# Isabel Schnabel: The ECB’s monetary policy during the coronavirus crisis – necessary, suitable and proportionate

SPEECH

## Speech by Isabel Schnabel, Member of the Executive Board of the ECB, at the Petersberger Sommerdialog, 27 June 2020

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The coronavirus crisis is having serious humanitarian and economic consequences. Current Eurosystem staff projections assume a decline in economic activity of almost 9% in the euro area in 2020, and of around 7% in Germany (Slide 2, left).

The **economic effects** will presumably reach **far beyond the current year**. The unemployment rate in the euro area, for example, will likely still be noticeably higher in two years than predicted before the crisis (Slide 2, right).

The changes to our economy induced by the pandemic are therefore in all likelihood not only temporary, but **structural**. Global value chains are already being put to the test, productivity in many service sectors may be permanently affected, and certain industries will probably never return to their pre-crisis levels.

The extent to which these structural changes will negatively impact the economy, and exacerbate existing divergences among euro area countries, will crucially depend on the economic policies implemented in response to the coronavirus pandemic. In this context, the question arises what is the **role of monetary policy in this crisis** and how to assess the measures that the ECB has taken so far.

In my remarks I will argue that the measures taken by the ECB since the outbreak of the crisis have been necessary, suitable and proportionate (in the narrow sense) in order to ensure price stability in the euro area.

Our measures have played a decisive role in allowing banks and financial markets to continue to fulfil their role as intermediaries and risk-bearers, and have thereby protected growth and jobs in the euro area from even more painful cuts.

**Are the measures necessary?**

I would like to start with the question of whether our measures were necessary, namely in the view of our primary mandate, i.e. price stability, which we have defined as an increase in consumer prices of below, but close to, 2% over the medium term.

I would like to distinguish between two phases of the crisis.

In the **first phase** – following the spread of the pandemic to Europe – we saw turmoil on financial markets reminiscent of the period around the collapse of Lehman Brothers: the prices of many securities collapsed, liquidity dried up, and price volatility hit levels last seen in 2008.

Indicators aggregating the stress levels in different market segments clearly show how serious the situation on global financial markets was during the first two weeks of March (Slide 3).

If we had not announced our new measures, in particular the pandemic emergency purchase programme (PEPP), we would presumably now be in the middle of a severe financial crisis with appalling consequences for the economy and employment in the euro area. Price and wage levels would probably have fallen significantly, which would have run counter to our price stability mandate.

Quick and decisive action by the ECB during the initial stage of the crisis was therefore essential, and **succeeded in stabilising markets**.

Nevertheless, current Eurosystem staff projections foresee a significant drop in euro area inflation in the short to medium term, that is during the **second phase** of the crisis, in which only a gradual recovery of the euro area economy is to be expected (Slide 4, left). Inflation could remain at close to 0% well into the next year, and even negative inflation rates are possible.

This kind of deviation from our inflation aim is tolerable under specific circumstances, and is not incompatible with our monetary policy strategy given the medium-term nature of our definition of price stability – especially if the forces affecting inflation are temporary.[1]

And, indeed, oil prices have been a major driver of recent changes in inflation dynamics, although they largely reflect the decline in aggregate global demand. But also core inflation, which excludes food and energy prices, will remain significantly below projections from as recently as March, and will do so for a very long time (Slide 4, right).

The Governing Council of the ECB unanimously agreed that the danger of such **low inflation taking hold** and leading to lower wages, growth and investment was too high, due both to the severity of the crisis and the preceding weak price pressures.

We therefore adjusted our monetary policy measures further.

First, we provided stronger incentives for banks not to reduce their lending during the crisis by further adjusting our targeted longer-term refinancing operations (TLTRO III).

Second, we decided to increase our bond purchases under the PEPP by € 600 billion, to a new total of €1.35 trillion.

**Are the measures suitable?**

But are these instruments suitable in the current situation to bring inflation closer to our aim in the medium term?

There are two considerations involved here.

First, the **room for manoeuvre** for “conventional” monetary policy measures – i.e. changes in the main policy rates – has been **almost fully used up** in recent years, in both the euro area and most other advanced economies.[2]

The reason for this is that central banks must keep the real interest rate below the so-called real equilibrium rate in order to increase inflation. The latter depends on structural factors that influence the desire of an economy to save and willingness to invest, for example demographic shifts and productivity. This means that it is not the central bank alone that is responsible for the level of interest rates.

