

Isabel Schnabel: Interview with Les Echos



Interview with Isabel Schnabel, Member of the Executive Board of the ECB, conducted by Guillaume Benoit, Elsa Conesa, Lucie Robequain and Sophie Rolland

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There has been a delay in the supply of vaccines in Europe. To what extent does that jeopardise the EU's recovery?

The recovery crucially depends on the pace of vaccinations. The vaccination campaign got off to a slow start, but it has accelerated in most Member States. Our projections for the short term show a deterioration due to the resurgence of the virus and the new containment measures imposed in several countries. But the good news is that in the last quarter of 2020, the lockdowns caused less damage than during the first wave of the pandemic. The economy seems to be adapting better to the situation. The economic recovery will be further supported by the new US stimulus package, the effects of which have not yet been included in our staff projections. We also expect additional fiscal stimulus measures in Europe, which will amplify the effects of our monetary policy. All of this leads us to expect a firm rebound of economic activity in the second half of the year once the containment measures are lifted. According to our staff projections, the euro area economy is expected to grow by 4% this year. Real GDP should return to its pre-crisis level in the second quarter of 2022.

But the economic impact of the pandemic will certainly be felt well beyond the duration of the health crisis. The economy will not be the same after the pandemic. This requires structural change, which is never easy. Some jobs will disappear, while new ones will develop. This process will take time.

Can we expect a uniform recovery across the eurozone?

Since the very beginning of the crisis, there was a fear that divergences would appear across countries in the euro area. The services sector has been much more affected by the containment measures than manufacturing. A K-shaped recovery has emerged. Some countries will suffer more severely than others, notably because of their reliance on tourism.

The United States has just approved a stimulus package worth \$1.9 trillion. Should Europe go further than the €750 billion announced under the Next Generation EU plan?

The comparison is not straightforward because part of the measures announced by the US Administration act as automatic stabilisers, which are already part of social security systems in Europe. So the difference is less significant than it may appear. Nonetheless, the US measures are bigger. It may be that the European support will turn out to be insufficient. But I think that the discussion is premature. What matters now is that the agreed European funds are disbursed as quickly as possible. That's absolutely fundamental. We cannot afford a delay, this would be detrimental. The earlier the funds are made available, the better. Even more importantly, we need to make sure that countries spend the funds wisely, in order to foster their growth potential.

The United Kingdom has announced tax increases in order to pay back the COVID-19-related debt. Do you think the countries in the eurozone should do the same?

Raising taxes in the middle of the pandemic would not be a good idea.

The priority is to generate growth. Once the recovery has set in there will be a need to reflect on the best ways of bringing public finances back onto solid ground. But the biggest risk at the moment is to withdraw fiscal support too early. This is a mistake that was made in the past and that we must avoid this time.

Why didn't the European Central Bank step up its asset purchases when there was a particularly pronounced rise in rates?

In December we decided to preserve favourable financing conditions for firms and households for as long as necessary in order to counter the pandemic shock to the projected path of inflation. This does not mean that we target a specific yield level. We assess the evolution of financing conditions in the context of the overall economic development in the euro area. To do so we need to look at what factors are driving the rate increase: expectations of a stronger economic recovery boosted by an accelerating pace of vaccinations, rising commodity prices, or the US fiscal stimulus programme? Overall, recent changes in risk-free rates have been consistent with an improving growth

outlook. Rising inflation expectations have been a key factor driving yields higher, signalling that the policy measures in place are bearing fruit. Despite the recent uptick in yields, financing conditions remain close to historically accommodative levels. But the speed of adjustment was a source of concern. It risked a premature and too abrupt withdrawal of policy support, which could have choked the incipient recovery. That is why we have announced a significant increase in our purchases under the pandemic emergency purchase programme (PEPP) in the second quarter. We will tolerate higher interest rates only if they do not risk slowing the recovery.

In the short term, even if the rates increase, they would remain extremely low. Is there really a risk that they may slow down the recovery?

