

Philip R Lane: Stabilising the economic outlook

Remarks by Mr Philip R Lane, Member of the Executive Board of the European Central Bank, at “The Outlook for the Economy and Finance” workshop (fully digital), organised by The European House – Ambrosetti, Frankfurt am Main, 27 March 2021.

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The theme of this panel is the “Competitiveness of Europe and of the European Financial Markets”. Although the near-term focus of everyone is predominantly on combating the pandemic, it is also necessary and appropriate for us to examine the longer-term determinants of income levels and living standards.

Let me emphasise that shorter-term and longer-term economic performance are inextricably linked, especially in the current circumstances. In particular, a sustained period of below-capacity economic activity damages the longer-term productive capacity of the economy through several mechanisms. First, inactivity hurts labour productivity through the loss of on-the-job knowledge accumulation. And for those entering the workforce straight from school or university, the damage has been compounded by the adverse impact of the pandemic on educational systems over the last year.

Second, the sustained loss of revenues in those sectors most affected by social restrictions has weakened corporate balance sheets. Since the financial health of firms is an important determinant of investment, the long-run level of productivity is threatened by a reduction in capital accumulation. And firm-specific knowledge capital may be lost if the revenue shortfall during the pandemic results in the closure of otherwise viable firms.

Third, the pandemic is also an uncertainty shock. Not only is there uncertainty about the timing of the exit from the pandemic – due to the opposing forces of vaccinations, other medical treatments and social restrictions on the one side, versus the spread of the virus and the emergence of mutations on the other side; but there is also a lively debate about the implications of the pandemic for the future of various sectors. In particular, the future balance between the office and the home as a workplace, as well as the option to work remotely from any corner of the world, has widespread implications for many sectors. It is also plausible that the accumulated experience with online meeting and collaboration technologies will reshape how international activities are organised, including a decline in the scale of business travel.

While a substantial proportion of this uncertainty is inescapable, there is a clear risk of self-fulfilling adverse dynamics taking hold through which uncertain economic prospects induce households, firms and governments to hold back on expenditure plans, leading to a decline in overall demand that validates the loss in confidence about the future. This risk is compounded by the danger of real financial amplification channels by which lenders (banks or bond investors) become reluctant to lend and borrowers (households, firms or governments) become reluctant to take on debt because they fear that lower growth prospects would be amplified by declining creditworthiness and a tighter credit supply.

To counter these risk factors, it is essential that the ECB acts as a stabilising force and boost confidence by committing to the preservation of favourable financing conditions. This commitment is delivered through our full set of monetary policy instruments: the low policy rate (together with the forward guidance that the Governing Council expects the key ECB interest rates to remain at their present or lower levels until we have seen the inflation outlook robustly converge to a level sufficiently close to, but below, 2 per cent within our projection horizon, and such convergence has been consistently reflected in underlying inflation dynamics); our asset purchase programmes – the APP and the pandemic emergency purchase programme (PEPP) (including the commitment to adjust the purchasing pace under the PEPP to counter any

tightening in financing conditions that is inconsistent with countering the downward impact of the pandemic on the projected path of inflation); the calibration of our targeted longer-term refinancing operations (the TLTRO III programme) and our collateral policies. In addition, these monetary policy measures have been reinforced by the countercyclical measures taken by the supervisory arm of the ECB.

Complementing our accommodative monetary policy, it is essential that fiscal policy counters the pandemic shock to incomes and the productive capacity of firms, ensures that overall demand conditions promote a timely recovery and underpins medium-term growth prospects through growth-enhancing public investment. The macroeconomic role for fiscal policy is especially predominant under current conditions: fiscal multipliers are higher in a low interest rate environment, while the asymmetric sectoral impact of social restriction measures can only be addressed through fiscal measures.

In addition to the combined contribution of national fiscal measures (which are collectively more effective when calibrated in a coordinated manner), the Next Generation EU (NGEU) initiative has a critical role to play. In particular, a multi-year programme of elevated and targeted public investment provides an important growth engine for the post-pandemic economy, which is further amplified by the commitment to carry out growth-enhancing reforms. Moreover, the coordinated focus on green investment and digitalisation has the potential to generate additional productivity gains on a cross-European basis in view of the shared benefits of an orderly carbon transition and the positive network externalities from enhanced digital capacity across all Member States. Of course, fiscal support for basic research and development activities also serves as an international public good. Another common principle that is relevant to all national reform plans is that improving the efficiency of public sector administration has the potential to boost economy-wide productivity in view of both the size of the public sector in European countries and the importance of efficient public sector administration to the operating costs and resilience of every sector.

Together with the success of the SURE bonds, the EU-level bond issuance to fund the NGEU initiative will also advance the development of a deeper and more complete pan-European bond market and add to the stock of European safe assets. More generally, making progress on banking union and capital markets union would further support the European Union's growth prospects by increasing competition, reaping the benefits of economies of scale and boosting entrepreneurial risk-taking through an expansion in international risk sharing. Of course, a true single market in financial services should be accompanied by a more general push to develop a single market for all tradable services across the EU.