

## **Peter Praet: Interview in *Jornal de Negócios***

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *Jornal de Negócios*, conducted by Mr Rui Jorge on 9 February and published on 16 February 2015.

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***The ECB has presented its quantitative easing (QE) program almost six years after the Federal Reserve System and the Bank of England. What took you so long to go in that direction?***

The Federal Reserve System intervenes traditionally by buying securities directly on the market, while we typically provide liquidity to the banks via temporary lending operations. As a result of the financial crisis, we have adapted our monetary policy tools: for example, recently we lent for longer maturities of up to four years provided that banks provide loans to the economy and we guaranteed very low rates for an extended period of time, through forward guidance.

***Why now?***

Monetary policy accommodation via the banking system has reached its limit. With its asset purchase program, the ECB wants to regain control over its balance sheet: we will decide how much base money we will inject in the system.

***Have previous measures failed?***

Monetary policy has had a big impact on the economy. Without all the measures we have taken since the beginning of the crisis, we would probably be in the midst of a depression today. Our measures have led to a significant degree of accommodation. Additionally, we managed to decouple our monetary policy from the United States in line with economic fundamentals. Recently we have also seen some positive effects from the credit easing measures we took over the summer, but given the persistence of too low inflation for a prolonged period of time, the Governing Council decided to take additional measures.

***Several economists question the effectiveness of QE in Europe: banks are still not in good shape; the euro area now has lower interest rates than the United Kingdom and United States at the time; and Europeans have fewer financial assets. How do you answer that?***

QE comes in addition to all the other measures of monetary policy accommodation. QE is intended and expected, in particular to strengthen one transmission channel through which non-standard monetary policy measures work, the so-called portfolio rebalancing channel. This channel depends on the amount of liquidity that is created by the central bank. QE will reinforce this channel, which was judged to be too weak otherwise.

***Do you have an estimate of the possible impact on inflation?***

The question is not so much to reach a precise figure of inflation at the end of September 2016, it is rather to influence medium-term inflation expectations. Our March projections will cover 2015, 2016 and 2017.

***One of the market indicators of the expected inflation rate in five years' time for the following five years was at 1.6%. This is still historically low...***

You cannot expect a big impact immediately. We have to start this programme, be patient and do what we said we would do.

***How would you describe the risks for your mandate of keeping inflation below, but close to, 2% over the medium term?***

We have had an extended period over which inflation has been below levels where the Governing Council wants to see it in the medium term that is below, but not too far from, 2% and that is why we decided to act further. We have not seen deflation, despite having negative inflation, but we did see a higher risk of deflation. If this risk were to materialise, it would be very damaging.

***People were a bit confused as to why it took so long to act, given very low and even negative inflation and the fall in expectations. Why was this?***

I don't agree that we are behind the curve. The measures we took in June and September resulted in a significant compression of loan spreads and yields, including in Portugal. They had a positive impact on financial conditions in general. The problem is that the volume of loans didn't follow sufficiently. We have seen some improvement, but it is still too little.

***Your measures are aimed at easing credit conditions. But Portugal is a very indebted economy. And several countries in Europe face that problem. How do we solve a debt problem with more debt?***

Indeed, in Portugal and other euro area economies some sectors need deleveraging, and this is what is steadily happening already. QE will help contain the adverse macroeconomic side effects of this necessary process of deleveraging. Portfolio rebalancing means some people will sell assets and get cash to buy other assets, or they will spend it partly. If they buy other assets, some will be outside of the Eurozone. Also banks could sell portfolios of credit to make room for new private loans and buy public debt.

***For QE to work, would you need aggregate demand to increase through more consumption and investment, or not?***

QE will stimulate aggregate demand through all of its components.

***The ECB has said that time is of the essence for approaches at the European level to address aggregate demand, such as the Juncker plan. We are still waiting for the results of a €315 billion plan that is leveraged 15 times. Are you worried?***

It is not just about having a common European plan. It is also about asking countries to reprioritise their budgets in terms of public investment and taxes, which is admittedly not easy to do.

***Should countries with fiscal space use it?***

You need to have fiscal space.

***When I look at aggregate values for the euro area, it is even better than those for the United States or United Kingdom. It is not as if the euro area is in a danger zone.***

You cannot reason only on aggregate, because one also needs to assure fiscal sustainability in each country. Moreover, the spillovers across the countries are relatively limited. So countries could use their fiscal space without compromising sustainability. There should be no illusion that a big demand shock will come from fiscal expansion.

***Without that demand shock, either with public or private money, QE will not work, or will it?***

Financial conditions are much easier and will support aggregate demand. Also, structural reforms in a number of countries have started to produce positive effects. In addition, you have to consider the oil supply shock, which is positive for growth, provided that inflation expectations remain anchored. This is important.

***Why?***

When inflation expectations are threatened by a shock, you may get negative impacts owing to possible delaying of consumption or investment. This is why QE comes at the right time.

***Why doesn't the central bank just print money and send a check to every household until September 2016. That would probably have an effect, wouldn't it?***

This point is made in some academic circles, but how should this money then be distributed? It would be up to parliaments to decide how to distribute it, but then the ECB would be directly involved in the monetary financing of governments, which it is not allowed to do.

***Wouldn't it be possible to find a solution whereby the exact money that is printed finds its way to the private sector without affecting the budget directly?***

But what would you do? Would you, for instance, give each person, rich or poor, a cheque for the same amount?

