Christine Lagarde: Monetary policy in a pandemic emergency

Keynote speech by Ms Christine Lagarde, President of the European Central Bank at the ECB Forum on Central Banking (virtual event), Frankfurt am Main, 11 November 2020.

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Let me begin by welcoming all of you to this year's ECB Forum on Central Banking. Regrettably, we cannot be together in Sintra this time, but I trust that this virtual environment will be no less conducive to challenging ideas and productive debate.

The purpose of this year's conference is to examine the challenges facing central banking in a shifting world. We will be discussing many of the long-term trends monetary policy has to contend with, including shifting patterns of globalisation, climate change and a lower natural interest rate.

Actually, the largest shift central banks are facing today may well turn out to be the pandemic itself. As John Kenneth Galbraith said, "the enemy of the conventional wisdom is not ideas, but the march of events". And the events we are seeing today are momentous.

The coronavirus (COVID-19) has produced a highly unusual recession and is likely to give rise to a similarly unsteady recovery. Today I would like to talk about how the ECB's monetary policy has responded to this unique environment, and how we can best contribute to supporting the economy going forward.

A highly unusual recession

The deliberate shutdown of the economy triggered by the COVID-19 pandemic has produced a highly unusual recession. Most importantly, it has infiltrated and crippled sectors that are normally less sensitive to the economic cycle. In a regular recession, manufacturing and construction are typically hit harder by the cyclical downturn, while services are more resilient. But during the lockdown in the spring, we saw the reverse.

Compare our experience in the first half of this year with the first six months following the Lehman crash. After Lehman, manufacturing contributed 2.8 percentage points to the recession and services contributed 1.7 percentage points. But this year, the loss was 9.8 percentage points for services and much less, 3.2 percentage points, for manufacturing.

This has three important implications.

First, research finds that the recovery from a services-led recession tends to be slower than from a durable goods-led recession, as services create less pent-up demand than consumer goods.[1] For example, people are unlikely to take twice as many holidays abroad next year to compensate for their lack of foreign travel this year.

Second, as services are more labour-intensive, services-led recessions have an outsized effect on jobs. Five million people in the euro area lost their jobs in the first half of this year. Of those, almost half worked in retail and wholesale trade, accommodation and food services, and transportation, despite these activities representing less than one-fifth of output. In the six months after Lehman, the worst affected sector – industry – suffered only 900,000 job losses.

And third, these job losses hurt socio-economic groups unevenly. In the first half of 2020, the labour force contracted by almost 7% for people with low skills – who typically also have lower incomes – while it fell by 5.4% for those with medium skills and rose by 3.3% for those with high skills. This is double the loss of low-skilled jobs we saw in the six months after Lehman.

In addition to their social impact, job losses for people with lower incomes present a particular threat to the economy, because around half of those at the bottom of the income scale face liquidity constraints and therefore consume more of their income.[2] The labour-intensity of the worst-hit sectors also heightens the risk of hysteresis and “scarring” in the labour market.

While job retention schemes have played a key role in mitigating these risks, they could not eliminate them entirely. Even though many workers quickly returned to regular employment once restrictions were lifted, a large number of people who lost their jobs in the spring left the labour force and stopped looking for work, with 3.2 million workers classified as “discouraged”. This is so far different from the post-Lehman period, when the drop in employment was matched by a rise in unemployment.

And young people have been particularly affected, seeing disproportionate lay-offs and delayed entry into the labour market. Research finds that this can have a variety of long-lasting effects, including lower earnings ten to fifteen years later, and worse future health conditions.[3]

So, from the outset, this unusual recession has posed exceptionally high risks. That is why an exceptional policy response has been required. And what has defined this policy response, in Europe in particular, is the policy mix.

Learning the lessons of the last decade, there has been a renewed consensus that the composition of policies matters for overcoming the crisis. More than ever before, macroeconomic, supervisory and regulatory authorities have dovetailed and made each other’s efforts more powerful.

Policy responses to the pandemic

What has this meant for monetary policy? There are two main ways in which we have adapted the ECB’s policy to the pandemic: via the design of our tools and via the transmission of our monetary policy.

First of all, we have responded to the unique features of the recession by designing a set of tools specifically tailored to the nature of the shock, including recalibrating our targeted longer-term refinancing operations (TLTROs), expanding eligible collateral, and launching a new €1.35 trillion pandemic emergency purchase programme (PEPP). The PEPP in particular has the dual function of stabilising financial markets and contributing to easing the overall monetary policy stance, thereby helping to offset the downward impact of the pandemic on the projected path of inflation.

The stabilisation function of the PEPP is ensured by its flexibility, which is crucial given the unpredictable course of the pandemic and its uneven impact across economies. In this context, the PEPP’s flexibility allows us to react in a targeted way and counter fragmentation risks. This was key in reversing the tightening of financing conditions that we saw in the early days of the crisis.

