Peter Praet: Interview in *Expansión*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *Expansión*, conducted by Mr Daniel Badía González and Mr Agustín Monzón Peña on 25 April 2016 and published on 29 April 2016.

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After last week's meeting, Mario Draghi repeated that interest rates cannot be cut indefinitely. Are negative interest rates close to their limit?

Since negative rates were introduced in 2014, they have been very effective. So far, the positive effect of an improvement in financial conditions outweighs any negative effects that may be associated with banks' earnings capacity or other financial stability risks.

On the other hand, it's clear that negative rates cannot be reduced indefinitely to ever lower levels. We have to monitor how the measure is being transmitted to the broader economy. In March we decided to focus more on the credit easing part of the long-term monetary policy strategy that we started in June 2014. We decided to launch a new series of targeted longer-term refinancing operations (TLTRO II) where banks can borrow funds at rates that can be as low as –0.4%, on the condition that they lend that money on to the real economy. This is a way to ensure that the easing impact of the negative rates doesn't stay within the interbank money market circuit, but reaches the broad economy.

Having said this, interest rates remain part of a broader toolbox. But deploying negative rates again in the future would require a distinct worsening of the inflation outlook. As Mario Draghi himself said, I don't think we're going to see these conditions materialising in the near future. But the instrument is in the toolbox in case risks re-emerge.

If the positives outweigh the negatives, why are negative rates coming in for such criticism?

I think the banks that are complaining aren't looking at the whole picture. They see the immediate loss associated with the tax on the cash they are holding with the ECB. They see the fall in unit margins if their loan book is indexed to low market rates. What they do not mention is that low interest rates are spurring more demand for loans, so they are able to expand their operations and collect more margins overall. They also don't refer to the fact that, in a better economy, the quality of their loan book improves. Spanish banks, for instance, have experienced a dramatic fall in non-performing loans, which would have been unthinkable if we had kept rates higher.

It is certainly easy to blame the ECB, but the truth is that the level of the interest rates is not the main problem for many banks. The problems are, rather, the need for some business models to evolve in directions that strengthen banks' capacity to successfully face competition, as well as tougher regulation.

Also in Spain, the squeeze on unit margins is not only due to low interest rates, but is also the result of competition. Part of this may also be due to the fact that the banking sector in the euro area has not undergone sufficient consolidation.

The new measures are improving liquidity conditions for the banking sector, but can they provide solutions to its capital needs?

Our measures have had a positive impact on banks' profitability and thus, indirectly, on their capital positions. For example, the relatively favourable lending conditions enable them to reduce their funding costs. As I said, the new TLTROs will reinforce these beneficial effects on banks' profits. More than in the past, when our long-term liquidity operations were positive mainly for banks (including of course Spanish banks), the new TLTROs will benefit both banks and the real economy.

Do you think the new refinancing operations (TLTROs) will be welcomed by the banking sector?

We believe that the new TLTROs will be even more favourable than the previous series and will be successful in helping to ease financing conditions. Even if the banks don't turn to us because they don't want to be overly dependent on the ECB, knowing that they have this option will give them sufficient comfort to keep credit flowing to the economy on attractive terms.

The ECB's actions have also provoked criticism from political circles, particularly in Germany. How far can the ECB go without political backing?

It's our belief that we have a lot of political support in Europe. Our policies are dictated by decades of monetary thinking and best central bank practices. The Deutsche Bundesbank has been the champion of this thinking and these practices. Central bank independence and low and steady inflation are written into the German founding law. In my opinion, the alternatives proposed by those criticising us are not very credible. If we raised interest rates now, it would no doubt abort the recovery of the economy and compromise the achievement of our objective.

And what's your assessment of Germany's position on the banking union?

I believe that Germany should be bolder with regard to completing the banking union. Completing the banking union in the near future is essential for a better-functioning monetary union. There are imbalances in the project that can't be resolved overnight, but it also can't take too many years.

Should banks limit their exposures to sovereign debt?

There are various considerations that need to be balanced when thinking about limits to banks' exposures to sovereign debt. First, we have seen that over-exposure to sovereign risk can undermine banks' financial health and business viability in times when sovereign credit risk surges. This clearly advocates finding ways in which regulation can discourage over-extension by banks to sovereign risk, but I would say country risk more generally, with a view to moderating concentration risk on banks' balance sheets. Second, we need to keep in mind that sovereign securities perform a well-defined function in banks' business activities, as they provide liquidity and hedging services for banks while guaranteeing some positive carry, at least in Spain. There is nothing abnormal or toxic about this practice: the fact that banks are so eager to invest in public securities has a lot to do with their general quest for a risk-free asset, an asset whose value is not subject to idiosyncratic risk. The ideal situation would be to have a pan-European asset which could perform this function. In its absence, banks tend to invest in public securities.

Are the measures announced in March sufficient to bring inflation back to the desired levels?

Assessing the impact on inflation will take some time: we have just started to update our projections taking into account the evolution of the economy since March and the new measures. The climate around the global economy has improved compared to February and March, although there are still many uncertainties, including of a geopolitical nature, which could have implications for growth and inflation moving forward. We want to make sure that the recovery is not derailed on account of new shocks.

If necessary, what additional measures could the ECB adopt?

We shouldn't be talking of new instruments. We must focus on the implementation of our recent decisions. By the way, two important components of the March package have not even been implemented yet: the TLTROs and the corporate sector purchase programme. That's very important, and it's what we said at last week's meeting.

I only wish to say that the Governing Council has demonstrated, over the years, that it has always had the ability, not just the will, to act. The ECB has always been able to act without being constrained by a supposed paucity of instruments.

Is "helicopter money" an option for the ECB?

Mario Draghi already pointed out that the use of this instrument would be very complex and fraught with legal difficulties. The option has not been on the table, not even informally.

Will increasing the size of the debt purchase programme make it more effective?

We haven't actually seen it become any less effective. But it's difficult to assess because it's part of a package with the rest of the measures. What is important to note is that, when we saw the need to increase the volume of interventions to €80 billion a month, we could recalibrate and increase the range of eligible securities under our purchase programme. We don't feel constrained by the instruments at our disposal.

Will the purchases of corporate debt help all companies and countries, or just the big ones?

It's true that most of the bonds available at present are issued mainly in only a few countries and by a limited number of large firms. But there are two things to note here. First, it's the realignment of portfolios that matters. If we go into the market and purchase bonds for cash, the sellers can use that money to purchase other assets, including those issued by smaller firms and in other countries. The ECB's purchases will be concentrated on just a limited number of bonds, but all bonds will benefit from the narrowing of spreads. Second, markets are never static. Currently, you may see a high concentration of issuance in a few countries by a few issuers. But, in our experience, markets are very unlikely to remain static. Our presence in the market will also spur supply in countries where today supply is limited.