Peter Praet: Interview in *Expresso*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *Expresso*, conducted by Mr João Silvestre and Mr Ricardo Costa and published on 18 February 2014.

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Q – The main discussion today is whether Portugal should seek a "clean" exit or opt for a precautionary programme. What do you think would be better?

A – The eleventh review of the assistance programme began this week and will carry out its regular evaluation. As far as we know, the results have been impressive. While a contraction in GDP was underestimated at the beginning of the programme, we are currently surprised on the upside. But we need to wait for the outcome of the technical discussions at the eleventh review. I cannot anticipate any decision.

Q – But we are in February and the Troika will leave Portugal in May.

A – We have a few months. There are pros and cons to the different options. What is important is that the government can convince markets and other euro area countries and the European Union that the programme will continue without hesitation. Growth in Portugal has started to become sustainable, which is new. The main question is whether there will be any doubts about the continuity of the reform programme. The precautionary programme would certainly help to dissipate doubts. In a clean exit scenario, the Government should make a credible commitment to continuing the reform process. Ultimately, what matters is credibility. But it is the Government's decision.

Q – You mean that the ECB does not need to have a defined position?

A – My point is that for Portugal, independently of the options available, what is essential is being able to convince the markets and euro area partners that reforms will continue to be implemented.

I think the Government is right to wait a little longer before deciding on the post-programme options. Everything depends on the credibility of the reform process. Imbalances created over many years cannot be resolved in three years.

Q – Is there a risk that, without the precautionary programme, Portugal would not proceed with reforms?

A – There is obviously conditionality associated with the precautionary programme.

Q – And there is not with a clean exit. That's the problem.

A – A clean exit has no formal conditionality attached to it. For the Government, the ECCL has a political price, due to conditionality, but I think that if it does not take the ECCL, the Government will face the issue of post-programme credibility whatever option it chooses. You can say you want a clean exit with enhanced post-programme monitoring, but whatever the case the country will face scrutiny from markets and other euro area mechanisms, especially since, after the programme, it still has to meet its obligation to reduce its deficit as laid down in the enhanced SGP.

Q – But, at the same time, the OMT programme, which was a kind of ECB bazooka, was not used. The German Constitutional Court said, “OK, we cannot decide whether or not it is legal” and referred it to the European Court of Justice, which will make a decision, but not before May. Therefore, when Portugal leaves the bailout programme, it will not be able to request the OMT because it won’t be available.

A – The OMT programme exists. The case was referred to the European Court of Justice, which the ECB deems to be a good decision. But independently of the court case, the instrument exists.

Q – But it is not easy to use it before the Court has reached a decision.

A – I wouldn’t say that. The instrument is there. For us nothing has changed.

Q – Is it possible to activate the OMT without the precautionary programme?

A – No, the conditions are very clear. But it does not mean that you have to make decisions now. Portugal is starting to regain market access.

Q – Still with 5.1% for ten-year bonds.

A – Yes, but it is regaining access. Interest rates have been gradually decreasing and are now at 4.8 % for ten-year government bonds.

Q – These are very high rates.

A – I agree. We have seen very significant developments, but this is still not a satisfactory rate for Portugal.

Q – Looking at the interest rates, a precautionary programme would probably be better for Portugal.

A – Not necessarily. The markets put a high value on the very tough policies that have been implemented. We have seen impressive results that have exceeded expectations. Market confidence has a lot to do with the willingness of the entire population to continue along this path, with or without a precautionary programme. In the end, the test is political. Can the country continue to make these challenging efforts?

Q – Even without a strong anti-euro movement in Portugal, there is a growing current of opinion which says,: “OK, we made all these political and economic efforts but are still paying high interest rates. It is very difficult to see where all this will end so perhaps it would be easier to leave the euro”.

A – Sure, I understand. But I’m not sure it would be easier. The OMT was an instrument created to address what we call “the break-up fear.”

Q – Do you think the break-up fear has disappeared?

A – Yes, absolutely. I think the break-up fear has disappeared, which is a very positive result. What is now important is the credibility of reforms. I think Portugal is on the right track. Of course the risk premium remains high, because the risk is still high. But I think that this domestic adjustment must – to the extent possible – continue in a balanced way.

Q – When we look at Europe – and we will have European elections in May – we can easily see that some political parties in Greece, Italy or even the UK or Germany and the Netherlands – not in Portugal, but... – there are anti-euro politicians who are doing well in the polls.

