Vítor Constâncio: "We are certainly not almighty"– interview with *Börsen-Zeitung*

Interview by Mr Vítor Constâncio, Vice-President of the European Central Bank, with *Börsen-Zeitung*, conducted by Mr Mark Schrös, published on 11 September 2014.

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The ECB's Vice President talks about the power and the limits of the central bank, the risks of very low inflation and the strong criticism in Germany

BZ: Mr Constâncio, many politicians and observers view the power and the instruments of the ECB in its fight against low inflation and a weak recovery as almost unlimited, but others say the ECB is already reaching its limits. Do you feel almighty or powerless?

Constâncio: This is indeed a really interesting question. But I would say it is neither one nor the other: We are certainly not almighty, but we are also not powerless. What we do has an effect on the economy and so it is very important.

But expectations or hopes that the ECB might change tack alone are overblown, yes?

If one is talking about the perspectives of growth it is true that monetary policy cannot do it alone. It's mostly up to governments, especially structural reforms. But if one is talking about inflation it is different: It is the responsibility of monetary policy to reach the inflation goal – that is the fundamental creed of monetary theory and of central banks. We cannot shift this responsibility to others, but if others can help, it is even better.

ECB President Mario Draghi has said that it might be difficult to reach the target of below but close to 2% without some fiscal stimulus and structural reforms. But you would say that when the inflation goal is at risk, the ECB has to act, regardless of what others do?

Right, this is how I see it with regards to inflation. However, Mr Draghi was also referring to growth in his speech, and as I just said, that is different. Naturally, at the moment it would help enormously if politicians would also deliver. If they would generate more growth this would reduce the slack in the economy. This would help against the very dangerous situation of low inflation.

But you have to be increasingly frustrated because the ECB always delivers but politicians do not, don't you?

Yes, absolutely. But it is important to acknowledge that the stressed countries have done a lot of structural reforms, and have started to grow again.

But at the moment the problem children are France or Italy, they refuse to make reforms.

Of course there are some countries in which structural reforms are urgently needed. If you look at OECD 2013 report about the responsiveness to their recommendations for structural reforms, the stressed countries are at the top and other euro area countries are below the euro average: France, the Netherlands, also Germany.

Recently there has been a lot of talking about a "grand bargain", meaning a kind of deal between fiscal, structural and monetary policy to overcome the crisis in the euro area. Draghi has said that there is no such bargain. But would you say this is something that is needed at the moment – like in Japan?

I think we need the three pillars. But at the same time we are much more concerned about the independence of the central bank in Europe. So this kind of coordination would not be appropriate. This is why we have decided what had to be decided on our part, and president Draghi has mentioned what the others should do.

Only three months after a historical package the ECB has again loosened its monetary policy significantly. Does that mean that there is an increasing worry about stagnation or even deflation?

Two things happened since June: On the one hand, the decline in inflation expectations across the whole spectrum. It would be extremely dangerous to let inflation expectations de-anchor…

… That means letting them fall significantly below the target of 2%...

… Right. Not under any circumstances we should let that happen. If that happens it would be extremely difficult to regain control of inflation expectations. They are a main factor for future inflation. On the other hand, the final results for the second quarter have been very disappointing. This increases the slack in the economy with downward pressure on inflation.

What really matters are medium- to longer-term inflation expectations. Are they still "anchored"?

They are starting to get de-anchored for horizons up to 4 years. These figures declined significantly during the past two months. Now it is also starting to attain the inflation expectations in five years for the following five years. Furthermore, the influence of short-term expectations on longer-term expectation is increasing. This is a bad signal and a big concern for us. The risk that the longer-term expectations get de-anchored has definitely increased enormously.

And that also means the risk of deflation in the euro area has increased?

I don't see a risk of an actual deflation in the sense of a broad-based decline in prices. But the big problem at the moment is a prolonged period of low nominal growth, so low inflation and low growth. This creates debt sustainability problems – both for private households and governments. Furthermore, increasing real interest rates have negative effects on the economic recovery.

But the new ECB projections for growth and inflation have been revised only marginally. Why did the Governing Council nevertheless decide to take quite far-reaching decisions?

These are not the Governing Council's projections –this is very important. These are the ECB's staff projections and in that sense they are just one element for the Governing Council's decision. The risks to the downside for growth and inflation were seen as more important by the Governing Council.

So it would be fair to say it was some kind of insurance policy against the downside risks?

