Peter Praet: Interview in *De Tijd* and *L'Echo*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *De Tijd* and *L'Echo*, conducted by Mr Wouter Vervenne and Mr Marc Lambrechts, and published on 28 October 2014.

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Growth in the euro area has come to a standstill. When should we expect a revival?

We are now seeing a loss of momentum. It is striking that growth is abating in an early phase of the business cycle. We take that seriously, but we shouldn't exaggerate: our base scenario for a gradual economic recovery is still realistic. The risks have increased and deserve our attention.

Regarding recent developments, the widest gap between expectations and reality was seen in Germany. France was weak and has remained so. Growth projections for Germany have been lowered, for both 2014 and 2015. The weakness there reflects the slowdown in trade with China and Brazil and the impact of the Ukrainian crisis, but also technical factors such as a higher than usual number of days leave in the motor industry.

We can't ignore the feeble economic climate. That is one of the reasons why we took measures in June and September and further loosened monetary policy. But we shouldn't over-dramatise.

So you don't fear a recession?

No, I wouldn't say that. Confidence indicators for the third and fourth quarter suggest marginal growth in the euro area. That is rather worrying, as the momentum is certainly not strong enough for self-sustaining growth.

Meanwhile, inflation and inflation expectations are still falling. Is there a likelihood of deflation?

The risk of deflation is limited. I find it difficult to accept the high probability of deflation (30%) published by the International Monetary Fund for the euro area. Our models come up with much lower figures. But we do need to be vigilant. A prolonged period of low inflation harbours the risk that an economic shock may trigger negative inflation. If you're hovering close to zero and you experience a new shock, the risk of negative inflation is by no means negligible.

Falling oil prices exacerbate the risk of deflation

That's a concern, but what matters are the inflation expectations for the medium term. Is the decline in oil prices temporary or lasting? The fall in oil prices is bringing general inflation down, but the impact also depends on the rate of the euro against the dollar.

It's hard to identify the primary cause of the fall in oil prices: the increased supply or the weak demand. It would of course be serious if prices were not pushed down by low demand. Cheaper oil supports growth but also threatens to drag inflation expectations down too far. It is a mixed blessing.

Will the ECB take extra measures to boost growth and inflation?

We already further loosened monetary policy in June and September. We do not feel comfortable with the current low level of inflation and are closely monitoring the path of inflation. We have clearly stated, and that is new, that the ECB's balance sheet will increase considerably as a result of these measures. That is necessary because we want to stimulate lending. ECB President Mario Draghi has given an indication, but that is not an objective in itself. We do not target a specific balance sheet total, but rather inflation over the medium term.

Are the current measures sufficient?

Some observers doubt whether the current measures will be enough to bring about the considerable expansion of our balance sheet. We are stating clearly: if we need to counter the risk of a prolonged period of low inflation, the Governing Council is unanimously prepared to take unconventional measures. The debate on the need for extra measures still lies ahead.

What do you think?

As always, I will thoroughly analyse the new information. But let there be no doubt: if it is necessary, we will not hesitate. Nothing is being ruled out. We have two clear messages: we are planning a significant liquidity injection and we are keeping a close watch on the situation.

What can governments do to stimulate growth? Germany and France are holding talks on that.

Monetary policy alone is not enough. A coherent package of measures is required, with contributions from monetary policy, fiscal policy and structural reforms. This combination is not easy. If necessary, we, as the central bank, will not hesitate to do more. But the politicians must also shoulder their responsibilities. They must find the right mix of fiscal policy and structural reforms.

France is once again seeking more time to reduce its budget deficit to 3%.

I think that France must do more to restore public finances. But as structural reforms may have a negative effect on growth in the short term, the Stability and Growth Pact allows countries that implement more reforms to extend the deficit reduction programme over a longer period. The problem is that, in the past, many countries have abused that flexibility in fiscal policy. They did not do enough to stabilise public finances and did not reform their economies. That is why there is now a problem of credibility.

France is a special case. Unlike most crisis countries, it has always enjoyed favourable financial conditions, such as low long-term interest rates. So you can’t say that France was a victim of high interest rates.

What can Germany do?

Germany recently decided to lower the retirement age for some groups and to introduce a minimum wage. Entrepreneurs say that the reforms are weighing negatively on the investment climate. There was some complacency. Germany must now ask itself: how do we stay competitive over the next ten years. There is now much debate on the excessively low level of investment.

Germany has some room to relax its fiscal policy without jeopardising stability in the medium term. It can use that scope to step up investment.

I am always surprised that the United States takes a completely different approach than Europe. Some US policymakers say that we should forget about structural reforms in the current circumstances; we should only support demand and should not scare people with structural reforms. That is not what we believe in Europe, although it is of course true that market flexibility in the United States is far greater than in Europe.

What is your view of the new Belgian government's plans?

Now that I have a European mandate, I am, in a manner of speaking, no longer a Belgian. In theory, I can take a neutral standpoint. But nobody will believe that I'm no longer a Belgian. I still read Belgian newspapers and also take a professional interest in Belgium. I am a displaced European. I look at Belgium as I would at any other country. Belgium has used the small fiscal margin cautiously. Just as for other countries, it's good to announce all reforms at the start of the cabinet term and then to implement them properly.

What is your general assessment of the results? Are they better or worse than you expected?

Given that banks since July 2013, in the run-up to the publication of the results of the comprehensive assessment, have already taken more than 200 bln in balance sheet repairing measures, the result is more or less what was to be expected. At the same time, this test is only a very good first step and the results will be taken into consideration in the day-to-day supervision which the ECB will conduct as of 4 November.

Will the test be sufficient the restore trust in the banks? Was the adverse scenario of the stress test sufficiently severe? The inflation in 2014 is much lower than the stress test assumes and a deflation scenario was not tested.

A deflation scenario is not an explicit part of the test and we do not expect it to happen. But the adverse scenario of the stress test does include inflation very close to zero (e.g. 0.3% in 2016). The most important thing is that the set of shocks which we included in the adverse scenario leads to a capital loss of 263 bln, a very significant amount. But the exercise should not be seen as an assessment of each conceivable risk a bank can face. If this was possible, it would make day-to-day supervision largely redundant and the exercise is most certainly not a substitute for the day-to-day supervision by the ECB.

Can we expect positive results on credit provision and economic growth quickly?

The test as such is not sufficient to restore credit provision, but it is a minimum condition. The test, together with the balance sheet repair measures of the banks, should have an impact on credit provision in the euro area and thus be supportive to economic recovery, as banks will be able to access funding more easily, given that investors now have a clear picture and transparency has been improved.