Yves Mersch: The world economy transformed

Remarks by Mr Yves Mersch, Member of the Executive Board of the European Central Bank and Vice-Chair of the Supervisory Board of the European Central Bank, at the Reinventing Bretton Woods Committee Webinar Series, 25 June 2020.

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The ECB's immediate response to the coronavirus (COVID-19) shock was crucial in maintaining market functioning and the monetary policy transmission mechanism. It cushioned the drop in activity and prevented a downward spiral in financial markets, thus dispelling tail risks. Price stability remains the focus of our policy measures, and this currently involves supporting the recovery, which is shrouded in an exceptional degree of uncertainty. Existing macroeconomic models are ill-suited to forecasting the evolution of the pandemic and assessing its economic impact. This is evident from the most recent Eurosystem projections, which are based on three scenarios that significantly differ in terms of the scale of the economic fallout.

We have designed our policy measures to be proportionate to such high levels of uncertainty. The inherent flexibility within the constrained framework of the pandemic emergency purchase programme (PEPP) allows us to adapt purchase flows to crisis contingencies. In particular, the adjustable purchase flows over time, across asset classes and among jurisdictions ensure the PEPP's effectiveness as a backstop for market stabilisation. At the same time, we would not need to make use of the full PEPP envelope if the Governing Council were to assess that market tensions had eased sufficiently.

The sheer size of the PEPP also goes beyond its primary backstop function by providing additional support to the monetary policy stance. Monthly flows under the PEPP help to close the medium-term inflation gap created by the pandemic. But in the long run, this flexibility should not undermine the safeguards and limits we have set in our purchase programmes to respect the constitutional red lines that monetary policy cannot cross and that contain risks of monetary financing. On account of its flexibility, the PEPP must remain a temporary crisis instrument.

The public sector purchase programme (PSPP), which follows pre-set monthly flows in accordance with the capital key, will continue to be the main instrument of our policy stance. The issue share and issuer limits under this instrument remains in place to mitigate the risk of the ECB becoming a dominant creditor of euro area governments. Notwithstanding such safeguards, we are mindful that the size of our balance sheet – the significant stock of acquired assets and reinvestments of the maturing principal payments – can have implications for market functioning and price formation.

While the short-term economic impact of the crisis is substantial and requires ample monetary policy support, the longer-term outlook is much less certain. It depends in particular on the extent to which the effects of the crisis exert prolonged pressure on supply and demand conditions, and on the strength and speed of fiscal and structural policy responses.

Fragmenting world trade is likely to redirect the focus of supply chains from short-term efficiency to increased resilience. This will lead to a shortening of supply chains and a reshoring of production. At the same time, a surge in corporate indebtedness could make firms riskier and weigh on their capacity for investment. While these combined effects could act as a brake on productivity growth, they can be effectively offset if firms and policymakers use this crisis to modernise our economies. This includes promoting the digital transformation and refocusing supply chains to fully exploit the allocative efficiency offered by the Single Market.

Such reform efforts will be crucial to smooth the sectoral reallocation which could result from the damage that even mild distancing measures inflict on labour-intensive service sectors. While a countercyclical fiscal push can help sustain aggregate demand in the transition, fiscal space may not be available in the countries most affected by the crisis. Policymakers should therefore use the current window of opportunity and create levers at the European level to reduce the risk of individual countries emerging from the crisis excessively scarred. The European Commission’s proposal for a major recovery plan, including the largest joint issuance in euro to date, is seen as a major step towards increasing the resilience of our union.

If decision-makers can ensure that all countries emerge from the crisis stronger, with more modern and dynamic economies, the recovery will be stronger and more sustainable. This would reduce the burden on monetary policy and the need for further easing of the policy stance.