Sabine Lautenschläger: Interview in Wirtschaftswoche

Interview with Ms Sabine Lautenschläger, Member of the Executive Board of the European Central Bank, in *Wirtschaftswoche*, conducted by Mr Mark Fehr and Mr Malte Fischer and published on 2 April 2015.

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Ms Lautenschläger, you have a unique role in the European Central Bank: not only do you have a say in the key ECB interest rates but, as Vice-Chair of the new banking supervision, you also monitor the institutions. Do you manage to avoid conflicts of interest between monetary policy and supervision?

I am a purist in this regard, so I strictly separate both of my tasks in order to avoid conflicts of interest. Before contributing to a discussion, I always clarify whether I am speaking as a supervisor or as a monetary policy-maker. Besides, in past crises, a supervisory model with a separation between the central bank and supervision was not shown to be more successful than the model with monetary policy and supervision under one roof.

On which issues do conflicts of interest arise?

Different interests could play a role in, say, the emergency loans for banks facing liquidity problems. From the banking supervisor's perspective, this liquidity assistance is initially welcome, because it gives the bank time to resolve problems. The monetary policy-maker must ask what transactions the liquidity will be used for, or whether the bank concerned is solvent.

Do you ever feel schizophrenic in your double role?

No, I believe that I manage to separate both tasks. In each of the two roles, I focus on the objective of the respective task, i.e. first for monetary stability and second for safe banks. Everything that goes on between monetary policy and banking supervision passes over my desk. And I am aware that, in my role, I have to act as a bridge and have to broker between the two sidess. In the long run, however, I see a separation of both tasks as the better choice.

Are the banks in the euro area stable enough to issue sufficient credit to businesses?

The vast majority of European banks have enough capital and liquidity to enable them to expand their lending activities. But that in itself does not suffice. If we want to see sustainable and sound credit growth, banks will have to take a positive view of their customers' creditworthiness and thereby of their future prospects. And, as a rule, that is closely linked to the economic growth of the customers' region, of their home country. But politicians are the only ones who can bring about lasting economic growth, namely by implementing structural reforms.

What is your view of demands that banks should top up their capital to 30% of their balance sheet total, as is the case at many enterprises outside the financial sector?

I am in favour of banks holding adequate and, above all, high-quality capital. But that has little to do with the demand you are referring to. I find that too sweeping; it ignores the risks inherent in a capital calculation that is geared to the balance sheet total rather than to the bank's risk. Investors want to see returns and, unfortunately, often take a very short-term view. If the capital share was too high, banks could be forced to invest in especially high-return, and thus particularly high-risk, projects, in order to generate the required returns. In this way we would indeed boost the banks' risk-bearing capacity, but also their risks. Nothing would have been gained.

Low interest rates alone are driving banks to enter into ever more risky commitments. At the current level of interest rates, does the business model with deposits and credits still work at all?

The low interest rate environment is certainly a challenge for the banks. On top of that, in particular the German banking sector is marked by strong competitive and price pressure. This means that some business models will drift into a precarious situation over the medium and long term.

What are you doing to counter that?

We must prevent banks from responding to the low interest rates purely by engaging in riskier transactions or by making savings such as job cuts in risk management. We respond to a heightened risk on a balance sheet by requiring additional write-downs or more capital. Moreover, we ask banks to improve their internal controls and their risk management by, for example, employing more staff for these tasks.

But banks are now more concerned with reducing headcount.

What matters for us supervisors is that the institutions not only attract business, but that they adequately monitor the accompanying risks. I can well remember times in which I left the banks to choose – to either make job cuts in trading or hire more staff for risk management.

How happy are you with the capital raising prescribed by the ECB for those banks that failed the stress test last autumn?

On the whole, I am pleased. For me, it’s not so much about the need for capital that we found during the health check of more than 120 of the largest banking groups in the euro area. The success of the health check was that the institutions prepared themselves for this test, also by indeed strengthening their balance sheets by around €200 billion. That has brought stability; now we need to turn to the many national transitional rules, that do not have a positive effect on the quality of capital.

For some weeks now the ECB has been buying large quantities of government bonds. However, the euro area economy has long since stabilised and no longer actually needs any monetary stimulus. Is the purchase programme a mistake?

