Philip R Lane: Interview in La Repubblica

Interview with Mr Philip R Lane, Member of the Executive Board of the European Central Bank, ir La Repubblica, conducted by Ms Tonia Mastrobuoni on 14 November 2019 and published on 20 November 2019.

* * *

Christine Lagarde takes office as President of the ECB at a difficult moment. The Governing Council is split about the decisions taken in September.

I wouldn't agree with your description! Of course, the September decision did have pros and cons, and it was not unanimous. But now we are two months on. That decision is made and we are moving forwards. Moreover, at Governing Council level this year there are many new members. It's natural, with a new composition, to have discussions about how we operate as a group.

How's the economic situation in the eurozone? Despite fears it could slip into recession, Germany's growth has slightly ticked up.

In Germany, even though manufacturing is taking a hit, the wider economy, the consumption-driven part of it, is still in good shape. For the euro area as a whole, remember that manufacturing only represents about 17% of GDP. It's more important in Germany and in Italy than it is in the wider European economy, but in the end it's only a limited fraction of overall activity. We can have a lot of bad news about manufacturing, but it may still be dominated by good news coming from services and consumption.

So do you think that the ECB's very accommodative September package is still justified?

There's no doubt that, compared with 2017, there's been a sustained slowdown, but in the euro area we don't see a recession. The bigger issue is that the European economy has been growing more slowly than we hoped. It's a disappointing performance, but not a negative one. We expect that there will be forces that help the recovery over the next year or two, including our monetary policy, which is going to contribute because it is leading to lower lending rates to firms and households. Our baseline scenario is a recovery in economic performance, but we have been consistent in highlighting that there's also downside risk.

The OECD said recently that Donald Trump's erratic trade wars might be the main reason for the global downturn, because they discourage investments.

It's a significant factor that has been here for nearly two years. But the question now is: is it getting worse? In recent weeks, compared with the worst-case scenario, there's been some optimism on the US-China trade relationship. That said, there remains a long-term discussion to be had about whether the world will restore its commitment to a global trading system, or whether, over time, we will see a bigger set of barriers that limit global trade.

How could a hard Brexit affect the eurozone's fragile economy?

A deal has been agreed between the UK Government and the European Union, which of course will be tested in the next election. The worst-case scenario of a no-deal Brexit in the short term has been eliminated and the uncertainty over it is fading. But even under the deal there is going to be a more challenging economic relationship between the United Kingdom and the EU27. That is regrettable and it's damaging, although – as the United Kingdom is a mid-sized economy – more of the damage will be in the United Kingdom than in the EU27.

There is a big discussion about the risk of a secular stagnation in Europe. You rule out a

recession in the short term, but do you see this risk of a "Japanese scenario" in the long term?

The bigger issue with secular stagnation is not that Europe would have soon a recession; it's that Europe and the wider world might grow at a very slow pace. It remains a relevant discussion because the big question is: are we going to grow at a low rate of maybe 1% a year? Or are we going to see a better performance than that? A lot depends on that in terms of living standards. One way to look at the issue – and I think this is very important – is that governments have a lot of opportunities in this environment because the decisions they make in terms of their policies towards business, their policies towards education, their policies towards employment, all of this matters very much. Essentially, if the policy choices by governments are more favourable to economic performance, then some of this stagnation fear may fade.

Do you mean countries that have a fiscal margin to use investments to boost growth, like Germany, should act?

That's one element, but the other element which is for everyone, all countries – for Germany, for Italy, for every country – is that there are many non-financial policies that matter. It's too narrow just to say let's look at the budget deficit. We know that sometimes some of these policies take years to pay off. A country's attitude to education, to the business environment, a country's legal system, its labour market, the way it addresses an ageing population; these are all difficult issues, there are no easy answers. But that's really where a lot more attention should be paid.

