EU and national monetary and financial policy responses

In sharp contrast to the beginning of the previous decade, this time, when faced with the imminent prospect of recession and a disruption in the financial markets, the European Central Bank reacted speedily and decisively to support economic activity and government fiscal responses, giving individuals, firms and governments across Europe the capacity to borrow, thus maintaining cash flows in the system and keeping it from collapsing. It did so by using both conventional and unconventional tools of monetary policy, as well as its leverage as banking supervisor of banks of systemic importance in the euro area. The ECB had already been adopting the use of unconventional monetary policy tools since 2014 in its struggle to fight persistently lower-than-target inflation (see Figure 1.21). In fact, while it moved swiftly in spring 2020, it did so in the shadow of a ruling of the German Constitutional Court, according to which the ECB's earlier unconventional policies of purchasing public sector bonds had not considered the potential repercussions for other economic policy objectives.

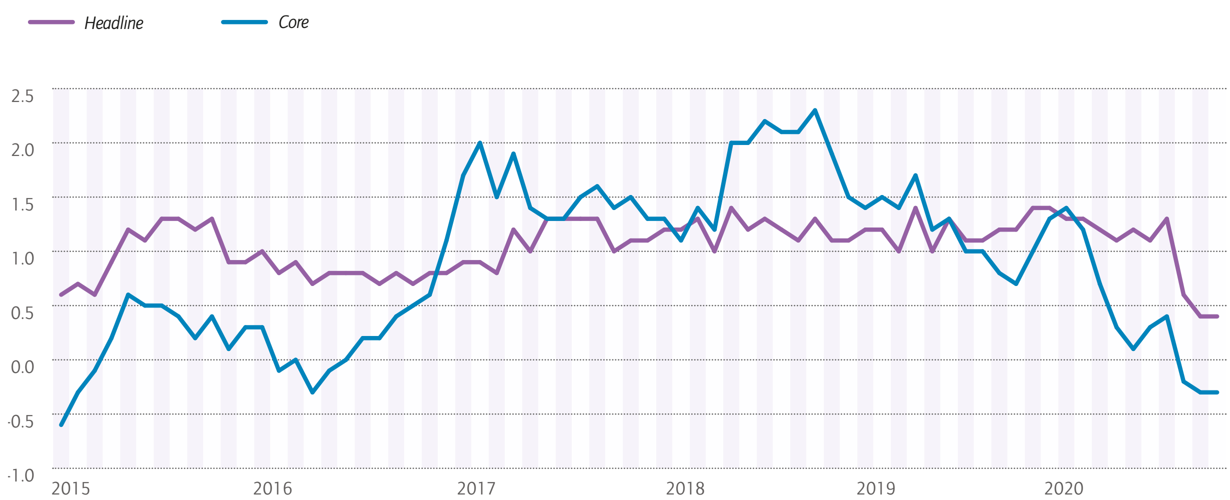
As far as monetary policy tools are concerned, it was the unconventional ones that did the heavy lifting: the ECB expanded and extended its asset-purchasing programmes, and increased the amounts that banks could borrow from it to lend and the collateral conditions under which they can do it.

As early as mid-March, when EU Member States began imposing strict public health measures, the European Central Bank launched its Pandemic Emergency Purchase Programme (PEPP). Under this programme, it pledged to buy private and public securities (e.g. bonds), initially to the tune of €750 billion and until the end of 2020. However, in June, following the worsening outlook regarding inflation, it expanded the 'financial envelope' to €1,350 trillion and the duration of the programme to *at least* the end of June 2021, leaving the possibility of a further extension open until the Governing Council of the ECB is reassured that inflation is on track for meeting its target. The aim of this programme is to ensure that households, firms and governments continue to have access to the funds they need in order to weather the crisis.

