Telephone call between Prof. Marcel Fratzscher, President, DIW Berlin economic research institute, Berlin, and David Marsh, OMFIF Chairman, 12 May 2020

David Marsh: Marcel Fratzscher, president of the DIW institute in Berlin, welcome today. Can we talk first of all about Germany and the reaction to the coronavirus.

Marcel Fratzscher: Germany seems to have gone through this crisis so far somewhat better, or not as strongly affected, as other countries in terms of fatalities and infected people. But in economic and social life there has been a massive shutdown. Maybe not as strongly as we have seen in Italy or Spain but still there has been a lockdown which is now gradually eased, starting this week. We have a very federalist structure. So basically every state, every local municipality has the power to design and implement policies - a huge heterogeneity which is either a strength or weakness. In terms of the easing measures, there is a danger that the risks are underestimated. Germany is not well prepared for a second or third wave. This holds for almost all European countries. There is still too little testing and the big issue of tracing is not solved at all in Germany.

DM: DIW was part of the group of forecasters which said in early April that Germany this year would contract by 4%. You're surely now much more pessimistic?

MF: You're right. On the economics, I was doubtful in early April. It's a typical case of Knightian uncertainty where we can't even attach probabilities to the different scenarios. There appears to be a consensus that it won't be a V-shaped recovery. We won't bounce back and be back to where GDP was at the beginning of this year. We won't be there for another probably two years. This is also what you see the IMF projections from mid-April. I would call it an optimistic scenario because it hinges on many assumptions. It assumes there is no second or third wave that could again trigger a lockdown with massive economic impact. Experts say a second wave is very likely. The question is how badly this would hit the different countries and whether it would trigger a further lockdown. If you consider the worst scenario, with an extended lockdown after a second wave, GDP would be 8 percentage points lower by the end of next year than the baseline. We should take downside risk seriously. You need to consider what could happen with a country like Italy that gets into difficulty with financing. You might say, with ECB policy as it is, the probability is small but I we can't rule it out.

DM: What would be the worst case in concrete figures?

MF: Currently the IMF has minus 7.5% for the euro area, minus 7% for Germany for 2020 and then a gradual recovery next year. That's the optimistic scenario. You could easily estimate a 10 or 15% contraction for this year. I think this is not entirely unrealistic. A second wave could be a lot more damaging for the economy than the first wave. In a second wave, you will have used up fiscal reserves and have much higher levels of debt, also among companies, so the credit guarantees that have been granted in the first assistance measures might not do the trick in a second wave. In Germany, we have not seen a big increase in unemployment so far. We have more than 10m out of 45m employees, more than 20%, on short-time work where the government pays around 60% of the salary. Contrast that to the US where you've seen a rise of unemployment by more than 30m.

DM: Short-time working could be turned into real unemployment if we don't get it right with returning to work?

MF: Yes that's right. To get an idea of could happen to unemployment, in the global financial crisis at the peak short-time work in Germany was 1.4m in early 2009. Now we have more than 10m.

DM: Are the financial markets wildly over-optimistic? We've seen this huge rally in Wall Street over the last six weeks.

MF: I'm not sure whether that reflects optimism about the economic recovery or optimism about central banks pumping money into the financial system. It will be crucial to ensure that the crisis in the real economy does not translate into any form of financial crisis.

DM: Politically, in Germany, who would you be putting your money on to be the next chancellor next autumn?

MF: There's been a complete reversal in German politics with the governing parties gaining a lot in popularity. The two frontrunners are two state prime ministers, Armin Laschet, of North Rhine-Westphalia, and Markus Söder, of Bavaria. The odds are that this will be a black green coalition (CDU/CSU and the green party).

DM: On to Europe. You've been vocal early on, with others, arguing for corona bonds. Are they more or less likely now as a result of the constitutional court judgment?

