

Philip R. Lane: Interview with the Financial Times



Interview with Philip R. Lane, Member of the Executive Board of the ECB, conducted by Martin Arnold

16 March 2021

What impact has the pandemic had on the eurozone?

A pandemic recession is unique because a lot of the decline in output results from public health measures. When these measures are lifted and the virus is contained, you should expect to see a very large recovery. We saw glimpses of that last year, especially in the third quarter. As the economy was unlocked and while infection rates were at a relatively low level, there was a strong recovery above what we had predicted.

Once we get better control of the virus we should expect to see most of the economy just go back to normal. There can be exceptions, though, such as the question of office work versus working from home. We all talk about a new normal, which will be somewhere in between. I think it is definitely not going to be fully back to the office, but, at the same time, the value of office life will probably be more appreciated now than it was a few months ago. That has both positive and negative implications for the economy: negative, maybe, for certain types of commercial real estate; and positive perhaps in terms of digitalisation.

Another sector that will probably take time to recover is international travel. By this I mean the airline industry and the hotel industry, whether

business travel or tourism, which have taken a big hit. Those firms that have not been earning usual levels of revenue will have weaker balance sheets coming out of this and we know a big factor in investment is the strength of the balance sheets of firms. It will probably take time for those sectors to go fully back to normal in terms of their financial capacity.

Coming back to the narrative of inflation in the euro area and to the 2015 to 2017 period, when the recovery of inflation and the economy was quite muted, it was due to a combination of the time it takes to recover from a financial crisis on one side and the prioritisation of fiscal consolidation on the other. This time, however, there is definitely an intention to secure the recovery – in the European context it is built into the EU recovery fund with a five-year horizon. It is not just about getting through the pandemic. In this context, you might be more optimistic about inflation dynamics, even if the pandemic itself is definitely a severe negative.

What percentage of output could be permanently lost after we come out of the pandemic?

Our staff projections published last week foresee that euro area GDP will have recovered to 2019 levels by mid-2022. This goes back to the unique nature of the pandemic. It is not like the global financial crisis, where there were many years of lost output. The whole logic of the very extensive fiscal and monetary accommodation is that you don't want to amplify the significant temporary losses in the pandemic by being too reluctant to provide policy support. And again, you can be quite extensive in policy support because it's only for a relatively short period of time. Then, with enough policy support the damage to the economy should be as little as possible. I am not putting the long-term damage to zero, but it is relatively contained.

With the Biden administration planning a \$1.9 trillion relief plan in the United States, does Europe's economy risk falling further behind the United States and other big trading partners?

There are different ways to do it, but the numbers show that, between automatic stabilisers and special measures, the United States offered fiscal support in 2020 of around 10 per cent of GDP and the euro area of around 7 per cent. You could spend time comparing these, but in each case this was a big effort and there was a lot of support provided.

Now, the United States is bridging the pandemic and going into the recovery phase. In Europe, too, a bit later but not that far away this year, we think it is going to be the same kind of transition from dealing with the pandemic to securing the recovery. If you use the European Commission numbers and compare what they were saying in the autumn to what they said in the spring forecasts, Europe has also been moving in the same direction in terms of having more extensive fiscal support.

That said, it is relevant that the euro area has 20 fiscal policies, the 19 national ones and the common fiscal element. In the United States, the fiscal union makes a dramatic difference, there is so much risk-sharing embedded in

a fiscal union of the scale of the United States. A combination of greater macroeconomic coordination of national fiscal policies and more joint fiscal action would be effective in unlocking more fiscal capacity in Europe.

As you know, across Europe a lot of the fiscal support for firms is now turning from guaranteed loans towards more kinds of equity-type support or transfers. So I wouldn't be fatalistic about it. There is a policy decision about protecting the financial health of the European economy through wage subsidies, loan guarantees and other forms of supports for workers and firms. Of course, it is not easy, because you always have to differentiate and be selective. You cannot have an unconditional approach. Clearly you had firms that were in good shape before the pandemic and, with the randomness of who gets hit by the pandemic, you might argue there is a public policy case to make sure that a very high proportion of those firms can get through this.

Then there is the EU recovery plan, which has two important attributes. It is a five-year programme – so it is not just for the pandemic but also to secure the recovery. And it is joint funding. You have a unique initiative in Europe now, which we may all have normalised, but if you go back to the debate last May it is really quite something.

Let's switch to monetary policy, an area over which you have more control. The ECB's 2023 eurozone inflation forecast of 1.4 per cent is still below your target of just under 2 per cent. Doesn't that imply that you need to do much more than you are doing?

We have an ongoing two-stage challenge – counter the negative pandemic shock to the inflation path and subsequently finish the task of raising inflation to our aim.

We are doing quite a bit – we have a policy rate of minus 0.5 per cent when most major central banks are hovering around zero. Even before the pandemic we had a significant quantitative easing programme and we had already accumulated nearly 30 per cent of the European sovereign bond market.

We always say, and our internal feasibility calculations show, we could do more in terms of providing additional stimulus. What is most important is converging to the target in good time, with the speed of convergence ensuring that inflation expectations do not drift further away from the target. While we don't think we are at the lower bound, there is clearly less room to deliver monetary stimulus when interest rates are already low, compared to historical norms. Under these circumstances, it is important to take decisive action to keep up the inflation momentum, while recognising that patience is required. By and large, I don't see any policy statement from any major central bank anywhere in the world saying they are going to deliver sustainable inflation at 2 per cent super-quickly – it is an uphill climb.