Most estimates of the real equilibrium rate suggest that it has fallen significantly over the past 20 years both in the euro area as well as in many other larger economies (Slide 5).

And with central banks around the world approaching the effective lower bound, they have started employing **“unconventional” measures** to stimulate the economy.

Second, the ECB tailors the choice of its instruments to real and financial conditions so as to support growth, employment and prices as effectively as possible.

In the current situation this means that we have decided on additional bond purchases alongside the TLTRO III, instead of further lowering policy interest rates.[3]

Negative interest rates are generally highly effective: they induce investors to exchange short-term financial securities for longer-term or other higher-yielding securities. Thereby they improve financing conditions for companies and households.

In periods of high uncertainty, however, this transmission mechanism is partially impaired: investors then prefer safe and liquid securities.

The implication is that, if we had lowered interest rates, we would have run the risk of their effects being limited and coming too late.

In contrast, **bond purchases** are **particularly effective** during turbulent times: they have an immediate stabilising effect and avoid dangerous and self-reinforcing price spirals.

Such price spirals are especially dangerous in a currency union: they not only endanger the stability of financial markets, but may also destabilise the currency area as a whole.

This is why **flexibility** in the implementation of our purchases is so **important** at the moment. This flexibility does not mean that we are questioning the fundamental principles of the currency union, in particular the prohibition on monetary financing, and we are purchasing bonds arbitrarily and without limits.

For this reason, we have taken **clear safeguards** also under the PEPP that protect these principles, including the fact that our purchases are guided by the ECB's capital key.

So the **ECB capital key** remains an **important compass** guiding us over the medium term, in order to ensure the singleness of monetary policy in the euro area and avoid creating false incentives.

Flexibility rather means that in this crisis, which poses an especially **high risk of fragmentation**, we are willing to tolerate deviations from capital key with a view to protecting the transmission of our monetary policy to all parts of the euro area.

It would go against the very idea behind the common currency if we were to stand idly by and watch the pandemic carve a rift into the euro area and produce deep divisions that would endanger the return to a single monetary policy in the long run.

But conditional on market conditions at the time, we could eventually reduce past deviations from the capital key, using, for example, the reinvestment phase of the PEPP.

The **effectiveness** of our measures is clearly visible in the data: the financing conditions for governments, firms and banks have gradually been moving back towards their pre-crisis levels, although they have not reached them yet (Slide 6, left).

Fiscal policy crisis measures at the national and European levels amplify the positive impact of monetary policy.

And our bank-based measures complement the improved market-based financing costs. Last week banks in the euro area took up € 1.31 trillion in the latest TLTRO III operation. The ample supply of liquidity at attractive conditions will contribute decisively to keeping banks lending to households and firms.

**Better financing conditions**, in turn, have a stabilising effect on macroeconomic developments: investments are not scaled back as much and jobs are preserved.

According to ECB estimates, our crisis measures will collectively give inflation a noticeable boost and increase real GDP growth in the euro area by around 1.3 percentage points between 2020 and 2022 (Slide 6, right).

These estimates may, in fact, be rather conservative, as empirical studies show that during a very severe economic downturn the impact of deteriorating financing conditions can be several times as high as in normal times.

**Are the measures proportionate?**

So, our measures are necessary and suitable.

The question, then, remains as to whether, in view of our mandate, the benefits of our measures outweigh their costs – i.e. whether they are proportionate in the narrow sense.

Here I would like to concentrate on two important **potential side effects** of our measures: the distributional effects of monetary policy and the impact on governments’ budgetary discipline.[4]

*Distributional effects of monetary policy instruments*

The first thing to note is that all monetary policy measures ultimately have distributional effects. This goes back to the very nature of monetary policy. Central banks adjust incentives for saving and investment so that they are consistent with stable prices.

This raises the question whether the distributional effects would be lower if we either used different monetary policy instruments or if we did not take any action at all.

To answer this question, ECB staff has analysed how far we would have had to cut our main policy rate – the rate on deposits that banks hold overnight at the ECB – in the current situation in order to achieve the same impact on inflation as with the additional asset purchases that we have decided upon since March.

The results show that we would have had to cut the interest rate on the deposit facility by more than a full percentage point to around -1.7% – from currently -0.5% – to achieve the same effect on inflation (Slide 7, left).