To further facilitate the access of households and companies to credit, the ECB increased the amount of money that banks can borrow through its targeted longer-term refinancing operations (TLTROs). Under these operations, the ECB has been lending money to banks at preferential rates with the condition that they extend credit to the real economy, for example to SMEs and households – hence the term 'targeted'. The ECB also eased the standards on the quality of collateral assets that banks could use as insurance to borrow money from the ECB, also issuing a waiver for the first time since 2015 on the use of Greek government bonds by Greek banks.

The ECB maintained its key interest rates, most notably its deposit facility, main refinancing operations and marginal lending facility rates, at -0.50%, 0% and 0.25% respectively, the rates at which they had been since 2019. The bank also made it clear that it was not planning to increase these rates until it had seen forecasts of headline but also core inflation approach its target of 'close to, but below 2%'. As Figure 1.22 shows, inflation dynamics in the euro area have been undershooting the target since 2015. While the headline inflation (HICP) measure did reach the

Figure 1.22 Headline and core inflation rates in the EA, (monthly annualised % rates), January 2015 August 2020



Source: Eurostat prc_HICP_manr.
Note: Headline: Harmonised Index of Consumer Prices (HICP). Core: HICP excluding energy and unprocessed food.

> “The attempts to mitigate the risk that Covid-19 poses for public health have seemingly led to the crumbling of a series of taboos and orthodoxies guiding economic policy over the last 40 years.”

2% target for relatively brief periods in 2017 and 2018 due to energy price surges, the core inflation measure presented here (which excludes commodities with highly volatile prices, such as energy) has trailed below 1.5% since 2015.

Core inflation is a proxy for the inflation expectations of economic agents in an economy, including those who bargain over wages. When, for example, wage bargainers expect that inflation will be below the target rate of a central bank, it is an indication to them that an economy is producing below capacity. Below-target inflation expectations are thus a trigger for the central bank to keep an expansionary stance in its policy, in order to stimulate activity.

The ECB also used its banking supervision competence to temporarily loosen up the application of prudential provisions on, for example, capital and liquidity buffers and composition of capital to allow banks more space for continuing to lend money to protect economies from the shock. It also requested banks to not pay dividends or buy back shares during the pandemic.

Going forward, the role of the European Central Bank is likely to remain important for powering the response to and recovery from the pandemic, given the uncertainties over whether – and if so, how far and how fast – an EU fiscal capacity could be established, and over whether EU fiscal governance will be reformed to allow for national fiscal policies with a stronger stabilisation capacity.

In January 2020, the ECB launched a review of its monetary policy strategy, the first of its kind since 2003. This review has been deemed necessary as inflation expectations have persistently remained below target and as, due to a number of structural changes in the euro area economy, there has been a persistent decline in interest rates to levels that require a greater use of unconventional tools.

Several questions are on the agenda of the review. The first is how to define and re-operationalise the mandate of price stability, including over what time horizon it should be pursued and which measure of inflation should be used as a target for the bank’s monetary policy decisions. Answers to these questions can have important repercussions for the way in which the ECB can balance the pursuit of its primary goal of price stability with that of other economic goals, such as jobs, growth and a just transition to a carbon-neutral socioeconomic model.

The second question is how to better understand the relationship between inflation and the real economy (output and employment growth), which seems to have changed in recent decades due to structural factors. One of the ways that this change manifested itself was in the fact that, despite accelerating output and employment growth, wage growth was for a while more sluggish than would have been expected in the recent recovery.

Finally, the mix of instruments the ECB should be using in the environment of low interest rates and low inflation expectations that it will most likely have to operate in for the foreseeable future needs to be better defined; so the third question is how effective they are and how this effectiveness can be enhanced. Like many other major central banks in the world, the ECB has had to resort to the use of unconventional tools (e.g. asset purchases) since the previous crisis (see Bibow 2020 for a review), as the effective use of its conventional tool of lowering interest rates has become more contingent on such unconventional tools since they reached zero (see for example Lonergan 2019). These policy responses were carved out in an ad hoc manner, and while there seems to be a consensus that they have been helpful in sustaining the recovery, they do not come without unintended distributional consequences (e.g. on wealth inequality) or risks (e.g. financial instability). There is therefore a need for a more systematic approach and understanding regarding what they should include, how they work and how their use interacts with fiscal policies.

