Benoît Cœuré: Interview with Thomson Reuters

Edited excerpts from an interview with Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, and *Thomson Reuters*, conducted by Mr Paul Carrel, Ms Eva Taylor, Mr Sakari Suoninen and Mr Andreas Framke on 12 February 2014.

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Thomson Reuters: What is your take on the Karlsruhe decision and how it affects the interim period?

Benoît Cœuré: "We're not commenting on court decisions. This case has been reviewed by the court. It will now be reviewed by another court, which is the European Court of Justice. We certainly stand ready to cooperate with the European Court of Justice and explain what we've been doing. The OMT is a programme that the Governing Council of the ECB has designed in a way that make it both efficient and safe legally, so we firmly believe that the OMT is safely within the remit of the ECB in terms of being monetary policy and in terms of not being monetary financing of governments. We have ourselves set a number of limits to the programme to make sure we are on the safe side.

The status of the OMT is not changed. It is ready to be used but it is highly unlikely it would have to be used at the moment.

Would you consider setting limits to the OMT?

We have to wait and listen to the European Court of Justice. Meanwhile there is not much that we can do to enter that discussion.

It is certainly not our role to double-guess or to anticipate what either the European Court of Justice or the German Constitutional Court would say.

Is the OMT off the table now?

As I said, it's not needed today, so that's not a discussion that is very high on the agenda. Bond-buying to cope with the redenomination risk, the way that the OMTs have been designed, that's not a discussion that is on the agenda.

More generally, ECB President Mario Draghi has been clear that the ECB can use all instruments that are allowed by the Treaty, and that includes asset purchases. We've done it already, many central banks have done it, including in the past in Europe, and it's being done daily in other regions. So it's possible of course, provided that it is justified in view of the ECB mandate, namely: provided that it is monetary policy and that is not monetary financing of governments."

Within that framework, a range of instruments are possible, and that includes asset purchases, which we've done already.

Is QE possible if we see a risk of deflation?

First, let me take one step back and say we're not seeing deflation in the euro zone. We see low inflation, slowly increasing from the current low levels back to below but close to 2 percent. That is the base-line scenario from which we are working. The discussion is which kind of risks we have around the scenario. Certainly we have upside risks and downside risks and we are alert to the notion that we are close to the region where a downside shift in our inflation path could bring us into dangerous areas, so we have to be prepared. But, again, this is not a discussion on deflation. It is a discussion on how low can inflation be without triggering adverse dynamics. We are not there, but we have to be alert that negative shocks could trigger that kind of scenario and then we have to be ready to react.

The second point is what we would do. We have a range of instruments that we can use to cope with different kinds of shocks and we have to distinguish broadly between shocks to the liquidity situation in the euro zone that would start from the front end of the money-market curve, and for that we have a number of instruments. Then we have other shocks that would change our medium-term inflation path and then we have other instruments. It can be either or a combination of instruments that we can use. The bottom line here is that it all depends on the nature of the shocks, so it has to be driven by the data and it has to be informed by judgment.

In that data that we will analyse, certainly ECB staff forecasts will feature prominently, but it's really too early to comment since we don't have the numbers. But staff forecasts are not the only input, the Governing Council will base its judgment on all economic data, soft and hard.

Will there be a certain trigger?

There is no trigger, it's all a matter of judgment. We have a very clear mandate and that's medium-term price stability.

Are you concerned that emerging market turmoil will affect that scenario?

That's certainly part of the developments that we have to follow closely. The G20 discussions in two weeks in Sydney will be an important milestone because then we'll know more, in particular from our emerging-market colleagues what the situation is in their jurisdictions.

It's too early to tell whether what we are seeing in global financial markets today can lead to disruptions that can prompt a change in either our growth scenario or our inflation scenario, or whether this is a shift in global demand that would have to take place anyway and that can be managed in a smooth way by the international community. It's too early to tell.

Just as an example, we haven't seen the exchange rate of the euro going up significantly since the start of the current emerging market developments. We haven't seen that much of a spillover effect on the euro zone so far, which is grounds for cautious optimism.

What channels of impact are you watching?

Generally, the main channel is the output channel. We have to understand whether the current volatility on global markets will have an impact on global output generally. That's why the G20 discussion is so important, since this has to be informed by the IMF in particular. So far the jury is still out.

In terms of inflation, it sounds like we are teetering on the brink of the danger zone, as ECB President Mario Draghi talked about. Is that a fair assessment?

It is a fair assessment, but what we are seeing from incoming data from the real economy in euro zone countries is that all so far confirms that the euro zone economy, both in core and in non-core countries, is on a recovery path. In our baseline scenario, the forces coming from the real economy, i.e. the ongoing strengthening in aggregate demand are enough to countervail disinflationary forces.

We will get the 2016 inflation outlook in March. Would a rate cut help if it turned out that inflation is moving too slowly back towards the target of below but close to 2 percent?

