Peter Praet: *Interview in Il Sole 24 Ore*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *Il Sole 24 Ore*, conducted by Mr Alessandro Merli on 17 March and published on 25 March 2015.

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In the ECB latest projections, as in those of other forecasters, besides the upward revision of figures, there is a clear change of tone from "fairly gloomy" to more "upbeat". What is happening in the euro area economy?

After two recessions, the first in 2009 and another in 2010–2011 as well as an aborted recovery, we had a stabilisation of economic conditions in the course of 2013 and an improvement in early 2014, but by the late spring we were seeing a slowdown in an already weak recovery. That's why we decided on a number of measures between June and September/October, the so-called credit easing package. Then, in November, we saw that inflation was remaining weak and, in spite of the measures we had taken, that inflation expectations had become seriously destabilised. We flagged the risk of being trapped in a 1%/1% economy: 1% inflation, 1% growth. This would create a vicious circle: if everybody revised their inflation and growth expectations downwards then there would be less investment and a debt overhang. That is why we decided to take further measures in January. In spite of favourable conditions created by the oil price, there was a high risk that some of the benefits would be saved and so the full effect of the positive supply shock would be in doubt. We have always said that low oil prices have an ambiguous effect: positive, because energy is cheaper, but negative if they reinforce the deflationary behaviour of economic agents. In January we also thought that taking further measures when there are signs of a turning point would give a boost to the economy. We believed that doing it at that moment would put us back onto a growth trajectory, reducing the risk of the de-anchoring of inflationary expectations. It's a combination of circumstances that we hope will help to support the economic recovery: the low price of oil, better financial conditions including the currency, a more neutral fiscal policy, and also the benefit of structural reforms in some countries. These effects are visible in Ireland, Spain and Portugal, where – although painful – reforms have created the basis for a solid recovery.

You have a fairly big jump in projections on growth, 0.5% or thereabouts for both 2015 and 2016, but what surprised some people in the markets was that you also expect inflation to pick up substantially between 2015 and 2016, going from 0% to 1.5%, and then to 1.8% in 2017. Some regard this as too optimistic.

The pickup in headline inflation is largely due to a base effect, namely the fact that the impact on annual inflation of the drop in the price of fuel and other goods influenced by the price of oil will disappear later this year. The gradual increase in the price of oil that markets expect to see over the projection horizon and which forms part of our assumptions will also give support to our headline inflation projections. The more relevant question is on core inflation when you take the price of food and energy out: this is now at 0.7%. It gets close to 2% in 2017, converging with headline inflation. The first element in the increase of core inflation is the pass-through of the exchange rate, which is the most important impact. The second source is the indirect effect of oil prices, for instance through transportation costs. Then we have the closing of the output gap, which might lead to firms regaining some pricing power. Most analysts have been discussing our assumption of the closing of the output gap by end of 2017. Some people argue that the output gap cannot be closed with such high unemployment. But the labour market can be tight in spite of massive unemployment if observed unemployment is all structural in nature. It's difficult to say today, but we think there will be somewhat higher wage increases in 2017, in spite of a still high jobless rate, because we expect the structural component of unemployment to remain large in 2017. But the key assumption giving support to the projected inflation is not a vigorous pickup in wage costs – which in fact are going to remain moderate – but rather firms regaining pricing power. In the last year producer prices have been negative. Profits of firms have been under pressure not only because of volumes but also because of prices.

Central banks normally tend to look through oil prices. Why did you have to act?

As I said, there was uneasiness about the serious risks of de-anchoring in inflation expectations. Maintaining price stability is the core mandate of the ECB. In 2003 the ECB announced that, in order to avoid risks of deflation, inflation should be below but close enough to 2% in the medium term. If the ECB does not deliver on this pledge, at some point, this creates a problem of credibility. If the risk is increasing, we have to give a signal that we are ready to do what is necessary to counter it, given our mandate. In January we concluded that we were confronted with the risk of falling into deflation. The price of protection against deflation jumped. These dynamics were reversed after we took very forceful action. The switch in the projections reflects this: we were in negative dynamics, with people being very pessimistic about the long run. We tried to invert those dynamics by very strong signalling at a time when we had favourable conditions.

Now, a number of people, including quite a few members of the Governing Council, argue that with conditions improving anyway, and the oil price being a temporary phenomenon, that quantitative easing (QE) wasn't really justified.

Let me clarify two points. First, there was a large majority in the Governing Council. We tried not to be overly conditioned by the question of risk-sharing. We made a purely monetary policy decision, separate from the question of doing fiscal policy through the back door. What is important is that the central bank has signalled its willingness and ability to act, to use the instruments available. The discussion on "wait and see" is a fair one, but the collective judgement of the Governing Council was that it was time to act. Second, what you see in our projections – which indeed give us some grounds for comfort – is that a more robust recovery is under way – but that this is conditional on a full implementation of what we announced in January.

Where do you see the risks, now that QE has started and seems to be having a strong impact, especially on markets.

The major risk is the risk of complacency. Take Italy, for example: the yields on 10-year government debt are at post-war lows, credit conditions are improving very fast, at the fastest pace in the euro area. It is clear that this additional, substantial amount of monetary accommodation will bring a lot of relief to the economy. But productivity in Italy stopped growing back in the mid-1990s, it was the worst performer among the large OECD countries, and in this long crisis, Italy has already had three recessions.

It's still a very challenging situation. The Italian economy, already debilitated by long-standing structural weaknesses, has gone through an accelerated downward trend and has underperformed other stressed economies, such as Ireland and Spain. This is now starting to be understood and we are seeing some structural reforms. But the implementation remains quite difficult. You have to communicate to people a sense of urgency and of ambition: reforms have to be done quickly and on a large scale. Implementation is key now. There is a long way to go. Monetary policy accommodation will help but will not make Italy a more productive economy.

