[Philip R. Lane: Interview with Il Sole 24 Ore]

INTERVIEW

Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Isabella Bufacchi on 8 June

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The ECB does not tolerate fragmentation, yet the pandemic is making the eurozone more fragmented than ever because fiscal responses and economic and social damage are asymmetric. Italy is at the forefront as one of the hardest-hit countries, with less fiscal space and high public debt. How will Italy's recovery out of the COVID-19 crisis be helped by the ECB, and by being a member of the euro?

This pandemic is a severe shock for all countries: it is a truly global shock. Italy's GDP projections are a little bit below the average euro area baseline scenario: the Banca d'Italia sees GDP contracting by 9.2% in Italy this year compared to a euro area average of -8.7%. But most importantly, the whole euro area is going through a big recession this year. And not only is the entire euro area severely affected, but being part of the euro area also provides a lot of benefits in terms of responding to the shock. We had a pandemic, which is a common shock, and a common response from the ECB as the common central bank. This is very important since it is unlikely that individually all countries could have responded on the same scale. When this big shock arrived in the middle of March, the ECB responded decisively to stabilise financial markets because there was a huge dislocation. The ECB showed it could be an anchor of stability and prevent self-fulfilling dynamics that otherwise could have escalated. In this respect, the ECB's pandemic emergency purchase programme (PEPP) has so far played two roles in the pandemic: first, it provides a market stabilisation tool, and second, it helps to make sure that the tightening of financial conditions was offset.

The ECB has stabilised the markets because conditions were getting tighter. How severe was the tightening and do you see some signs of normalisation?

In the middle of March the world realised that COVID-19 was going to be a really very large shock, and financial markets had to adjust to all this very quickly. But when a shock is so large and uncertainty exceptionally high, it is difficult to have adjustments that are orderly and smooth. So it was very important for central banks in the world to step in to stabilise financial conditions. However, compared to before the crisis, financial conditions are still tighter now. The stock markets are lower and the average sovereign yield for euro area Member States is higher than before the shock. And these tighter financing conditions would be passed on to firms and households. To address this we took the decision to expand the PEPP last week. We assessed those conditions and we decided we had to do more. In the initial phase of the PEPP, market stabilisation was particularly important. Now, we want to make sure that stability stays but also that financial conditions are sufficiently accommodative to support the economic recovery and counter the substantial negative shock to the inflation trajectory.

In just less than three months, the PEPP has become bigger and longer, from €750 billion to €1,350 billion and extended from December 2020 to June 2021. But now we have two purchase programmes running: the APP and the PEPP. What is the difference between these two programmes; why do we need two?

Before the pandemic, the ECB had been on a sustained mission since 2015 to strengthen inflation and to bring it closer to the Governing Council's inflation aim. To this end, we were using a package of instruments: the asset purchase programme (APP), the targeted longer-term refinancing operations (TLTRO III) programme, the level of our key policy rates and forward guidance. Then the pandemic arrived, and our projections indicate that this shock is having a significant negative impact on inflation. As regards the role of the APP and the PEPP, we can draw a clear distinction: in the background, we have the traditional suite of policy instruments. But to deal with the unique and severe pandemic shock, we needed an additional and temporary tool. So it made sense to have two purchase programmes, the "traditional" APP and the pandemic programme. The PEPP is here to make sure the downside shock from the pandemic is addressed. However, even after the coronavirus crisis phase is over, inflation will still be far from our inflation aim, so the APP will still be needed. By the way, the horizon of the APP is open-ended in a state-contingent fashion; the horizon for APP asset purchases is conditional on the ECB's Governing Council seeing a robust convergence of inflation to our aim.

The PEPP is "more temporary" than the APP. Yet the maturing principal payments from securities purchased under the PEPP will be reinvested until at least the end of 2022. So it looks like a very long temporary period of time…

At our meeting last week, we extended the horizon of net purchases under the PEPP to June 2021, although in any case we will conduct net asset purchases under the PEPP until we judge that the coronavirus crisis phase is over. The June 2021 horizon broadly aligns the PEPP net purchase horizon with the horizons of our other monetary policy measures taken in response to the pandemic, such as our targeted lending programmes and collateral measures. As regards the reinvestment of maturing principals under the PEPP, we indeed announced that we would make reinvestments until at least the end of 2022. We want to make sure that the reinvestment strategy avoids the risk of an unwarranted tightening of financial conditions at a time when the recovery from the pandemic shock remains incomplete. It is also important that the management of the wind-down phase will not interfere with the ongoing conduct of monetary policy. At the same time, it is appropriate that the reinvestment strategy for the PEPP reflects its temporary nature and link to the pandemic emergency. The end of 2022 is a reasonable guide to the horizon for this, also as this horizon coincides with that of our macroeconomic projections.