A – What we learned from the crisis is that we have an unfinished Monetary Union. A Monetary Union that seemed to work well in good times, but in harsh times we saw that the institutional mechanisms didn't work well. There was no crisis preparation, no good crisis management, no joint supervision – many things were not in place before the crisis. That's what we're doing now. So the solution, if I may say so, is not less Europe – this would have drastic consequences on the domestic market – but the opposite: what we need is more Europe. The crisis showed that what failed were the unfinished institutions within the Monetary Union. That's what we're building. The banking union is an example.

For Portugal in particular, I think that it is very good news that we are talking about the end of the current adjustment programme, with or without a precautionary programme. The key is to convey this message of credibility that Portuguese politicians – not just the government – continue to support reform. I know it's not easy and I know that the European elections may have to deal with anti-European movements. Nevertheless, I think that the vast majority of European parties have come to the same conclusion, i.e. that for Monetary Union to work, we need stronger European institutions, not the opposite.

Q – When you see the Portuguese government getting ready to lower taxes next year, do you think this undermines its credibility with the markets?

A – I do not know. Let's see what the outcome is. Public finances were in bad shape – this has already been addressed – and at the same time we had to improve what we call the supply side of the economy, the productive capacity of the economy. The third point, which was often very difficult to meet, was to have a minimum level of balance in the measures. The European crisis was much costlier than it should have been, in social terms, owing to failure both on the part of institutions and in terms of crisis management. Now we are preparing the banking union, which includes a Single Resolution Mechanism, and we are trying to catch up institutionally. I think that was the hard lesson we learned in Europe. The other way would have been an increase in nationalism and an entrenchment of borders that would have disastrous consequences for welfare. I am convinced that Portugal will continue to grow if reforms are sustained.

Q – But there are things that are changing for the worse and not for the better.

A – Like what?

Q – Pensions have been declining for a long time, wages, the unemployment rate has risen sharply, there is a lot of emigration, youth unemployment, youth emigration...

A – Certainly. It is important to look at the social consequences.

Q – Therefore, all these structural changes in Portuguese society are very difficult to bear.

A – I agree with you, it's a difficult situation. But what can you expect, what are the possible alternatives? There comes a time when countries have to make reforms, when you are in that situation. What would have been the consequences if these policies had not been adopted? I fully agree that the social and economic cost was much higher than it should have been, but I don't see which other policies could have been followed at that time. Of course we can always think, as good planners, that we could have extended the time of the fiscal adjustment process, made it more gradual, made the measures more balanced, but there was no time and there were no European instruments to deal with this. I think we did what we had to do in Europe, including in Portugal.

Q – Do you consider it important to have a broader political consensus?

A – It is key to have ownership. The more ownership there is at the national level, the more it can be demonstrated that reforms will be maintained and the less a precautionary security mechanism is needed.

Q – But it is not easy to have this kind of political agreement at the time of the elections.

A – It's not easy, of course.

Q – And at a time when society is so divided.

A – I agree, it is not an easy choice. That's why I say that every month counts, because we have seen a succession of surprisingly good results for several quarters in Portugal. I fully acknowledge that this national burden-sharing is obviously tragic.

Q – When you use the term "tragic" for 2014, there are people who compare it to 1914, just after the start of the First World War. Many books and newspaper articles compare the two main events of these times and say that Europe is failing to see the real dangers of this kind of situation, like in 1914 when not many people predicted what would happen. Do you not think that the political institutions of the euro, particularly the ECB and the European Commission, as well as some governments, are not seeing the real dangers and are now looking towards the European elections as real political dangers?

A – Personally I am very confident, because the economic cycle is changing positively. This is very important. But, again, I agree with you that, for an unemployed person who will continue to be unemployed, the situation is very difficult. From a macroeconomic point of view it is going well, but for a large part of the population it will still take a long time before they see results. The cycle is definitely changing for the better. I think we are building these institutions – we're not over yet, but we have to look at where we came from: a situation of huge imbalances that we needed to fix in one way or another. At one point, markets feared the break-up of the euro area – we talked about this – and that caused the panic, and authorities were able to stop that vicious cycle. 2013 was basically the start of the second half of the turning point, and now we have to consolidate this turning point. Of course it is very difficult for a population that, in the first ten years of the euro, saw a recovery in terms of income compared with the euro area average. Therefore, it is very difficult, because there were high expectations, but this level of income growth was not based on sound fundamentals. Tragedy is a very strong word. I do not think we can use it, as a tragedy ends badly. Especially in Portugal, we see the results, we see signs that there is a recompense for this reform; it is not in vain.

Q – Shouldn't some creditor countries, such as Germany, also help to correct imbalances?