***This option, at least from what we have learned from others' experiences, also has a redistributive effect through a wealth effect: it makes the rich richer!***

Governments have to take care of redistributive effects.

***How important is confidence in the private sector?***

It is extremely important. The biggest risk now is that after years of lower inflation expectations and lower real growth there is a risk of an entrenched pessimism that might become self-fulfilling, delaying expenditure and investment, which in turn leads to underemployment and lower potential growth.

***What would you expect the main impact of QE to be in Portugal?***

The portfolio rebalancing effect will be quite significant. There will also be a steep drop in the lending rates that banks apply to households and firms in Portugal. We saw this happening even before the start of the programme.

***There is a discussion going on about the fiscal impacts of the operation in Portugal, both as a result of lower interest rates in the market and owing to the fact that the interest paid to the central bank will be given back in part to the government. And this depends a lot on how much you buy.***

Yes, but you have to look to all of the consequences for the economy, not only the consequences for the interest rates. The impact on debt is just part of it.

***You have decided that around 90% of the risk in sovereign bonds will be national, and 10% will stay with the Eurosystem. However, profits are supposed to be shared.***

To be precise, considering all the additional purchases, sovereign and European institutions bonds around 20% of the risk will be shared, and 80% will be borne by the national central banks. The legal acts have not yet been published. Several options were considered, but for the part of the overall portfolio that is not shared, the Governing Council intention is to have the same approach applied to both the profits and the losses.

***What is your evaluation of the current economic situation in Portugal?***

We have seen an improvement almost everywhere, including Portugal, which will also benefit from the reforms undertaken, the fall in the oil price and better financial conditions. The question mark hangs over what we call "reform fatigue", whereby, for example, some reforms have been suspended in recent months.

***There is a risk that Novo Banco will be sold below the value of the recapitalisation. Is this a problem from your perspective?***

It is premature to say anything on this.

***Your sustainability analyses imply levels of growth and primary balances in the next 10 to 20 years hard to achieve. How worried are you about the sustainability of the public debt in Portugal?***

The financial assistance programme and the policies implemented are in line with the conclusion that Portuguese debt is sustainable. The question is more whether the country can increase its growth performance in a structural way. If growth is weaker, it becomes more difficult.

***The rules of the fiscal compact, namely the debt reduction rule, imply primary surpluses of 3% to 4% of GDP every year for decades in Portugal and other economies. Few countries have achieved this for more than a few years. People are asking whether it is feasible.***

It is feasible. The question is whether the country will continue with the reforms and will be able to increase its potential growth. Otherwise, it will indeed be very difficult to achieve. I come from a country where we had around 6% of primary surplus and it was sustained for a number of years. But it is more difficult to reach a primary surplus than to sustain it.

***Portugal is expected to grow at around 1.5% to 2% in real terms in the next few years – is that enough?***

The question is always the interest rate you pay versus the nominal growth rate (that includes the effect of inflation), which is also important. It is challenging, and that is why the reforms are really essential.

***In future programmes and post-monitoring programmes will the ECB be out of the Troika?***

This is still under discussion. What I can say is that the ECB came to be in the Troika out of European necessity. The fact that the ECB participates very closely in the design of the programme, in a role that we saw as advisory, means more information and better assurances.

***The recent opinion of an Advocate General of the European Court of Justice is that the ECB should not get involved in financial assistance programmes.***

This opinion relates to the outright monetary transactions and states that being a part of the Troika might lead to a conflict of interests. It is not clear whether this can be generalised.

***The ECB says that it does not get involved in politics. However, it participates in the Troika and has influenced several countries to accept bailouts. How do you explain the ECB's influence to voters?***

We had weak institutions in Europe to deal with the crisis. The ECB was asked to participate in discussions on the financial assistance programmes in liaison with the European Commission. The fact that governments have implemented credible programmes, has allowed us to be more flexible in the context of the financial crisis.

***For instance?***

There are a number of rules in the ECB, namely defining the counterparts to our monetary policy, and the rules for accepting collateral.

***So if the ECB does leave the Troika, you will not be able to have waivers.***

We need to have assurances that imbalances are credibly tackled.

***Does that explain why you have stopped accepting Greek debt as collateral?***

The initial technical extension was possible, because we had this credible prospective of finalising the review, which made it possible to prolong the waiver. Recently, however, the Governing Council concluded that it is no longer possible to assume that there will be a successful conclusion of the programme review.

***What do you need from the Greek government?***

At the moment this is a topic for politicians to discuss.

***Could emergency liquidity assistance be extended for months?***

Emergency liquidity assistance (ELA) can only be temporary and can be given only to solvent banks. When you have a systemic crisis, you may need flexibility in terms of duration.

***Is a country that is cut off from ELA cut out of the Monetary Union?***

ELA is provided to banks, not to countries. And I will not comment on speculative scenarios. We are not in that situation. We suspended the waiver on government debt to be accepted as collateral, but Greek banks are still counterparties. When they have insufficient eligible collateral for monetary policy, they will have access to ELA.

***ELA is given by the national central bank, which bears the risk and should depend on its own judgment of the solvency of the banking sector. However, since last year it is the Single Supervisory Mechanism that supervises the banking sector. How does this work?***

Yes, it is the responsibility of the SSM to provide an assessment of the solvency of banks.