Peter Praet: Interview in *Público*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *Público*, conducted by Mr Sérgio Anibal, published on 23 May 2016.

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The ECB has warned about the risks of a long period of low inflation. Aren't these two-and-a-half years of very low inflation already too much? Isn't there a risk of the economy being already in a situation of deflation?

Our monetary policy has been very much on the alert in order to avoid a de-anchoring of inflation expectations towards a lower level. We have always said this is key. And sometimes it is difficult for the public to understand why we act so strongly, trying to avoid a de-anchoring of inflation expectations to below 1% or close to zero. The reason is that when you go from an inflation rate of 2% to 0%, in a context where you have a lot of output gap, firms with excess capacity will try to underprice their competitors, and they can do so by reducing their prices, which means that inflation will fall below zero on aggregate. You go quickly into a deflationary risk scenario. So very low inflation in the presence of economic slack is a dangerous cocktail.

Is it possible that we are there already?

What we say is that the risks of de-anchoring have increased, obviously. And that is why we acted forcefully. We have seen in some countries some signs of de-anchoring in wage formation. But, this being said, we haven't concluded that inflation expectations are de-anchored.

Isn't that an argument for those who say that the ECB is acting too late?

The financial crisis started eight years ago. We had eight years of very bad economic performance with two recessions during a short period of time. The first phase of our monetary policy action was basically the period between 2008 and 2009, when the ECB provided liquidity to the banks. Then we had this big fragmentation problem brought about by a very severe debt crisis. This was the second phase of the crisis, which called for a change in our policy action and the peak of that new course of action was of course the "whatever it takes" remark by Mario Draghi. Because of this change, the situation started to improve. But in 2014, the recovery was showing renewed signs of weakening, with an acceleration in the pace of disinflation which was threatening the stability of inflation expectations. That's when we really started to address the problem of aggregate demand in the whole union. Our policy rates had been reduced repeatedly before, of course, and in the summer of 2013 we had already reinforced accommodation by starting to offer forward guidance on the path of future policy rates. But in June 2014 we brought the rate on our deposit facility to a negative level for the first time, with three further reductions in September 2014, in December last year and in March this year. Also, we started our asset purchase programme in March 2015. And in March 2016, mainly because of the emerging markets' shock which had weakened our outlook for price stability further, we took additional measures. With hindsight you can always say that we could have done it differently, but I think that what the ECB has demonstrated with its action is that we are absolutely determined to avoid deflation. All the actions we took to avoid a banking crisis and in the end the break-up of the euro, were instrumental in avoiding deflation.

But you didn't avoid this increased risk of de-anchoring?

We didn't really see high inflationary pressures in the boom years, so when the bust of the financial cycle came, after a short spike due to higher oil prices, inflation started to fall very sharply. After a renewed surge in commodity prices in 2010 and 2011, the reversal of those shocks set in motion a prolonged period of disinflation. When we realised that this process was starting to contaminate the domestic components of inflation, including inflation expectations, we acted very forcefully. We haven't succeeded yet in getting close to 2%, but on the other hand we really have avoided deflationary conditions. So I would say, given the nature and size of the shocks, it wasn't easy to achieve that result. Obviously, we are not satisfied with it and that is why we are persevering. And we have got the means to do it.

Does the ECB have the tools to face another shock?

The lesson we have drawn from our experience of the last few years is that we had the capacity to decide. We have a Governing Council with 19 Governors and six Board Members and we could make a decision. We could act when it was needed. We never had a paralysis problem or a chaotic decision-making process. We always had quite strong agreement on decisions actually. Not always unanimity, but very strong support.

And do you still have the instruments that are needed?

We have shown in the past that we can be very creative within our mandate. When people ask: "Are you ready for a new shock?", I always answer: trust us, we always find the means within the scope of our mandate. Some of the measures we took in March, such as TLTRO II and the purchase of corporate bonds, have not even started being implemented. So we still have accommodation in the pipeline.

On interest rates, can the ECB go even further?

In our guidance on interest rates we have said that rates will remain at present or lower levels. So this means that interest rates are still in the tool box. The question is of course the conditions under which we would decide to use that instrument, because it is clear that the negative rates at some point have also side effects that start to become more important, namely on the profitability of banks. But, on balance, the positive impact is dominating, that was our judgement.

And as for the asset purchases? Have you reached your limit?

There are different tools, including purchase of assets, but you don't open the door when you haven't even implemented one part of the programme. The important message is that we have not felt hindered in our action by a lack of instruments.

Aren't you constrained by what governments don't do?

