Peter Praet: Interview with Bloomberg

Interview by Mr Peter Praet, Member of the Executive Board of the European Central Bank, with *Bloomberg*, conducted by Mr Alessandro Speciale, Mr Jeff Black and Mr Jonathan Ferro, and published on 17 November 2015.

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How can we estimate the impact of the tragic events in Paris?

I would like first of all to express our profound sympathy for the victims. It's something that concerns everybody. Now when we talk about the possible impact on the economy, in general, we have to take a holistic view. It's not so much the economy as the geopolitical environment that is impacted by these events. The impact remains to be seen, beyond the tragic events of last week. The main issue is the economic context of such events, which is a rather difficult one, we cannot deny that.

It's difficult because the euro area is still going through the aftermath of a balance sheet recession which started in 2008. As of today, the GDP of the euro area has still not recovered the level it had in 2008. That's one thing, and the second thing is the management of immigration in Europe which creates some strains at the political level in different countries.

How is the next round of staff economic forecasts shaping up?

It's too early to tell, of course, because the teams are working on it. But let me say that when we look at the flow of information so far, the economy is still in a cyclical recovery. Incoming data have been supportive to our base scenario. But we are also very well aware that downside risks are present and even that they may have increased in light of the weekend's events.

On the inflation side, the return to close-to-two-percent is at risk of being pushed backwards again. I know that today we just had the final data for October for inflation, we had 1.1 for the core inflation and 0.1 for headline inflation. But we remain in an environment of weak price pressures in the medium term. That has not really changed. We will have to see what the new projections show.

Hard data have been a little bit less encouraging. We see Q3, which was more or less in line with what we were expecting, but on the low side of estimates. We also had, from the German side, slightly less positive news on the real economy. It's not sufficient to say that the base scenario has changed, but I would say that the downside risks haven't decreased, probably rather, unfortunately, increased a little bit.

One important thing about the projections is that they are based on financial conditions, and financial conditions incorporate also expectations about policy actions – not only in Europe but also everywhere. Financial conditions have not worsened since the last meeting of the Governing Council, but that's also partly due to expectations of policy reactions.

Can you explain the ECB's assessment of how inflation is developing?

Looking at incoming data, I would say that data are more or less in line with our expectations. But this has to be seen in a context where we had repeatedly overestimated future inflation rates. In the last years, we have repeatedly lengthened the horizon over which we would get back close to 2 percent.

Mechanically updated projections suggest that the risk is present that we may again have to extend this horizon. And even if it's slightly, it's a repetition of a past pattern.

And then you go into the question of credibility of monetary policy.

If you observe for example, that the price people are ready to pay for protection against inflation is zero, or very low, that's not necessarily a good signal, as it suggests that they are not convinced there'll be inflation. And that could be related to scepticism about the ability of the central bank to influence inflation even five years ahead – which would be quite serious. You cannot just reject that.

Markets might be signalling that there could be some second round effects related to the fall in oil prices. Inflation expectations would then be hit at some point.

Finally they could also reflect a very pessimistic view on the future, and that's the more secular stagnation scenario where the falls of oil prices would be more the reflection of deep structural problems in the global economy. That's the most pessimistic view. I don't take that view, I think it's extreme. Indeed, after our communication at the last Governing Council meeting in Malta, you have seen that inflation expectations, five-years-five-years, have recovered – which is not the case for oil prices.

It's not a "normal" recession followed by a "normal" recovery. We have a cyclical recovery, but recently we have additional downside risks to our scenario unfortunately.

Is there a point at which the ECB's assessment of risks to the economy starts to actually erode confidence?

We say clearly that we have a cyclical recovery, which is moderate. The investment cycle is quite weak still. We know the recovery is fragile. There are a number of geopolitical issues that weigh on confidence in general. This fragility is a fact of the environment. I think what is different about the recovery is that this is the aftermath of what some have called a balance-sheet recession, and that starts to be better understood now. It's a stock adjustment, there are legacy problems which our societies have big difficulties in addressing. You have still in a number of countries non-performing loans weighing on the balance sheets of a number of financial institutions. We also see that insufficient changes in the way that European institutions function have been weighing on the recovery.

