Peter Praet: Interview in *La Repubblica*

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in *La Repubblica*, conducted by Mr Ferdinando Giugliano and Ms Tonia Mastrobuoni on 15 March 2016 and published on 18 March 2016.

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Can you explain why you took such a big package of measures last Thursday?

You have to put these decisions in the context of heightened risks to our price stability objective. External shocks, mainly originating from emerging markets, high market volatility and the crucial need to avoid second-round effects warranted a strong and comprehensive package to counteract these adverse forces.

We don't have a gloomy assessment of the economy, domestic conditions have improved, financial conditions have clearly improved. But it is still very fragile, and external shocks can easily trigger a vicious circle, with further downward pressure on inflation. We wanted to ensure that this did not happen, in line with our mandate. It was decided by the vast majority in the Governing Council, that we had to act very forcefully to ensure an even more accommodative monetary policy stance.

What can be said about the composition of the measures? We discussed the pros and cons of the different measures. On the negative deposit rate: it is clear that it served us very well in the past, it has been quite efficient in easing financial conditions, including the exchange rate, as a natural by-product of differences in the monetary policy stance in the major currency areas. As we proceeded on the path of negative interest rates on our deposit facility, it was also clear we had to look at the impact on the profitability of the banks. Banks are very important for the monetary transmission mechanism, so you have to look at what is the impact of the package on the banking sector. Against this background, we decided in favour of a package which still made use of changes in the ECB interest rates but increased the weight of measures aimed at credit easing.

Since the markets had already anticipated three cuts in the deposit rate this year many money markets traders had to turn their positions. However, with a little bit more time to scrutinize and digest the complex package, markets and analysts finally tuned again.

Were you surprised by the strength of the market reaction?

I expected that the short end was going to be repriced but that the rest of the package would dominate. Looking through some volatility, what we have got at the end makes sense from an economic point of view. Basically, we had a substantial impact on credit markets, which is good as financial conditions were worsening and credit spreads were going up. What dominated was very much the TLTRO and the broadening to corporate bonds of the asset purchases.

In terms of other asset prices, I believe markets are very conscious already that the monetary policy courses of the major world currency areas remain quite on different trajectories as they reflect fundamentally different domestic underlying conditions. As we have said few times in the past, the fact that there are significant and increasing differences in the monetary policy cycle between major advanced economies will become ever more evident in the near future.

But do you think the market is right to believe there will not be more cuts?

In the Introductory Statement we said very clearly that we "expect the key ECB interest rates to remain at present *or lower* levels for an extended period of time, and well past the horizon of our net asset purchases.

So you haven't reached the lower bound?

No, we haven't. As other central banks have demonstrated, we have not reached the physical lower bound. This re-composition of the tool-box does not mean that we have thrown away any of our tools. If new negative shocks should worsen the outlook or if financing conditions should not adjust in the direction and to the extent that is necessary to boost the economy and inflation, a rate reduction remains in our armoury.

On corporate bonds purchases: would this instrument be accessible for companies like, let's say, Volkswagen?

Yes, as long as they have investment grade. You have corporate bonds in other sectors too, such as utilities, insurance, telecommunications, energy.

Don't you think you are entering the dangerous territory of choosing who to distribute money to? For example, you may end up favoring larger companies.

Normally what you do is that you give liquidity to the bank in exchange of collateral. Here, you take a direct exposure. The other point is, you want to avoid influencing relative prices. We asked the committees to work on the specific definition of the bonds we will buy. We could buy something that is close to the index, but excluding banks, so that we avoid price distortions in the corporate bond market. The important point is that if the price goes up because you are buying non-financial corporations, there will be search for other bonds by the markets participants so they will rebalance the portfolio with other bonds that are not in our portfolio. So the initial effect of our purchases will spread further and the market can still function.

Can we put it like this: in countries like Germany and France with big companies with high ratings, you are helping with corporate bond purchases, and in countries like Spain or Italy, with less access to this type of measure, you will help via the TLTRO?

