Telephone call between Vitor Constancio, former vice president, European Central Bank, and David Marsh, OMFIF chairman, 3 April 2020

David Marsh: What should be the role of the EU compared with national governments in helping alleviate the crisis?

Vitor Constancio: The crisis has shown that the state once again is playing its role as risk manager of last resort, absorbing private losses. The European Commission should use what the Treaty foresees related to aid to countries hit by natural disasters or extraordinary emergencies, and take over payment for certain types of national expenditures. The European Commission has an existing legal framework enabling it to raise loans with joint EU liability (Treaty article 122.2) and then finance some crisis-related national expenditures without increasing upfront the debt of member countries. If there is political will, this would be the quickest way to get money to countries. If there was full consensus in the Eurogroup, this would be very swift to enact and would be preferable to 'corona bonds' through a new mechanism. There would be a debate about conditionality, but right now, it should be very mild, addressing transparency and a long-term commitment to debt sustainability, without any number or time-frame.

DM: Is the stage set for Italy to apply to the European Stability Mechanism for a credit and then seek unlimited help from the European Central Bank via Outright Monetary Transactions ?

VC: An ESM credit line is not very attractive to countries at the moment, as only 'weaker' countries would use it, implying stigma and negative signals to markets – but this would also be efficient as the credit line exists already and can be activated without delay. ESM loans can be useful to deal with the crisis, with little to no conditionality for a lengthy period , say, 10 years. OMT would not be the way for a country such as Italy to access credit at present. The yield spread (BTPs against Bunds) is not sufficiently large to justify this.

DM: Is the ECB doing too much, with the emergency bond buying programme, PEPP, announced on 18 March? Some say the ECB is, again, 'the only game in town'…

VC: The ECB is not the only game in town as national governments have stepped in. However the Eurogroup will have to do more depending on how long the crisis lasts; the 7 April meeting provides a chance. -Budget deficits for all European countries will be around 10% this year or higher. We are all in this together. Countries are under pressure to act in a unified way

DM: What could be the role of the German constitutional court with reference to the PEPP? For this programme the ECB has lifted the 33% issuer/issuance limits and will treat the capital key question flexibly over time…

VC: Questions including at the German constitutional court concerning the ECB issuer/issuance limits and capital key are being exaggerated - the ECB is acting proportionately and within the legal framework set by ECJ . The 33% limit ~~is~~ was self-imposed, and therefore it is within ECB's rights to lift this as it sees fit.

DM: Where do you see central banks' room for manoeuvre?

VC: The ECB should focus on quantitative easing and liquidity. Further cuts in the negative interest rates are not advisable, they would not have the desired effect. Questions on central bank independence are bound to arise – it will be very difficult for central banks to raise interest rates even if inflation rises once recovery sets in, because of the negative effect on government and private debt service costs at elevated debt levels. However the oil price collapse and headwinds from crisis will keep inflation low for foreseeable future – a result of low investment, loss of productivity, damage to supply chains, and lower global trade.

DM: What is the right monetary-fiscal balance?

VC: Monetary policy can only do so much. The only way to boost economies and guide countries out of recession is for spending in the real economy via a fiscal stimulus that will increase demand for goods and services.

DM: What are the l**onger-term effects?**

-

VC: Recovery will be sluggish – states might have to think about how to do more to withstand the collapse of bank credit. The EU might have to suspend the European directive against government bail-outs for banks if, later on, the crisis puts the banks in danger and in need of public capital . One impact of the crisis might be to drive greater banking integration in Europe. Though the recovery will be slow, the downturn won't be as long as that caused by a 'war'. We are looking at one year of 10% budget deficits, not many years of debt accumulation.

DM: Will Jean Monet's precept hold - Europe is forged in crisis?

VC: The crisis has hit all countries worldwide so there will be global recovery. I am cautiously hopeful that, in Monnet's spirit, this crisis and the subsequent slow recovery might move Europe towards further fiscal integration. This is important not just in stabilising economies now, but also in developing further mechanisms such as capital market union. This shock is hitting all countries. There has to be a unified response across Europe with greater risk-sharing.