# Peter Praet: Interview in *Financial Times*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *Financial Times*, conducted by Ms Claire Jones and published on 12 December 2013.

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***The European Central Bank has forecast inflation of 1.3 per cent in 2015, which is usually seen as the policy-relevant horizon. How can you justify not doing more now when inflation is forecast to be almost a third below your target two years from now?***

We aim at an inflation rate of close but below 2% over the medium term. Given the subdued outlook for prices, we are already doing a lot. We have cut rates. Since July 2012 our overnight rate has been in general lower than that controlled by any other major central bank. We have offered our forward guidance. We have extended the conduct of our main refinancing operations as fixed rate tender procedures full allotment until at least 7 July 2015.

So, after a prolonged period of low inflation, we would expect inflation rates to return back to rates closer to 2%. However, this will take some time given the nature of the shock, namely the unwinding of real and financial imbalances, and the possibly longer than normal transmission lag of monetary policy in such an environment.

But we have also said that we are ready to act again should risks to the downside materialise.

What matters, in particular, is that medium to long term inflation expectations remain firmly anchored in line with price stability.

***Mr Draghi said last Thursday that there had been a brief discussion of negative interest rates and that any further LTRO would have to involve an extension of lending to the real economy. Are these two policies for which you feel as though you could build a strong consensus of support on the governing council should economic – or financial – conditions disappoint?***

What is important here is to remember that the governing council unanimously – and I'd like to emphasise this – shares the same assessment of economic conditions. There is unanimity on the outlook; the view on the economy is very much shared in the governing council. Price pressures are going to be subdued for a prolonged period of time

As a result, we all agree to have an accommodative monetary policy for as long as needed. And even take more measures, if needed.

That's why we can say: we are ready to act and able to act.

***Under what conditions would you act?***

We are very well aware that price pressures are likely to remain subdued for a prolonged period of time but we expect inflation rates to converge again towards 2 per cent as the cyclical upswing of the economy takes hold.

We are at the same time very conscious that, if some of the downside risks do materialise, then – because price pressures are already weak today – we would act decisively again. This view is very strongly shared by the governing council members.

***What are the scenarios that could lead you to act?***

There are a number of downside risks that we have identified.

They relate to the state of the economy and downside risks to growth, a tightening of global financial conditions with undue spill-overs to the euro area, energy prices, and – last but not least – a fatigue in structural reforms in Europe. This would mean that investments do not pick up and that business confidence doesn't improve further. For me that's the most important aspect of all – that structural reforms are being implemented so as to improve growth potential, employment opportunities and overall confidence. However, for this last downside risk, monetary policy has clearly its limits in what it can do.

Another risk would be that, as a result of the comprehensive assessment, there could be some dampening effect in the short term. That risk is still fairly limited and temporary – and should be compensated for by the expansionary effects over the medium term, which will positively affect confidence in the nearer term. We will be monitoring this risk from a monetary perspective.

However, this potential procyclical effect of an AQR should not lead to softening the rules of the AQR.

The instruments you use to handle each scenario may depend of the nature of the shock. Each instrument has a different impact and any of the measures taken would depend on our analysis of the monetary and economic developments.

***Could you just say a little bit more about the possible impact of the AQR?***

A strong comprehensive assessment makes central bank action more effective. Monetary policy does not work as well if banks' capital basis is thin and insufficient to support lending.

In the US, you can intervene directly in the markets to transmit monetary policy stimulus, because the markets play a bigger role in financing the economy. Here, the pass-through of your monetary policy is primarily via the banks and it takes time. The comprehensive assessment should shorten the time it takes for monetary policy to impact the real economy. Indeed, it is easier for the central bank to support the economy as healthier banks tend to lend more.

The worst case, to say it very bluntly, is of a central bank providing liquidity to banks just to buy or carry legacy assets, and the banking sector doesn't restructure. This was typically the Japanese situation in the early 2000s.

Perhaps paradoxically, a rigorous AQR and stress test helps monetary policy. Appropriately treating banks' holdings of sovereign debt according to the risk that they pose to banks' capital makes it unlikely that the banks will use central bank liquidity to excessively increase their exposure to sovereign debt. This is because banks will be wary of the constraints placed on sovereign debt by the stress tests to which they are subject at the same time.

Therefore, should the procyclical impact of the AQR be significant, then monetary policy would be able to act – without hesitation and being reassured that the side effects of a liquidity injection that we have seen for the 2011–2012 operations would be minimised.

***So how would you assess whether the AQR was procyclical?***

Don't forget we have our two pillar approach: we analyse the business cycle, but we also look at money and credit.

We will see from the second pillar very quickly if the credit situation doesn't improve. At this stage of the recovery, what we see at the moment is quite normal. The big corporate firms do not have as many constraints as the SMEs. They have around €2trn in excess cash, they can access debt markets. The reluctance to invest comes more from the business confidence side.

***And if you did act because of the impact of the AQR, what exactly would you do?***

Depending on the situation, the central bank can decide on the most effective way liquidity provision can be provided.

There are no restrictions on the way a central bank provides liquidity to the banks via repo, a priori.

You want to reach your price stability objective. At the same time, you want to be sure that when you provide liquidity against adequate collateral, it doesn't reduce the incentive to restructure the banking sector. And so by having a well-designed comprehensive assessment – like the one we're preparing now – we are easing the job of the central bank.