The ECB has switched in the past few months to a focus on maintaining "favourable financing conditions". Does that indicate that you don't think the cost-benefit analysis of trying to lower rates further is worth it?

No, I don't think so. Let me try to rephrase it. Everyone would agree that by

our December meeting what we had was a pretty flat yield curve compared to our deposit rate. If you look at the risk-free rates going out ten years, that curve had never been so flat. What is true is that we could lower the deposit rate. In that sense, we don't think we are at the lower bound. To me it is an efficiency issue: rather than focus on pushing down the curve compared to the mid-December level, monetary accommodation could be better provided by preserving favourable financial conditions, especially in responding to a tightening that would be inconsistent with offsetting the pandemic shock to the inflation path.

That is already happening.

Yes, and our objective is basically to make sure that yield curves – which play an important role in determining overall financing conditions – do not move ahead of the economy. Because, as you know, financial markets are very forward-looking and you can have a steepening in yield curves which is not conducive to maintaining progress in terms of the inflation dynamic. It is really a shift in monetary policy away from focusing on just the short-term rate by looking at all financing conditions. For many economic decisions, especially under the conditions we have now, the longer end also matters.

I should say that our favourability assessment of financing conditions is dynamic. It does depend on how much progress we are making in terms of the inflation forecast. It is not yield curve control in the sense of saying we want to keep the yield curve at some fixed value; because over time the relation between the appropriate level of yields and inflation will move.

We have quite volatile inflation during the pandemic but we look past most of that. If you are the type of firm, or household, or government that needs to rely on medium to long-term financing, you should be reassured by this forward guidance on maintaining favourable financing conditions.

Wouldn't it be more reassuring if you did as the Japanese and Australian central banks have done and commit to keeping yields at a specific level?

By and large, with the exception of Japan, the yield curve control debate globally is focused on the two to three-year horizon – the Reserve Bank of Australia has a three-year horizon. The ongoing question that is always worth considering is whether it is enough to have forward guidance on our policy rates. Markets and survey participants don't think we are going to raise rates in the next two to three years. So in that sense we have secured that two to three-year part of the yield curve through forward guidance.

Japan is a special case as the Bank of Japan offers a fixed value for the ten-year yield. You might say that, in a highly dynamic context, where you know there is going to be a recovery – and with the pandemic you are much more certain there is going to be a recovery than after a financial crisis – committing to a fixed value seems unnecessary.

Why is it unnecessary?

Because we are not in such a knife-edge situation that it makes sense to keep

the 10-year yield at a permanently fixed value. The important point here is that we provide enough monetary accommodation to make sure that financing conditions are favourable so that the pandemic shock to inflation is offset and we deliver a path to convergence with the inflation target.

Another debate at the ECB as part of your strategy review is whether you should follow the US Federal Reserve and commit to allowing inflation to overshoot your target to make up for a period of undershooting. The early signs are that you will not go that far and opt for a more symmetric inflation target instead. Is that right?

We are right in the middle of the strategy review and everything is still under analysis. The interesting question is if there is a strategic commitment that following a period of undershooting you signal that the correction phase is not just going to the target but going moderately above the target for a period. I think there is a very strong logic to that.

There are some open questions too. One is that the ECB has always had a medium-term orientation and there have been plenty of overshooting periods in the past, when the ECB has been above 2 per cent. So I don't think that 2 per cent has necessarily been seen as a ceiling.

It is also true that there are communication issues here. Now, these are not necessarily insoluble communication issues. But as you know, across Europe there are very different histories of inflation and the history of inflation in some European countries is very different to the American experience.

Are you going back to hyperinflation in the 1920s?

Sure. We are very scholarly people here. We look at how different kinds of outcomes create very persistent memories in populations, not just from the recent past.

No one would go for a strict version of averaging where a period of inflation above target inflation would require engineering a subsequent period of below-target inflation to hit the average. But the history of inflation matters. You need ways to demonstrate that people should believe that you will deliver your target over the medium term. It's too early in our process to say there is only one way to ensure that inflation expectations are where we want them to be. There is a very strong analytical case for flexible average inflation targeting, but there are other options that may also be successful in anchoring inflation expectations.

Let's talk about fragmentation. Is it a concern that we could have a two-speed recovery in the eurozone, with growth and inflation surging in some countries while others lag behind? How do you set monetary policy for the whole bloc in those conditions?

We look at the aggregate data. There is no other way to do monetary policy. But what is true is that in addition to the single monetary policy, other measures are needed. We are consistent in emphasising that for those countries where monetary policy is looser than the national economy would

need, macroprudential policy or fiscal policy should be set differently. You can't just have one policy lever, and I think we learnt that in the previous crisis years to great regret.

What is amazing about last year is that we had that divergence, we had a big surge in public debt and yet risk premia came down. To me, a very important element of that – coming back to the EU recovery fund – is that the global investor community could draw its conclusions from the fact that when there was a large common shock, Europe was able to respond in a way that made sure there was that joint support. That is a very fundamental revision of global beliefs about the durability and resilience of the euro area.