What do we still need in terms of European reform?

We have gone a big part of the way with the banking union, but there the last miles are very important. For example, we do not have a system where the private sector will share risks across borders, where capital and liquidity are fungible in pan-European financial institutions. A common deposit insurance would help, but it's important to allow a European bank to be able to operate in the euro area as a single entity. Not all banks would be able to do that, but we need to have a timetable where we say, four or five years from now the banks that qualify in terms of quality and quantity of capital will get a European license. You need to put a very serious, technical, timetable for that, and announce it. That would create a new environment for banking.

Is there a challenge to the ECB's credibility because of the change of stance on the effective lower bound of rates?

The story of the lower bound is a very simple one. For all non- standard measures there is not much historical experience, there was very little academic literature until recently. Many central banks thought the zero lower bound is zero, and when we initially decided to go for –0.1, we were not fully sure of the total impact on financial conditions in general and especially on banking. The negative deposit rate, like most non-standard measures – the forward guidance of July 2013, the LTROs starting in 2011, the TLTRO and the APP – delivered more than we expected in terms of their impact on financial conditions. What surprised us more on the negative side was the slow transmission of easier financial conditions on current and future inflation.

So what have you learned so far?

Our own experience with a negative deposit rate was more favourable than we initially thought. We then went to minus 0.20. Since then we also have the experience of smaller countries which cut the rates to even more negative levels. We also reopened the discussion on the zero lower bound. There is no decision which has been taken but it is true that, given the experience that we have seen, we thought in the Governing Council that there was the case to re-discuss the lower bound.

Have you looked at what other central banks have done?

Yes but one needs to be very careful when looking at the experience of other countries. Each central bank works in a different environment, what you see in a small open economy is not necessarily applicable in a larger zone.

Could the euro area tolerate minus 0.75 percent, like, for example Switzerland?

In terms of level, I wouldn't have any judgement in terms of 'they can do it so we can do it', that would be too simplistic. You have to look at the specificities of each one.

What's your thinking on how to avoid the so-called 'Cliff Effect' if QE were to come to a sudden end?

We are very well aware of that. I think at some point we will have to clarify, what happens after September 2016 and what happens with what comes to maturity. Quite a lot of securities come into maturity into the early years after September '16, this is something the Governing Council at some point will have to decide and communicate.

Some people say the ECB is dominated by the financial sector.

I strongly disagree with that, it's more the opposite. Since we implemented our Forward Guidance we have been signalling more of our reaction function. When we talk about our ability and willingness to act under a number of conditions, of course markets incorporate that.

What's your view on the need for further monetary policy action now?

There will be different views as usual in the Governing Council, there will be a very good dialogue on the economic assessment. You cannot prejudge at this time the decision on what combination of measures to take or not to take. The staff has also been tasked to look at the impact of all measures on financial conditions, on the economy and on inflation.

The Governing Council will discuss whether there is a case for further action in the context of heightened uncertainty. This is a key issue.

What would be the impact on the banking system of an even-more negative deposit rate?

What we have seen is that there is a pressure on banks' unit margins, but that's been compensated by volume effects – as there is more activity in the banking sector thanks to the support of monetary policy to the recovery. Nominal GDP has been better and NPLs have started to go down, and as a result banks have been able to reduce provisions. Globally you would see that the net effect of those measures so far has been positive on bank profitability.

Inflation has repeatedly undershot your forecasts…

It is key for a central bank to keep inflation expectations anchored, especially in a period of slack in the economy. And we have some signals that these inflation expectations are still fragile.

Is that still the case?

I think it's still the case. Long-term inflation expectations remain fragile. I never said they are de-anchored, I don't think they are, but there are risks and this is why we are considering further action. A possible de-anchoring of inflation expectations together with a lot of slack is a dangerous cocktail.

A lot of the latest wave of commodity price declines is demand related. At some point in the recent past you had a supply side issue, which is a windfall for consumers, but now a significant part is also coming from weak global conditions. Global growth this year will be the weakest since 2009.