In parallel, the stance function of the PEPP gives us the scope to counter the pandemic-driven shock to the path of inflation – a path that has also been greatly influenced by the specific characteristics of this recession. Not only has inflation fallen into negative territory, but we have already seen services inflation, which is normally the more stable part of the price index, drop to historic lows.

But the PEPP, together with the other measures we have taken this year, has provided crucial support to the inflation path and prevented a much larger disinflationary shock.[4] And its impact has been amplified by interactions with other policies. For instance, the combined effect of the ECB’s monetary and supervisory measures is estimated to have saved more than one million jobs.[5]

At the same time, the nature of the pandemic also affects the transmission of monetary policy. Normally, an easing of financing conditions boosts demand by encouraging firms to borrow and invest, and households to bring forward future income and consume more. In turbulent times, monetary policy interventions also eliminate excess risk pricing from the market.

But when interest rates are already low and private demand is constrained by design – as is the case today – the transmission from financing conditions to private spending might be attenuated. This is especially true when firms and households face very high levels of uncertainty, leading to higher precautionary saving and postponed investment.[6] In these circumstances, it is crucial that monetary policy ensures favourable financing conditions for the *whole* economy: private and public sectors alike. Indeed, these are the times when fiscal policy has the greatest impact, for at least two reasons.

First, fiscal policy can respond in a more targeted way to the parts of the economy affected by health restrictions. Research shows that, while monetary policy can increase overall activity in this environment, it cannot support the specific sectors that would be most welfare-enhancing. Fiscal policies, on the other hand, can directly respond where help is most needed.[7]

We have seen the efficacy of such targeting in the euro area this year. The ECB's Consumer Expectations Survey shows that households with lower income have seen a greater reduction in the hours they work, but they have also received a higher share of government support. As a result, while compensation of employees fell by more than 7% in the second quarter, household disposable income fell by only 3%[8], because government transfers compensated for the loss of income.

Second, fiscal policy can break "paradox of thrift" dynamics in the private sector when uncertainty is present. Public expenditure accounts for around 50% of total spending in the euro area and can therefore act as a coordination device for the other 50%. Our consumer survey demonstrates this: people who consider government support to be more adequate display less precautionary behaviour. And in this way, by brightening economic prospects for firms and households, fiscal policy can help reinvigorate monetary transmission through the private sector.

The risk of an unsteady recovery

But regrettably the economic recovery from the pandemic emergency could well be bumpy. We are seeing a strong resurgence of the virus and this has introduced a new dynamic. While the latest news on a vaccine looks encouraging, we could still face recurring cycles of accelerating viral spread and tightening restrictions until widespread immunity is achieved.

So the recovery may not be linear, but rather unsteady, stop-start and contingent on the pace of vaccine roll-out. In the interim, output in the services sector may struggle to fully recover.

Indeed, services were already showing a declining trend before the latest round of restrictions: the services PMI fell from 54.7 in July to 46.9 in October. And while manufacturing has so far remained relatively resilient, there is a risk of the recovery in manufacturing also slowing once order backlogs are run down and industrial output becomes better aligned with demand.

In this situation, the key challenge for policymakers will be to bridge the gap until vaccination is well advanced and the recovery can build its own momentum. The strength of the rebound in the third quarter suggests that the initial policy response was effective and the capacity of the economy to recover is still in place. But it will require very careful policy management to ensure that this remains the case.

Above all, we must ensure that this exceptional downturn remains just that – exceptional – and does not turn into a more conventional recession that feeds on itself. Even if this second wave of the virus proves to be less intense than the first, it poses no less danger to the economy.

In particular, if the public no longer sees the pandemic as a one-off event, we could see more lasting changes in behaviour than during the first wave. Households could become more fearful about the future and increase their precautionary saving. Firms that have survived up to now by increasing borrowing could decide that remaining open no longer makes business sense. This could trigger a "firm exit multiplier", where the closure of businesses faced with health restrictions cuts demand for complementary businesses, in turn causing those firms to reduce their output.[9]

If that were to happen, the recession could percolate through the economy to sectors not directly affected by the pandemic – and potentially trigger a feedback loop between the real economy and the financial sector. Banks might start tightening credit standards in the belief that corporate creditworthiness is deteriorating, leading to firms becoming less willing or able to borrow funds, credit growth slowing and banks' risk perceptions rising further. The ECB's bank lending survey is already signalling a possible tightening in the months to come. We are also seeing indications that small and medium-sized firms are expecting their access to finance to deteriorate.

