Benoît Cœuré and Joachim Nagel: Interview in *Börsen-Zeitung*

Joint interview with Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, and Mr Joachim Nagel, Member of the Executive Board of the Deutsche Bundesbank, conducted by Mr Mark Schrörs of Börsen-Zeitung on 12 September 2013, published on 18 September 2013.

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Dear Mr Cœuré, Dear Mr Nagel, former US Treasury secretary Henry Paulson has warned about a new financial crisis. The BIS has called it a "phenomenon reminiscent of the exuberance prior to the global financial crisis". Are we already sowing the seeds of the next financial collapse?

Nagel: A long period of low interest rates increases the risk that market participants will "search for yield". Overexuberance in the markets could pose risks to financial stability. As central banks we have to monitor that very closely. This is all the more true because we now have a major share of responsibility for macroprudential supervision. At the moment, I see a low risk of a crash of the kind you have described.

Cœuré: In this moment I would be less worried than the BIS is. But I'm talking about the here and now, not about the future. In the future we have to be very cautious.

What do you mean? This BIS is especially worried that historically low yields led to a continuing squeeze of credit spreads and increased issuance of riskier bonds.

Cœuré: We know that there is a risk of asset price bubbles if there is a lot of liquidity. We have to remain very vigilant. But you also have to keep in mind that the whole regulatory framework has changed radically. Before 2007 banks and other financial actors have borrowed to invest in risky assets. Now the ability for banks to do so is much more limited. And with Basel III we will get even higher capital requirements and the leverage ratios. But there is no reason for complacency.

In Germany a lot of people fear a real estate market price bubble.

Nagel: We have emphasised several times that we are monitoring the increase in real estate prices very closely. In the past few years, prices in Germany have risen distinctly – especially in urban centres. However, there do not appear to be any price bubbles at present. We therefore see no acute financial stability risk for the moment.

And what about the euro area as a whole, Mr Cœuré?

Cœuré: Currently the superfluous liquidity that has been created by the ECB to fight the crisis is coming back to us. Therefore we see no material risks of bubbles and even less of inflation. When the situation improves and liquidity finds it way to the real economy, this could change. As soon as we see risks of asset bubbles or of inflation, we will have to start withdrawing liquidity. But again, this is still a remote perspective.

You mentioned the tighter rules for banks. But there are other segments with less or even no regulation – for example the shadow banking sector.

Nagel: If one sector is heavily regulated and another less strictly, this may provide an incentive to sidestep the regulated part. Credit intermediation outside of the sphere covered by banking regulation could give rise to systemic risk. We need to identify this risk and take action if required.

A big issue for markets is the looming exit of the US Federal Reserve ("tapering"). This has already created turbulence. What will happen if tapering really starts? Will it get even worse?

Cœuré: I think the Fed is very aware of the importance of having a smooth transition towards the exit. We fully trust in their ability to steer markets through that process.

But the recent weeks have not been "smooth", right? For example, yields on ten-year Treasuries have increased significantly and this caused capital market rates worldwide to increase – including in the euro area.

Nagel: When looking at yields, we also have to realise where we started from – yields were at very low levels. There was certainly an increase. But I would not characterise it as "exaggerated".

So fears of a bond crash such as in 1994 are overblown?

Nagel: The IMF warned of a repeat of 1994, when Fed policymakers did an about-face. At the time, yields on two-year Treasuries rose by nearly 400 basis points within the space of a year, and growth then collapsed in 1995. The recent rise in interest rates, however, is more of a return to normalcy from the hitherto very low values than a repeat of 1994. At the beginning of the tapering discussion there was a little excessive exuberance among markets. But now market participants understand better what the Fed is going to do. And the Fed knows the markets very well. I'm not worried about what the Fed will do.

Cœuré: We must see the difference between the short and the long end of the euro area yield curve. The long end of the curve has always been driven by arbitrage, activities of market participants – and we are not going to suppress that. This is how international financial markets work. What really matters for us is the short end. There we wouldn't like shocks from outside the euro area to drive money market rates to levels not consistent with the situation of the euro area economy. This is the reason why we have decided to give forward guidance: to make sure that money market rates remain appropriate for our economic fundamentals.