When we deal with risk management we always have to be as preemptive as possible. This is particularly the case if there is a risk to inflation expectations. We simply had to do more right now.

With the recent decisions the Governing Council explicitly aims at a significant increase in the ECB's balance sheet. This is a major shift in the ECB's policy, bringing it even closer to other central banks.

With the recent interest rate cut we are now at the zero lower bound. So if we believe that we need an even more expansionary monetary policy, we have to find different channels. An increase in the balance sheet is one option. On the one hand, it influences the inflation expectations for the future, and on the other hand, it triggers shifts in investors' decisions. This will spill over to other asset markets and also have an impact on the exchange rate.

According to many observers the effects could be even bigger if the ECB would give a precise figure for the two purchases programs of Asset Backed Securities (ABS) and Covered Bonds.

I understand the argument. But from our perspective it is difficult and it would not be appropriate to commit to a certain number. We have decided not to do so.

So even when we get more details at the beginning of October we will not get a precise figure for the planned purchases?

At the moment we are not intending to give a concrete number.

But Draghi has signaled that – including the new TLTROs – the aim is to increase the balance sheet by €750 billion to €1 trillion. Many observers doubt that this is possible, especially within a short period of time.

We are convinced that the three components will have a sizeable effect on our balance sheet – with the consequences I have described. We expect the most significant effect to come from the TLTROs. This is also why we again cut interest rates. There had been rumors that banks might not come to the first TLTROs because they were speculating that interest rates could be cut later. This is now off the table.

Does that also mean the smaller the TLTROs uptake, the bigger the purchase programs will be?

This is not necessarily the case. But again: We believe that this new facility is very attractive. So banks are well advised not to miss this opportunity.

And if everything else fails the ECB will start buying government bonds? This option of a broad based Quantitative Easing (QE) was already discussed in the Governing Council, but it did not happen already this time. Does that mean there is no "comfortable majority" for this step – like for the others which were announced last week?

There was no proposal for doing QE at this meeting. QE was discussed, but it was not on the table for a decision. So I don't think you could draw this conclusion.

So QE, including the purchase of government bonds, would be the next logical step for the Governing Council?

We are convinced that we are allowed to buy government bonds in the secondary market, if it is justified by monetary policy considerations. But we also know what it means and this is certainly something we would prefer not to be forced to do. We hope that the recent package will be enough. But in view of our responsibility and our mandate, buying government bonds certainly is something we cannot exclude.

But this would lead to even more dissent within the Governing Council. Last week's decision was not unanimous – although it is always stressed that the Governing Council is unanimous in its commitment to do what is necessary against the risks of low inflation.

This phrase does not mean that in a particular moment everybody has to agree to a concrete package. The most significant thing about this phrase – which was decided upon unanimously – is that no unconventional instrument is a priori excluded. But calibration and timing can occasionally be a source of discussion.

But with the most recent decision the consensus decision-making is ultimately history now?

Since 2010, we have had some decisions which were not taken unanimously. In such difficult times, there are different views. I would not qualify this as surprising or even negative as such. In the future, we will also always try to reach consensus. But sometimes we have to take decisions.

You have mentioned the impact the ECB's policy has on the euro. Your colleague Ewald Nowotny made even more blunt comments by saying the aim was to weaken the currency. Is the ECB also in this respect becoming more like other central banks, which implicitly use the exchange rate as an instrument? Don't you fear counter-measures by others?

I have to contradict you: We have not taken a single decision which was aimed directly to the exchange rate. No one can say that. Our monetary policy is targeted to domestic objectives. We are justified to do so because of the difficult situation of low inflation we are in. Of course everybody knows that unavoidably there are consequences for the exchange rate. The devaluation of the euro is a collateral consequence of our policy. But what really matters is the domestic objective. Not a goal for the exchange rate. We have not changed our policy in that respect.

This reminds me of Japan. In 2013 Japanese leaders also said that the ultra-expansionary monetary policy was aimed at domestic targets and not to weaken the Yen. At that time also European policymakers and central bankers doubted and criticized that.

If you read the IMF or the G20 statements, the Japanese policy was always considered acceptable because it was directed towards understandable domestic targets. Now the same applies to the euro area, although in a different scale: We are not in deflation and we will not be in deflation.

In Germany the ECB's policy is heavily criticized. This will increase with the planned asset purchases. One concern is that the ECB takes risks on its own balance sheet which could at the end cause some problems for taxpayers again. Isn't it a big risk that the support in Germany for the ECB could be get lost completely?

