BANCA PROMOS

Pandemic review

Why the ECB's strategy overhaul is now more relevant than ever

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For the European Central Bank, **2020 was supposed to be the year of the strategy review**. Then the coronavirus took center stage.

Christine Lagarde had decided to start her mandate at the helm of the Frankfurt-based institution with a historical overhaul of the operations of the central bank, which would have had to face all the thorniest issues of its business, from the redefinition of its inflation target to the effects of shadow banking on monetary policy transmission mechanisms.

The spread of the coronavirus epidemic has unavoidably pushed the ambitious reform project into the background. After all, who needs a year-long strategy review if in just a few weeks the ECB has taken measures with no precedents to preserve the stability of the euro area?

Yet, although its conclusion has been postponed by six months (from the end of 2020 to mid-2021), **the strategy review remains a process of paramount importance for the future of the ECB and the single-currency area**. The long-term drivers that motivated the launch of the review back in January -- an ongoing ageing population, (de)globalization, digitalization, climate change -- not only are still in place but have been heavily conditioned by the pandemic, whose impact on inflation has sparked an intense debate.

The ECB's response to the coronavirus pandemic

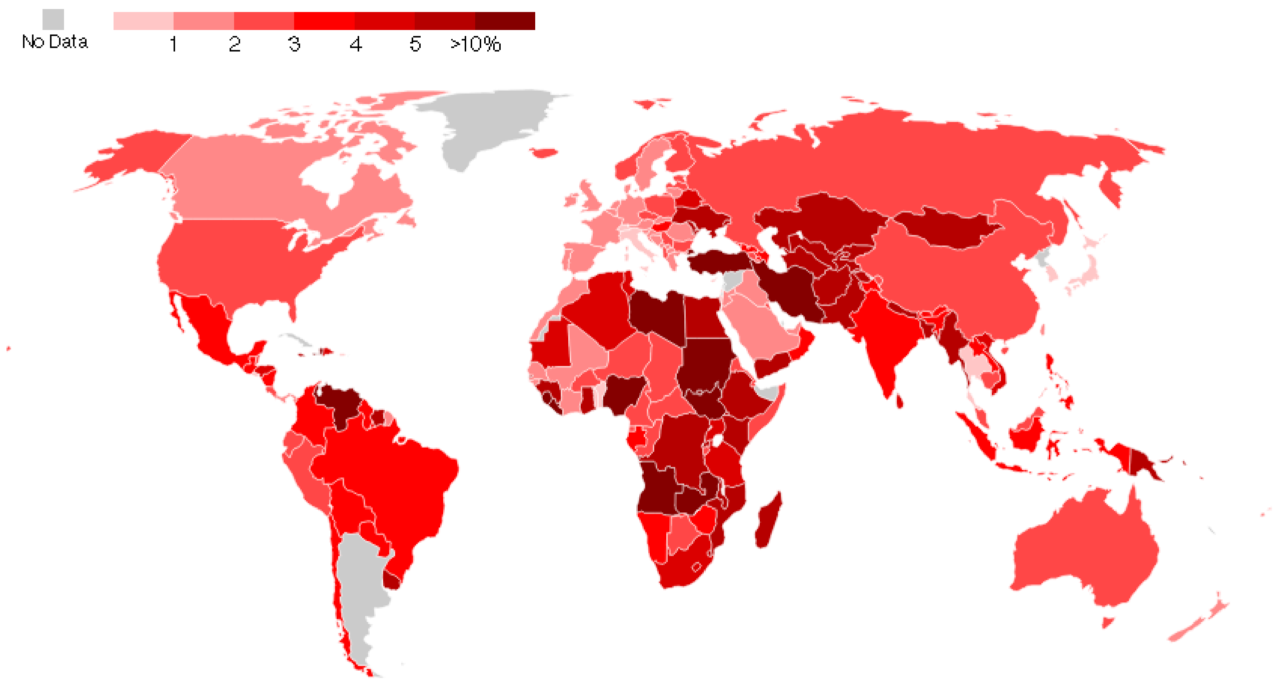
March 12
The ECB allows its directly supervised banks to operate temporarily below the level of capital defined by the P2G, the CCB, and the LCR. Banks are also allowed to partially use capital instruments that do not qualify as CET1 (e.g. AT1 or T2) to meet the P2R.

March 12
The Governing Council decides to increase by €120bn its net asset purchases until the end of the year. Moreover, the ECB announces the easing of conditions for TLTRO III operations and a series of additional LTROs.

March 15
The ECB agrees on a coordinated action with other major central banks to enhance the provision of liquidity via the standing US dollar liquidity swap line arrangements. The facility will be further enhanced just five days later.