But market participants do not seem to be convinced. Money market rates – for example the Eonia – are higher than before the start of the tapering discussion.

Nagel: Are they really not convinced? I have a counterquestion: Where would Eonia be today without forward guidance?

Cœuré: Exactly. We have already seen some degree of de-correlation between the US and euro money market rates as a result of forward guidance. But of course it remains to be tested.

What does that mean?

Cœuré: Our forward guidance should protect the euro area economy along the whole recovery path. If the Fed – as intended – starts tapering the QE, then there will be other developments in the global economy. In that case the guidance will help the euro area economy to be shielded. This is the purpose: We see the value of the guidance not only in what happened since July. What is more important is what will happen over the horizon of forward guidance, that is, an extended period of time.

And what will happen if rates increase further, but – as in recent weeks – also because of better economic data from the euro area itself and not only because of the US influence?

Cœuré: We are looking at it closely in an environment where global financial markets are generally more volatile. We want to make sure that money market rates don't overreact even to positive economic news from the euro area. Their reactions should remain in line with the economic situation.

But it is clear that the ECB is aiming at the – short-term – money market rates and less so at the – longer-term – bond yields, right?

Nagel: That is the tradition of monetary policy in the euro area. We are much more focused on the short end of the yield curve. With our forward guidance we also want to stabilise expectations at the short end. Forward guidance can help reduce uncertainty about future developments in policy rates and can thus also have a stabilising effect on longer-term interest rates.

Cœuré: I would like to add another reason: We need a functioning market at the long end of the curve. One of the issues that we have been facing before the crisis was lack of price discrimination in the bond markets, both for private and public issuers. Market discipline had de facto disappeared. That has not served the euro area well. When you think about how the euro area should look like and function after the crisis, one desirable feature would certainly be that market discipline works and is effective at the long end of the curve. I don't think that central banks or public authorities should steer long term rates.

But some critics of forward guidance say that central banks should not try to "fine-tune" markets at the short end, either.

Nagel: To be honest: I really don't understand this argument. This "fine tuning" was even greater before the crisis. For our refinancing and fine-tuning operations we always tried to estimate the liquidity needs in such a way that at the end Eonia was pretty close to our MRO rate.

Cœuré: It is normal that central banks monitor short term money market rates. This is about the transmission of our monetary policy. This is our core business. But the further we move along the yield curve the less legitimate central banks are to manipulate prices and to substitute market forces.

You mentioned the influence on market prices. In recent years central banks have pumped enormous amounts of liquidity into the markets. This has eliminated price mechanisms. Is an exit without turmoil possible?

Cœuré: You are absolutely right, central banks around the world – the Fed, the BoE, the BoJ, and we at the ECB – have injected so much liquidity into the markets that we have suppressed price mechanisms to some extent. But this period will end. Market participants must learn to price risks correctly again. And they have to get used again to the idea that markets can go both ways – up and down.

The tapering discussion and the turbulence seem to suggest that this learning process might become very difficult.

Nagel: Financial markets always have a tendency to overshoot the mark a little bit. But all in all my impression is that the learning process is making progress.

Cœuré: One proof of that seems to be the situation in the emerging countries. Markets have not adjusted identically in all economies. Countries with better fundamentals are less affected. Market participants look at the fundamentals and differentiate again. This is a good sign. We need properly functioning markets.

Nagel: Perhaps the turmoil surrounding tapering was even helpful.

In what way?

Nagel: By reminding market participants not to forget that, sometime in the future, there will be an exit from non-standard monetary policy measures.

Cœuré: Yes, it was a useful reminder.

Nagel: From time to time we have the feeling that banks are getting too used to these extraordinary circumstances. There is a risk that they might change their business models in a way we do not approve of. Banks have to understand that the current monetary policy regime is truly exceptional: the ECB's mandate is price stability – and the ECB Governing Council's interest rate policy is oriented to this mandate. The Governing Council expects the euro-area economic outlook, and thus also the outlook for price stability, to remain dampened for some time. However, I do not expect interest rates to remain low for years – not least because the cyclical stimulus of the ultra-loose monetary policy will diminish over time and risks to financial stability will increase. Full allotment at a fixed rate – this will not be the reality in the future.

