Peter Praet: Interview in Trends/Tendances

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in Trends/Tendances, conducted by Mr Daan Killemaes and Mr Jasper Vekeman on 4 May 2017 and published on 11 May 2017.

* * *

So let's kick off straight away with the topic of the moment: the risk of deflation has subsided, the economy is recovering, political risk is on the wane… Isn't it time…?

Peter Praet: (interrupts) "Yes, political risks are diminishing, yet policy uncertainties still persist – Brexit, for example. We've seen how negotiations can swing very fast from one side to the other. And as far as the economy is concerned, there's still a wide array of risks. They're moving towards a more balanced configuration, but are still tilted to the downside.

For the first time in many years, we're seeing a synchronised recovery of the world economy. But two key points deserve mentioning here. The first is that the euro area recovery is not yet sustainable without support from our monetary policy. In addition to monetary support of the recovery, structural reforms are necessary for sustainable growth over the medium to long term.

The second point is that confidence indicators, the soft data, tend to be stronger than the hard figures. To accurately assess the level of monetary support that is still needed, it's important to have a confirmation of confidence indicators in hard data."

Given this uncertainty, do you think it's too early to start reducing policy support?

Praet: "Let me start with the good news, and that is that our monetary policy is working. Am I being too triumphalist? That's a matter for discussion, but our policy has undeniably played a key role in avoiding deflation and supporting the economy. And for the first time in many years, growth is now being driven primarily by domestic demand, and in particular private consumption. So the argument that our policy is leading people to hoard their money is unfounded. And the argument that people are actually saving more due to negative real interest rates doesn't hold either."

So why the caution about which policy direction to follow?

Praet: "The last time we tightened our policy was 2011. After a long period of accommodative policy such as the one we have today, any change in the policy stance must be prepared carefully and implemented very gradually. And such a change must also be supported by sufficient evidence that growth is translating into a path of sustained adjustment in inflation towards below, but close to 2%."

So you're not yet seeing a sustained rise in inflation?

Praet: "Inflation has recently been quite volatile. We've always maintained that we should look through short-term volatility. That's why what counts most now is underlying inflation, for example core inflation *(inflation excluding the more volatile elements, such as energy, Ed.)*. And that's still on the weak side. In recent months we've seen producer prices rising worldwide, and now even in Europe somewhat. In the past, the pass-through from producer prices to consumer prices for non-energy industrial goods, an important component of core inflation, typically took one to two years. We'll have to wait and see how fast it will go this time.

We are also looking at prices in the services sector, which are to a large degree determined by wages. In the past, we have sometimes overestimated wage inflation, as we failed to properly factor in people who gave up on the job market or those forced to accept part-time rather than

full-time jobs. But we now have a better picture of underutilisation in the economy, which is greater than the official unemployment figures would have us believe.

Recently, the gap between that broadly defined unemployment and the traditional measure has begun to narrow. That suggests people are returning to the job market. Over the next couple of years the pressure on wages should start to feed into inflation. Things are evolving in the right direction. We're not trapped in a low inflation environment."

You're happy that inflation is returning?

Praet: "We currently have increased confidence in the path of inflation that we have outlined in our forecasts. But before we can start scaling back our policy, even gradually, we'd like to see further confirmation. We believe that the output gap (*the gap between potential production and real production, Ed.*) will have closed by 2019, and that price pressure will follow as a result.

However, for the time being, economic developments are still dependent on very favourable financing conditions, for which monetary policy plays a very important role. But there are other factors too. Financial conditions also depend on international factors, in particular on potential spillovers from the United States."

You are waiting for greater clarity, but in the meantime there is growing criticism. The banking sector in particular is grumbling about negative interest rates.

Praet: "That's true, but their criticism is often excessive. The banks don't have it easy and their profits are under pressure, but that's not only due to negative rates. There was too little consolidation post crisis, for instance. So there is now a great deal of competition in the banking sector. However, we observe that this situation does not prevent banks from letting their clients benefit from easy financing conditions, including access to cheap long-term central bank credit (TLTROs). So right now we are satisfied with the impact of our policy. Surveys of SMEs for example show that they're no longer particularly worried about access to credit. And that suggests that lending is no longer holding back growth."

As long as interest rates are negative, this will fuel criticism. Not least because the concept of 'negative rates' is so difficult to grasp. Could that be an argument for hiking rates before scaling back your bond-buying programme?

