodiversity.

For video coverage of Council sessions and audiovisual material, please see the following Council websites: