Vítor Constâncio: Interview in *Börsen-Zeitung*

Interview with Mr Vítor Constâncio, Vice-President of the European Central Bank, in *Börsen-Zeitung*, conducted by Mr Mark Schrörs and published on 31 December 2015.

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Mr Constâncio, when you became Vice-President of the European Central Bank (ECB) in 2010, could you have imagined that one day the ECB would be using all available means to drive up the rate of inflation instead of trying to curb rising prices?

That would never really have occurred to me at that time. It was completely unexpected for everyone. However, it is not just an issue for the euro area. Inflation is currently very low worldwide.

Many people, particularly in Germany, consider it crazy that a central bank like the ECB is trying to create inflation in any way it can.

As the ECB, we have a clear mandate and a clear target. The mandate is price stability, which we defined in 2003 as an inflation rate below, but close to, 2% over the medium term. We do not want inflation to be too high, above our target. But we also do not want it to be too low. That is our maxim, and that is why we are doing what we are doing.

Nevertheless, many people are asking themselves what is so bad about an inflation rate of around 0%, whether that doesn't actually mean stable prices.

You could, of course, question whether price stability does not mean 0% inflation. At first glance, that would appear to be a good thing for people. But you should also ask yourself why almost all major central banks have an inflation target of around 2%. There must be good reasons – and indeed there are.

And what are they?

First, measuring inflation accurately is difficult and both experience and the literature show that inflation numbers have a tendency to be higher than inflation actually is. When statisticians say that inflation is 0%, it is highly probable that it is in fact below 0%. That could lead to a potentially very dangerous situation. In addition, when inflation goes down, real interest rates rise.

You mean nominal interest rates adjusted for inflation or expected inflation.

In view of the decline in potential growth and productivity in the developed economies, it is estimated that the "real equilibrium interest rate", which provides full employment without creating inflation, is currently negative in the United States and probably also in the euro area. When inflation is so low, it is difficult to bring the economy into balance. Another reason is that wages are not flexible. Wages cannot simply be lowered when inflation falls. This means that labour costs rise, which makes production more costly and reduces competitiveness.

But many savers are worried about their pensions.

Savers are confused by the "money illusion". They look at nominal interest rates. But what really counts are real interest rates – what is left after deducting inflation. In Germany, for example, the real interest rate on deposits in 2007 was around 0%, because interest rates of 2.2% were offset by inflation of 2.4%. Now it is 0% again.

So is all the concern about expropriation through the current low interest rate policy overblown?

Allow me to quote the Bundesbank, which in 2014 came to the following conclusion: "negative real rates of interest have been the norm, rather than the exception, over recent decades." There is absolutely no basis for blaming the ECB for the problems of savers. Interest rates will only rise when growth and inflation pick up again. That is precisely what we are trying to achieve.

At the beginning of December, the ECB's Governing Council decided on further monetary easing. The financial markets were disappointed; they had expected more. The volatility was bigger than it has been for years. What lessons does the ECB draw from this?

That was undoubtedly the largest gulf so far between what we intended to do and what the markets expected. Both sides need to learn lessons. The markets need to understand our decision-making processes better, and must not allow themselves to get carried away by wishful thinking. But we also have to communicate better. We made the decision that we wanted to make. However, we did not want to give the markets such a surprise.

What does "communicate better" mean? Why did the ECB's Governing Council not try to dampen expectations in advance?

It is difficult enough to calibrate monetary policy correctly. But it is even more difficult to fine-tune market expectations. Sometimes our statements are over-interpreted.

Will the ECB's Governing Council, and in particular the ECB's President, Mario Draghi, find it more difficult to guide the markets after this incident?

We should also not exaggerate the importance of this one episode.

With regard to the future, there are very different expectations in the market. Some say the ECB has now "finished" or, at least, that the barrier to further loosening is very high. Others say that further measures are only a matter of time. Who is right?

It is too early to speculate about further steps. I would prefer it if our monetary policy did not have to change again in the foreseeable future. However, we are, of course, always dependent on the data. The decisive thing for us is the inflation outlook. Over 15 years we have achieved an inflation rate of 1.9% on average – i.e. below, but close to, 2%. We have kept the euro safe. We have delivered and we will continue to deliver. We have the tools that could help us reach our goal, and, if it becomes necessary, we will use them.

If the projections of ECB economists for 2018, which will become available in March 2016, show inflation persistently falling short of almost 2%, would that be a trigger for further support?

The deviation of inflation expectations from our medium-term target is what counts for us.

How concerned are you about the risk of deflation?

I have always said that I do not believe that the euro area as a whole could slide into deflation. But as I said, even inflation that is positive but too low poses significant risks. It weighs on inflation expectations if it persists, which then has an impact on wage and price decisions. That can make it even more difficult to reach our target. We have to be very vigilant about second-round effects.