There are two very recent cases that seem perfect examples of what you were just saying about the best framework to do business. One is the surprising announcement by Elon Musk that he will build Tesla's European Gigafactory in Germany. The Italian example of Arcelor-Mittal abandoning Ilva seems the very opposite case. You have legal uncertainty, a law that has changed from one government to the other. What do these examples say about "doing business" in Germany and Italy?

It's not for a central banker to declare which particular policies should be adopted, but I think it's important that all countries can learn from each other. This is one of the potential gains from being a member of the European Union. We have seen many examples where, in a given country, there might have been an intense debate about a particular policy. But then a number of years later we see that a country which adopted a particular policy is succeeding. Take Spain, for example, which has been growing very, very well. I think there's a strong consensus that some of the policies they adopted in terms of reforming, for example, the labour market, have helped that. It's important to remain optimistic that policies can make a difference. It is not the case that we are in a fatalistic situation where nothing can be done. Political leaders can make decisions that can improve the performance of their economies.

And many reforms don't cost anything.

Yes, there might be good policies that do not cost anything. It's not only about fiscal policy. And when there is an upfront cost, the European fiscal framework recognises that. It's part of the way the fiscal policy is assessed. If you have a reform that may involve some upfront costs, that can be taken into account in calculating the fiscal space.

Going back to the secular stagnation, this scenario would also be very difficult for the ECB because it would condemn it to long-term accommodative policies. And recently Olivier Blanchard said that "monetary policy is almost out of ammunition, but if the central banks say it too explicitly, the markets may freak out." Is that true?

We all have to recognise that the situation we face now is very different from the normal central banking experience 15 or 25 years ago. This has led to the famous question: is this the new normal? I think this discussion will continue for as long as a very substantial amount of monetary accommodation is needed, as you say. There will be a lot of discussion about where exactly the limit is. But our assessment here at the ECB is that we're not at the limit and that if more is needed, we can do more. We've learned a lot in the last five years. Since 2014 the ECB has been exploring ways to provide monetary stimulus even though the policy rate turned negative in 2014. And our assessment is that our measures have been very successful. But I would also agree with your basic question: if the overall economic performance was stronger, then indeed the situation would be less difficult. We've talked about the role of reforms that can boost the growth rate. But we also say, as you know, that those countries which have fiscal space, especially if they are facing a slowdown, can do more to raise demand through fiscal policies as well.

The inflation target of the ECB hasn't been reached for a long time. And it won't be reached for years. So there is ongoing discussion about whether it would be better to change the target. Do you agree?

No matter what the exact definition of the target is, the current inflation rate of around 1% is unsatisfactory. The discussion about how exactly to define the target is more relevant the closer you get to it. When we're sufficiently far away, we need to make sure we are providing the necessary monetary stimulus to help inflation increase over time. That is actually our forecast. We do not expect the current inflation rate to remain where it is. We do expect that all the stimulus we are providing will help inflation to move up over time. We now see it in wage inflation, which at the euro area level is now in line with our projections. What remains is converting the wage inflation into price inflation. Our projections say that this will happen in the next couple of years.

Coming back to a country like Italy: it has been growing very slowly for a very long time now, 20 years. How do you think it can grow faster?

When the discussion is about how to improve long-term economic performance over a longer time period, over ten or twenty years, the primary focus should not be on monetary policy but on other policies. Monetary policy is very important, but tends to have a temporary effect. The exact formula for Italy can really only be worked out by a discussion at the expert and political level in Italy. But the fact that the ECB has provided so much monetary accommodation provides a good environment for reforms. The conditions are now very favourable to implement policies to foster growth, in any country.

Many Germans say this accommodative stance has been a moral hazard for countries like Italy that haven't made the necessary reforms. Some are even accusing the former Italian President of the ECB, Mario Draghi, of helping Italy with low interest rates and the government bond buying programme, exploiting German savers.

