Christine Lagarde: Hearing at the Committee on Economic and Monetary Affairs of the European Parliament

Introductionary speech by Ms Christine Lagarde, President of the European Central Bank, at the ECON Committee of the European Parliament (by videoconference), 19 November 2020.

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Madam Chair,

Honourable members of the Economic and Monetary Affairs Committee,

Ladies and gentlemen,

Thank you very much for giving me the opportunity to speak to you today as part of our regular hearings.

We continue to be confronted with serious circumstances, from both a health and an economic perspective. Pandemics are highly infrequent and unpredictable events, and consequently the economic outlook is characterised by high uncertainty. The key challenge for policymakers will be to bridge the gap until vaccination is well advanced and the recovery can build its own momentum.

In this situation, it is pivotal that public policies chart a clear way forward and inspire confidence in EU citizens. Good public policies are what will allow us to persevere in these challenging times, and to do so, they need to be ambitious yet realistic.

Given the central role played by the European Parliament in ensuring that EU policies work for EU citizens, I could hardly be in a better place to discuss the topics you have chosen for today's hearing. First, I will comment on the evolving economic outlook and the impact of uncertainty on the economy. Second, I will discuss the respective roles of the ECB's monetary policy and of fiscal policy in the current environment.

Economic outlook, monetary policy and uncertainty

While the latest news on the vaccine looks encouraging, the recent surge in coronavirus (COVID-19) cases and the associated re-imposition of a number of containment measures are adding to the already heightened level of uncertainty and present a serious challenge to the euro area and the global economy.

Following a strong but partial and uneven rebound in real GDP growth in the third quarter, latest surveys and high-frequency indicators signal that euro area economic activity lost momentum going into the fourth quarter.

The resurgence in COVID-19 infections is weighing on services sector activity in particular, which is especially vulnerable to the voluntary and mandatory social distancing measures introduced. The Purchasing Managers' Index for the euro area shows that while manufacturing output continued to improve, services sector activity weakened further in October. This uneven impact is also evident across euro area countries, with those countries particularly dependent on tourism and travel affected the most.

So far, government support measures, particularly short-time work schemes, have protected households against job losses and a drop in incomes. But this has not prevented unemployment from spiking in some countries. In addition, consumers are expected to remain very cautious in the current highly uncertain environment as the ramifications of the pandemic are threatening people's employment and income prospects.

In turn, subdued demand and the weakening of firms' balance sheets and profitability are weighing on business investment. Companies are likely to remain hesitant about committing funds to long-term investments as long as there is continued high uncertainty on how the pandemic will unfold and the roll-out of a vaccine.

Overall, the euro area economy is expected to be severely affected by the fallout from the rapid increase in infections and the reinstatement of containment measures, posing a clear downside risk to the near-term economic outlook.

The weakness in economic activity since the onset of the pandemic is also reflected in inflation developments. Low energy prices and the temporary reduction in German value added tax are dampening inflation. But weak demand, notably in the tourism and travel-related sectors, and significant slack in labour and product markets are adding further downward pressure. In this environment, we expect that headline inflation is likely to stay in negative territory until early 2021.

The key role of monetary policy in this situation is to preserve favourable financing conditions for all sectors and jurisdictions across the euro area, thereby providing crucial support to underpin economic activity and to safeguard medium-term price stability. When thinking about favourable financing conditions, what matters is not only the level of financing conditions but the duration of policy support, too. In this regard, preserving favourable conditions for as long as needed is key to support people's spending, to keep credit flowing and to discourage mass lay-offs.

As announced at our October meeting, over the coming weeks the Governing Council will carefully assess the incoming information, including the new round of Eurosystem staff macroeconomic projections in December. These projections will enhance our information set and allow a thorough reassessment of the economic outlook and the balance of risks.

On the basis of this updated assessment, the Governing Council will recalibrate its instruments, as appropriate, to respond to the unfolding situation with a view to fostering a convergence of inflation towards our aim in a sustained manner, in line with our commitment to symmetry. While all options are on the table, the pandemic emergency purchase programme (PEPP) and our targeted longer-term refinancing operations (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.