The policy goal of engineering a transition to a carbon-neutral socioeconomic model has ramifications for all of the above questions (see also Chapter 3 in this volume). For example, the ECB currently defines its mandate in terms of the harmonised index of consumer prices (HICP), which includes energy prices. If, in order to reduce carbon emissions, the price of fossil fuels has to increase (through taxes), then the HICP would also rise. If the ECB were to tighten its policy in response, it would be penalising other parts of the real economy. Decisions on how to adapt monetary policy strategy in response to the structural changes that will come about from this transition will also determine in part how the costs will be shared between labour and capital.

A debate which has been creating controversy among not only monetary policymakers but also environmental campaigners is whether the ECB should abandon the principle of ‘market neutrality’ when buying corporate bonds from the financial markets. According to this principle, the ECB buys corporate bonds in proportions that would not alter their relative prices in the financial markets (therefore having a ‘neutral’ impact on the structure of the market).

Proponents of abandoning the principle, whose pleas the governor of the ECB Christine Lagarde seems to be considering, advocate that the ECB should instead actively seek to reduce or even eliminate its purchases of bonds issued by companies that contribute heavily to carbon emissions (from airlines to oil and gas and utility companies) as, in this way, it could help to support one of the EU’s chief policy objectives. Such a move would put downward pressure on the price of these bonds, effectively reducing the capacity of carbon-emitting companies to draw funds from the financial markets.

Opponents, however, have retorted that such a move would mean that an electorally unaccountable policymaker, such as the ECB is, would be taking policy actions with distributional consequences, decisions which are the prerogative of elected governments and which would ultimately call into question the ECB’s political independence. The fact that, in the context of its ongoing strategy review, the ECB leadership has stated that it intends to take into account new challenges that ‘people care about’, such as climate change or inequality, and has even organised public consultations and ‘ECB Listens’ events in recent times, suggests that such a threat is not entirely unfounded.

Conclusions

Europe is undergoing its second recession in the span of 12 years, and one that is even bigger than the previous 'Great Recession'. The attempts to mitigate the risk that Covid-19 poses for public health have seemingly led to the crumbling of a series of taboos and orthodoxies that have been guiding economic policy over the last 40 years. National governments have had to take far-reaching measures limiting highly valued individual liberties and forcing large parts of national economies to grind to a halt. A massive expansion of public support schemes and, ultimately, of the size of the state has taken place and hailed as a welcome development, even a highly recommended one, by the likes of the former governor of the ECB, Mario Draghi (Financial Times 2020a). For the first time in its history, the EU has established a temporary yet sizeable fiscal capacity to help those Member States most harmed by the pandemic, irrespective of their contribution. Central banks have embarked on massive purchases of government bonds to support these efforts, raising questions over whether a monetary financing of public debt should take place in the future to deal with the accumulated debt – and if so, how (see for example, Demertzis et al. 2010, Diessner 2020, DeGrauwe and Diessner 2020). At a more microeconomic level, the principles of healthcare system management have also come under scrutiny, as allocated resources have often not proved sufficient this year to effectively deal with such a rare yet catastrophic event as the current pandemic.

These developments could offer hope that the crisis will indeed result in different ways of managing the economy in general and prevent us from going through what would be another lost decade for parts of the EU by avoiding a repeat of the damaging policies of the 2010s. On the other hand, it is also possible that, as prominent new classical economist Robert Lucas Jr. stated, 'we are all Keynesians in a foxhole'. While the Great Recession was described as the failure of globalised capitalism, raising hopes that a shift in orthodox economic policy would happen as states stepped in to recapitalise financial institutions 'too big to fail', the aftermath of the initial Keynesian stimulus response was the imposition of harsh and counterproductive fiscal austerity policies. Is this time going to be different? And can it be?