Should the ECB's Governing Council believe that further measures are necessary, what would be the preferred instruments? For example, why has it now considered it more effective to extend the asset purchase programme (quantitative easing (QE)) until March 2017 instead of increasing the monthly purchases of around EUR 60 billion?

Letting the programme end in September 2016 would probably not have been enough to bring inflation to where we want it to be by the end of 2017. That is why we extended our programme – so that it has longer to take effect.

So there is more of a tendency to extend the programme?

The extension is what we considered appropriate and decided to do.

The Governing Council also further lowered the interest rate for its deposit facility to –0.3%. When will negative interest rates become a risk to financial stability?

I very much hope and believe that negative deposit rates are a temporary phenomenon worldwide and not a permanent feature of normal monetary policy. When potential growth picks up and inflation rises, they will be a thing of the past. Now, however, this instrument is being tried in many countries because normal interest rates are close to zero and central banks are faced with the problem that the real equilibrium interest rate is negative and inflation is so low. Neither development was created by central banks, but they are trying to overcome them.

Which isn't easy. Do you not feel simply overwhelmed as a central banker every now and then?

There have been calmer times for central bankers, I guess.

Is "helicopter money" one of the tools available to the ECB, i.e. the idea that a central bank prints money and gives it directly to the public?

The original idea of helicopter money refers to the direct financing of public expenditure. That is not an option for us. That is not something that we are considering. As President Draghi has said on this topic, the Treaty on the Functioning of the European Union prohibits direct financing of governments in the euro area.

Isn't there a great danger that the ECB's stance undermines the necessary adjustments in the economy, as the cheap money makes balance sheet adjustments unnecessary or keeps unviable banks and businesses alive? Some critics warn that the ECB is ultimately creating "Japanese conditions".

That is certainly not the case. Of course, no policy is completely "clean" – there are always side effects. But the responsible authorities must stick to their given target. For us, it is an inflation rate that is below, but close to, 2%. We do not ignore the consequences of our actions. But we must also fulfil our responsibility and others have to fulfil theirs. That also applies to potential risks to financial stability resulting from current monetary policy – basically, a task for macroprudential supervision, not monetary policy.

The Federal Reserve (the US central bank) has increased its key interest rate for the first time after seven years of a policy of zero interest rates. Does that make the ECB's job easier or more difficult in the long term?

Both scenarios are possible. Our task would be more difficult if bond yields in the euro area were to increase along with US interest rates in the medium term, but that is not likely. What is likely, however, is that the interest rate increase will have an impact on emerging market economies. That may lead to a further dampening of growth in these countries, which is already weakening. That would make it harder for us. In contrast, it would be easier if, for example, the "lift off" ultimately leads in the medium term to an increase in the foreign currency price of US exports. That would help to normalise inflation worldwide.

Some observers fear turbulence in the financial markets as a result of the almost unprecedented divergence between the monetary policy of the Federal Reserve and the ECB.

I don't see any particular source of risk there. Everyone understands that both central banks are reacting to their domestic situations – to growth, employment, inflation. And both history and theory clearly show that when countries ensure equilibrium in their national economy, that is positive in the end for the equilibrium of the global economy as a whole.

So you don't share the concerns that the dollar's appreciation could turn out to be stronger than expected, with negative consequences for the United States and emerging economies?

It is nearly impossible to predict exchange rates.

The biggest impact of QE appears to be on exchange rates. The ECB has therefore been accused of pursuing, at least indirectly, a policy of depreciation.

We do not have any sort of target for the exchange rate.

We have spoken about the ECB's mandate and target. Would you consider it meaningful to review both of these in the future, as you did in 2003?

No central bank is changing its inflation target at the moment and we are not considering anything like that either. I do not see any need to engage in such a discussion now.

President Draghi said at the start of December that, in the future, the Governing Council will have to take into account the fact that inflation has been well below 2% for a long time. This reminded some of the idea of price-level targeting, whereby if a target is missed, that shortfall must be made up for later. Is a rethink on the horizon?

That is certainly one of the over-interpretations which I mentioned earlier. I would never agree to price-level targeting. That is also not a consideration for us.

During the financial crisis and the euro area debt crisis, the ECB has continually gained more power and become a political player. What will be the consequences of this in the long run?

I don't agree with your assumption that we have become more political – that is simply not true. We had to be courageous in the crisis and make use of some exceptional, non-standard instruments. We have become more visible as a result of this, but not more political.

So you're not worried about the independence of the ECB? In US politics, efforts are being made to exert greater control over the Federal Reserve.

Some people don't feel comfortable with what the central banks have done in the crisis. I sincerely hope, however, that the majority understands that central banks played a decisive role in preventing the global economy from falling into a deep depression. As regards our independence, history shows just how essential the independence of central banks is.

But, in fact, isn't this independence at risk if the ECB rises to become the biggest creditor of euro area states with QE?