Economic prospects have indeed improved. Besides the fall in oil prices, the ECB’s previous monetary loosening was a contributory factor. Just think of the reductions of the key interest rates and the additional liquidity injections for the banks offered at favourable conditions. Sometimes more patience is called for. Especially when we’re talking about large-scale purchase programmes for government bonds, which in my view can only ever be a last resort, namely because of their side-effects.

But consumer prices in the euro area are nonetheless falling…

...which is not yet deflation. Deflation exists when citizens expect a long-lasting fall in prices and adapt their behaviour accordingly, e.g. by postponing purchases or being prepared to work for lower wages. A downward spiral then looms of falling prices, lower demand and declining wages. There are no indications of this at present. The current slowdown in the rate of inflation is largely attributable to the fall in energy prices. Moreover, the crisis countries of the Monetary Union have introduced essential corrections in wages and prices in order to improve their competitiveness.

The ECB’s bond purchase programme is also supposed to stimulate bank lending. How can that come about when, as is currently the case in the euro area, interest rates are already low?

The programme aims at, among other things, making it better economic sense for banks to extend credit. By putting downward pressure on the yields for government bonds, it enhances the incentives for investors to shift to higher-risk and higher-return investments and for banks to release funds for lending operations. Even before the purchase programme commenced, long-term yields on the bond market in the euro area had already reached an extremely low level. However, experience in the United States shows that the higher the level of the relevant yields, the stronger the impact of government bond purchases.

What effect do you expect in the case of the ECB?

Given the low interest rates in the euro area, I have my doubts as to whether the economic effects of the purchase programme will be able to reach the desired order of magnitude…

...and finance ministers are pleased that they can cheaply run into debt.

That is a crucial disadvantage of the purchase programme. I am absolutely aware of the danger that the low costs of financing alleviate the pressure on governments to consolidate their public budgets and tackle the necessary structural reforms. Expansive monetary policy can only provide an impetus for more growth. The decisive impulses must come from economic policies.

Are zero per cent yields on German government bonds justified too?

Depending on the class of securities, we are in negative territory in some cases. To the extent that the decline in yields on German government bonds can be traced back to the purchases by the ECB, I take a critical view.

In Germany the low interest rates are threatening to overheat the economy.

I would not speak of an overheating of the economy, of an excess of economic growth in Germany. The German economy may be able to absorb a higher key rate of interest but the same cannot necessarily be said for the euro area as a whole. A crucial point is that the ECB has to pursue monetary policy for the whole euro area, not just for one country. And it’s also essential that we look at price stability in the medium term and at medium-term inflation expectations. However, medium to long-term inflation expectations have clearly fallen; that is why the current low key interest rates are definitely justified. But we should not forget that we cannot have a low key interest rate without undesirable side-effects. We must bring interest rate levels back to normal as soon as possible.

Do you understand why savers, banks and insurance firms become critical when they suffer from extremely low interest rates?

I can well understand those concerns. A prolonged low inflation rate environment carries risks for banks and insurance firms. Low interest rates increase the danger of riskier investment behaviour; overheating or price bubbles in other asset classes can easily arise.

...especially, when an economic region as heterogeneous as the euro area is governed by a single interest rate.

The more heterogeneous an economic area, the harder it is to govern with a single interest rate. That is of course felt especially painfully when economic conditions are tough. We therefore need the euro area Member States to pursue economic policies that will ensure sustainable economic growth for all. The competitiveness of each individual Member State must be strengthened through sound fiscal policy and structural reforms. And in places where we see overheating occurring, we must use targeted macro-prudential supervisory tools…

....that is supervision of the whole financial system with targeted regulation.

Such oversight enables us to identify the systemic risks and outliers in individual countries and individual markets and to counter them in some sections.

Given such complex tasks in different countries, are we asking too much of the ECB?

No, the ECB is not on the frontline in macro-prudential oversight; in Europe this involves many institutions in all Member States, which have a vast amount of information and considerable analytical capacity. In Germany these are the Bundesbank, the Federal

Financial Supervisory Authority and the Federal Ministry of Finance, which all work together in the Financial Stability Committee.

Do we already have a housing bubble in Germany?

Up to now, the rise in property prices has been concentrated in the larger cities. In some of these there are definitely overvaluations. But have we seen excessive growth in lending too? Broadly speaking, that does not seem to me to be the case. The Bundesbank, and we ourselves, will certainly continue to monitor the situation closely.