Cœuré: This is not only true for banks but for all market players: There was a need for central bank action in the crisis to avoid a collapse of the system and in so doing to protect price stability. But we will withdraw them. And market participants will have to live again with higher levels of interest rates. With our decisions we gave them time. It is important that they use this time and prepare themselves and become more resilient. But there is one important point I would like to stress.

Which one?

Cœuré: The timeline of the exit in the US is completely different from the one in the euro area. For the euro area economy an exit at this moment in time would come way too early. Our judgement is that the economic recovery will be very gradual. We still need a high degree of monetary accommodation to protect the recovery. Or to put it another way: We should not steel the patient's crutches before he is able to stand up and walk by himself.

Nagel: I agree one hundred percent. Given the dampened euro-area inflation outlook, the monetary stance is appropriate for the time being. This is why we have introduced our forward guidance. But it is also clear: if new data cause a change in the outlook for price level stability, we will also modify the monetary policy stance. Forward guidance is not a paradigm shift in the ECB's monetary policy and, above all, not an unconditional promise to keep central bank policy rates low over a relatively long period of time.

Cœuré: And this is also the most important reason why we delivered our guidance the way we did. We have one single objective and this is medium-term price stability. So we will move out of guidance when we see upside risks to medium term price stability.

Besides forward guidance, markets have been talking a lot about OMT and the upcoming decision of the German constitutional court. What would be the implications if Karlsruhe imposes tight constraints on OMT?

Nagel: It is not helpful to speculate about the upcoming decision of the court. We expect to see a legally balanced outcome to the pending case. The Bundesbank has expressed its criticism of OMT and stands by its reservations. The conduct of OMTs involves risks of which we must be aware at all times.

Mr Cœuré , do you agree with that assessment?

Cœuré: I also do not want to speculate. We at the Executive Board of the ECB think that the potential risks of the OMT – also those raised by the Bundesbank – have been identified and mitigated through the design of the programme. OMT has helped us eliminate the risk of an unintended euro exit, which could have had catastrophic consequences and would have threatened price stability. The subsequent improvement on financial markets also reduced the reliance of banks on ECB liquidity, and as a consequence it reduced the risks to the ECB's balance sheet. One can speculate about the potential risks related to OMT, but the existence of OMT has – as a fact – reduced risks borne by the ECB and its shareholders. Anyway, from the legal point of view the decisions of Bundesverfassungsgericht would not be binding on the ECB, which is a European institution.

This would only be the case with a decision of the Court of Justice of the European Union. But Karlsruhe could impose de facto limits on OMT – through the ESM and the Bundestag.

Cœuré: I really don't want to speculate on such ideas, this is an unchartered territory.

Klass Knot of the Dutch central bank has said that OMT could last at least for 10 years because it would take at least a decade for euro-area countries to reduce their debt ratios substantially.

Cœuré: OMT is a very narrow instrument targeted at a very specific type of risk, which we call the redenomination risk. Meaning: the risk of markets wrongly expecting countries to leave the euro area. There is only a low probability that OMT will be used, but it will stay with us. I also don't see any reason for changing the conditionality. It is as it is. Now it's for the countries to decide whether they want to apply or not.

Ireland will ask for a precautionary credit line from the ESM to safeguard the return to the capital markets. Would it be possible for the ECB to activate OMT and buy bonds before such a credit line is drawn?

Cœuré: Once the Eurogroup has agreed on an appropriate programme, the ECB's Governing Council can activate OMT. The credit line doesn't have to be drawn. But the Governing Council will make this decision in full independence.

There is another issue I would like to discuss with you: the collateral framework of the ECB. In the recent past there have been several problems with national central banks being too lax with regard to the eligibility and valuation of collateral.

Cœuré: The ECB and the Eurosystem is unique in the sense that we operate in 17, soon 18, countries, across very different legal frameworks, contractual standards and market structures. This creates complexity. We have to ensure a level playing field across all countries. At the same time market structures are constantly changing. And to put it bluntly: There is a risk that market participants try to circumvent our rules.

