Benoît Cœuré: Interview in Börsen-Zeitung

Interview with Mr Benoît Cœuré, Member of the Executive Board of the European Central Bank, in Börsen-Zeitung, conducted by Mr Mark Schrörs and Mr Detlef Fechtner on 20 December 2016, and published on 31 December 2016.

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Mr Cœuré, the euro area economy is currently growing above its potential, and inflation, according to ECB President Mario Draghi, should reach the objective of nearly 2% between 2018 and 2019. But the monetary policy of the European Central Bank (ECB) is even more accommodative than at the height of the global financial crisis. That doesn't really fit together, does it?

Things are clearly moving in the right direction in the euro area: the recovery is on track, growth is higher and inflation is picking up. 2016 is ending on a positive note. At the same time, however, the inflation rate remains well below 2% and core inflation...

…in other words, excluding energy and food…

...continues to be very subdued. There are signs of an acceleration in headline inflation, above all because of the increase in oil and commodity prices. However, we are still waiting for signs that core inflation is on the rise and will clearly exceed 1%. That said, our assessment of the balance of risks, including for inflation, is shifting. That allowed the Governing Council to send a balanced message on 8 December: the euro area will need monetary support for an extended period of time, but the amount of purchases can be reduced.

You mean the reduction in the volume of purchases every month under the asset purchase programme from €80 billion to €60 billion, starting in April 2017 – and the extension of the purchase programme until December 2017?

Exactly. Our decision strikes a careful balance between the two considerations I have just outlined, and it met with a very broad consensus in the Governing Council.

Has the ECB started to move towards the exit?

Not at all. It's an adjustment, not an exit. There is no plan to cut back the purchases to zero. That wasn't even discussed by the Governing Council. A discussion will be needed about normalisation of monetary policy but it needs to be initiated carefully. For two reasons: on the one hand, inflation is still very low. On the other hand, there is a high level of uncertainty.

You say that the ECB has to act carefully. But is it careful or reasonable to commit to spending €60 billion every month until the end of 2017?

Clarifying our intention is not only important for financial market participants but also for investors and consumers. They want to know what the financing conditions for the next 12 months will be. For us, it is crucial that financing conditions in the euro area continue to be appropriate for the economic situation.

And do you see risks?

Political uncertainty is mounting both inside and outside of Europe. Of course, the ECB is not a political institution. We cannot and should not be influenced by political developments in individual euro area countries. But uncertainty may inflict economic damage at euro area level by holding back investment and consumption, which we may then take into account. Outside the euro area, major changes are expected in US economic policy, with a stronger focus on fiscal policy. These changes will reverberate across the global economy, with both positive and negative implications which are still difficult to assess. We can't accept that long-term euro area interest rates would be entirely driven by US interest rates. We need a certain amount of decoupling, as the recovery in the euro area is not yet as robust as in the United States. Our asset purchase programme helps ensure this.

But is a further reduction in the purchase volume possible in 2017 if the situation improves? The Governing Council has only left open the option of an increase. Might your assessment even change?

Our forward guidance is not a commitment to a particular course of action. It explains, at a given point in time, our expectations, our views on the economy and how we would respond to shocks. Any new data will of course be taken into account. The Governing Council's decision was appropriate given the available data. A further reduction can only be considered at a later stage depending on how inflation adjusts towards 2%.

But do you think upside risks to inflation are increasing?

Developments since the latest projections by ECB economists – i.e. the weaker euro and higher oil prices – are pointing to slightly higher inflation. But we need to look at precisely how that affects the economy. Don't forget that higher oil prices also have a negative impact on the purchasing power of companies and households. Moreover, it is unclear how these developments will impact underlying price pressures, if at all. Speaking personally, I don't exclude upside risks to inflation in 2017 if the reflationary impact of the new US policies dominates.

Is a kind of "forced exit" out of quantitative easing looming in 2018 because the ECB will run out of purchasable paper – at least as long as the 33% purchase limit on individual issues and issuers is not increased?

We have discussed the risk of bond shortage at length, both at technical level and in the Governing Council. That's why we have decided, in the future, to also buy paper with maturities between one and two years and, to the extent needed, with yields that are below the current rate of interest on our deposit facility, namely –0.4%. This puts us in a position to purchase bonds, at least until the end of 2017. The other restrictions to our purchases, in the opinion of the Governing Council of the ECB, are more binding and more important, especially the limits relating to issues and issuers. This is for two reasons: they serve as a safeguard against monetary financing of governments, which we are strictly forbidden from doing. And they ensure adequate price formation on markets. The Governing Council, myself included, is very reluctant to change these limits.

If, in the future, the ECB is holding one-third of euro area government debt, can it really be argued that it isn't monetary financing?

