Fabio Panetta: Interview with Der Standard

INTERVIEW

Interview with Fabio Panetta, Member of the Executive Board of the ECB, conducted by Andras Szigetvari on 6 May and published on 14 May 2020

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The European Central Bank has responded to the crisis by launching a new emergency programme, under which it will buy €750 billion of securities, mainly government bonds, by the end of the year. At the same time, European rules have been loosened and the usual limits on government deficits no longer apply. Can governments now take on as much debt as they like?

We are currently going through a severe economic shock. The first and most important thing we have to do is to maintain the euro area's productive capacity. This crisis is affecting weak and strong companies alike, because their revenues disappeared from one day to the next. It would be a very serious mistake to let viable companies go bankrupt and lose the productive capacity we need for the recovery. By improving financing conditions for all sectors of the economy, our monetary policy complements and reinforces the European and national measures taken to provide relief to the economy. And the more we protect our productive capacity today, the easier it will be to manage public debt in the future.

Italy announced a massive €50 billion stimulus programme a few days ago. Interestingly, yields on Italian government debt have fallen. That was never

the case in normal times – whenever a southern European country announced an increase in spending, yields rose.

It isn't a law of nature that a country's risk premia rises just because it plans to spend more money. If a government announces that it is increasing spending when there are no grounds to do so, that is in a pro-cyclical way that increases economic risks eventually, yields generally go up. But when governments' action reduces economic risks in a counter-cyclical way and monetary policy is acting in tandem to stabilise the economy, yields typically go down. It would be much worse if fiscal policy was not used in the current situation, even in countries where public debt is relatively high.

What do you fear more at the moment: higher inflation, because the ECB is pumping so much money into the markets, or deflation, meaning falling prices?

Right now we're facing a situation where companies aren't really in a position to offer their goods and services. But that is only part of the story: the prevailing uncertainty and higher unemployment are severely affecting demand. On top of that, there are the effects of cheap oil, weak international demand and weak trade developments. All of that is weighing on prices. It's clearly a disinflationary environment.

So the ECB needs to do even more to avoid deflation?

We will do everything that is necessary to secure price stability in line with our mandate and avoid disinflationary or even deflationary risks. And we remain determined not to tolerate any tightening of financing conditions for as long as the economic damage caused by Covid-19 persists. We have all the necessary tools, we are using them decisively.

But if we see a recovery in 2021 and a rise in oil prices, wouldn't there be a risk of much higher inflation?

I wouldn't expect to see that. We think that inflation will stay very low for the next two or three years, well below our definition of price stability. I can't say what will happen in ten years, but I note that market-based indicators of longer-term inflation expectations have remained at depressed levels.

But then shouldn't the ECB change its inflation objective? Inflation has fallen short of your target of below, but close to, 2% for years, and you're saying that this is set to continue. Why not match the target to reality?

That wouldn't be a good idea. There are sound reasons why we chose our objective of below, but close to, 2%. First, it grants a safety margin to deflationary territory, also taking into account possible cross-country differences in the price level. And it's extremely hard and extremely expensive to find a way out of a deflationary situation. This margin is also important as it implies that nominal interest rates are higher, giving additional policy space for monetary accommodation, and makes it easier for real wages to adjust if needed. Moreover, there is a possibility of distortion when measuring inflation as price pressures can also reflect improvements in product quality, which means that measured inflation is always somewhat higher than actual inflation. A US study puts that distortion at as much as 1%.

Governments are pumping a great deal of money into the economy, with expenditure rising everywhere. The ECB is supporting the process from its side. When will we see a return to the old normality?

To paraphrase Einstein, as soon as possible but no sooner. It would be counterproductive if, having made every effort to keep the economy going, policy support were then to be switched off too early. What would happen then? Growth would immediately disappear again. So on the monetary policy side we will need to ensure that inflation moves towards its aim in a sustained manner. And on the fiscal side, it will be key to have self-sustaining economic growth. One of the big mistakes after the financial crisis was that fiscal policy in the euro area shifted too quickly to a pro-cyclical stance. Spending was cut during the crisis, and that is always fatal. But this time we have seen a substantial response even from countries that were previously very conservative in their spending. So I'm optimistic that the euro area has learned this lesson.

Former ECB President Mario Draghi has said that one of the biggest changes in this crisis is that government debt will be much higher than it was before. Do you agree? And what consequences will this have?

Yes, I would agree. But I would also expect interest rates to stay low for a long time. Three factors determine whether a country's debt is sustainable: the level of debt compared with economic output; the rate of growth of the economy; and interest rates. So, on the one hand, we will be worse off, because government debt will be higher. But there are also a number of factors keeping interest rates low in the future, which are by no means solely attributable to the ECB.