We responded promptly and forcefully to the first wave that hit the euro area economies by designing new tools specifically tailored to the nature of the shock and recalibrating our well-diversified portfolio of existing instruments. Our measures have been very successful in stabilising financial markets and underpinning economic activity, thereby helping to offset the downward impact of the pandemic on the projected path of inflation. We will address the current phase of the crisis with the same approach and determination.

The interaction of fiscal policy and monetary policy

The crisis response thus far has also powerfully illustrated how monetary policy and fiscal policy can be mutually reinforcing in the current circumstances. For monetary policy – as I have argued above – it is crucial to ensure favourable financing conditions for the whole economy. At the same time, fiscal policy has a primary role to play in bolstering demand in the short and medium term, reinforcing confidence and enhancing the growth potential of our economies. Fiscal policy has this role for three reasons: the stimulus has needed to arrive quickly; it has an important sectoral dimension for which monetary policy is not the right instrument; and some of the policy tools, for example credit guarantees, are inherently fiscal in nature.

To date, euro area governments have implemented fiscal measures amounting to more than 4% of euro area GDP in 2020 alone. These measures are in addition to liquidity support initiatives and the operation of automatic stabilisers.

These national fiscal responses have been highly effective. Job retention and loan guarantee schemes in particular have helped to secure employment and prevent an unnecessary loss of viable businesses. They have been crucially complemented by EU-level support – the so called "safety nets" – that reinforce their confidence-enhancing effects. By propping up demand and facilitating access to credit for companies in particular, these measures have also reinforced the effectiveness of our monetary policy.

While the fiscal measures taken in response to the pandemic should, as much as possible, be targeted and temporary in nature, weak demand and the heightened risk of a delayed recovery warrant continued support from national fiscal policies. An ambitious and coordinated fiscal stance remains critical and we should by all means avoid cliff effects.

Public investment can positively affect economic growth in the current circumstances. In an environment of accommodative monetary policy, public investments have the strongest short-term demand effects, including in terms of cross-country spillovers.[1] Moreover, in times of elevated uncertainty, public investment raises confidence and thus tends to have a higher fiscal multiplier.[2] By raising confidence, a push in public investment is also likely to foster investment from private stakeholders. At the same time, we should not forget that the longer-term positive effects on the economy's potential output and the impact on public finances crucially depend on the effectiveness of investment and the productivity of public capital.

Public investment and reforms, especially if geared towards medium and longer-term challenges such as environmental sustainability and digitalisation, can build a bridge towards a successful and inclusive recovery. We should not think about the two in isolation: combining reforms with an investment-led stimulus has the potential to raise growth even more. The two together should shape the future of our economies and ensure that they adapt to the "new normal" that will materialise once the peak of the pandemic is over.

For these two reasons, the Next Generation EU package must become operational without delay. The package's additional resources can facilitate expansionary fiscal policies, most notably in those euro area countries with limited fiscal space. We should also ensure proper arrangements to allow for the well-sequenced and effective spending of these funds. I therefore welcome the recent contribution by this Parliament to foster transparency and accountability in the use of EU fiscal support.

It is thus more important than ever for monetary policy and fiscal policy to keep working hand in hand. The Treaty's safeguards ensure that this is done in full respect of the ECB's mandate and independence.

Conclusion

Let me conclude by underlining that Europe's response to the crisis thus far has not only been impressive, it has also been highly effective. Entering the second phase of the crisis, we must persevere and continue with the same commitment to keep on delivering for Europe's people.

The overwhelming majority of Europeans – in fact, almost all of them according to the latest Eurobarometer survey – demand such action from us.[3] As I said in my introduction, let's ensure that the policies we are shaping allow us to get there. As Johann Wolfgang von Goethe once said, "In the realm of ideas, everything depends on enthusiasm; in the real world all rests on perseverance".[123]

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1 See "Public investment in Europe", *Economic Bulletin*, Issue 2, ECB, 2016.

2 See "Public Investment for the Recovery", *Fiscal Monitor*, Chapter 2, IMF, October 2020.

[3] Asked whether the EU should put in place an economic plan to help all EU Member States recover, 88% of EU respondents said they agreed with the statement. See "Standard Eurobarometer 93", Survey requested and co-ordinated by the European Commission, Directorate-General for Communication, October 2020.