Conversation between Carlos da Silva Costa, Governor, Banco de Portugal, and David Marsh, Chairman, OMFIF, 8 July 2020

David Marsh: Thank you for agreeing to this conversation, Mr Governor. You are within a few weeks of stepping down from your post as governor of the central bank and a member of the Governing Council of the European Central Bank. You have seen a lot in this time. How would you say that this crisis is different from the one in Europe in 2010-15? What lessons have we learned?

Carlos da Silva Costa: The two crises are totally different. The one in 2008-09 originated in the financial sector. It came from the US and spread around Europe, at a different speed for different countries. It first hit the northern countries, with a savings surplus, because they invested a lot in American paper and junk bonds. The first banks hit were from the UK, Belgium, the Netherlands, France and Germany. Only after we had the second wave did it hit the southern banks, because they were unable to access the capital markets. The third wave was the sovereign crisis affecting countries with high debts and deficits.

DM: And now we have a crisis that impacts all countries at the same time...

CC: An external shock, not an economic or financial shock, impacting first the sanitary conditions, then the supply side through policies to contain contagion, then cash flows and income, and then demand. In parallel, we have seen an impact on the financial sector because as people were unable to reimburse capital or to pay interest, which led to wise decisions to accept moratoria on interest payments and reimbursements. The impact depended on the measures taken by policy-makers: on moratoria, on incomes, through short-time working (layoffs to preserve production capacity), and on state budgets.

DM: A symmetrical shock, but with asymmetric effects. Are you worried that different countries in Europe will recover at different rates? Some countries have much more financial firepower, and they can expand their budget deficits much more quickly than other countries?

CC: I’m very concerned. First, on the sanitary level. If the answer is not the right one, as it is a common threat, the problem will stay at the level of the weakest link in the chain. We cannot save ourselves if others are not safe. Second, if we don’t take into account that public money is needed to preserve social cohesion and the social fabric, we will create a lasting problem. If countries exit from the crisis at a different pace and with different levels of social cohesion and economic force, it will have a great impact in political terms, because it will feed populism – a big risk to the acceptance of the European Union. If you compare the costs, solidarity will be cheaper than the opportunity cost of breaking supply chains, breaking the internal market and breaking social solidarity.

DM: How important is it to make sure that the European Central Bank acts in a complementary way with fiscal policies?

CC: Central bank action, during the last 10 years, has been essential. In the first crisis, the central bank was essential for ensuring the role of lender of last resort when banks couldn’t refinance themselves in capital markets. The central bank was critical to preserve monetary union, because it was necessary to ensure that the transmission of monetary policy was not impaired by redenomination risk and fragmentation. The European Central Bank and national central banks have also acted in the secondary market to ensure there was no fragmentation in sovereign debt markets. This is continuing. It is necessary to ensure the transmission of monetary policy. And it is very important to ensure that the funding enters the economy: to ensure that sovereign debt is not
disturbed, and that the banks continue to lend with the right incentives – to stop any disturbance from the risk of fragmentation.

**DM:** What about the fiscal side? We now have a European programme of more than €2tn. How important is it to get to the EU recovery fund going, so the ECB is not the only game in town?

**CC:** It’s very important. In the global financial crisis, the central bank and monetary policy represented the only game in town, because the problem flowed from the financial sector to the real economy. Now, we are facing a different problem. The problem flows from the health side to the real economy and after that to the financial sector. We need to ensure that the real economy stays alive after the sanitary crisis. We started with relief, through moratoria, layoffs and provision of liquidity including with the ECB’s pandemic emergency purchase programme. Then comes the repair phase, avoiding insolvencies of companies that are viable but are under big pressure in terms of treasury and liquidity: there is the need to reprofile debt to ensure that liquidity problems will not impair the company.

**DM:** And the banks?

**CC:** Prudential rules for banks need to be implemented flexibly to avoid that such reprofiling of debt becomes a big source of impairments, impacting banks’ capital, their capacity to lend, and, in the worst outcome, risking failure and requiring recapitalisation. We need a fiscal policy that pays attention to the health of the corporate sector to preserve the health of the financial sector.

**DM:** Where does the EU recovery fund fit in?

**CC:** This repair phase is more a question for national authorities. Afterwards, we have a third phase. That is the recovery phase. The fourth one will be the reorientation phase; that is digital and greening. The recovery fund kicks in in these last two phases.

