Yves Mersch: Interview in *Börsen-Zeitung*

Interview with Mr Yves Mersch, Member of the Executive Board of the European Central Bank, in *Börsen-Zeitung*, conducted by Mr Mark Schrörs and published on 8 April 2015.

*   *   *

Mr Mersch, the start of the ECB's public sector purchase programme has made a deep impression on the financial markets: the stock markets are up, the euro is sharply down and the returns on euro government bonds have clearly fallen again. How surprised are you by the strength of the impact of quantitative easing (QE)?

It's true, long-term interest rates have fallen further, in some cases to all-time lows. All in all, the financing conditions for the economy have improved. There are also signs that we will soon be moving into positive territory again in terms of lending. It would perhaps be somewhat bold to claim that the better mood in the economy is solely due to QE. But it is clear that QE is having a signalling effect and this channel is working very successfully.

But aren't such reports about the successful effect of QE on the real economy somewhat premature? Previously, even the ECB used to say that monetary policy measures take 12–18 months to have an effect.

Yes, but monetary policy also works via the signalling channel and in this case it works very effectively and quickly. Now we have to wait and see how the other channels work. However, the decision on QE certainly came at the right time.

Because the economy of the euro area was at a turning point, not least because of cheaper oil?

At the beginning of the year we had weakly positive signs. With QE, this development has strengthened.

But isn't there also a danger of "overdosing"?

The Governing Council will carefully monitor the situation every month. We have now adopted a plan that we intend to follow up on: we are making purchases to the tune of €60 billion every month until September 2016. This forms the basis for our March projections, which envisage a slow return to an inflation rate that is close to our understanding of stable prices: accordingly, we shall be at 1.8% in 2017. However, if we see that we are going beyond that figure, it would of course be appropriate to consider whether we need to adjust our plan.

In other words, if the new projections in June foresee an overshooting of the inflation target of just below 2% in 2017, as is currently conceivable, would you be in favour of a discussion to reduce purchases or to stop them earlier?

Let me say again: we have specified a course of action and we'll be sticking to it. If we see that it is bringing us more quickly to our goal, we are of course not so tied to our decisions that we could not adjust our course of action. Incidentally, that also applies should we do not come close to the target. We cannot in either instance turn our eyes from reality.

Some market participants are claiming that the ECB is putting its credibility at risk in the case of a reduction [of the purchases]. But wouldn't it also be a problem if the forecast were to rise above 2% and you were to continue with QE and not react?

What you are mentioning plays into the discussion on price-level targeting...

...in which a central bank specifies a certain price development which it has to achieve every year. If it doesn't manage it, the bank has to steer towards it all the more resolutely in the following year.

The proponents argue that we should declare this to be a new strategy. But in my view, that would be the wrong approach: it would be a fundamental change in an environment in which steadfastness and anchoring a proven strategy are very important. Moreover, in theory and under certain conditions this approach may be clever, but in practice, it is a highly questionable experiment.

So you don't believe in allowing temporarily higher inflation in future, because inflation was significantly below the 2% target in recent years?

I don't find this approach at all convincing. Such a change in our strategy would, in my eyes, be incompatible with stability. The Governing Council's decision refers to "…a sustained adjustment in the path of inflation that is consistent with its aim of achieving inflation rates below, but close to, 2% over the medium term".

QE is ostensibly the answer to the long-lasting very low inflation. But is that really so dangerous if it is due to falling oil prices?

I also distinguish between an undershooting of zero inflation, which is mainly attributable to temporary phenomena such as the price of oil, and on which we can effectively have no influence, and a general fall in the price level. Before January, however, the proportion of goods for which the rate of increase was less than 0.5% was steadily rising. Also, inflation expectations slumped from 1.8% to 1.4%. These were the arguments that persuaded me to recognise that we had to turn to the final resort.

This means you would have voted in January for QE if a formal vote had been taken in the Governing Council?

I've never said publicly how I vote in the Council – because that is forbidden and all those voting respect this.

Sometimes one has the feeling of being a "topsy-turvy world": the Fed, which has traditionally been very worried about deflation, is relatively relaxed in view of the oil-price-depressed inflation. The ECB, however, which has always warned against exaggerated fears of deflation is very alarmed. How come?

As far as I can remember, we have never been in a situation where things have turned negative so quickly. I would not say that in January we were already at a point where consumers postpone their purchases in the expectation of falling prices. But the danger was that we were heading for such a situation. In addition, lending has been falling for years. Since April 2014, the situation has been improving, but at a worryingly slow pace. That's another reason why we could not just sit back and say, things will get better by themselves. We have a mandate and should try to achieve that goal not only over a five-year cycle, but as soon as possible.