MF: Corona bonds won't happen. No chance. There's too much opposition not just from Germany, but from the Netherlands and from other countries. The question is not 'What instrument do we want?' but more 'What's the challenge? What do we need in terms of financing? How can we help Italy quickly and most effectively?' Italy has had a fairly sizable fiscal stimulus. The government has responded well. The big question is how to design the European reconstruction. How much will be transfers and how much will be loans? And how quickly can the money reach the regions that need the money?

DM: Are you very surprised about the constitutional court judgement? Could it turn out positive because he could mean that the ECB will have to explain its policies more and maybe get more support among the population?

MF: I was a bit surprised. I was an expert witness at the 2013 hearing at the constitutional court about the OMT programme. I had the feeling even then that the court was on a mission to claw back some authority or sovereignty from Europe. There has been for the last few years a very strong view in the constitutional court that what the ECB is doing is really monetary financing. Very importantly they didn't say that this time. They said it comes dangerously close, but I think this was tactical. They have a clear problem with the mandate. They say the ECB must conduct a proportionality assessment, weighing the benefits of its monetary policy, including in terms of achieving price stability against what they call the negative side effects. The court claims the purchase programme PSPP is robbing savers, creating zombie companies and providing perverse incentives - moral hazard – for governments to do the wrong things. But if the ECB cannot pursue monetary policies in pursuit of price stability without weighing the side effects, then that means the court doesn't want an unconditional mandate of price stability.

DM: How do you think all the different parties will react? The ERCB at the moment seems to be in a defiant mood.

MF: In public, the ECB should be defiant. Their statement last Tuesday said basically: 'We will keep doing what we are doing in the pursuit of price stability.' They seem to be saying that they will ignore the judgment to protect their independence. The ECB is not accountable to the German parliament. It's not accountable to the German court. The ECB is accountable to the European parliament and the European court of justice. So that's the dilemma. The ECB cannot react in public because that would limit their independence.

DM: But the ECB can't simply ignore it. The process surely has to be that Mr Weidmann, the Bundesbank president, puts in an application for the council to come up with his assessment. So the ECB is not responding directly to the court, but to a member of the governing council. Through that mechanism, the ECB will produce some sort of assessment to be given to the German parliament, government and constitutional court within that three-month deadline. That would be the sensible way of doing it, rather than simply saying we're not going to take this seriously.

MF: Yes, exactly. There's a mechanism to do this via the Bundesbank. But it's setting a very dangerous precedent. In Germany, you have many politicians, most of the media and many economists who say this was a great ruling by the court, that they were exactly right to push the ECB and restrain them. That is my bigger worry: the public view in Germany about what the ECB has been doing. It's all about risk-sharing. There's a widespread view that the ECB is taking risks on its balance sheet at the expense of Germany and to the benefit of southern Europe. This ruling will further damage the ECB's credibility. For the central bank, credibility and trust are the most important assets.

DM: With the pandemic programme PEPP, the ECB is now spending €8bn a day in this intervention. They will run out of that €750bn by the autumn . The governing council seems to be split. Some members say they are worried about whether they could now go ahead with increasing the €750bn, possibly as early as next month, showing that they are independent. Others think they should be a bit more cautious.

MF: The ECB has to signal clearly that they are independent: the message must be, 'We need to do whatever we need to do.' And so any deviation from what they've been planning to do, or even any perception that the ECB might give in, would be fatal. So they need to signal that the German court will not change what they're doing,

DM: Some people say the Bundesbank should deliver the report. The lawyers there seem to be saying it has to be the ECB council that delivers the report, it can't be the Bundesbank. What would be your judgment as an economist not as a lawyer?

MF: I don't think the governing council will deliver the report. The ECB is not accountable to the German constitutional court. The court is asking the German government and parliament to make sure such a report is delivered. The government and parliament cannot do that directly with the ECB. They could do that only via the European parliament.

