# Yves Mersch: Interview in Luxemburger Wort

Interview with Mr Yves Mersch, Member of the Executive Board of the European Central Bank, in Luxemburger Wort, conducted by Mr Pierre Sorlut and Ms Barbara Tasch on 8 March and published on 14 March 2018.

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**Mr Mersch, the Governing Council has not yet decided to raise the interest rate. When that happens, the debt-to-service ratio will increase and put pressure on households who took out loans to buy their houses. How big is the danger?**

Let me say first that the bigger the imbalances, the less the economy is prepared for a monetary policy change. Any change in the monetary policy stance is always a shock to the economy, positive or negative.

It's not in our mandate to consider the households of any particular country when we change the monetary policy stance. That includes Luxembourg. We set interest rates for the euro area as a whole. We are not yet ready at this stage to change interest rates. We first take the non-conventional measures towards the exit. Only then will we consider the conventional ones. Today, at our press conference, we confirmed that we're confident with the path which is leading to our objective. The primary objective is price stability, which we have defined as an inflation rate of below, but close to, 2% in the medium term.

Second, on some banks' balance sheets, loans to the private sector are very substantial and in some there is a high concentration of mortgages. In Luxembourg there are one or two institutions that rank among those with the highest exposure to mortgages in Europe. If a shock affects this cluster of assets, then they are at risk. Household indebtedness in Luxembourg is higher than in other countries – however the wealth of these households is also higher than in other countries, and disparities between the holders of assets and liabilities also have to be considered. What is specific to Luxembourg is that the price pressure on the housing market is growing faster than in many other countries. We're speaking of a 7% increase while the economy is growing at only half that rate. We're speaking of a more than 50% increase in house prices over the last eight or nine years. This is mostly explained by the insufficient supply and by the strong demand resulting from labour inflows. This also results in wealth per capita in Luxembourg not growing. In turn, that creates the impression that wealth is not being fairly distributed. To sum up, Luxembourg is not running into a wall but risks are clearly there and actions have to be taken, as recommended by international and domestic institutions.

**What actions?**

That's up to the national authorities. It's not a matter of monetary policy. Monetary policy is a blunt weapon. But those best equipped to deal with the situation are the national authorities, as they are the closest. This is why macroprudential policy, as it is called, is in the hands of the national authorities.

**What would be the room for manoeuvre?**

There are tools which are aimed at the borrower or the lender. You have debt-to-income ratios, loan-to-value ratios, etc. There are also tax measures. If, on the one hand, you support lending by reducing taxation, it makes no sense to tighten lending with macroprudential tools on the other. One has to be consistent.

Being consistent is the first rule of governance. If monetary policy is loose, as it is now, and on top you also have loose fiscal policy, and on the supervisory side you deregulate or have very lax supervision, then you're asking for trouble. That's exactly what caused the last financial crisis:

the combination of loose fiscal policy, accommodative monetary policy and lax supervision.

### How exactly does the ECB assess the risk of Brexit?

First, we need to know what the UK is requesting. Second, we need to know what is happening during the transition period – if there is one. If there is no deal and there is a hard Brexit, this will harm both sides. There will be a need for some legal clarity. For instance, will contracts still be valid and, if so, how could they be implemented? The private sector solutions could be extremely difficult and cumbersome. But there could also be a need for a public sector response, e.g. some recognition or grandfathering of existing contracts. When do you start this grandfathering? At the moment they declare Brexit or at the moment you start the transition? This is all unclear. I can't give you all the answers, but neither am I one of those who believe that the EU will go under without London.

### How would you define your cooperation with the Luxembourg regulator?

I consider that the central bank side is working better because it is constructed differently. We are a Eurosystem, while supervision is not. For the supervisors there are still a lot of national regulations to respect. If a supranational body like the Single Resolution Mechanism (SRM) were to use only European law, things would be clear. That would be our preference. But in supervision sometimes national law prevails and there is still a lot of divergence between national laws that the single supervisor has to respect.

### How would you centralise the whole thing?

Different agencies exist, such as the European Banking Authority (EBA), the European Securities and Markets Authority (ESMA) and the European Insurance and Occupational Pensions Authority (EIOPA). But they only have what is essentially a coordination role at the moment. The Single Supervisory Mechanism (SSM) at the ECB has the effective supervisory function for banking. For all the agencies, there are proposals for improvement on the table. For securities markets, another important piece of draft regulation is the European Market Infrastructure Regulation 2 (EMIR2). If we have to contact 25 different regulators or supervisors in order to get a picture of who and what in the single market is allowed and under what conditions, it would be extremely cumbersome. From that point of view, we welcome an increase in efficiency at European level. We consider the completion of the banking union important for the single market and the single currency, in other words, one market, one banking supervisor and one security supervisor in the medium term. That should be accompanied by one deposit insurance system as well. But I understand those who say, "Let's first clean up all the remaining negative elements from the past before we accept a sharing of responsibility at European level. That is exactly what we are doing now by pushing for the resolution of non-performing loans. We're trying to put supervisory standards on the same level. It is not enough to assign only the responsibility to the European level, we also need a level playing field in terms of the tools and their implementation.

### The Commission de Surveillance du Secteur Financier[1] (CSSF) has recently expressed its concern about its sanctioning powers. What do you think of Director General Claude Marx's statement?