You mentioned inflation expectations. A closely followed indicator is the "5y5y" rate, i.e. the markets' expectations the of the inflation rate in five years' time for the five years thereafter. This rose at the start of QE, but only slightly. Are you disappointed?

We are not 5y5y fetishists. We know the weaknesses of individual indicators. But what has worried me was the sagging that occurred under a certain limit. When it dropped to 1.4%, it was a free fall and there was a risk of a de-anchoring of inflation expectations. At 1.7% to 1.8%, we are now back at a level of expectations that is more closely in line with our medium-term projections.

How great is the risk that the ECB may at some time no longer find enough bonds to purchase? Sure, ultimately everything depends on the price. But it can't be in your interest to pay excessive prices.

High prices inversely mean low interest rates – that is now precisely what we are aiming for. I don't think there will be any shortage generally: many euro bonds have been issued and are available on the market because foreign investors have other regulatory requirements. In one

segment or another there may be a shortage. Then we have to see how we handle it. Of course, the range of public offerings is defined very broadly and extends beyond central government. In any case, the programme is being constantly monitored.

Some people are speculating that the ECB could reduce its deposit rate of –0.2% still further in order to increase the pool of available bonds, as the rate forms the lower limit at which government securities can be bought with a negative return.

This is certainly a theoretical possibility. But we must always ask ourselves whether an instrument is appropriate and proportionate. Such a cost/benefit analysis, to my mind, rules out that we are going down further with the deposit rate. We have also repeatedly said that we have reached the lower limit in respect of the interest rates. Please take a look at our most recently published "account", the non-verbatim summary of the monetary policy discussion of the Governing Council members.

With the launch of QE the euro has fallen in value once again. It has stabilised more recently. Are you pleased about that? When does a devaluation become a problem?

Exchange rate developments are always dangerous when they are extreme and out of line with fundamentals. That still applies. For me, it's time for the highest level of alarm when attempts are made to use the exchange rate as an instrument – and under the pretext of returning to stable prices, in order to improve competitiveness. That would deviate completely from our obligations, as laid down in the EU Treaty. That would be a red alert.

But didn't we reach that point a while ago, according to some commentators from Rome or Paris?

There will always be atavistic reactions. But I do not want to overstate them. We at the ECB have no exchange rate target, and we don't even use the exchange rate as an intermediate target. We are aware that it plays an important role in inflation. That's all. Let me stress that it would be a mistake to regard the exchange rate as an instrument of general economic policy.

The QE programme is currently designed to come to an abrupt end between September and October 2016. The Federal Reserve has been finding out how difficult it is to exit and has been tapering its purchases. Does the ECB have to make some adjustments in that respect?

First of all, I'm very glad you asked me about the exit. Many others are only focusing on what else the ECB can do. We still have a lot of persuading to do. But of course you have a point, we absolutely have to avoid "cliff-edge" effects. The entire monetary policy is oriented towards smooth developments. So that's a question which we will have to deal with when the time comes. But we are not yet at that point.

But when embarking on such a policy shouldn't you have an exit strategy ready?

I am convinced that we have not yet arrived at a point where we need to conduct a public discussion on the exit.

In Germany there's a debate raging about the ECB's inflation target of "below, but close to, 2%". Some are saying that price stability is actually 0% and that it is crazy for the ECB to use all ways and means to create inflation.

We had a detailed discussion on this matter in the early 2000s under the ECB's chief economist at the time, Otmar Issing. We quickly and unanimously concluded that we should not have an inflation target of 0%. In that scenario we would tend to be deflation-oriented, not least because of statistical distortions in measuring prices. An economy therefore needs a little inflation in order to have a buffer. I don't think much at all of unsettling our definition of price stability – just as I don't think much of questioning our strategy, as we have seen in the discussion on price-level targeting.

Greece is currently another major issue for the ECB. How painful is it for you to rubber-stamp the emergency liquidity assistance (ELA) for Greece's banks in volumes of more than €70 billion?

For ELA decisions we apply our rules strictly. This works both ways: I'd really feel the pain if we didn't observe our rules. But of course we have to be careful that this step doesn't lead to hidden monetary financing of governments. This risk increases if a country has no access to markets.