The temporary nature of the PEPP is clear, but not so clear on reinvestments. The reinvestments of the APP, a programme that started in March 2015, are still going on. In Italy there is a widespread wishful thinking that ECB reinvestments will go on forever, becoming a proxy of debt monetisation, even if the ECB cannot finance governments directly.

The interest rates needed for the world economy are much lower now than they were 25 years ago. This is not unique to the ECB or the euro area. The reason why interest rates are so low has to do with many factors, such as demography and productivity, among others. Right now these forces are putting downward pressure on inflation. Central banks globally are fighting against low inflation and are engaged in asset purchases to do that. But our central bank actions are motivated by our monetary policy mandate: if the inflation outlook changes, then central bank policies will adjust as well. We do not know where interest rates will be in the future because we do not know where inflation will be in the next three, five or ten years. The advocates of debt monetisation claim that central banks will keep public debt no matter what. This is not the case. And anyway, the Treaty does not allow us to undertake debt monetisation.

You refer to a world of very low interest rates. TLTRO III goes as low as -1%. But does this mean that an interest rate cut is off the table now?

Our key policy rate, the deposit facility rate, is at -0.5%. For banks participating in our targeted lending programme that lend sufficiently, the TLTRO III operations offer a rate as low as -1%: this provides an incentive to banks to keep the flow of credit to firms and households going. When it comes to our policy rate, we are ready to adjust it if necessary, as is true for all our instruments. We made our last cut of the policy rate in September of last year. In the current environment of exceptional uncertainty and remaining stress in financial markets, asset purchases within the PEPP have proven a particularly effective tool, so we focused on these in our most recent decision.

Are you satisfied with TLTROs and more lending with pandemic emergency

longer-term refinancing operations and bridge longer-term refinancing operations to avoid a credit crunch?

We have learnt a lot from previous crises. An important part of our lending programmes is to incentivise banks to lend to households and firms. This is especially important when risks go up and the revenues of firms are hit. We have also revised our collateral framework: we expanded the set of eligible collateral against which banks can borrow from the ECB. This allows banks to lend more to the real economy. As a modern central bank, we recognise how important it is for households and small and medium-sized enterprises (SMEs) in Europe to obtain credit. And our decisions in March and April addressed this: the highly attractive pricing of TLTRO III will run until next year. We are determined to make sure that this crisis is not made worse by an avoidable credit crunch.

Liquidity is there for sure, but does it go to SMEs or does it inflate financial bubbles?

What we have seen in the last weeks is a restoration of investor confidence in the European economy. Back in the middle of March, global investors were asking themselves whether European policymakers would respond appropriately to the shock. Would the ECB response be enough? How would the European institutions respond to the pandemic? Would there be enough solidarity? At the ECB, we have responded decisively, not only with our monetary policy but also through supervisory measures. Moreover, the response by national governments and at European level has also been centre stage. I think now, with all the various instruments in place, global investors have improved their opinion of the European response. So one thing we see in financial markets is more optimism about the prospects of the euro area economy.

At the beginning of the pandemic, did you perceive the return of the euro break-up fear like we had during the sovereign debt crisis back in 2010-12?

This is a very large shock. And we have seen that a crisis environment can give rise to self-fulfilling flight-to-safety dynamics and illiquidity in individual sovereign bond markets. But our monetary policy response has been effective in countering this, and the response of national governments and through European initiatives has addressed any underlying concerns. The European institutional framework is stronger than it was in 2010. And we also do not have now the imbalances in the euro area that we had in the last crisis.

Yes, many new tools have been created to fight the pandemic: the European Stability Mechanism pandemic support, SURE, the recovery facility, PEPP. But how do fiscal and monetary policies stay together? Any risk of overlapping?

Under current circumstances, this big negative economic shock is putting downward pressure on inflation. So, around the world we have seen simultaneous and ambitious policy actions by governments and central banks, including central bank purchases of government bonds. Monetary policies and fiscal policies are working in the same direction when these face a huge shock.

The German Constitutional Court raised an issue on the risk that the ECB’s monetary policy would get into the domain of fiscal policy…

The mandate conferred on us by the Treaty to maintain price stability is unambiguous and we are undeterred in the pursuit of this mandate, as President Lagarde has said. As a European institution we are subject to the jurisdiction of the Court of Justice of the European Union, and the Court ruled in 2018 that the public sector purchase programme is legal and in line with our mandate.