Q1: The court is laying down a challenge to the government to stand up and endorse the policy settings, instead of passing the buck and hiding behind the ECB. Is it possible that a black-green coalition government, led by Laschet, would give a tacit endorsement of wat the ECB is doing?

MF: You're right, in a sense the court is asking the government to do that. I don't think that, in future, we will see a massive change in the government's view of the ECB. The current government is actually quite sympathetic to the ECB. We have a very different finance minister compared with Wolfgang Schäuble, who five years ago called for Greece to leave monetary union. Olaf Scholz is very supportive of European policies and also the ECB. I don't see that a new government would be more or less sympathetic to the ECB. The big challenge in Germany is that the public perception has been very hostile towards the ECB and this will increase as a result of the ruling.

DM: It’s a good opportunity for Angela Merkel to get out in front and defend the ECB. Why doesn't she do that?

MF: The constitutional court has a very high standing and reputation in Germany. She would not do that. It’s reported in the media, in an internal party meeting [on Monday], that she said Germany is going to find a workaround – to protect the ECB and try to satisfy the constitutional court. She's looking for a compromise for both sides to save face.

DM: Is it wise for the European commission to threaten to take the German government to court with an infringement procedure? That looks like confrontation.

MF: Yes, it's wise. If you look at the reactions in Poland and Hungary, there was jubilation at the verdict. They are saying: ‘The German constitutional court is finally agreeing with us.’ For the commission, it would be very important to put their foot down and protect European laws. They need to fight tooth and nail.

Q2: Italy has public debt of 135% of GDP, due to rise to 160% by the end of this year. The PEPP is intended to be an emergency facility that should conclude at the end of the year. Given he court it would be very hard to have that as an open-ended facility. That leaves Italy in a very difficult position. How do you get around that without either debt mutualisation or debt restructuring? Italy is an order of magnitude larger problem than Greece. How does that get resolved while keeping the European dream alive?

MF: I agree. it's a massive problem. The key is the ECB. It’s an absolutely crucial element in keeping debt servicing costs contained. Spreads have gone up but, after the PEPP was announced, they have been relatively stable over the past few weeks. I agree that, if the ECB is constrained in any way, this would be dramatic for Italy. We all know 70% of Italy’s sovereign debt is held domestically within Italy by banks and insurance companies, partly by savers. So you could expect some attempts at financial repression. The debt issue not a problem at the moment. It could become a huge problem, if the ECB cannot act. To me this means the PEPP will almost certainly have to be increased and extended, beyond the €750bn. The legal interpretation that the ECB announced in late March said they are not bound by the 1/3 - 1/3 issue and issuer limits. This is seen as a crucial question by the German constitutional court in terms of proportionality and monetary financing. The ECB will remain crucial to avoid a run on Italian debt. So far, it has been doing a convincing job.

Q3: If the PEPP is extended would you expect another constitutional court complaint? These things can take a very long time.

MF: There would almost certainly be another lawsuit against the PEPP. But as you said it will take years. So I don't think this would worry the ECB very much at the moment.

Q3-2: Is Italy being pushed towards the ESM, now available practically without conditionality?

MF: Member states can draw 2% of GDP from the ESM. For Italy this is €46 or €48bn. The Rome government’s position on the so-called stigma has softened, so I could imagine Italy drawing upon it. But €48bn will not be a game-changer, in view of the size of the debt. Some people hope, misguidedly, that this could trigger the OMT, but this requires that Italy complies with conditions. I think PEPP is a lot more potent than OMT because there can be deviations from the capital key.

Q4: On increasing and extending PEPP, there are three components: the size, the duration, and the long-run reinvestment commitments and whether it's viable to commit to maintain an allocation of assets skewed away from capital key for a long period into the future. Can you elaborate on these different dimensions?

MF: I believe the ECB will extend the programme, maybe double it. The increase might be smaller, it might not be €750bn, but €500bn, and we go into early next year and then we'll see. I don't think that will they can make it open-ended. They have to give some kind of limit. The capital key is crucial. This relates to the proportionality.