The pandemic hit Europe at a time when momentum was building around the policy challenges of engineering a just transition to a carbon-neutral socioeconomic model and of addressing both the opportunities and the threats posed by digitalisation. It was clear that public investment would be necessary for such challenges. Moreover, the experience of the previous crisis had set in motion some policy initiatives, such as the programme for deepening the EMU, including items like the reform of the ESM and the completion of a banking union, and the implementation of the European Pillar of Social Rights (see Theodoropoulou et al. 2019a and Mueller et al. 2019). Both these programmes, which were born at moments of crisis (of public debt and of trust in the EU, respectively), illustrated that while there was a consensus on where Europe needed to reach, there was no consensus on how to get there. The pandemic crisis has thrown into sharp relief the gaps that these policy initiatives aimed to fill, from the need for a better fiscal governance framework and a deeper EMU to the need for a more robust social safety net which could reduce the great divergence of outcomes within and across Member States. Last but not least, both the European Commission and the ECB had initiated review processes for the EU economic governance framework and monetary policy strategy, respectively, with a view to making them fitter for purpose.

The current crisis context provides several windows of opportunity for capitalising on recent policy decisions to bring about changes in the EU which, as well as supporting a faster and more robust recovery, could outlast the current pandemic and form the base for powering green, digital and 'just' transitions.

The current suspension of EU fiscal rules, as well as the ECB's declaration of intent to keep on purchasing assets in the financial markets, mean that national governments should not face difficulties in maintaining their support programmes for workers and firms, even if it means recalibrating them over time to prepare the recipients for making the most of the recovery once economic activity can resume. Taking advantage of the longer than originally expected recession and the spirit of solidarity that has seemingly prevailed across large parts of Europe, the SURE scheme should, if possible, be turned into a permanent automatic mechanism of reinsurance and extended to also cover unemployment benefits. At the labour market level, this would ensure that not only jobs but also valuable job-specific skills are not lost. At the macroeconomic level, this could be a more permanent fiscal capacity for stabilising EU and especially euro area economies in the face of idiosyncratic economic shocks, as well as for lightening the burden of national fiscal policies.

The suspension of the EU fiscal rules, possibly to be extended until 2022, is an opportunity for pushing through a reform of the EU fiscal surveillance framework to address at least some of its shortcomings. Rethinking the operationalisation of the debt fiscal rule to allow Member States whose public debt will be much higher than the reference value of 60% of GDP after the crisis to consolidate their public finances at a more gentle pace, and provided that the recovery is robust, would be sensible, especially given the low interest rates that are likely to prevail for several years (cf. European Fiscal Board 2020). Meanwhile, establishing a golden rule for public investment (which will exempt it from budget deficit calculations) will be necessary in view of the investment needed to engineer a just green transition and the likely economic scars that the current recession is likely to leave (see for example Alvarez et al. 2019).

"The pandemic hit Europe at a time when momentum was building around the policy challenges of engineering a just transition to a carbon-neutral socioeconomic model and of addressing both the opportunities and the threats posed by digitalisation."

Getting the next EU budget and the Next Generation EU instrument across the finish line of ratification will be imperative for creating the foundations for these reforms, for providing real support to national fiscal policies, and for navigating the aftermath of the pandemic. It will also provide the financial means for a transition to a fairer, more sustainable socioeconomic model. The current stalemate with Poland and Hungary raises questions over how to ensure that future windows of opportunity for advancing and consolidating forms of economic solidarity across Member States are not jeopardised, while respecting the political preferences of individual countries.

Finally, the monetary policy strategy of the ECB should be adapted to help meet EU economic policy objectives and to the context of chronically low inflation and interest rates. The issuance of EU social and green bonds in large quantities should ease such shifts.