What would that have meant?

By way of example, the yields on long-term government bonds would probably have been much more negative and in all likelihood the interest rates on deposits with banks would have crossed over into negative territory.

Hence, **further policy rate cuts would have** significantly **intensified** the **distributional effects** on borrowers and lenders (Slide 7, right).

The analysis shows that the additional losses of the average European saver from reduced interest income as a result of our new asset purchases would have been negligible.

Had we instead cut the rate on the deposit facility to counter the current crisis, the estimated losses would have been almost as large as the total losses accumulated over the course of the past six years. These figures speak for themselves.

In addition, especially in the current situation, it is the **weakest in society** who will **benefit most** from the ECB’s decisive intervention.

Empirical studies show that it is above all people in poorer and less educated income groups who benefit from our monetary policy measures because their jobs are most at risk due to the crisis. Our measures help avoid liquidity-driven job cuts and support the creation of new jobs by setting incentives for investment.

So the distributional consequences would likely have been significantly larger without our decisive actions.

*Incentives for budgetary discipline*

The second potential side effect relates to the incentives that the current monetary policy creates concerning budgetary discipline among the euro area governments.

All monetary policy measures have indirect effects on governments’ funding costs – here, as everywhere else in the world. This matters for the effects of our policy measures since the borrowing rates for firms and households are usually related to the level of the government’s interest rates.

However, lower interest rates can lead to governments taking on more debt, possibly even to an extent that may affect their debt sustainability.

The best way to gauge the relevance of such **incentive problems** is through the evolution of the primary budget balance – in other words, the budget outcome before subtracting interest costs (Slide 8, left).

In fact, the primary balances for both the euro area as a whole and the vast majority of individual euro area countries have been improving since we started public asset purchases in 2015. This does not suggest that the current course of monetary policy has given rise to any significant incentive problems.

The COVID-19 crisis will naturally put an end to this trend in Member States’ fiscal policy.

Fast and decisive fiscal policy intervention – across all countries – is essential in order to alleviate the health, social and economic consequences of this crisis.

So **moral hazard** plays a **minor role** during the current crisis: it is desirable that governments increase their borrowing so as to mitigate the adverse effects of the crisis on the people and the economy.

The ECB’s measures – and in particular the PEPP – have prevented the disruptions in financial markets from jeopardising the urgently needed fiscal response to this crisis.

And so far there are no signs that our measures have gone beyond this – that is, that we are seeing excessive government borrowing on the back of the decline in yields.

On the contrary: we are seeing a clear gap emerging between the fiscal responses at the national level and the estimated economic consequences of the crisis (Slide 8, right). Countries that have been hit the hardest by this crisis have so far issued less debt than the severity of the crisis would suggest, also reflecting differences in the available fiscal space.

The **fiscal programmes at European level** to complement the national measures should therefore be welcomed greatly. A further drifting apart of the member countries would be toxic for the cohesion of the monetary union and, therefore, for the single monetary policy.

The ECB counters these risks of fragmentation within its mandate. To avoid setting wrong incentives in the long run, we have made the PEPP a temporary programme that we will unwind after the crisis has been overcome. We have deliberately linked the time frame for the purchases to the length of the crisis, which underlines the temporary nature of the PEPP.

Recent history shows that measures can indeed be unwound. At the end of 2018 we wound down our net asset purchases completely, as the Governing Council of the ECB was of the view that inflation would approach 2% again over the medium term.

**Concluding remarks**

I would now like to conclude.

Without the PEPP, we would probably have found ourselves by now in the middle of a severe financial crisis with unforeseeable consequences for the economy, employment and price and wage developments in the euro area. Through the stabilising effect of our measures, the current course of the ECB’s monetary policy has decisively contributed to effectively preventing the fragmentation of the euro area, alleviating the financial consequences of the crisis and, by doing so, preserving jobs and investment. In the current situation it is the weakest in society, whose jobs are most at risk due to the crisis and who are benefiting the most from our measures

All in all, the benefits of our measures clearly outweigh their costs. For the average saver, the additional losses arising from our new policy measures are very small. And there are no signs so far that the monetary policy response to this crisis has meaningfully affected governments’ budgetary discipline and created moral hazard.

This means that the measures taken by the ECB in response to the crisis broke out have been necessary, suitable and proportionate to ensure price stability in the euro area.

Thank you for your attention.