DM: How long can the ECB can deviate from the capital key?

MF: For or a considerable period of time. In terms of size and timing, I can imagine that in June or the latest in July, in the governing council meeting, the ECB will make an announcement to manage expectations, so financial markets don't have to worry about that.

DM: 'Considerable period' - Can you be more precise: two years, three years, five years, 30 years?

MF: My hunch is the ECB will announce this summer that they're going to extend the programme by half a year to early next year…

DM: ..There's no way they can get back to the capital key by the middle of next year …

MF: They can try to get back via reinvestment and you can you can adjust that over time, but I don't I don't see any way for them to get back to the capital key by early next year. And that's certainly not desirable at this point. That would widen the spreads if they changed the portfolio allocation towards Bunds.

Q4-2 Some people hope for a silver lining. The court ruling might galvanise governments to do dramatically more by way of the recovery fund and other joint programme to harness fiscal capacity to support a more symmetric economic rebound. Do you share that optimism?

MF: I'm less optimistic. One thing I've learned particularly in Berlin is that governments act only if they have no other choice. There will be a recovery fund. It will have a decent size but, like the Juncker fund, the numbers sound impressive, but the capital behind it and the transfer components are rather limited. There is the view here that it's quite convenient that the ECB is doing what it's doing. Everything I've heard and seen here over the last week has not at all triggered the reaction that we need now a stronger European fiscal response on the European side.

DM: Isn't some of moral hazard opening up? The governments could say there's no need for them to do anything if the ECB is there. And that's surely why Christine Lagarde did say more than a month ago: 'We're not here to close to spread.' She wanted to put pressure on the government. It was a game of chicken with the governments. And, unfortunately, she failed.

MF: She will continue to fail. Mario Draghi did as well. Surely the ECB will keep trying to put pressure on governments, and you're right there is moral hazard. But the German government and other governments are dragging their feet because they don't see the necessity to do a lot more on the fiscal side. And that's the same for also completing capital market union and other parts of monetary union.

Q5: We now have a lawyer at the helm of the ECB. Is that a good thing?

MF: I think it doesn't matter. Draghi as you know was an excellent economist by training and he had a very deep understanding. Christine Lagarde has other strengths and certainly she's a great communicator. She's politically very well connected. She made that mistake at the press conference in mid-March where she talked about not closing spreads, and she corrected that. I must say I'm really impressed by the PEPP. In terms of the measures they have done everything right. They acted very early massively and with many other elements, not just the purchase programme. They really stepped up to the plate.

Q6: We are living in a different world compared with when the Maastricht treaty was agreed, with its prohibition on state monetary financing. Could that be rectified in some way?

MF: I think over the next five years that it won't make much difference because of what the ECB has been doing. Even once it stops buying and extending its balance sheet, the ECB will not be able to shrink its balance sheet anytime soon. The public here in Germany haven't realised that. The Constitutional court has. Part of the ruling was the ECB must not hold their assets to maturity, they must sell it back to the market at some point. That signals that the constitutional court has understood that through reinvestment you can extend or keep the balance sheet at the current level or even the higher level for a long period of time. I fully agree that at some point it is desirable and necessary for the ECB to shrink the balance sheet not to monetise the debt, but I think it's more a philosophical point. I don't see the EC the balance sheet of the ECB in five years' time being any smaller than it is today.

DM:. You've told the ECB to remain defiant which is what they seem to be doing. We'll see whether that works out or whether the compromise works that Merkel is clearly engineering . Will we see compromise or confrontation?

MF: I think it will work out, but you have to be honest. It's kicking the can down the road. You can dodge the bullet of the constitutional court. But as long as you have a hostile public that doesn't understand or is opposed to the ECB's monetary policy, the ECB has a problem in terms of its credibility and standing.

DM: Marcel, that is an appropriate note on which to end. Thank you very much indeed for being with us today.