A – For the central bank, it has been very difficult to manage all this heterogeneity with a single monetary policy and, in reality, with very weak institutions to deal with this crisis. The measures we have taken are working but the financial conditions remain very difficult in countries like Portugal. If you look at Germany, the situation is different. The Germans are afraid that monetary policy is too expansionary. At this time, could the German domestic market be stronger? The German domestic market was afflicted by widespread fear when the crisis began. I think things are calming down now, which is very good for the recovery of domestic demand. Wages are likely to increase by more than 3% this year. Are they doing enough or not? It is not easy to defend that Germany should try to boost demand by creating a public deficit.

Q – The inflation rate in the euro area hit 0.7% in January and the forecast is that it will remain below the 2% target for quite a while. Is it the ECB's greatest concern at the moment?

A – This question is very important, because our primary mandate is price stability in the medium term, which we define as below, but close to, 2%. When we issued our forward guidance last November, we communicated that we will continue to have a very loose monetary policy and we will do whatever is necessary to fulfill our mandate. We are therefore very aware of what you are referring to, i.e. that low price pressures have extended to the medium term. Let's make this assessment in March. Today, our assessment is that with the recovery that we are seeing now, inflation will converge in the medium to long term and in saying this I admit that the price pressures are quite weak.

Q – What other measures can be used if necessary, since interest rates are virtually zero? A new round of LTRO, various other measures, etc.?

A – We are very careful in our communication not to announce the next steps. We have a great deal of discussion in the Governing Council, and then we decide. We have a toolbox that we are ready to use if our assessment concludes that our objective of price stability will not be achieved. The signals we give are not so much to do with the tools themselves, but not having any hesitation to use them.

President Draghi has said several times that we have various tools at our disposal and we will see which are the most appropriate. But we will not hesitate to use them if we consider it necessary to do so. If our mandate is at risk, we will act without hesitation, as we did in recent years. We do not see a risk of deflation, but we admit that the pressures on prices are weak, and that this weakness in price development is extending to the medium term.

Q – Is Greece your biggest failure?

A – I think that Greece is the biggest failure of Greece itself. It is a failure of the pre-crisis policy. It is true that it has been very difficult.

Q – After all these years of great difficulty, the numbers are still not very positive...

A – No, but I would qualify it a little better. First, the size of the problem was enormous, and much greater than expected for several reasons. The big problem in Greece is Greece itself and the difficulty that its society has to unite. That's where large divisions appear, as well as a kind of decision paralysis, which is worse. A crisis feeds on itself, the fears grow, market confidence is lost, and we enter into a terrible vicious cycle – then comes outside intervention, trying to force a solution. So I think the biggest asset of a country is the ability of its society to come together in difficult times.

Q – But if we look at debt, although Greece is much larger, it will still be very difficult to find a way to pay it.

A – No, not if the country applies a sound policy.

Q – No?

A – Even in Greece, the OECD indicators show that the labour market is performing rather well at the moment. Clearly there is still a lot to do, but I would not lose hope. When a country faces its problems, it is successful. But we must reach a consensus on reforms, which I think Portugal has generally achieved. I know there are elections and all that, but every month will count in order for confidence to return.

Q – Is the currency crisis in emerging countries a concern right now?

A – The international environment was the main engine of growth that we have had in recent years, so of course we are very attentive to developments in Asia and Latin America and emerging markets in general. We had positive surprises in developed economies like the US or the UK. So we had a much greater support to growth in developed economies. From the point of view of growth, for now, the slowdown in emerging markets is being offset by higher economic growth in developed countries.

Q – What can we expect from the asset quality review and the new round of stress tests?

A – For us it is a very important issue. The crisis was very severe because our institutions were too weak to deal with it and there were many imbalances. It is a difficult exercise in operational terms, it is a lot of work, it is crucial and will require much effort and commitment from the entire system. All supervisors, even if they sometimes complain about the operational burden – it takes a lot of time – are, I think, very committed, because everyone realises that this is a milestone on the road to recovery: do it well and recover credibility. From the point of view of the market, there is always something of a paradox: that confidence has returned before the exercise is complete, because the signal that went out that we would deal with the problems was very positive. Some say that this exercise can be bad for growth because banks will deleverage faster and all that, but what we see today is the opposite; it is a contribution to the restoration of confidence in the banking system. If we look at the banking systems, Portugal, for example, was, last year, in terms of recapitalisation and restructuring, important. The problem, not only in Portugal, is the profitability of banks. In general, they have made great headway in terms of capitalisation, and we'll see, with this exercise, if it is confirmed, because we analyse portfolios in great detail, but the question is about the profitability of the banking system in countries such as Portugal. Profitability is now the ultimate question. I think that recapitalisation in countries such as Portugal was extremely convincing, but the sector must be profitable again. With the recovery and the gains in efficiency that we see it should be so again, but this will be a very important test for 2014 and the industry must go back to being profitable.