In the context of the Outright Monetary Transactions, the European Court of Justice has said it is not, and I rely on the Court's judgement on what is compliant with the EU Treaty and what isn't. As long as we don't buy on the primary market and we don't set the price, it's not monetary financing.

You recently said that the euro area needs "financial protection" in 2017, also because of the elections in Germany, France and perhaps Italy. Is it a task of the central bank to offer protection from democratic elections?

We offer no protection from political events. We conduct monetary policy for the whole of the euro area. If an individual country were to encounter problems in the markets and if redenomination risk were to rise again, as in 2012, there is a specific instrument for this – the

Outright Monetary Transactions (OMT) programme. It's available and has been approved by the European Court of Justice under strict conditions. These conditions are known and include reassurance that the country is undertaking strict structural adjustment under a financial assistance programme of the European Stability Mechanism (ESM). It would be completely wrong in my view to tweak our government bond purchases to manipulate government bond yields in such and such a country.

A current internal analysis by the ECB has concluded that, although political risks are high, macroeconomic risks are relatively low. How does this fit in with your reservations?

Domestic demand is firming up and our concern is more about the resilience of the euro area economy to exogenous shocks. The lessons of 2016 indeed provide some comfort. The euro area was hit by significant shocks in 2016: the Brexit vote, the US election, the Italian referendum. And the economy proved to be resilient. We can therefore be reasonably confident that it will be resilient in 2017 as well.

Which euro area country are you currently most concerned about?

It's not about a particular country. What matters for me is the capacity of euro area governments to take collective action. In a period of important elections, they are concentrating on national issues and risk losing the will and ability to act together. But for the euro area to be strong and stable, governments have to work together. This applies both in the short term, with possible economic shocks ahead, as well as in the long term with the necessary structural reforms and strengthening of Economic and Monetary Union. My concern is that in 2017, because of the elections in several countries, not much will be done to reform countries and to improve the functioning of the monetary union. But monetary policy cannot always remain as supportive as it currently is. Reforms are urgently needed to allow euro area economies to stand on their own feet, both at national and at euro area level.

Isn't the basic problem the fact that in the euro area there are generally very different visions of economic and fiscal policy, not least in Germany and France?

The various governments have different starting positions, which is natural – even good – because Europe is about diversity. Combining different perspectives has always made Europe stronger. But for this to happen, they should talk *with* each other instead of talking *about* each other! There's a need to clarify how the euro area will evolve and what the balance should be between solidarity and national responsibility. As long as the euro area is an unfinished house, the ECB will always be expected to do all the hard work.

What is particularly important now?

I would like to distinguish between two sets of issues. First, there are deep political discussions which we know will need time – such as improving national fiscal responsibility, taking steps towards a fiscal union based on existing elements such as the ESM or the Single Resolution Fund, and taking forward the discussion on a common deposit insurance scheme and on limiting banks' exposure to governments. There is no quick fix for these issues. However, smaller steps can be taken to improve the functioning of the banking union – such as the removal of national options in regulation and supervision, as asked by ECB Banking Supervision. A philosophical discussion is not needed for all of this. 2017 will present an opportunity to make tangible progress on these issues, while the debate continues on the bigger ones.

Without fiscal capacity, will the euro area just keep falling into one crisis after another?

I personally think that the euro area will not be out of the woods until Member States create some form of a common fiscal capacity to help cope with large economic shocks. Monetary union with a fully decentralised fiscal framework, as initially envisaged in the Maastricht Treaty, has clearly not worked because market discipline has been weak and governments have not lived up to their responsibility.

But a fiscal capacity requires a few important things.

And what would those be?

First, we need more convergence between participating economies. If Member States were to discuss a fiscal union while their economic strengths are as different as they are now, the debate would in fact be about creating new fiscal transfers, and our monetary union is not a transfer union. Second, any new set of rules should build on the existing ones. They should be enforced fully. It is a question of mutual trust. I have often said that fiscal rules should not be stretched to the point where they lose their credibility, and that countries like France or Italy have no fiscal space under the common rules. And third, political accountability is needed. A decision about a joint fiscal capacity must be taken democratically, in due knowledge that it entails joint sovereignty.

It is 25 years since the signing of the Maastricht Treaty. Former ECB Chief Economist Otmar Issing thinks the euro has divided Europe more than it has united it. Has the euro failed?

That's not what the people of Europe answer when they are asked about the euro. If you ask the citizens, their trust in the European institutions is indeed low, but not as low as in national governments. And public support for the euro as a single currency is high – currently at 70% in the euro area and 81% in Germany.

How worried are you that the situation in Greece could escalate again in 2017?