Let me first of all stress an important point. All of our discussions in the Governing Council are about the aggregate euro area, not about individual countries. Essentially, when we look at the inflation rate, when we look at unemployment, when we look at investment, all we look at is the overall picture. The Governing Council makes the decision collectively, so the nationality of the President is not a factor in how the policy is made. At the European level, concerns about moral hazard are addressed via the EU fiscal framework. It's the responsibility of the European Commission and the European Council to monitor and discipline Members States, not that of the ECB. And that's appropriate, because fiscal policy is a political competence. It is not for the ECB to be involved in that. What we do say is that all countries are benefiting from favourable financing conditions. We do think that the low interest rate environment provides an opportunity for those countries which need to reduce their debt ratios – and that's many countries. These countries should use the interest rate windfall to reduce their debt ratios rather than be tempted to spend all of the windfall on new expenditures or tax cuts.

But how do you respond to the accusations that your monetary policy is exploiting German savers?

There are many savers in Germany, but there are also many savers elsewhere. Italy has a high savings rate, so there are many households in Italy that are in the same situation of receiving a lower interest rate on their savings. That's true in every country. Some households, typically older and richer households, are savers. Other households, because they're at a different point in their life, or their individual circumstances are different, are debtors. Roughly speaking, about 30% of European households are in debt, so their attitude to low interest rates would be quite different from someone who's fortunate enough to have a significant amount of savings.

Do you think that this accommodative monetary policy fuelled right-wing populism in northern European countries? As you know, the former German Finance Minister, Wolfgang Schäuble, accused the ECB of having strengthened the AFD.

I think this discussion has to evolve over time. The ECB or any other central bank has to recognise what the market forces are delivering. The big, difficult discussion is: how do governments respond to that in terms of their reform policies, in terms of their fiscal policies? Essentially, if the world economy is growing slowly, if there is not sufficient support from fiscal policy, if the reform policies are not sufficiently ambitious, then the policy choices for the ECB or any other central bank are going to be quite limited.

On the other hand, right-wing populists in southern European countries, the Italian Lega for example, often blame the euro for the weak growth of the last decades. How dangerous are those discussions for the future of the common currency?

It's an important debate and it's an evolving one. Recent Eurobarometer surveys show a significant improvement in the attitude of individuals towards the euro. Some of the worst of this is fading. One has to remember that the euro remains a very young currency; it's only 20 years old this year. We should all recognise how important it has been to reform the institutional architecture of the euro area, particularly in the last years. It's a massive regret that some of the reforms that are now in place had not been implemented in advance of the crisis. The crisis could have been managed better if we had already put the European Stability Mechanism (ESM), the banking union and so on in place earlier. Thanks to these reforms, we now have a lot more stability, which has helped the euro area to perform better. But other important factors have had a role in influencing the debate around the euro.

Which ones?

In the last 25 years a number of developments overlapped with the introduction of the euro. We've had major changes in the world economy, which have been especially challenging for some European countries because of the rise of competition from the emerging economies. We have also had the IT revolution, and the ageing of the European population, which has a long-term effect on how the European economy operates. I think it's an interpretation error, a fallacy, to say all of the problems we have had are due to the euro. I'm pretty sure the euro has had a much less important contribution than these wider forces. Then we could also consider that one of the major reasons why Europe performed quite well in the 1990s was the success of moving forwards with the Single Market. Building a single market across the European Union provided new opportunities. That's now been pretty stagnant for a long time. A renewed emphasis on building the Single Market would provide new opportunities for firms across Europe, including Italian firms. Coming back to what many people ask: where can the euro be helpful? I think the single currency can help sustain renewed efforts in completing the Single Market in goods and services.

There is very strong rhetoric in Germany about always being a creditor towards other

countries. Isn't it also true that no other country gains so much out of a currency that is far too weak compared with its economy and boosts its exports?

I don't think it's useful to put a label on any country, saying "this country wins, that country loses." We absolutely have to recognise that all of the ESM debt has been paid back. At the same time, the risk of bearing losses was there. In other words, the ESM was a very important act of solidarity, a sign that the member countries stand with each other if needed.

