Peter Praet: Interview in Expansión

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in Expansión, conducted by Andres Stumpf Guirao on 27 March 2017 and published on 3 April 2017.

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Growth in Europe is higher and inflation is rising. Is the situation better?

Yes, about a year ago we had the emerging markets shock. Then a high downside risk to the world economy emerged and the G20 member countries signalled in a statement that they would use all the tools at their disposal to support the economy. In the United States, the Federal Reserve halted its rate rises, and in the euro area, the Governing Council of the European Central Bank decided to add further monetary accommodation. This coordinated reaction was very effective globally. In the euro area the economy is now gaining momentum. This improvement is very visible in confidence indicators but still needs to be confirmed in hard data.

Has the ECB finally won the battle against deflation?

Yes, it has. Since the crisis we have had serious concerns about deflationary risks on several occasions in the euro area, but now we can say that they have disappeared.

Have they given way to concerns about inflation?

No, I don't think so. It's headline inflation that has picked up, and this is significantly affected by volatile elements such as oil and food prices. Underlying inflation, which is an indicator of price stability over the medium term, remains subdued.

In Spain the CPI was at 3% for three months, before falling to 2.1% in March. How do you assess these developments?

We always look through transitory changes in euro area HICP inflation. As in the euro area, underlying price pressures in Spain remain subdued.

So isn't it time to withdraw the stimulus measures?

We anticipate that the recovery will be reflected in hard data and not only in confidence indicators. We have more confidence in the economic outlook. Incoming data are making us more confident that the economic expansion will continue to firm and broaden. But the important question is whether the adjustment of the path of inflation towards below, but close to, 2% would continue without our expansionary monetary policy. At the present time, I would have to say no, but it's clear that the tone of our communication has changed – we are now more optimistic on the economic outlook. Our monetary policy stance thus remains appropriate. Of course, it is our job to continuously assess the appropriateness of our stance.

But from April the ECB will reduce its asset purchases by €20 billion. Is this the first step towards the end of these purchases?

In December 2016 we decided to move from a monthly volume of €80 billion to a monthly volume of €60 billion, and to extend the programme for a further nine months until December 2017. The ECB Governing Council considered two options and concluded that both options – continuing for six months with a volume of €80 billion, or for nine months with a volume of €60 billion – would have a broadly equivalent impact on the economy. Overall, we considered that our presence in the market would ensure a more lasting transmission of our stimulus measures. This adjustment does not signal the start of a gradual reduction of purchases (tapering).

The programme is experiencing some distortions regarding the capital key. Is that sustainable?

The purchase volume depends on each country's percentage contribution to the ECB's capital. Temporary deviations can occur, but the capital key remains the criterion for allocating our purchases, and we will comply with it. We have always shown that, whenever it is necessary to act, we do so. In this context, in December we changed the maturity restriction regarding the securities that we could purchase. The aim is to continue the purchases until the end of the year, and we have no doubt that we will be able to achieve this.

Does this mean that other conditions will be changed?

That's not our intention, but the Governing Council could do so at any time.

Have we seen the upper limit of expansionary monetary policy?

The Governing Council reiterated at its last meeting that "we continue to expect rates to remain at present or lower levels for an extended period of time and well past the horizon of our net asset purchases" and that, if necessary, "we stand ready to increase our asset purchase programme in terms of size and/or duration". So we still have the option to be more expansionary, but currently the probability of us having to provide more monetary accommodation to meet our objective has reduced considerably.

What stage has Europe reached in the process of banking union?

We are just over half-way along the path to banking union. There is a need to distinguish between the area of regulation and supervision, where we have made great progress, and the field of crisis resolution, i.e. what to do when a bank fails, where much remains to be done.

What do you mean by that?

If, for financial stability reasons, a bank is not able to rescue itself by calling on its investors (bail-in), it currently still falls to the national authority to respond (bail-out). This system is asymmetric, because banking supervision now takes place at the European level, but when a bank fails, footing the bill is still largely a national responsibility. Completing banking union would help the banks to develop their cross-border strategy.

Would relying on such institutions be beneficial, or would it add more systemic risk?

Let's look at an example. If Spain had not had two large international banks and the whole sector had been exposed solely to the Spanish market, the crisis would have been much worse. We need cross-border banks at the European level. In a monetary union, private sector risk-sharing through cross-border banking and capital markets is essential to cushion asymmetric macroeconomic shocks. Systemic risk would not increase because the public backstop in case of bank failure would be European rather than national.

There is an ongoing debate on this issue...

This is indeed subject to debate, but the doubts raised are not about whether or not it should be done, but rather about how and when to achieve it. Some countries believe that it is first necessary to reduce the risks in banks before sharing them, but we are in favour of making progress on both risk reduction and risk-sharing in parallel. What is missing today is a clear timetable, a political commitment to achieve banking union in, say, four or five years. We need to finish what we have started, and a clear timeframe would help the banks to develop cross-border strategies.

After what happened in Italy in November last year, is the concept of the "bail-in" still alive and well?

The European rules allow flexibility for financial stability reasons under well-defined conditions. Without any specific reference to the case of Italy, it has to be clear that when the authorities are forced to intervene in this way, they must ensure that the bank undergoes a decisive restructuring process to ensure its viability on a lasting basis. This is crucial for generating the necessary confidence so that we can together move forward with the process of banking union.

What is the situation of the Spanish banks?

I think they have made a tremendous effort and improved their situation significantly. The level of non-performing loans to the private sector has fallen below 7%, which, while still high, is certainly manageable. Nevertheless, there is still room for greater consolidation because their cost ratios, while not the highest in the euro area, are still too high. Profitability remains weak, although there are substantial differences between banks. While there is a need for more consolidation, preserving a diverse banking system, with both large and local banks, remains important.

The banks are blaming low rates for their reduced profitability.

Yes, they are, but at the same time they are also recognising the favourable effects of low rates on improved economic conditions and the need to change business models and reduce costs. Over time, the economic recovery will increasingly support bank profitability.

The deposit rate will remain low, but the last series of targeted longer-term refinancing operations (TLTROs) that helped banks have already come to an end.

The banks benefitted greatly from these operations, which were heavily subscribed. The transmission of the ECB's stimulus measures through the banks is working well at the moment. Credit conditions have improved sufficiently, so there is currently no need to renew the TLTROs.

And what about the sequencing of monetary policy normalisation?

The current sequencing of monetary policy normalisation makes a lot of sense. There is no number, period of time in months or anything like that which will determine when interest rates go up after the debt purchases end. This will happen based on the ECB's assessment. It will depend on the kind of situation we find ourselves in.

And the deposit rate?

The deposit rate is the key monetary policy rate. It is the deposit rate that is currently driving monetary conditions and will in the end shape the risk-free asset curve. If the markets were to pick up any change in communication about the deposit rate, it would have the potential to change the policy stance, and we do not want that to happen right now.