The overarching aim must be for Greece to implement the ESM programme so as to regain access to the financial markets. In order for this to happen by mid-2018, the country needs decisive reforms as well as measures to ensure the sustainability of its debt. Both the government in Athens and its euro partners must deliver what they have committed themselves to. Short-term debt measures as decided earlier this month by the Eurogroup are welcome but let me be clear: they are not enough to eliminate concerns over debt sustainability in Greece, unless strong assumptions are made on Greece's fiscal surpluses beyond 2018. Medium-term debt measures will also be needed. But we are currently in the midst of a programme review and the ball is clearly in the Greek camp.

Volatility on the financial markets is low, share prices are rising and rising, especially in the United States. Do you see a decoupling from fundamentals?

I don't want to comment on US markets. High share prices are predicated on high corporate earnings expectations. But one thing is sure: financial markets' reactions to the various shocks seen this year were very subdued. This makes it all the more important for authorities to be vigilant as far as risks to financial stability are concerned. We have seen recently significant corrections in bond yields. This is not all bad: higher yields and wider spreads recreate scope for a proper assessment of risks. In this respect, and up to a point, they can foster market discipline.

Are we at risk of a bond crash like in 1994?

There are no signs pointing in that direction. But all actors must prepare themselves for the time when extremely favourable interest rate conditions gradually come to an end. In particular, governments should be aware that their budgets are subject to interest rate risks. They have not used the unexpected gift of low interest rates as they should have – that is, in most countries, to reduce debt and return more quickly to a balanced budget.

What about private agents? Have they become too accustomed to loose monetary policy?

I hope they have not. It is clearly their duty to prepare for risks. We conduct monetary policy with a mandate of price stability. We don't issue a blanket guarantee for the financial system.

Won't this risk awareness be undermined if the ECB promises to be active in the markets "for a long time"?

But we are doing that with a clear objective – price stability. And with our decision in December, we provided evidence that there is scope within this mandate to reduce the pace of our bond purchases. Governments and market participants must understand that we do not issue guarantees to them to secure their budgets or their profit and loss accounts. If the economic situation continues to improve, which we all wish, they must be prepared for increasing interest rates, albeit the increase is likely to be very gradual.

How concerned are you about the strength of the US dollar? Does it pose a risk for the global economy and the global financial system?

G20 countries are committed not to target exchange rates for competitive purposes. As far as advanced economies like the United States and the euro area are concerned, recent exchange rate adjustment mirrors the divergence in monetary policies. It helps maintain a monetary policy environment in the euro area that is appropriate for the economic situation. Where there may potentially be some cause for concern is in emerging markets. There, the stronger dollar may lead to a significant tightening of financing conditions – coinciding with heightened geopolitical uncertainty and a new debate about international trade. That creates new risks which will be monitored closely in international fora.

Are you afraid there may be a new wave of protectionism?

Yes, I am. It is essential that the global economy remains open. Europe has a responsibility and a duty. We must signal that we will do everything we can to ensure the international economy remains an open one.

Some observers say that the ECB and other central banks are already sowing the seeds for the next financial crisis. There are worries about the desperate search for yield. Or fears of a banking crisis when interest rates will increase because banks are reacting to the ongoing low interest rate policy by increasing maturity transformation, which increases interest rate risk.

Your question seems to imply that low interest rates are bad but higher interest rates are also bad. If your point is that bankers always complain, then I agree with you! But in all seriousness, we know that interest rates being low and yield curves being flat for too long are not helpful for banks. So far, the net impact on banks of our monetary policy has been positive because they have benefited from a stronger economy. However, that may change in the future. We have to monitor the situation closely and this is anchored in our monetary policy thinking because banks are important for monetary policy transmission. At the same time, it is the banks' duty to adjust their business models to the environment. Banks should not use monetary policy as an excuse not to make the necessary effort to change their business models and become more profitable.

The central bank of central banks, the Bank for International Settlements (BIS), also warns that central bankers are repeating the mistakes of the start of this century when loose monetary policy contributed to a credit and housing boom which then collapsed and gave rise to the financial crisis.

It's the BIS's duty to issue warnings, and we take its advice seriously. Today, we monitor risks in the financial system in much more detail than before the crisis, as shown for example by our biannual Financial Stability Review. Second, we now have new tools under European law – particularly macroprudential instruments. And third, banks are much less leveraged today, thanks to the new regulatory constraints. History teaches us that, always and everywhere, asset price bubbles were accompanied by high leverage. That is not the case now, because banks' balance sheets are smaller. That reduces the amount of risk in the financial system. Where we need to be particularly vigilant is with regard to market-based finance, also known as shadow banking. We need to gather the right information and we may need new instruments to make sure that the next big crisis does not come from the shadow banking system.