Compared with our purchases, the Federal Reserve, the Bank of Japan and the Bank of England have bought more sovereign bonds relative to the economic output of their respective countries. When we believe that an exit from the present policy is justified at some point in the future, we will take this step and there won't be major problems.

The ECB is calling for a "quantum leap" in terms of integration within Europe and the euro area. But it seems that there is hardly any desire for this in politics and among the general public. Should we always count on there being crises?

The lesson from the crisis is quite clear, namely that we need more integration within the monetary union. But, of course, everyone sees that the political willingness to realise this is rather low right now. That is the result of the economic crisis, the high unemployment. This is destabilising social and political systems in Europe. But I believe that the fundamental logic of the European project remains valid: in an increasingly interconnected world the countries of Europe have joined forces so that they are better able to promote their interests. Also, the European Union is already now an historic achievement which brought decades of peace and which nobody should risk light heartedly. I trust that further steps will be taken towards greater integration.

And what if that doesn't happen?

The alternative would be to call into question the whole edifice of Europe – and that would harm the interests of everyone. We must certainly be on guard: from time to time history can go mad.

Does the refugee crisis also call into question "the whole edifice"?

First, please allow me to say one thing: I very much admire how Germany behaved in response to the initial shock of the refugee crisis – the willingness to welcome large numbers of refugees without solidarity from other European countries. Now, as regards your question, we were all, and are still, concerned about the possible consequences, especially given the rapid turn of events in the beginning. However, it is my impression that the process is now under better control. At the end of the day, this could be a very good thing for Europe.

What exactly do you mean by that?

Europe is facing a serious demographic problem. The proportion of the population which is of working age is already receding significantly and, if nothing happens, this trend will continue. That puts downward pressure on potential growth and makes the financing of social security and pension systems an increasingly difficult task. An influx of people that are able to work, who can be integrated into the labour market, can help prevent this, but the practicalities are not straightforward and not a task a central bank can advise on.

The refugee crisis has superseded the crisis in Greece. During the summer it was said for the first time that, with Greece, a country could make an exit from the euro area. To what extent did this damage trust in the euro?

Only a country can decide on its own to leave the euro, it cannot be legally expelled, although pressure can be exerted. However, just to make it quite clear: the ECB has no say as regards the entry or an exit of a country. We are responsible for securing the euro and the integrity of the monetary union – regardless of its composition. Now, as regards your question: any discussion about the possible exit of a country weakens the monetary union as a whole and also means additional financial costs for all countries. Fortunately, the Greek crisis has now been overcome.

Really? Athens is again lagging behind vis-à-vis the reform plan.

There is an agreement and it is now the responsibility of Greece – and also of the other euro area countries – to meet their commitments.

Recently, ANFA – the secret Agreement on Net Financial Assets which covers the securities purchases of euro area national central banks – created quite a stir. There's a suspicion of clandestine monetary financing of states. The ECB has rejected this. But perhaps the most important question remains open: why is it that the ANFA volumes increased so strongly exactly in the crisis years?

I find that the discussion about ANFA misses the point. Firstly, we have a decentralised system of central banks. Each national central has its own tasks and costs and can decide on how these are covered. But, above all, the following also applies – no national central bank is able to increase its balance sheet indefinitely or freely. There are strict limits, which are decided on each year, as regards the size of these net financial assets of each national central bank. And this is closely monitored by the Eurosystem; all the more so given that we want to maintain a structural liquidity deficit in the banking sector so that financial institutions come to us for liquidity.

But that neither answers the question nor explains why some countries have made more use of it than others.

Now regarding the numbers, you should take into consideration that some of the figures mentioned in public are not correct, partly because they include emergency liquidity assistance (ELA) which exists only in very few countries. Excluding it the numbers must also be put into perspective: at the end of 1999, all net financial assets amounted to EUR 251 billion out of a balance sheet total of EUR 1.1 trillion. At the end of 2014 there was a figure of EUR 534 billion, against a balance sheet total of EUR 2.2 trillion. So, in relative terms, that's more or less the same. Moreover, the annual rate of increase of 5.5% on average corresponds to the increase in liabilities, for example, as related to more banknotes in circulation and higher minimum reserves. Alone banknotes in circulation rose by 9.2% a year since they were issued. Part of those net financial assets include net holdings of gold and less than one half of the EUR 534 billion is accounted for by domestic sovereign bonds – and that's on outstanding government debt of EUR 8.5 trillion. And something else is readily overlooked.

What's that?

When we took the decision to purchase sovereign bonds in January, we said that not more than 33% of a country's debt would be bought by the Eurosystem. And that's including ANFA. Under the agreement, if a central bank buys domestic government securities for its own financial assets, the Eurosystem will buy less if that is necessary to make sure the above mentioned limit is not violated. The whole ANFA debate is thus a pointless distraction.