(cont'd)

IMF predictions for inflation rate at end of 2021



Source: Bloomberg, International Monetary Fund (April 2020)

Long term

Since the beginning of the epidemic, it's been clear that **SARS-CoV-2 is a virus that particularly affects the older segments of the population**. Although its impact will hardly be able to reverse the age pyramids even of the hardest hit countries, there is no doubt that it is dramatically exposing the demographic weaknesses of Western societies and of realities such as nursing homes.

Globalization, already strained by the election of Donald Trump to the presidency of the United States and by the vote on Brexit, could suffer a new blow now that -- for pragmatic more than ideological reasons -- **governments will rethink their economic systems in the sense of greater protectionism and companies will redesign their production chains in favor of greater localism**, with shorter and more diversified supply chains. Such autarchic dynamics could alter the disinflationary role played by global trade over the past few decades.

The huge global work-from-home experiment of the past few weeks has highlighted the weaknesses of remote work but overall it **is probably delivering better than expected**. In a world governed by the rules of social distancing, digitalization is a trend that can only emerge further strengthened.

As for climate change, many commentators say that factors such as the pronounced drop in oil prices and the fears associated with mass transit may slow down a phenomenon of environmental awareness that had reached its peak in 2019. **What will happen to the environmentally-friendly investments announced by the European Commission or the Green New Deal invoked by the American left?**

Some observers argue that these resources will be reallocated to other sectors, primarily healthcare. Others, however, see the pandemic as one more reason to insist on the fight against global warming, especially now that a worrying correlation between air pollution and mortality rates from Covid-19 is coming to light and that lockdowns imposed in large industrial areas have empirically confirmed that climate change is a reversible phenomenon.

March 18
The ECB introduces a €750bn Pandemic Emergency Purchase Programme (PEPP).

April 7
The ECB deploys a wide package of temporary collateral easing measures, including a waiver to accept Greek sovereign debt instruments as collateral in Eurosystem credit operations.

April 22
The ECB takes steps to mitigate the impact of possible rating downgrades on collateral availability.

April 30
The Governing Council decides to further ease the conditions on the TLTRO III operations and to conduct a new series of pandemic emergency longer-term refinancing operations (PELTROs).

Source: European Central Bank

Medium term

However, beyond structural trends, **the most immediate issue remains that of inflation and the potential trade-off between price stability and sovereign solvency.**

The debate among economists about the impact of the epidemic on price levels is open. The prevailing position is that of those who argue that, **overall, demand will likely suffer a harder shock than supply**, with consequent downward pressure on inflation rates. Both negative oil prices and the rise in unemployment due to lockdowns seem to support this hypothesis, for now.

In a deflationary environment, economic agents would progressively leave behind the expectation of a gradual downsizing of central banks' balance sheets, eventually accepting the de facto permanent nature of the massive public debt monetization carried out in previous years.

Should the exponential growth in the monetary base not to be accompanied by a significant growth in the money supply and in inflation (as already happened after the global financial crisis), the idea that such a transmission mechanism now exists only in theory would be strengthened.

The alternative scenario, that of **an inflationary shock caused by the massive monetary interventions, although considered less likely, is certainly worthy of consideration**.

What would happen if inflation in the euro zone were, at some point, **to approach 2% while countries like Italy still need monetary easing** to refinance their debts at low rates? If the ECB slows down its asset purchases, the risk of sovereign defaults and of a dissolution of the currency block would become palpable, given the high levels meanwhile reached by the public debts of some European States.

Olivier Blanchard
Former Chief Economist of the International Monetary Fund

I put most of my probability mass on the low inflation forecast. But I cannot completely dismiss a small probability of high inflation.

April 24, 2020

At this point, **two** different **scenarios could materialise**:

- **In the first scenario** (fiscal dominance) **the ECB would 'bend' to the needs of eurozone's most troubled countries, keeping its stimulus in place and lifting its inflation target** (for example, bringing it to 3%, or beyond) in order to make it compatible with the faster pace of price growth (perhaps within the context of the strategy review, if it is still ongoing).

  The ECB would remain respectful of its mandate of ensuring price stability (in fact, by fine tuning its quantitative definition) and even the opposition by Northern hawks, based on the supposedly central bank's loss of independence, could be won on the basis of the consideration that the alternative would be the disappearance of the euro and, without a single currency, the ECB's own raison d'être would vanish.

- **In the second scenario**, the ECB would leave unchanged its current price growth target (if anything, bringing some slight revisions to make it more symmetrical than it currently is) and start a tapering process.

  To avoid a default and the redenomination of its debt, **Italy would be virtually forced to resort to the European Stability Mechanism so as to unlock the central bank's Outright Monetary Transactions** (therefore, the ECB would continue to support Italy but in a more selective fashion).

  However, those from the ESM would be loans or credit lines backed by full conditionality (unlike those currently under discussion among European leaders), so the intervention of the bailout fund could end up strengthening the populist and sovereigntist parties of the beneficiary countries, potentially only postponing the eventuality of a break-up.