Again, what concerns us is not so much the level of interest rates – which are still very close to their historic lows – but rather the rapid change. If we see that the market may get ahead of itself in an environment of still high uncertainty and weak demand, it is important to protect our policy stimulus. But it would be wrong to think of us as having defined a threshold above which we have to respond. That is not the case.

Do you think the eurozone should have a permanent borrowing facility?

From a macroeconomic perspective it would be an important complement to our single monetary policy. But this is a political decision that also raises governance issues. Clearly, the Next Generation EU recovery programme is a crucial element of Europe's response to the pandemic, which mitigates the risk of economic divergence between countries that have been affected very differently by the crisis. It is a crucial step in the history of the euro area. Whether this temporary instrument could pave the way for a permanent borrowing facility will largely depend on how it is used. If the funds that are deployed enable Member States to embark on a sustainable growth trajectory, this will foster trust and hence increase the chances of fiscal integration in the euro area being strengthened in the future.

Several members of the Governing Council expressed differing opinions before your last meeting. Was it particularly difficult to reach a consensus?

There was full consensus about the decision to step up the pace of purchases. Everyone was aware that we needed to act, and nobody opposed this. Of course, there are always slightly different views on how to judge the economic situation or the recent interest rate developments. But in the end, we came to a common understanding of what needed to be done. The Governing Council consists of 25 members with diverse views. That is a strength.

Everyone is wondering about the new purchase amounts that will be deployed within the framework of the PEPP...

We decided not to pre-announce any amounts because flexibility remains one of the most important features of the PEPP. That means that we can adjust our asset purchases according to market conditions. We purchase more when necessary, and we can reduce our purchases when markets are calm.

Aren't you worried the market will test precisely that flexibility?

No, I think the past months have shown that markets are behaving in an orderly fashion. Clearly, we were sufficiently credible such that market participants knew we would react if needed. That's what we have done. I think markets will learn quickly how we implement our December decision.

Is the ECB concerned about the level of asset valuations in the markets?

We are monitoring financial markets closely but, so far, the situation of European stock markets is not a reason for concern. Valuations in the US stock market are more stretched, however. In the euro area they are more in line with their historical distribution but also here we are seeing valuations moving consistently higher.

The ECB has created an ideal environment for Member States to deploy fiscal policies. Debts have massively increased. Aren't its hands tied? Isn't the ECB at risk of losing its independence?

I don't agree that our hands are tied. The euro area is built on the fundamental principle of monetary dominance – our actions are guided by our mandate, as it is defined by the Treaty. This principle is supported on the one hand by our independence, and on the other hand by the EU's fiscal framework, which is designed to ensure that governments pursue sound fiscal policies. Our monetary policy is always guided by our price stability mandate, so I don't see a threat of fiscal dominance. Currently, fiscal policy is key to stabilising the economy. And if the funds are used wisely to boost potential growth, that's also good for monetary policy, as it would increase our room for manoeuvre in the future. It would also enable countries to stabilise their debt-to-GDP ratios. So it would be a big mistake to reduce fiscal spending prematurely for fear of fiscal dominance.

Have the banks done everything they could to support the economy?

Banks played a crucial role in supporting the economy at the height of the pandemic. They allowed firms to draw down their credit lines and there was a sharp increase in bank lending to firms. Since then, lending activity has moderated. This is linked to the fact that firms still have fairly high liquidity buffers because part of the loans they have taken out have not been used so far. They appear to be hesitant to invest in the current uncertain economic environment. Our bank lending survey indicates that the banks have recently tightened their credit conditions. So far this is not visible in the rates they charge, which remain at historically low levels, but rather in non-price components, such as the required collateral. As public guarantees are gradually being phased out, banks are concerned about rising credit risk. Our targeted longer-term refinancing operations (TLTROs) set incentives for banks to continue lending, even in an environment with higher corporate vulnerabilities. This has worked very well in the past, and we are confident that it will also work in the future.

After the ECB's "classic" public sector purchase programme was challenged before the German constitutional court, it's now the turn of the PEPP. Do you

think it will be called into question?

