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ECB's De Cos Says Rising Deflation Risk Warranted More Stimulus Published in Bloomberg

Interview with Pablo Hernández de Cos, Governor of the Banco de España.

By Jeannette Neumann

Fears of deflation justified the European Central Bank's decision to ramp up its emergency bond-buying program, according to policy maker Pablo Hernandez de Cos. "Deflationary risks have increased and that's one of the reasons the European Central Bank is taking the action it is taking -- to ensure that risk doesn't materialize," the Governing Council member and Bank of Spain head said in a Bloomberg News interview in Madrid. "I'm among those who think that this crisis is essentially disinflationary, in the sense that some of the problems we had with low inflation are accumulating."

That view was echoed on Friday by Executive Board member Fabio Panetta, who told Italy's Radio 1 that coronavirus lockdowns have led to a "resurgence of deflationary pressures." The comments highlight the fear that the pandemic could tip the euro area into a Depression-like spiral of falling prices and wages if the hit to the economy isn't countered. The ECB's actions on Thursday were the latest in an unprecedented series of spending measures by authorities to save jobs and keep companies afloat.

Hernandez de Cos said demand will remain weak in coming months even as lockdown measures are lifted. Consumers are likely to stay cautious and continue to save as they worry about losing their jobs or the threat of a new coronavirus outbreak, he said, citing a high correlation between joblessness and savings rates in Spain.

The ECB boosted its pandemic bond-buying program by 600 billion euros (\$680 billion) to 1.35 trillion euros, and extended it until at least June 2021. Those purchases will go a long way toward soaking up the massive debt burdens the governments are building, though economists have already started to say it'll need to do more later this year.

"When the uncertainty is very high -- for example, when there is the risk of low inflation or even deflation -- the monetary policy response has to be even more forceful and even faster," said Hernandez de Cos. "It didn't make any sense to hesitate until the last minute about when you're going to extend and by how much. The sooner, the better."

While a minority of economists say that a combination of spending packages and supply disruptions could lead to an inflationary wave after the crisis, the ECB's own projections show consumer prices staying well below its target. It cut its forecast to 1.3% by 2022, compared with a goal of just-under 2%.

Chief Economist Philip Lane said in a blog on Friday that financial conditions are still tighter than before the virus, and that is “the opposite of what is required to counter the negative shock” to inflation.

President Christine Lagarde emphasized in a press conference Thursday that the goal of the pandemic program is two-fold: to reduce the risk of inflation falling short, and to calm market volatility that could splinter the euro zone – for example in stressed economies such as Italy. That latter issue of market fragmentation “is still present but it has more or less stabilized, precisely as a consequence of this program,” Hernandez de Cos said.

The ECB has stepped up its purchases of Italian debt in particular and Hernandez de Cos, 49 years old and a potential future candidate for ECB president, said the institution would continue to run the program as flexibly needed.

He said the rule that debt should be purchased in proportion to the relative size of each economy, under the so-called capital key, is a guideline but not a straight-jacket. That’s a potentially controversial stance because the capital key is largely intended to ensure the ECB doesn’t breach European Union law on financing of governments.

Hernandez de Cos said the central bank could align with the capital key at a later point over the entire life of the program, but now is not the time to decide. “The capital key is a benchmark that’s there but it’s not a constraint in the short run,” he said. “Now, what’s important, is that we are going to continue exercising the full flexibility of the program without considering the capital key as a restriction.”

He said the Governing Council didn’t discuss the possibility of buying bonds that fall below an investment grade rating, known as fallen angels, but that “obviously doesn’t mean we won’t discuss it in the future.”

He lauded the spending plans launched by national governments to shore up their pandemic-hit economies and said their programs were working hand-in-hand with monetary policy. “In this crisis, there’s more of an equilibrium,” he said.

“The national fiscal response has been very strong and the European response is getting progressively better.”