It's reasonable and important to recognise that solidarity is there and it involves the willingness to bear that risk. The fact that the stronger countries stood behind the more vulnerable countries was an important and risky move. It has been successful. If we look at international trade, definitely, the last 25 years have been a period when, by and large, the exporting countries have gained. Germany, but also Italy, have benefited from the euro being a major stable global currency. But let me emphasise right now: in the last year the exporting countries are of course those that are suffering the most from the global slowdown. It doesn't always go in one direction.

The third pillar of the banking union, the common deposit scheme, is still missing, but the German Finance Minister, Olaf Scholz, has now proposed completing it, but still with some caveats that led the Italian Finance Minister to reject the proposal. Roberto Gualtieri warned that the German proposal would harm the competitiveness of European banks. What do you think about this?

I think that there's room for negotiation. There are valid concerns in the German paper, but equally it's not framed with red lines.

Are you sure?

Well, I don't read it as a set of red lines; I read it as a set of important issues where there is room for negotiation. My view is that there is a middle course, there is a way to reconcile these different concerns. Risks have come down. The non-performing loan ratios have come down. There's more and more evidence of stability in Europe, and the conditions now are much more favourable to a negotiation than several years ago, when the amount of concern about risk was much greater.

One of the critical points for some countries seems to be the German request to limit the exposure of the banks to government debt.

Right, but I think that banks in the euro area can diversify their sovereign bond holdings without taking on currency risk. They already do, to an extent. The question is: what is a reasonable level of diversification? All countries should be confident that, by and large, while their own banks may hold less of their domestic debt, this should be offset by new sources of demand for the home sovereign debt from the other countries. If the banks across the euro area are essentially holding the debts of all countries in a risk-adjusted way, then in net terms there may be very little difference for the debt issuers. Their debts are just differently shared.

In Germany and outside there is a huge discussion about the "schwarze Null". There are some economists and politicians that even think that the government should change the constitution, and the famous debt brake of 0.35%, to give it more margin to act when the economy goes bad. Do you agree?

The issue is more general, because Germany is not the only low-debt country. In general terms, it's an interesting economic question. I think these debt brakes can play a useful role when you're trying to move from being in a high debt situation to a safe level of debt. Once you've achieved that, the question is: what is a reasonable framework? Once you're in the safe zone I think that fiscal policy can be conducted differently.

Germany is there now, its debt is around 60%.

All countries know that there can be many pressures on public spending in the years ahead, basically because of the ageing of the population, the rising costs of healthcare and, of course, there's going to be significant pressure on the public finances from what is necessary to tackle climate change. However, in a world where interest rates are so low, I think it's perfectly possible to reconcile the fact that you need to make sure that your long-term fiscal goals are achieved with the fact that the business cycle is also affected by fiscal policy. And probably this can't be summarised in a single rule. Historically, this was not especially relevant because the fiscal multipliers have traditionally been low. Essentially, central banks would offset fiscal stimulus if it was proven to be inflationary. But in a world of low inflation and low interest rates, we think fiscal multipliers under the current conditions are quite high if you have the fiscal space. I think we should be confident that there isn't really a kind of excessive trade-off between being stimulating in the short term, while still making sure that we're sufficiently prudent that long-term goals can be achieved. I think that a gear shift is required. For a long time the overwhelming focus was on how to make sure the high debt levels came down. But at some point that gear shift has to happen for those countries which have been successful.

In Italy there is a heavy brain drain, many young people go abroad. This poses a problem for the future of the country as well. And many highly qualified young people choose France or Sweden or Germany because they earn much more. Should Italian companies raise salaries?

One of the great achievements of the European Union has been free movement of people – the freedom to move across borders. At an individual level, of course that's a fantastic gain from being a member of the European Union. But it can also be a difficult choice to make for the individuals concerned, as people by and large would like to live in their home country. Governments should recognise that if opportunities are greater abroad, many will take that decision. However, if wages are not backed by productivity, they should not go up. The way I would phrase it is: countries need to make sure that their economy is sufficiently productive to sustain the high wages that would make sure they not only attract their local workers, but they are also a hub for workers from across the rest of the EU.