This is of course a concern to us. We don't live in an ivory tower. But we have a mandate and this mandate is for the 18 euro area countries as a whole. But I also think there are a lot of misunderstandings and unjustified fears in Germany. Just to give one example: When we started buying some government bonds for the first time in 2010, everybody was writing in Germany about the forthcoming hyperinflation. This did not happen and there is no reason to believe that it will happen now. And also in 2010 there had been fears about potential losses. If anything, the Eurosystem made a very significant profit with these acquisitions.

But the feeling is that the ECB is more and more deviating from the stability-oriented monetary policy of the Bundesbank in its former days. This feeling even increases if Bundesbank President Jens Weidmann is opposing ECB decisions.

I find it difficult to say that the ECB is deviating from a stability-oriented policy when inflation rates are at 0.3%. You could say so if inflation was at 3% or 4%. Our primary mandate is price stability and we will not embark in policies that may create dangers to the upside in this regard.

Another big fear is new bubbles in the financial system.

Our mandate is price stability regarding products and services, not the level of asset prices. This is the mandate politicians have given to us in the Treaty. If we are talking about asset prices we need macroprudential instruments, not the use of the interest rates. Some instruments were given to the ECB in the SSM regulation – a limited set. I would like to have more instruments of that nature.

For example?

In the UK, the government recently gave to the Bank of England the instrument of loan-to-value- and debt-to-income-ratios, especially to prevent bubbles in the housing and real estate market. In the US, the Fed can declare non-banks systematically important and then have the supervision over them. These are some good ideas.

In the euro area the situation of the banks is still a big concern. They are still seen as undercapitalized. What do you think, especially after the ECB's Comprehensive Assessment comes close to its conclusion?

First of all: Since last year banks have already frontloaded a lot of decisions in anticipation of the Comprehensive Assessment. They have raised new capital and increased provisions. All in all since June 2013 the 128 banks that will be under ECB supervision in the future have strengthened their balance sheets by €197 billion. This also means that the ECB's check is already a big success.

So the fears are unjustified?

Such concerns were in general based on the assumption that some assets in the banks' balance sheets were wrongly valued. This is exactly where the Asset Quality Review comes into play. We are confident that we can dispel such concerns once and for all. The behavior of stock prices also shows that investors have started to again put money in European banks.

A study by advisers to the European Systemic Risk Board (ESRB) recently called the European banking system bloated and highly risky. Do you agree and is there a role to play for the ECB as the new supervisor?

While not denying that some parts of Europe are "overbanked", I would qualify this statement a little bit. The European banking sector looks much bigger than the US one compared to GDP, but in the US most mortgages are not in the banks' balance sheets. That is an important difference. The shadow banking system is also much bigger in the US. The banking union will provide an environment in which we will see a concentration in the banking system. But this should be left to the markets and not be achieved directly by policies. I also believe that the importance of capital market financing will become more important also in Europe. Banks are going to see their role shrink.

Let's get back to monetary policy. There is an intense debate about a "new normal", for example in the sense that unconventional instruments are becoming normal and that interest rates are going to be lower than in the past. Do you also see such a "new normal"?

I think there is a "new normal". The first element is the introduction of macroprudential policies. The financial crisis has shown that price stability does not automatically lead to financial stability and that financial crashes can be a risk to price stability. Therefore central banks need new instruments. It is dangerous and not very effective to try to prevent or prick bubbles via the interest rates. Another element is the necessity of unconventional measures. It is a fact that the environment is such that the neutral real interest rate…

…that means the interest at which real GDP is growing at its trend rate and inflation is stable…

… That this rate is negative at the moment and that it will be very low or even negative for quite a while. This rate has a lot to do with the potential growth rate of an economy and this potential growth rate is decreasing in many countries for some time now, because of demographics but also because of other factors. On top of that, the planned savings structurally are ahead of the investment opportunities. This is why I'm convinced that unconventional monetary policies will be normal for some time to come.

Does that also mean that you fear a "secular stagnation", a long period without growth?

I'm not sure and I think nobody can be sure. Certainly there is a trend to a continuous decrease of real interest rates that has been visible in the advanced economies in the past decades. In this context, it is very important to increase potential growth. Therefore a lot of different policies are needed. We must hope that this period will not last too long and that we will be able to increase potential growth in our economies again.