You first have to ask yourself what are the causes for low inflation and in particular whether downward pressures on prices come from the demand or the supply side. That is a very important discussion from a monetary policy standpoint. Certainly aggregate demand is weak, which explains a lot the low level of inflation. But we see positive news coming from this side. We see aggregate demand now developing in the euro zone. But on the supply side, we have an ongoing adjustment of relative prices in several countries, which relates to reforms on the labour and on the product markets, in particular through compressed margins. This also contributes to the low inflationary pressures, but on this front there is nothing monetary policy can do and there is nothing monetary policy should do, because it is a healthy adjustment in these economies.

It sounds like you are pretty relaxed and there is no need to do anything?

Central bankers are never supposed to be relaxed (laughs). More seriously, we are confident that the baseline scenario is a safe one, in terms of inflation coming back to 2 percent. But as I said there are risks around this scenario and we are certainly ready to act in case shocks to the European economy would significantly change the scenario. It is not only about the staff forecasts, because the Governing Council decisions are a matter of judgement. There is no mechanic link between the staff forecasts and Governing Council decisions. It will depend a lot on our understanding of the forces that are at play in the euro zone economy and these are complex forces. But if the conclusion of the Governing Council discussion is that we see a significant risk that inflation does not come back to 2 percent, even in the medium term, then of course we will have to act and we certainly stand ready to do it.

Is there any thought being given to extending the horizon beyond two years, publishing or looking at forecasts further out?

We decided to extend the disclosure horizon of the staff forecasts, so in March there will be a forecast until 2016 published. That does not imply that the definition of medium term has changed. There has never been a number attached to the definition of the medium term and there is one good economic reason for it, which is that it all depends on the nature of the adjustment path and on the nature of shocks that hit the economy. Shocks can be more or less persistent and I would certainly argue personally that given the persistence of the adjustment process over a long period of time in the euro zone, the definition of medium term under the current environment is probably longer than what it would have been under different kind of shocks, say an oil shock.

Would you say that money markets are in a self-regulating mode? What is your assessment of the situation?

Money markets are today in a self-regulating mode. Market participants are learning to adapt to an environment with a lower level of excess liquidity. They are learning their way back to normality. They are using the instruments currently provided by the ECB, meaning the main refinancing operations (MRO) and the SMP sterilisation operations, to regulate the level of liquidity and prices. This is now stabilising. That said, there is an element of inherent fragility that is related to fragmentation in the money market. There are pools of liquidity that cannot necessarily be tapped when liquidity is needed. Liquidity is not flowing smoothly across the euro zone, the market remains fragmented and that hampers the self-balancing process that you should normally see in a market. This makes the euro zone money market vulnerable to shocks either from the inside or the outside. That explains why we remain vigilant. And certainly in case we would see the current equilibrium being unsettled, the ECB would stand ready to act and add to liquidity. It is very easy for us to do so. We have instruments that are ready and usable. We stand ready to do it, but I do not see the need to do it today.

Would a negative deposit rate help to address the fragmentation in money markets?

It is a very possible option. That is something we are considering very seriously. But you should not expect too much of it. It can help to provide an additional incentive, but it is not the answer to everything. But it is possible and something that we have been discussing and as you know, we are technically ready to do it.

Would other options, such as suspending the sterilisation or cutting the reserve requirements, just add to the existing liquidity pools or would they also be effective?

They can be effective to recreate a level of excess liquidity which would find its way in all the cracks of the system, as we saw when excess liquidity was at very high levels about a year ago. They can be effective in particular circumstances where there would be a need at some point in time to inject liquidity into the market. But I don’t see the need to do it now. And they are very much one-off measures and cannot be a permanent answer to the issues faced by the money market.

If deflation in the euro zone is a very alarming situation, why is deflation in the part of euro zone not a very alarming situation a very alarming situation for that part?

Because deflation is a dynamic concept. It has to do with expectations and, it has to do with both inflation and output. One measure of deflation is private agents in the economy postponing their decisions to invest or consume and these are by essence macroeconomic dynamics that can only be observed at the euro zone level, because our economies are not closed economies. The euro zone economy is one economy. You have trade links and links through the interest rate, the money market and capital markets. Within a monetary union with a single market for goods, services and capital, which is our situation, you cannot have a deflationary spiral at the level of one single country. You can have relative price adjustment, but you cannot have a deflationary spiral. And by the way, we are not seeing consumers, households or companies postponing their spending decisions. Quite to the contrary, what we are seeing is aggregate demand accelerating. That's the best evidence that we don't have deflation.

What do you think would be the most effective way to strengthen your forwards guidance, should you need to?

The best way to support the forward guidance is to act whenever necessary in compliance with the forward guidance. That is why we are saying we are ready to act if the situation would need it, consistent with our forward guidance that rates will remain low or lower for an extended period of time. The Governing Council certainly is ready and has started to confirm its commitment to the forward guidance. What I would not favour personally is putting numbers on the forward guidance, by putting thresholds or triggers. An unemployment threshold in our case doesn't make sense because we don't have a single labour market in the euro zone and we have a primary price stability mandate. And an inflation threshold is not feasible in my view because the euro area is undergoing deep structural change that shifts the relationships between economic variables.