Praet: "The negative deposit rate is part of a complex package of interrelated measures. If one element changes, this can have an immediate effect on all interest rate levels. Suppose you keep buying bonds, which pushes down long-term rates, while raising short-term rates, which changes the expectations for all future interest rates. You then exert two opposing forces on long-term rates, ultimately partially negating the effect of the bond-buying programme by raising short-term rates.

Look, there is a very strong chain of logic behind the decision to first scale back Quantitative Easing (*QE, the bond-buying programme, Ed.*), raising the term premium included in long-term rates, and only then hiking short-term rates. We have to scale back our policy in an orderly fashion if we don't want to undo the benefits of what we've been doing for the past few years."

Why does this sequence cause so much discussion if it's so obvious?

Praet: "Some bankers assert that an increase in the deposit rate would actually constitute a loosening of our policy, as banks would then give more credit. But as I said, lending levels are already developing well.

No one likes the current environment. Not even me – I'd love to see higher growth and investment and more structural reforms. But that's just not the way things are right now. We will of course

re-analyse the situation in June. It's difficult to pinpoint when to start scaling down our stimulus. We first need assurance that inflation is on a sustainable path. But we need to be patient. The economy is normalising.

But it is a slow process and there are still downside risks."

What is your message to savers, as they have the feeling that they've already been paying for the crisis for years?

Praet: "I'm a saver too but we should not forget that the crisis has cost many people their jobs. Without our monetary policy, we would have been stuck in a deep economic depression. One also has to consider that low interest rates have made debt servicing easier, in particular on mortgages. In a number of countries like Belgium these gains are larger than the losses on savings accounts."

That's of little comfort to savers, who are losing purchasing power due to inflation and zero interest rates.

Praet: "That's true for a certain category of savers. And in absolute terms, this group is a large one. I have in mind pensioners who are not especially wealthy but have some savings, and that have been living partly on the income from their savings. Not everyone is in a position to diversify into equities. Low interest rates are also an important issue for pension funds and life insurers, but it doesn't make a decisive case for pursuing the wrong monetary policy."

So they're *collateral damage,* as it were?

Praet: "Well, all monetary policy entails certain redistribution effects. Had the ECB not acted, the distributional effects would have been much worse. We have our mandate and that is price stability. And where there are major redistribution effects, we have governments to even that out. It would be a major mistake to conduct monetary policy based on considerations other than price stability. Then you might as well place the central bank within the Finance Ministry. And I doubt that even they would like that idea. It remains essential to keep monetary policy separate from the government."

But you might also make a mistake and turn off the money flow too late?

Praet: "I think there is a major difference in the sort of mistake you could make these days. If you react late, you risk some inflationary pressures, as the economy turns out to be stronger than you thought. This risk is deemed to be limited given the degree of slack we are still seeing in the euro area. On the other hand, scaling back too early could jeopardise the recovery and the convergence of inflation towards our objective"

Is that the discussion that ECB President Mario Draghi referred to in his most recent press conference?

Praet: "No, that debate primarily concerned upside and downside risks for growth. Are they balanced or not? The assessment of the balance of risks plays a very important signalling function. The Governing Council signalled that risks are increasingly balanced, but still tilted to the downside. We will of course be re-evaluating the situation in the following meetings."

We see that Draghi sometimes changes half a sentence, and on other occasions alludes to the lower risks. Is he trying to massage the markets?

Praet: "It's not a matter of massaging the markets, it's more a question of careful communication."

Do you look forward to the day when your every word is no longer dissected?

Praet: "Well, I'll still have to wait two more years for that, until I retire. A Belgian banker once told me, when I was working with the Generale Bank: 'I had a great deal to tell, but nothing to say. Now I have a lot to say, but may tell little. Once I retire, I guess I'll have nothing left to say and nothing left to tell'."

Text box

Bond-buying has increased the central banks' balance sheets dramatically. Will they ever shrink back to pre-crisis levels?

"It's still too early to say. There are many aspects to this issue, which is a matter of discussion in the Federal Reserve. This is also uncharted territory. What if you stop reinvesting in bonds when they reach maturity? What effect would that have on the normalisation of interest rates? Would that process then speed up? It's not a simple matter at all. Everything in monetary policy is interlinked. Every time you change direction, you set a chain of events in motion.

Another aspect, which relates more to the functioning of financial markets, is the balance between the supply and demand for *safe assets.* A general trend has been a decline in the supply of safe assets: corporate bonds with the highest credit scores have almost disappeared; some countries have lost their AAA-rating. On the other hand, demand remains very high. A lot of research is being conducted into this matter. Some researchers are suggesting that central bank balance sheets should remain permanently higher, to use their reserves to reduce the gap between supply and demand."