**DM:** Is there a danger that Europe will not do enough and, again, the ECB will be the only player in town?

**CC:** We need to create confidence that the economic actors will not be abandoned, that the national public authorities commit to the funds that are needed. Exceptional spending for exceptional circumstances. European decisions are needed to support the national authorities on the debt side, through grants to alleviate the impact on the public national debt and to support investment in the recovery phase.

**DM:** How important is the European Stability Mechanism? Could Portugal go to the ESM? That would help Italy. As you know, Italy is worried about the ESM. They see a stigma attached to this. Could you be a pioneer?

**CC:** It’s not a question for a central banker, it’s a question for the finance minister.

**DM:** But what do you think as a Portuguese citizen?

**CC:** We need to be realistic. The European Stability Mechanism is a real advance in the right direction. But is in some ways suffering from some sins coming from the way it was born.

**DM:** Let’s turn to the PEPP. Why did you raise the amount, from €750bn to €1.35tn, on 4 June? There isn’t so much pressure in the market at the moment. Was it necessary? Some people think you did too much on 4 June.
CC: It's good they say that because this means that they are confident that there will always be action in the market. It's important that people are confident that there will be no lack of intervention, if needed.

DM: Do you think it's possible that you may not use it all up? You've got another €1tn between now and the end of June 2021. Is it possible that that may be more than enough and you could end the programme not having used it all?

CC: It is a nice idea, because it means that we were credible in what we are doing. Our objective is to do what is necessary to avoid fragmentation of the monetary union. If we look at the yield curves, we see them behaving in a way that shows that markets are confident that we can transmit our monetary policy without any difficulties.

DM: Can you define what is an acceptable and non-acceptable spread? Christine Lagarde said on 12 March the ECB is not there to close the spreads, but it looks as though that is what you are trying to do.

CC: We are trying to determine whether the yield curve is the result of normal market functioning or is it the result of mistrust. If it is a result of mistrust, we need to act. If it is the result of a normal market working, then we need to let the market to do the job. People will look to sovereigns if they trust sovereigns. This means that the Portuguese bonds are falling in yield because people are looking for investments that are safe. It's necessary that they are confident of our participation in the monetary union and above all that we will remain able to intervene if there is a problem.

DM: There are going to be more demands on accountability, transparency, and so on, because central banks are now so important and so influential. Are you happy with the results of the German constitutional court action?

CC: The German constitutional court ruling is a domestic issue. The issue was whether the proportionality of the ECB’s public sector purchase programme, started in 2015, was examined before the decision to start it. It’s now clear that proportionality was checked. Until now, it was not necessary to show that the checking was done. It is necessary in future to give to my German colleagues the possibility to show that it was done. The evidence that we provided to the Bundesbank showed that the ECB was diligent. We did our job, even if it was not made public.

DM: Will it have an effect on Portugal? Will your successor Mr. Centeno have to go to parliament from time to time to explain the actions? Will the German episode have repercussions on Portugal?

CC: For the moment, I'm not able to say that. We would need to have a parliamentary monetary commission that is well informed and able to discuss European monetary policy for that purpose.

DM: You've been on the council for 10 years. You've seen three different presidents. How would you define the differences and the similarities between Jean-Claude Trichet, Mario Draghi and Christine Lagarde?

CC: We were fortunate to have the right chair at the right moment. With Jean-Claude Trichet, it was very important to build up the ECB. We needed to be patient, to negotiate a lot. It was necessary to build from scratch. The qualities of Jean-Claude Trichet fit very well with these needs. When Mario Draghi arrived, we needed someone who was clairvoyant. And at the same time understood very well the rapport de force, when it was possible to move forward or not. And to understand when there was a majority behind him. Mario Draghi understands what is essential and he did it very well. In the phase we are in now, it's necessary to mix the Trichet and Draghi approaches. Christine
Lagarde has the qualities to ensure this mix: giving enough attention to take steps forwards, but at the same time ensuring that the links stay close and strong. She is the right person for the right moment.

DM: One of your colleagues on the governing council said to me that he’s never seen somebody so socially competent as Christine Lagarde. She likes to get people on side, she talks to people. She spoke to the hawks to try to make sure they weren’t too irritated.

