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

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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.

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