That could happen. However, it is clear that it is the Court of Justice of the European Union that has jurisdiction over the ECB, and not the German constitutional court. But of course, we take these issues very seriously. We adhere strictly to the limits of our mandate, and the proportionality of our measures is fundamental for our decisions. I am convinced that our new asset purchase programme – the PEPP – will also be considered to comply with the European Treaty, because it was designed as an emergency measure in an extreme situation. This is the worst economic crisis we have experienced since the Second World War. In an exceptional situation, policymakers must take exceptional measures. This was done both on the fiscal side and on the monetary policy side. Our actions were proportionate to the situation we were facing.

As you said, the PEPP is an exceptional programme put in place to respond to an emergency. On what basis will you decide when it's time to end it?

The PEPP is clearly linked to the pandemic crisis, so it is a temporary programme. When we judge the pandemic crisis phase to be over, and when we have managed to counter the shock to the inflation path, it will be time to end it. But let me emphasise that the economic effects of the crisis will likely be more persistent. Our other instruments will remain available to ensure that inflation converges back to our medium-term aim.

The crisis has resulted in Member States taking on a lot more debt. How will they be able to reduce it? Thanks to inflation? Could a partial debt cancellation be envisaged?

The most important factor is economic growth. At some point, fiscal consolidation will also need to be considered. But it must not happen too early and it has to be implemented in a growth-friendly way; that's very important. As for the debate on debt cancellation, which I know is quite active in France, such a measure would clearly be in breach of the Treaty as it would constitute monetary financing. But the question goes beyond a legal argument. Economically speaking, it does not make sense. The whole idea is based on an accounting illusion. Moreover, cancelling the debt would call into question the ECB's commitment to its price stability mandate. It would undermine the rule of law and could jeopardise the ECB's independence. That opinion is widely shared, including by French economists.

There are growing calls for the ECB to take a more active role in combatting climate change, like the Bank of England, which has announced that it will stop buying bonds from big polluters. How can the ECB contribute?

This is a topic we are discussing intensively as part of our strategic review. Obviously, it's governments that are mainly responsible for climate policy. We cannot pursue climate policies ourselves, because that's not part of our mandate. But given the urgency of the matter and the partial irreversibility of climate change, all policymakers – and that includes central bankers – must ask themselves how they can contribute. But we must stay strictly within our mandate. We do have some room for manoeuvre,

however. It can even be argued that the Treaty requires us to take climate change into account. In any case, we have to take physical climate-change risk, and transition risks stemming from climate policies, into account in our economic models. Those risks must also be monitored in the context of banking supervision. And if climate change poses risks to our balance sheet, we will need to adapt our monetary policy operations. One of the points being debated more fiercely is whether our private asset purchase programmes unduly favour carbon-intensive firms. In fact, this is partly true, simply because those are the firms that tend to issue bonds. This situation necessitates an in-depth discussion on whether the existing interpretation of what we call the principle of market neutrality is the right one.

Is the sharp increase in corporate debt brought on by the pandemic a cause for concern?

Many firms had to take out loans to bridge the time of the lockdowns. It is likely that some of these firms will not be able to survive, because certain businesses will not be viable after the pandemic. Some corporate restructuring will probably be inevitable. This will also lead to an increase in non-performing loans for banks, along with potential losses on loans backed by government guarantees. More generally, a debt overhang in the corporate sector could reduce firms' incentives to invest. It would be preferable to offer equity-type support to firms, as this does not create the same problems. The main challenge will be to manage the transition from a situation in which firms are protected by public guarantees and in which there are almost no insolvencies to a situation of normality, in which firms must once again operate without state support.

What could be a good indicator of financing conditions in the eurozone?

That's the million-euro question! The truth is that there is no single indicator or simple formula for assessing favourable financing conditions in the euro area. What we must do is examine a broad dashboard of indicators among which sovereign yields and risk-free rates play a prominent role, as President Lagarde explained last week. We must then interpret changes in those indicators in the light of the economic environment. An increase in interest rates, for example, could be a result of an upward shift in inflation expectations. This would be a sign that our measures are working. That's why we need to understand what is behind the changes measured by our indicators.