A continued, powerful and targeted policy response is therefore vital to protect the economy, at least until the health emergency passes. Concerns about "zombification" or impeding creative destruction are misplaced, especially if a vaccine is now in sight. Remember that lockdowns are a non-economic shock that affects productive and unproductive firms indiscriminately. Policies that protect viable businesses until activity can return to normal will help our productive capacity, not harm it.

The right policy mix is essential.

Fiscal policy has to remain at the centre of the stabilisation effort – the draft budgetary plans suggest that fiscal support next year will be significant and broadly similar to this year, and the Next Generation EU package should become operational without delay. Supervisory authorities are working to ensure that banks can continue to support the recovery by readying them for a potential deterioration in asset quality.[10] And structural policies have to be stepped up so that policy support can accompany the wide-ranging changes that the pandemic will bring, such as an accelerating spread of digitalisation and a renewed focus on climate issues.[11]

The outlook for monetary policy

So what is the role of monetary policy in this response?

It is clear that downside risks to the economy have increased. The impact of the pandemic is now likely to continue to weigh on economic activity well into 2021. Moreover, demand weakness and economic slack are weighing on inflation, which is expected to remain in negative territory for longer than previously thought. This is partially due to temporary factors, but the fall in measures of underlying inflation also appears to be connected to the weakening of activity. And developments in the exchange rate may have a negative impact on the path of inflation.

Continued policy support is therefore necessary to achieve our inflation aim. But we should also consider how best to provide that support.

The unusual nature of the recession and the unsteadiness of the recovery make assessing the inflation path harder than in normal times. Shifts in consumption baskets caused by supply-side restrictions are creating significant noise in the inflation data.[12] And the stop-start nature of the recovery means the short-term path of inflation is surrounded by considerable uncertainty.

In these conditions, it is vital that monetary policy underpins inflation dynamics by supporting demand and preventing second-round effects, where the negative pandemic shock to inflation feeds into wage and price-setting and becomes persistent. To that end, the best contribution monetary policy can make is to ensure favourable financing conditions for the whole economy.

Two considerations are important here.

First, while fiscal policy is active in supporting the economy, monetary policy has to minimise any "crowding-out" effects that might create negative spillovers for households and firms. Otherwise, increasing fiscal interventions could put upward pressure on market interest rates and crowd out private investors, with a detrimental effect on private demand.

Second, monetary policy has to continue supporting the banking sector to secure policy transmission and prevent adverse feedback loops from emerging. Firms are still dependent on new flows of credit. And those that have borrowed heavily so far need certainty that refinancing will remain available on attractive terms in order to avoid excessive deleveraging.

In other words, when thinking about favourable financing conditions, what matters is not only the *level* of financing conditions but the *duration* of policy support, too. All sectors of the economy need to have confidence that financing conditions will remain exceptionally favourable for as long as needed – especially as the economic impact of the pandemic will now extend well into next year.

Currently, all conditions are in place for both the public and private sectors to take the necessary measures. The GDP-weighted sovereign yield curve is in negative territory up to the ten-year maturity. Nearly all euro area countries have negative yields up to the five-year maturity. Bank lending rates are close to their historic lows: around 1.5% for corporates and 1.4% for mortgages. And our forward guidance on our asset purchase programmes and interest rates provides clarity on the future path of interest rates.

But it is important to ensure that financing conditions remain favourable. This is why the Governing Council announced last month that we will recalibrate our instruments, as appropriate, to respond to the unfolding situation. The Council is unanimous in its commitment to ensure that financing conditions remain favourable to support economic activity and counteract the negative impact of the pandemic on the projected inflation path.

In the weeks to come we will have more information on which to base our decision about this recalibration, including more evidence on the success of the new lockdown measures in containing the virus, a new set of macroeconomic projections and more clarity on fiscal plans and the prospects for vaccine roll-outs.

While all options are on the table, the PEPP and TLTROs have proven their effectiveness in the current environment and can be dynamically adjusted to react to how the pandemic evolves. They are therefore likely to remain the main tools for adjusting our monetary policy.

Looking beyond our next policy meeting, our ongoing strategy review gives us an opportunity to reflect on the best combination of tools to deliver financing conditions at the appropriate level, how those tools should be implemented, and what features our toolkit needs to have to deliver on such a strategy.

Conclusion

Let me conclude.

The pandemic has produced an unusual recession and will likely generate an unsteady recovery. All policy areas in Europe have responded promptly and decisively. The European policy mix has proven that when different authorities work together – within their respective mandates – countries can successfully absorb the pandemic shock.

The second wave of COVID-19 presents new challenges and risks, but the blueprint for managing it is the same. The ECB was there for the first wave and we will be there for the second wave. We are, and we continue to be, totally committed to supporting the people of Europe.

In pursuit of our mandate, we will continue to deliver the financing conditions necessary to protect the economy from the impact of the pandemic. This is the precondition for stabilising aggregate demand and securing the return of inflation to our aim.

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