Monetary policy can't do it alone. We have always said that we need a comprehensive policy response. We need structural, fiscal and monetary policies. But at the same time, we cannot make monetary policy decisions conditional on the actions of others, because you have a mandate which is unconditional, namely it does not depend on the actions of others. Our institution was created with a mandate – price stability – but also with the tools to achieve that, so we don't shy away from our responsibility. We do it. We are not hindered by the inaction of others. At the same time you also warn other policymakers that monetary policy will not solve the problems of low structural growth and unemployment.

In some countries, it is often said that monetary policy can reduce the incentive for reforms…

I don't think this is proven. Some people defend the opposite, that with monetary policy you make reforms potentially easier. I think that for reforms what matters is not so much what happens in monetary policy, it's really the political cycle.

How is the ECB dealing with the fact that its policy affects in different ways the countries that save more and the countries that are more indebted, such as Portugal?

Within Economic and Monetary Union (EMU) you have indeed countries that had a very pronounced financial cycle, for instance Spain or Portugal, and then a big correction. And then you had other countries such as Germany, with no financial cycle and with excess savings. This is a situation where some countries of the monetary union are creditors and some are debtors. It is important to say that in all the adjustments that we had, looking at the union as a whole, you had a compression of demand, because this was very strong in the crisis countries, but you didn't have compensation from the surplus countries in terms of expansion of domestic demand. In Germany, for example, GDP did very well throughout the crisis, but domestic demand was relatively weak. At the end of the day, the current account surplus that we will have in EMU is 4% of GDP, which is huge, with Germany having almost 9%. There's an excess of savings. Before the crisis we had a current account range of -1% to 1% of GDP. It's an imbalance that is difficult to resolve.

The surplus countries are complaining that they are the ones that will be hit by negative rates. Does this affect the ECB's decisions?

I don't think the Governing Council changes in any way its capacity to decide because of political debates. We do what we have to do as good central bankers. We are unanimous in defending that view, even if we aren't totally unanimous in the measures we take. The dominant fact is that we are unanimous in our intention to reach our inflation objective and support the economy.

The ECB has often made recommendations to and expressed criticism of deficit countries, such as Portugal and others. Is it fair to say that the ECB has not been so vocal in criticising or recommending policies to countries that have surpluses?

It's a very good point. We had to go through a balance of payments crisis in the deficit countries because money was flowing out and we don't have a good adjustment mechanism in the EMU for asymmetric shocks. And the question in those countries was a big loss in competitiveness. There were structural reforms in those countries. At the same time, when those countries were hit by asymmetric shocks, there was no compensation by other countries. It is a problem that is quite difficult to solve, but it is a fact that EMU hasn't functioned very well in this respect. One worry is that the fundamental reflection about how to make EMU work better is not advancing sufficiently. Not all is negative, of course. We have managed to set up better mechanisms to deal with sovereign debt crises, but you are still in an unclear position when dealing with issues of sovereign debt. And we have banking union, we are especially advanced in terms of supervision, but we have not finished it.

The fact that banking union is not finished, doesn't that lead to small banks in small countries being bought by big banks from big countries?

I know this is a big discussion here in Portugal. I always have problems in understanding why that would be a problem. I experienced the crisis in Belgium with Fortis, and that bank represented a huge risk for that country. Now, it is part of BNP and this has been absolutely instrumental in avoiding a catastrophe. For Europe, this is an important question. You see the banking systems are in general more national than they were. Not in Portugal, but in many countries. The banks, even when they have subsidiaries, are tending to manage by way of separate entities more and more. Banks today are exposed to country risk because most of the assets are related to the country. This means that, if you have a shock in the country, the banking system is not diversified enough. Of course, the fact that we are in a monetary union limits the room for manoeuvre: you don't have the exchange rate instrument, you have a single monetary policy. So it is absolutely vital to evolve towards pan-European banks, banks that are geographically diversified and also that would be backstopped by EMU as a whole.

So what you are saying is that, in a monetary union, if small countries want to have safe banks, they have to forget the ownership question?

I think what matters in banks is good governance, not national ownership. You can always have local banks, that's not the problem, but having the whole banking system exposed to the local economy in a monetary union like ours is a dangerous combination. We have two problems in the euro area: a fragmented banking market and the lack of common backstop. It cannot be done in one day, but you have to spell out how you make the transition to it.

Monetary policy in Europe is done essentially through banks. Isn't that a problem? Is there no other way to get the money more directly to households and companies?

As for helicopter money, we are not discussing that. It's true that the main transmission mechanism of our monetary policy is via banks. But when you cut rates, people also have an incentive to consume more. Consumption has increased more in relation to real disposable income in some countries. Also, think about portfolio rebalancing: when we buy bonds, the sellers, which are not necessarily banks, get liquidity. What do they do with the cash? Some people spend it, others reinvest.

Aren't you benefiting more the rich than the poor?