It is true that in some jurisdictions you do not have many corporate bonds. But as I just said: the initial effect of our purchases will spread to other assets and other markets. So there will be a reinvestment of the liquidity. Those having sold corporate bonds will rebalance by buying other things. Some people will question the need for such a measure. They are right in saying that the situation is not dramatic, but I would stress that it is still fragile. Yes, we can see that the situation is improving, as, for example, unemployment is coming down. But we have not reached the "escape velocity" yet where the rocket is not bound by gravity anymore.

On the TLTRO, some say it is not going to make much difference, because the problem is the demand, not the supply of credit.

As shown by our Bank Lending Survey, credit demand is picking up and you also see from actual bank credit growth that the numbers are improving. So we now give a push for these developments to proceed and maybe to accelerate. Do not overlook the following: In the last tranches of the TLTRO I you could borrow for less and less time, as the loans had all the same maturity, that is September 2018, in an environment where the rates were falling. This time it's different: in one year you can still borrow for four years at the conditions prevailing at that time. And, banks can benefit from a negative rate as low as our deposit facility rate if they meet the thresholds for credit growth. All this is quite bold. It will certainly facilitate cheaper funding of banks by replacing more expensive funding instruments by our TLTRO II.

Don't you think that the discussion in Germany about how harmful the accommodative stance of the ECB is lacks some analysis on some wrong business models, for example the one of the Sparkassen?

What we experience in the banking sector is difficult and we have to be very attentive to that, but it is also true that the banks have to rethink their activities fundamentally. I mention here digitalization, which is a very big challenge for the banks. It has the potential to change the business model fundamentally. The interest rate is not a favourable factor, but it is one of the factors. And as long as you have a positive impact on the economy from negative rates, you have better growth, fewer NPLs, so we have seen positive factors for banks. The problem for banks is not 2016, it is the medium term, if the situation becomes persistent and the business model is not adjusted, then profitability becomes a major issue.

The staff projections don't include the impact of the new measures. What will be the impact on inflation and growth of the package?

The measures we took should bring us close to the 2 per cent target at the end of 2018. But don't forget, the measures we take like the APP are supposed to remain in place as long as inflation has not reached a sustainable adjustment in the path of inflation. It must be sustainable. We are not yet there. In the forward guidance we said: we expect the interest rates to be low or lower for an extended period of time, and well past the horizon of our net asset purchases, which currently have an horizon to at least March 2017.

Can I ask you about what's left in the toolbox? Could we see "helicopter drops"?

There has been a lot of skepticism recently about monetary policy, not only in delivering but in saying "your toolbox is empty". We say, "no it's not true". There are many things you can do. The question is what is appropriate, and at what time. I think for the time being we have what we have, and it is not appropriate to discuss the next set of measures.

But in principle the ECB could print cheques and send them to people?

Yes, all central banks can do it. You can issue currency and you distribute it to people. That's helicopter money. Helicopter money is giving to the people part of the net present value of your future seigniorage, the profit you make on the future banknotes. The question is, if and when is it opportune to make recourse to that sort of instrument which is really an extreme sort of instrument.

There are other things you can theoretically do. There are several examples in the literature. So when we say we haven't reached the limit of the toolbox, I think that's true.

In Germany, the biggest economy in Europe, there is a very distortive discussion about the ECB. Aren't you worried that this discussion is very dangerous to maintain trust within the eurozone?

I think the responsibilities for the problems we have are collective. I think everyone has to look from the point of view of the other. Don't forget, a lot of excess German savings went to Spain, to the Spanish banking system. I don't deny that the problem in creditor countries gets worse in some respects the lower we cut the deposit rate. It is true we are looking at this, and it is true that when we decided some recomposition of our toolbox, we took that into account. But, fundamentally, the issue is not so much the negative rates, the main issue is mistrust in the willingness of the more indebted countries to really seize this opportunity to forcefully address the problems. This is much more what drives the German view.

Italy is often accused of not doing enough to solve its structural problems. What are the changes that could really unlock growth in Italy?