CC: It’s a question of priorities. Sometimes you need to move faster. Sometimes you need to move more cohesively. When it’s necessary to move faster, you need to use your time differently. When it’s possible to move in more orderly fashion, you need to spend time doing it. I think that in the present conditions, it’s easier, in terms of consensus building, because we’re facing an external shock. This is a shock common to all, where there is no risk of different evaluations about the national actions of different countries. It’s easier to create a bloc for team building.

DM: There are a lot of smaller countries now in monetary union. It started off with 11. Portugal was one of them. There’s now another eight. How does that change the governance? Linked to this, do you foresee new countries joining monetary union in the next five years?

CC: Some countries are asking to join the exchange rate mechanism [Bulgaria and Croatia – announced on 12 July] – the beginning of a move towards accession. Concerning the working of the Governing Council, I have seen in the past, from my times in Brussels, how it works when people are representing national interests and national economies. I don’t see that now. Our mandate concerns the euro area economy. What divides us is not the national approach. It is the way we look to the same indicators. Some Council members are more optimistic. Others are more pessimistic about the evolution of prices, and about the possibility to provide nominal stability. If you introduce more people on the Council, it changes the density of the views, not the underlying issues about of forming a consensus.

DM: Are you in the optimistic camp?

CC: I am in the realistic camp. I was one of the first, at the beginning of March, to issue a serious alert on the implications of the pandemic. I saw subsequently that my colleagues understood what I was saying.

DM: Regarding the mandate, let’s go back to the PEPP briefly. Some people say the PEPP is there to improve the transmission. Others say is it there to get inflation up to 2%. Which is it?

CC: If you want to comply with our mandate, you need to ensure that monetary policy will raise inflation to the target, that is, close to, but below, 2%. To do this, you need to ensure that the monetary policy is transmitted appropriately. There are two risks to the transmission: overall fragmentation, and monetary and banking transmission. We need to act on the two, to meet the final goal that is ensuring inflation will go up. This requires a repaired economy with employment and economic growth. There is no nominal stability if there is no transmission of monetary policy. And if there is no transmission of monetary policy, there will be no recovery. And if there is no recovery, there will be no revival.

DM: You said before that everybody on the Council is there not to represent their country but because they care about the euro area-wide mandate. One former member of the Governing Council says that was true up to the financial crisis. After that, he says, they became much more representative of their national countries. Is it a good or a bad thing that more members are joining these days directly from their posts as finance ministers?
CC: You should not accept this as a presumption of how the Governing Council behaves. If you know how the financial markets in your country are working, how the transmission of monetary policies is functioning, you are able to speak to your colleagues about the risks we all are facing. And if we are doing that, bringing our stone to a common building, it’s very useful. This is not based on positions favouring different nations. It is based on knowledge of reality. For instance, when my German colleague informs us about how prices are developing in Germany, it’s very useful for understanding our overall situation and stance. Taking into account the mandate, the dynamics and the culture of the Governing Council, it’s very difficult to think that someone coming from the political side will influence the way the body works. On the contrary, what do you see is acclimatisation of new members by those already there.

DM: Maybe the ECB has become mature enough that it can cope with this. If you remember, at the very beginning, the German government wanted to nominate Jurgen Stark in 1998 to become the first chief economist. But in the end, they said, ‘No, we’ll choose Otmar Issing because Stark is too close to the government’. But now, 22 years later, perhaps it’s possible. The ECB has got bigger, it’s become more established. Maybe now it’s more possible to bring in somebody from politics without interfering with the basic ethos of the central bank.

CC: You are right. The culture of the institution is already very established. Also, we have several lawyers coming from the Committees to the Governing Council. So, you have the servants of ECB themselves, very proud and very independent. And you have the independence among the governors. No one wants to be seen as a political puppet.

DM: We call it the Thomas à Becket effect. Sometimes a government will bring people in, thinking that they’re going to be very close to the government, and they turn out to be actually very independent. Maybe we’ll see that also with your successor. Thank you for this interview. You put together these ideas into a very coherent and compelling narrative. I look forward to staying in touch after you cease to be governor.

CC: A final word: if there is a moment when we need to create some virtual or real meeting point among central banks, to speak about monetary policy and financial stability problems, it is now. It is a very important role you can play in this situation. When times are good, nobody cares too much. When times are bad, we need to speak about independence, about the efficiency and effectiveness of instruments, in the right setting – in parallel institutions such as OMFIF.

DM: OMFIF was set up to do that. To be a neutral forum and an independent forum. We do not take sides. Thank you very much.