So QE may remove the urgency to undertake the reforms?

On the contrary. It's a window of opportunity. Monetary policy accommodation facilitates the implementation of reforms. It's a risk if governments look at the electoral cycle and think they can just benefit from some growth and stop the reforms. Will structural reforms depress demand again? That is totally wrong. One has to be careful in selecting the right structural interventions, in prioritising the measures to take. There is a very limited window in which to carry out the reforms.

Is a weaker exchange rate the main channel through which QE will help the Italian economy?

I would say it's more the financial conditions, a factor which is broader than just the exchange rate. The Italian banking system was not exposed to sub-prime, but it is very exposed to the Italian economy and government debt. So there's a local exposure to an economy that wasn't growing even before the crisis. The financial sector entered the crisis already weak, with low profitability and high costs. It withstood the 2009 crisis, but when the sovereign debt crisis hit in mid-2011, and interest rates on government debt went to 7%, the sector's large portfolios of Italian sovereign securities depreciated rapidly. At that point, as was to be expected, banks retrenched, tightening credit conditions for their customers. Financial conditions became very harsh for the real economy. It took a long time to improve. Even one year ago, rates were very high for an economy that had not been growing for years and was expected to stagnate in the future. Market discipline can move from too soft to too harsh. It was perhaps not enough in the past but then it became excessive. Governments should take measures to avoid a pro-cyclical financial loop that creates instability.

In Italy a lot of people are starting to think we would be better off outside the euro.

Italy joined the euro because the previous regime, i.e. fixing the exchange rate and devaluing occasionally, was a source of uncertainty and instability. Markets learned how that regime worked, and therefore interest rates were constantly high, creating that snowball effect that brought Italy the very high public debt burden it has now. The country's problem is that it entered monetary union with that high public debt and governments did not seize the opportunity offered by lower interest rates to reform the economy. Now the low interest rate environment and easier financial conditions are again facilitating the necessary reforms. It's a window. I think this is understood: some reforms are in the pipeline. But as I said it's always a matter of implementation.

What is your early assessment of the reforms, including the labour market reform, in Italy?

The so-called Jobs Act can be a very important building block in a bold reform agenda. In Spain a similar step was taken three years ago, and it was a key factor pushing the Spanish economy to generally outperform the rest of the euro area in 2014. As we have seen in Spain, the Jobs Act reform can make Italy a more attractive location for doing business. It can create new employment opportunities, reabsorb the unemployed and give more stable and better-paid jobs to those who seek work certainty. But, again, this should be the starting point of an ambitious agenda for economic reforms. It should not be the end of the efforts.

The fall of the euro has been the most visible consequence of QE. There is a disconnect between the state of the economy and monetary policy, especially in respect of the dollar. Will the Fed be "patient" about a further rise of the dollar?

Currencies will reflect fundamentals and that is basically what we have seen. I cannot comment further on the exchange rate movements. From the European point of view, the decline of the effective exchange rate has been relatively modest.

But can you be accused of having started a currency war, given what other central banks have had to do to respond to your QE?

We have received a lot of international support for our recent measures. We do it for domestic reasons. The IMF told us we should have done it faster, so it was no surprise for anybody. We did the credit easing first, which gave renewed incentives for banks to create credit for the real economy, but in terms of the quantity it was not sufficient. Inflation expectations were not rebounding, so we took a new set of measures.

Have the TLTROs been obscured by QE?

As I said, we have been positively surprised by the impact of our summer 2014 measures on the pricing of credit even before QE. What we now see is that those banks which participated in the first two operations in September and December last year have cut the price of their loans to households and companies by more than non-participating banks. They have a strong incentive to generate more loans because the advantageous borrowing conditions under the TLTROs are conditional on their actual loan flows. Also, the third tender last week went quite well in terms of volumes. So, the TLTROs are also playing an important role.

Banks claim that while you tried to promote credit easing with your monetary policy, your supervisory arm, the Single Supervisory Mechanism (SSM), and the constant change in the rules makes this more difficult.

The flood of changes in regulation has had a certain cyclical effect, which has been compensated by monetary accommodation. But there is no contradiction. You need to make banks safer, less leveraged, and reduce liquidity risk. It is a caricature to say that we squeeze the banks and then provide more liquidity. We want more resilient banks.

Negative interest rates have now become so widespread that they must be posing some risks and interfering with your macro scenario. You could reach your target sooner than expected.

I would be very cautious here about the implications of the early days of QE. You need to give the markets some time to settle and get used to our purchases of €60 billion per month. When we designed the policy we wanted to have a sustained path of inflation towards where it should be. It will take time to assess its impact.

The people who said we may be in a deflationary spiral may be the same people who now say it’s too much. We’ll have a steady hand in implementation and we stick to the fact that a steady improvement in the outlook for price stability is conditional on us carrying out purchases at least until September 2016.

Are you encouraging excessive risk-taking and therefore instability?

We are coming from a situation in which the risk of financial instability came from inflation being permanently too low, possibly a deflation risk. A third recession would create huge financial stability problems. A shift in investment patterns by banks and other financial entities to longer-dated and riskier exposures is part of the policy of QE. Furthermore, in some countries some banks may have an excessive exposure to the sovereign. That creates a big correlation between the sovereign risk and the bank risk. Therefore, banks of the countries concerned could decide to reduce their exposure to the sovereign. Having said all this, we are monitoring financial markets constantly and with extreme care to detect pockets of exuberance.