The real question is "what drives prosperity?" I think prosperity is linked to education, productivity, the rule of law, property rights and all these things, certainly not monetary policy. In Italy productivity really started to stop growing in the early 1990s. I think this is a fundamental reflection for the country. Some key questions like the efficiency of the judicial system, the labour market reforms, liberalizations in services, have in all or in part been tackled. But I think the agenda remains unfortunately significant. To give you just a few examples, I have been worried by the insufficient spreading of ICT technology. Business investment is recovering everywhere, because demand is recovering so investment is following, but one of the weaker investment performances is in Italy. I think the minister of finance and the government are well aware of what the priorities are, of what needs to be done.

One thing you haven't mentioned is fiscal policy. In Rome one often hears the argument that Italy should be allowed to expand fiscal policy more to really help the

recovery. One also hears that the European fiscal rules are not fit for purpose. How do you respond to that?

Experience tells that there is always a reason to postpone fiscal savings and that fiscal policy is often procyclical.

So the only appropriate response to these experiences is having suitable fiscal rules and following them over the full cycle. Yes, there is the risk of doing the wrong things. For example, in 2011, not necessarily mentioning Italy but focusing on the European level, consolidation was necessary. However, the composition could have been more growth friendly. Instead of raising taxes, spending could have been cut, and instead of cutting investment in infrastructure, government consumption growth could have been reduced. And particularly in the current juncture, investment should not be penalized but encouraged in countries like Italy.

Fiscal consolidation is always a lot about composition, about timing. Successful consolidation could involve pension reforms, which spread consolidation through the years. In this respect, in the past Italy went a long way to improve fiscal sustainability through its pension reform.

I know in Italy there is a discussion over a coordinated tax reduction. What I see is that fiscal policy was slightly expansionary last year and will be this year. Well-designed structural reform packages, which entail short-term costs and have a clear impact on growth potential, are taken into account by the Commission and they may affect temporarily the adjustment toward the achievement of fiscal objectives. But of course the lower fiscal adjustment has to be commensurate to the beneficial impact of reforms on the growth potential and the sustainability of public finances.

Do you think there should be a haircut on Greek debt?

If you look at the wealth improvement of Greece in terms of disposable income, before the crisis it was spectacular and then it went the other way very quickly. So it was basically on shaky grounds, a large current account deficit, it borrowed money, so at some point it corrected. All this makes you very cautious to say we just do this or that and support the recovery in the absence of a very convincing programme of reforms. Greece was the extreme case, the demonstration that the monetary union was unprepared to deal with a financial cycle correction, especially in some countries. Fortunately, new institutions have been put in place, such as the European Stability Mechanism, the Single Supervisory Mechanism, the Single Resolution Mechanism. But we are not there yet, the banking union is not a real banking union yet.

Who is stopping the third pillar of the banking union?

It is always the same problem. All will accept it, if they can trust the other members of this mutualized system to address what they think are risks.

Do you accept the argument that one needs to find ways to limit risks in the banking sector?

Yes, but the question is how you define that. That's where the differences are. The single deposit guarantee has rarely been called and only for very small institutions. There is plenty of bail-inable assets before you reach small deposits. This deposit guarantee for me is something which distracts. We should do it. We could take the risk of having this guarantee.

A common deposit insurance would help, but it's more important to allow a European bank to be able to operate in the euro area as a single entity.

Even this small deposit guarantee scheme is a big political problem for Germany.

I think personally you should announce an objective and a roadmap. We have a roadmap for the deposit guarantee scheme, but it is very far away. We have to spell out on paper what we consider as required conditions before you can mutualise in, for example, 5 years. That would create a new environment for banking.

But the Germans have a roadmap: they say government bonds must not be risk-free and that they want a common bankruptcy law. These are very difficult conditions.

As for sovereign debt, we have learnt from the crisis that it is not risk-free, that is clear. On the other hand, sovereign debt plays an important role in our economy, in the financial sector. So one needs a very thorough reflection on this. That's why the sustainability of public finances is key. That's why one can't just say "let's lower taxes and the economy will follow and we will self-finance the tax cut". I think one needs to be careful as sovereign debt is a key pillar of our financial system.

A final question on Brexit. Do you have any contingency plans in place at the ECB?

Brexit is part of this tendency for some to say that independent nations can do it better than collective solutions. I am confident that the voters will understand that national solutions are worse, that we have to reinforce Europe and not the opposite.