With this argument the ECB is also rejecting Athens' attempt to raise the limits for the issuance of short-term government securities, the T-bills. Bundesbank President Jens Weidmann however goes one step further. He already sees a problem if Greek banks extend T-bills, i.e. perform a "rollover". Is he right or is he too strict?

The ECB's Governing Council has not yet reached a conclusive opinion on that matter. For me, this is a dynamic process: the more a country – and a banking system – loses market access and the less likely it looks to regain it soon, the greater the risk of indirect monetary financing, and the stricter we have to be. Our response has been to observe the current situation very closely and promptly in order to prevent any circumvention of the ban on monetary financing. The supervisory arm also has a role to play here.

That means that the course is set and that no more T-bills should be issued, but it can even amount to a requirement for Athens to reduce the volume?

We have to see how the situation develops. But I also uphold the applicable legislation.

The government in Athens is complaining that the ECB was less severe with the previous government in 2012.

No, the rules are the same. At that time there was a programme, a cooperative government and the prospect of a successful review of the programme and its implementation. Currently, we are far from agreement. Promises alone are not enough. That applies especially when they are undermined in public.

How frustrated are you by the government in Athens? The fragile recovery in Greece seems to be stalled and government finances are deteriorating.

The figures have clearly got worse. That's no surprise. It also shows how dangerous the crisis is if it leads to parties from the far ends of the political spectrum bearing responsibility which have no experience of government or of how Europe works. This then requires a period of adaptation in a phase when there is no time.

In your view, would it make sense to introduce capital controls in order to stop the enormous outflows of capital?

Capital controls are alien to a monetary union and they should only be invoked in an emergency.

Or is it too late because a lot money has already "fled"?

We certainly have to keep an eye on the situation.

How likely is it that Greece deliberately or "accidentally" leaves the euro area?

If you have a chance to shape things, you don't assume that the result will be an accident. Instead, you do everything to avoid an accident. That is our approach, and that is, I think, the approach throughout Europe. But one can also clearly say: we have our rules in Europe, and everyone must stick to them.

Large-scale purchase of government bonds by the ECB, new flexibility in the stability pact – is there a fundamental change under way in the monetary union, away from the idea of a stability union?

I would of course prefer to have no country in the [excessive] deficit procedure and debt reduction going faster. But compared with other regions in the world, we are not doing that badly. However we have to do much more to raise our growth potential. To that end, structural reforms are urgently needed. In that respect every country – and I stress every country – still has a lot to do. Some countries are still not tackling the issue of an ageing population. But I don't believe that we have basically said goodbye to a stability union. We still have the corresponding body of regulations. I would also be pleased to see that being applied in a more targeted way.

How can that be done?

It has been shown that common rules alone do not suffice to provide the necessary discipline. In my view, stronger institutions are therefore needed at European level, a deepening of the monetary union. The crucial question is then: what can we still do without changing the EU Treaty. I don't see much room for manoeuvre there.

Are you still convinced that the euro is more of a boon than a bane? Some observers have long been saying that it only sows discord.

I continue to stand by it: the euro has brought Europe a lot – economically and much more than that. I can only warn against allowing ourselves, as Europeans, to be divided. I'm glad that the political will exists in almost all countries to stand together. That also shows how strong the cement of cohesion via the single currency has become. It also makes me confident that together we can find a way out of this crisis.

In monetary policy circles there's a discussion raging about the "new normal". Are non-standard instruments and mini or even negative rates the new normal for central banks?

No. We are quite clearly in the unconventional area. That's why these measures have a time limit. In the case of some of them the question will arise whether in future they should be a regular component of the "normal" tool box. As for our purchases of government bonds from euro area countries however, I don't see that happening. Perhaps at some time there will be a new permanent monetary policy instrument for the ECB via a system of new European bonds. But I can't imagine that without a change to the Treaty. In addition, I remain sceptical about the concept of secular stagnation.

And what about negative interest rates?

I don't regard them as being justified over the long term either. We have taken these measures in order to return as soon as possible to our normal instrument, the positive key rate. Yet it's structural reforms that should take us back to an economic environment with no negative real interest rates.

So you believe that at some time we'll have key rates of 3% or 4% again? Many observers can hardly believe that and the problems the Fed is having in reversing its interest rate policy are strengthening such beliefs.

No question about it: if we don't manage to raise growth potential interest rates will not be able to rise in a sustainable way. That's why it's essential for policy-makers and business people to make the necessary adjustments. Rates at 0% are definitely not normal and shouldn't be so. And that's why the debate about higher levels of investment is so important.