I'm not convinced. If we avoid a recession or we facilitate the recovery of the economy and unemployment goes down, the distribution effect of that is very important. You should not look only at asset prices, such as share prices, but also at the impact on the economy.

In Portugal, should we believe that the ECB's measures will make banks lend more when the demand for credit is so low?

In a weak environment, you have growth but credit is still negative year on year. In general, in Europe, there is weak demand for loans. As the banking sector has not really consolidated enough, the biggest issue for banks now is too much competition. Our Bank Lending Survey shows that there is increasing competition in the banking sector. The good news is that rates are passed on to customers, but at the same time banks don't have enough profits to recapitalise. There are big challenges in the banking sector in many countries in Europe, and Portugal certainly is one of those countries.

What do you think of the Portuguese plans to create an entity to deal with bad loans?

Developing a market for bad loans is key. But there are many conditions for it to work. In Spain they did it very early, but most of their non-performing loans were related to real estate exposures, which are easier to deal with than with loans to SMEs, as in Italy or in Portugal. These loans are much more difficult to price. If you, as a banker, try to sell them, the buyers will not know exactly what they are buying, so the price is going to be very low. These are technically very difficult things to do.

How decisive do you think the ECB has been in the last three years in keeping Portuguese bonds interest rates relatively low?

One of the main factors why Portuguese rates went down was that the country completed the programme.

So you don't feel that the country is dependent on the ECB's low interest rates and its promise of support in case of need?

We have seen that interest rates in Portugal have recently gone higher. This shows that market discipline is present, in spite of the fact that the ECB is buying sovereign bonds. Portugal should not forget this message: market discipline is still there. And then there are the ratings. In the asset purchases, we look at the assessment of rating agencies. There is one with the minimum, and it is BBB-…

If Portugal loses that rating, what would the ECB do?

It's very clear, we only buy investment-grade assets. We can have a rating waiver, but this is subject to a programme. So there is no ambiguity there.

Don't you think it's strange that the ECB's action regarding Portugal is dependent on a single rating agency?

The ECB relies on four recognised rating agencies and has an economics department looking at the vulnerability of countries.

Probably better than the ones at DBRS, I assume?

The rating agencies have to fulfil a set of criteria. You can say: why don't you do your own ratings? We certainly can and do make an analysis to cross-check the conclusions and assessments of the rating agencies. But it is good practice to have this cross-checking going in both directions: our assessment also needs some double-checking by outsiders.

The IMF calculates that, at the present rate, the ECB will reach the limit of Portuguese bonds that it can buy at the end of the year. Will Portugal have a problem here?

I don't want to comment on this.

You talked about market reactions to the latest developments in Portugal. And you, are you worried?

The markets are somewhat worried, but not excessively. So there's still the benefit of the doubt. The fiscal direction has been confirmed but a number of things are not clear for the budget of 2016. And the number for nominal GDP growth looks on the high side. There is a political declaration of continuity and of following the rules in Europe, that's positive, but there are some doubts about the details and the macro assumptions. So it is something we are following and I think the government is quite aware of the fragility of the situation. The other thing we are following is structural reform. The Portuguese plan has six priorities, one of them is social cohesion, which I think is quite important. But there are some of the reforms that are to be reversed and we need to ask a number of questions. What are the budget implications, for example, if you go back to 35 hours a week? It is still in a period where there are question marks.

The government thinks that the priority in the reforms has to shift towards education and social cohesion, instead of flexibility in the labour market for instance. Don't you agree with that?

I think the reforms have to be continued. But it's up to policymakers to decide about distribution and where you put the accent, but in the end what we want is a country that is more stable, has more productivity and financial stress is reduced.

And on the banking sector, what do you think of government policy in that area?

It's still unclear. The indicators show that the banking sector is still fragile, the adjustment is far from finished, and it is still difficult to see what the strategy is here. For example, an asset management company is a good idea, but it is technically difficult to do and can take time to become operational.

And how do you see the possibility of nationalisations?

If nationalisation means deciding on the allocation of credit on the basis of unsound economic criteria, it is not a good idea. If the problem is about a private bank allocating savings badly, then you have to see why the bank is making bad decisions. That usually means that the owners or managers of the bank are not good. What a bank needs, whether it is state-owned or not, is good governance and control over the soundness of credit decisions. We have equally seen examples of bad public and private banks.

We have had the troika since 2012 and now we still have problems with the banks. Shouldn't that have been addressed during the programme?

Banks were a priority. In Portugal, there was a lot of credit compared to deposits, so in the programme there were a lot of constraints on that, which means a crunch. It's difficult to judge, ex post, because you have to see the conditions at the time. What we know is that the lack of a banking union when the shock came very much amplified the crisis. And we have not yet finished the banking union. Fundamentally, Portugal has longer-term growth issues. It has made a huge effort in the past few years but needs to persevere.