And what is the consequence?

Cœuré: First: We need a strong will within the Governing Council to make sure that our rules are enforced in a consistent way. I see this will. And second we constantly have to monitor market developments and adapt our framework so that market participants cannot game it.

Nagel: The single collateral framework must be understood and applied the same way by all central banks. All central banks must have the same interest: to reduce the risk stemming from our operations. If there is a loss it is a loss for all of us. Moreover, the Governing Council of the ECB regularly reviews the adequacy of the risk control measures in the collateral framework.

But critics say that it is not only market players trying to circumvent rules but also national central banks using loopholes to support their domestic banks.

Cœuré: I wouldn't cast the blame on national central banks. One proof of the common will of the Governing Council is the fact that it has agreed unanimously to create a compliance unit at the ECB and a network of collateral experts to check any inconsistency and any factual error in the eligible asset database, and report back.

Nagel: There are around 40.000 items of eligible collateral in our database which have to be valued on a daily basis. There are also historical reasons for this: the idea behind a broad collateral framework was to ensure that banks from all participating countries could participate in the Eurosystem's refinancing operations. It is not a big secret that this is a big challenge. Especially in a crisis this might become extremely difficult. However, I still think our track record over that period is good – with a very few exceptions.

And what about simplifying the system?

Cœuré: In the future we should aim at simplifying it to the extent possible, not forgetting, that good availability of collateral to our counterparties across the euro area allows proper implementation of our monetary policy. This is why the system became even more complex during the crisis times.

So for the time being there will be errors?

Cœuré: We will do what we can to avoid errors. What is important to know is that none of these errors have led the Eurosystem to lending too much to financial institutions. All operations are over-collateralised.

Nagel: In cases where errors were made, we have eliminated them. In cases where loopholes emerged, we have closed them. We are constantly learning lessons from our experiences.

On lessons: What will the collateral framework and the framework for monetary policy operations in general look like after the crisis?

Cœuré: It is too early to say. On one hand, we are not yet in the exit mode. On the other hand, we have to see how markets and regulation will look like in the future. My personal view is that we should have an aim at one point to eliminate the temporary measures that we have taken. But there is a possibility, that we will include some of these assets, for example additional credit claims, in our permanent list. But under the common control of course.

Nagel: I am critical of the additional credit claims (ACCs) because they entail risks and I, in particular, regret the fragmentation of the monetary policy framework. The Bundesbank therefore advocates reducing the ACC framework as quickly as possible as soon as the situation in the financial markets permits. It is possible to expand the general collateral framework provided the Eurosystem's current high creditworthiness standards are maintained. I see two particular future developments. The long-term funding of banks will become more important, owing not least to new banking supervisory regulations. And the unsecured money market will not play the same role as before the crisis.

Some experts say the ECB should look at its collateral framework not only as an instrument to control risks but as a monetary policy instrument – also to enable a response to country-specific circumstances.

Nagel: The collateral framework is not about monetary policy in and of itself but about its implementation. If different country-specific collateral requirements were to be introduced, this would ultimately mean, owing to the division of risk, a redistribution of financial risks between countries.

Cœuré: Indeed the collateral framework is not a monetary policy instrument per se. These decisions are not aimed at injecting liquidity into one country and withdrawing it from another one. There is a problem if there are collateral shortages in some countries. This is something we would have to look into. But – and that is a very important but – I don't see a trade-off between these considerations and controlling the risk. We have to achieve both. We will not expand our collateral framework at the expense of risk and just for the sake of improving the transmission of monetary policy. This wouldn't be right.

Some people argue that the ECB should not worry about risks and losses because central banks can operate with negative capital.

Nagel: There is a general understanding that central banks can function with negative capital. But the Bundesbank believes that this would be a dire signal.

Cœuré: This is exactly the right answer. Technically and legally it would be possible for the ECB to run with negative capital, but it would undermine the confidence in the ECB and the trust in the euro and therefore it should not happen.