Which factors?

First and foremost, demographic developments, the ageing of societies in many industrialised countries. As that entails an excess in saving and less potential for innovation, many economists refer to a secular stagnation: economic growth slows down, also lowering inflation and interest rates because there is less demand for capital.

How long can that work for?

The path towards secular stagnation is not inevitable. It all depends on whether we succeed in stimulating growth. Stronger growth makes it easier to service debt. Households that have a good income find it easier to keep up their loan repayments.

The eurozone comprises 19 countries. What would happen if growth returned in the north and inflation increased there, but not in the south, not in Italy? The ECB has to conduct policy for all countries in the euro area. Wouldn't it

be a dilemma if higher interest rates were needed in the north but not at all in the south?

One of the biggest challenges is to prevent the eurozone from emerging from this crisis with even more regional fragmentation than it had on entering it. This risk is real and one reason why we need a symmetrical and forceful response to this crisis. Not out of solidarity towards anyone in particular, that is a moral category, but because of our tight economic interlinkages. If one part of the euro area falls into a deep and prolonged recession, do you really think that the rest could forge ahead as if nothing had happened? No. So it is in every country's own interest to secure the recovery across the euro area and to collectively provide resources to that end.

How can such joint development be achieved?

What matters now is to stabilise the economy. Next comes a phase in which we need investment, with the environment meriting particular attention. Some countries, as has also emerged, will need to invest in their healthcare infrastructure. And, as always, innovation and human capital – i.e. education – remain central. There are sensible strategies for boosting growth through public investment in these sectors.

Do the additional public debts actually ever need to be repaid?

The lower the costs of servicing debts, the easier they are to bear. Many prominent economists believe that, given structurally low interest rates, advanced economies can tolerate higher debts today without having to rush into premature fiscal consolidation. What matters is whether the debt is financing productive spending that leads to higher future growth.

Japan has debt of more than 200%. The country is barely growing, but appears to have no problem with this mountain of debt.

If a country needs to borrow in order to fire up growth, to generate innovation, then it makes perfect sense to run up higher debts to finance productive spending. But not indefinitely. At a certain point, these investments will need to pay off, allowing debt to be repaid through the growth they generate, otherwise the government faces a problem.

Could the current situation result in a banking crisis? The hotel sector – which is highly dependent on bank loans – has been massively hit by the crisis. If borrowers default en masse, it will be problematic.

Banks are more resilient today than they were a decade ago, but we can't rule out risks. If there is a longer recession, the financial sector will be hit too. But compared with the time of the financial crisis, governments are now far more aware of the kind of difficulties that could lie ahead for the financial sector. Countries are offering government guarantees to borrowers. They are intended to protect borrowers but offer security for the banks at the same time. Moreover, this time European banking supervision has relaxed some rules, enabling banks to more easily provide loans to businesses and avoiding undesirable pro-cyclical lending policies by banks. A credit freeze in the private sector would only exacerbate the turmoil.

In its decision last week, the German Federal Constitutional Court set its sights on the ECB’s asset purchase programme. Among other things, it criticised the fact that the ECB had never explained that its actions were proportionate. The Court objected that, as interest rates were so low, the ECB had affected savers.

The ECB does not fall under the jurisdiction of the German Federal Constitutional Court, but rather under that of the Court of Justice of the European Union, which ruled in December 2018 that the ECB is acting within its price stability mandate and in compliance with the principle of proportionality. The German Federal Constitutional Court’s ruling is addressed to the German Federal Government and the Bundestag. And the Deutsche Bundesbank is in close contact with them.

Did the Court understand the ECB’s strategy? Its argument was that the ECB also needed to consider other effects of its policy, such as its impact on house prices and on savers.

The ECB has repeatedly discussed these issues in public in the past, including as part of its accountability to the European Parliament. We have spoken extensively about the potential side effects of our public sector purchase programme. There have been ECB publications on the topic as well as frequent interactions with parliamentarians. Proportionality was discussed in detail, also with the Court of Justice of the European Union in the course of its decision about our programme.

Do you see it that way too, have German and Austrian savers been harmed by the ECB’s ultra-loose monetary policy?

No, in my view, the ECB’s policy was beneficial for both German and Austrian people, who are at the same time savers, employees, mortgage holders. Many of the jobs that were created in the euro area over the past few years were in these countries. Their economies grew particularly strongly after the financial crisis, increasing the income that can be saved, and the ECB had a significant role in that. As regards interest earnings, they ultimately depend on growth – only when the economy grows interest rates can increase – and our policy has underpinned that growth.