So this leaves us with an interest rate cut?

If warranted.

It's not necessary to sharpen the forward guidance now?

So far the forward guidance as it has been designed by the Governing Council has served us well in the sense that is has made it possible to some extent to disconnect European interest rates from U.S. interest rates.

It has served us well to protect our money market from outside shocks and it remains consistent with the monetary policy framework of the ECB, meaning that it is fully consistent with both the economic pillar and the monetary pillar of the ECB. So, if we can find ways to strengthen it, why not. But I would not argue for introducing thresholds. I don't think that would work in our case.

What other ways are possible to strengthen it?

One of the stated objectives of the forward guidance is to stabilise our money market and it has been, in my view, pretty successful so far. We have a number of instruments that are available to stabilise the money market, for instance fixed rate full allotment. The Governing Council has decided that fixed rate full allotment will stay until July 2015. And fixed rate full allotment is, in my view, the most powerful instrument that we have to stabilise the money market and it is being used by market participants, meaning that the MRO effectively acts as a safety valve. It is being used by market participants to stabilise liquidity.

Something we could do if there is a need to extend the horizon under which this liquidity backstop is available to market participants is just to extend the horizon of fixed rate full allotment. That's not very spectacular but that's a way to provide security to the money market in a way that is consistent with our forward guidance. That's just an example.

Would you now be upset if we see Eonia and other very short-term interest rates steadily and an in orderly fashion go to the refi rate?

What matters most for me is stability in the money market rate, meaning that it is either stable around a level known to market participants or it fluctuates in a way that is known to market participants. And it will fluctuate, because we do have liquidity cycles in the euro zone. We have a maintenance period, you have autonomous factors – treasuries pumping liquidity in an out of the market etc – and these are factors well known to market participants that explain why there is a certain amount of cyclicality in both liquidity and Eonia within the maintenance period.

Insofar as this is stable and known to market participants, I think that's fine because this does not create uncertainty. Another important criterion for me is that any volatility in short-term money market conditions does not spill over to longer maturities, where they would start having an impact on lending rates to households and companies – variable rate mortgages, for instance. We are not seeing this at all. We have seen movements up and down in the front end of the money market curve but we haven't seen that being transmitted to longer maturities, which explains also why I don't see a reason to act now. So that's about stability. We used to be in a situation before the crisis where the Eonia was fluctuating close to the MRO. We're probably back to a situation where we will see wider fluctuations between the deposit facility rate and the MRO but that's also because of fragmentation that hampers the adjustment process. But at long as this is a stable process I think it is fine.

What are your expectations as regards the recent proceeding in the European Parliament's on the SRM?

The ECB deems the single resolution mechanism a necessary complement to the single supervision mechanism, so it's very important that an agreement is reached in this parliamentary session. Any remaining time should be used to improve this mechanism. We've suggested for instance that shortening the timeframe for mutualisation of the single resolution fund would be helpful to give a clearer perspective that a single European backstop will come within a reasonable timeframe, helping to cancel the link between banks and sovereigns. That does not necessarily imply that the contributions of banks would be accelerated, because you can build up the fund within a certain timeframe and have a different timeframe for mutualisation within the fund.

Do you expect bank lending to recover now that banks have adjusted their balance sheets for the asset-quality review?

It would be a risky situation in my view to start single supervision without a perspective for a single resolution mechanism. That would be a very uncomfortable situation for the ECB as a supervisor.

We've seen a certain amount of front-loading, of accelerated deleveraging ahead of the AQR cut-off date, meaning Dec. 31, 2013. There is a risk that we will see another wave of deleveraging when the AQR results are known and action has to be taken. My personal plea to supervisors and to banks would be that this will be done through raising capital rather than by cutting loan books.

How concerned are you about the mood in Europe and the lack of trust towards European institutions?

We see elements of a negative spiral whereby European citizens don't trust European institutions and governance, while at the same time it is necessary to strengthen them to provide a solution to the crisis and put the euro zone back on a sustainable growth pact. European institutions jointly have to break that negative spiral and to create enough trust so that European citizens will feel comfortable and then they can deliver on addressing the sources of the crisis. We have to turn that negative spiral into a positive spiral. The best way to do it is first to deliver on what has already been decided, in particular the economic reforms in EU member countries. Reform really starts in countries and it starts bearing fruits, with competitiveness being restored and growth coming back, even in the periphery. It has to be continued to give tangible evidence to citizens that reform efforts are bearing fruit.

Europe also has to deliver on what has been decided in terms of euro zone governance and that's where the banking union features prominently. Delivering the single resolution mechanism, delivering the bank resolution and recovery directive, these are all elements of trust for the citizens. The burden of proof is not on the side of citizens, it is on the side of European institutions."