I don't know this statement. According to European law, the authority for criminal cases is still a national affair. When it comes to administrative sanctioning, that's another issue. Some propose setting up a sanctioning authority that does nothing but sanctioning. I don't know, and I do not have to know, national initiatives in a national context in this respect. On the central bank side we have sanctions at national but also at European level.

### You're referring to the case of the Latvian bank ABLV...

The Latvian subsidiary. I read in the media that the supervisory side of the ECB informed the national authorities of what happened and suggested to them to use the tools they have at their disposal. Since the way the national tools were used is now the subject of a court case, I cannot comment further on it. Let the court decide. The national central bank for its part took its own measures. And they suspended the bank. The ECB did not suspend the whole group [from monetary policy operations] until later. The Banque centrale du Luxembourg (BCL) suspended the group before the ECB because they have the possibility to do so at national level.

**Would you have another example?**

There are some investment funds which ought to provide information and statistics to the national central bank, which then reports to us. But some funds don't do it. We have asked the BCL several times to initiate sanctions because we consider that the local authority has clear knowledge of the matter. I think they are now ready to do it. I would not say centralisation is better per se. Sometimes proximity leads to higher efficiency.

**Another topic which is concerning the ECB and national lawmakers is virtual currencies. Luxembourg and other countries in the EU are granting more and more importance to virtual currencies, but you seem to be really cautious. What do you see as the biggest potential threats emanating from cryptocurrencies?**

One should consider various aspects. One is financial stability, the second is consumer protection, the third is investor protection, the fourth is market integrity and the fifth is anti-money laundering. Concerns regarding these aspects are especially high in relation to what you call cryptocurrencies. I call them virtual tokens, by the way. They are like the tokens you buy when you go to a casino. Studies have shown that 50% of transactions made using these virtual tokens and 25% of users are linked to illicit activities. There are four main risks. The first risk is market liquidity. The market is excessively concentrated, with about 96% of transactions being carried out by 2% of account holders. Second is liquidity risk. These currencies still always need transferring to the real economy because your bakery will not accept them. There were conferences on bitcoins where they said you could pay with bitcoin. But when you tried to pay the entrance fee with bitcoin, it took so long that the conference was over by the time the payment was received. It is not an efficient system.

The third risk is that people use cryptocurrencies to create leverage because they don't get leverage any more in the real economy. For example, consumers could use their credit cards to make such investments and increase their indebtedness. The higher the leverage, the greater the risk as well.

The fourth risk is the operational and technical immaturity of the technology. We are open to the technology of distributed ledgers. But that is something different from bitcoin. Bitcoin itself belongs to no one; no one is backing it, no one is issuing it. The mining is happening to a large extent in remote places and involves very high energy consumption. Bitcoin's estimated annual energy consumption has now reached more than 52 terawatt hours per year, which is more than the total energy consumption of Portugal. We see that, for example, when approval is sought, it sometimes takes several hours to get one block validated. The ECB, by contrast, is about to offer instant payments in all European countries. An instant payment costs 0.2 cent and the recipient has it within 10 seconds. This is efficient and pan-European, and it is also operated by trusted authorities as well as regulated and supervised entities.

Then you have contagion channels for the risks of virtual currencies. If households are heavily involved in bitcoin and the whole thing collapses, it could create a wealth effect on the economy, depending of course on the scale of the market. With official currencies, you have central banks, like the ECB, you have governments who put political capital into maintaining a currency and supporting it. But if people do not distinguish between the two things – and this is why I don't like the word "currency" for these schemes – it would undermine confidence in the official currency.

And some of those who promote these new schemes want a currency which is not controlled by a government. So it's a slightly sympathetic anarchic or libertarian approach, but unfortunately there is no libertarian law enforcement and there is no libertarian world government.

**You said in London last month that virtual currencies were not real money and that they wouldn't be for the foreseeable future. So what would have to change for them to be considered money, what would need to be implemented?**

Without a trusted authority backing the stability of a so-called currency, an institution whose primary objective is to do just that, you don't have a currency. A currency has three functions: a unit of account, a store of value and a medium of exchange. These tokens don't fulfil any of the three functions, as I said in London.

**There is another sector growing without proper authority, and that's shadow banking. A recent study has shown that it's growing, and that the Luxembourg market – which is for the first time included in the study – could represent 7.2% of all shadow banking. How would you judge whether activities like securitisation represent a threat to financial stability?**

Let me first say that you cannot call everything that is not a bank a shadow bank. Banking by definition means that you give credit and you take deposits. Indeed, many of these institutions don't do that. But on the other hand it is certainly true that some vehicles have been created to remove risk from banks and thus reduce their regulatory capital requirements, with such vehicles being used in order to escape supervision. That is what we cannot accept any more. We cannot afford another crisis of the magnitude we had.

**How would you manage that risk?**

We need to be determined and implement the rules that were agreed at the Pittsburgh G20 summit. But not everything is shadow banking. For example, the World Bank – and above all its sister organisation the International Finance Corporation (IFC) – is doing a lot of financing through Luxembourg. All the international development banks are issuing through Luxembourg because of its efficient legislation. Many corporations which operate worldwide cannot raise funds in each country; it's more efficient to bundle them. I would say that this is efficient international finance, not shadow banking, and it does not create additional risk for the customer but rather lowers the cost of funding.

Another topic for discussion is money market funds, which to some extent can have leverage and so are much closer to being like a bank. And that is also the reason why money market funds are obliged to report to the ECB. Then you have investment funds from entities like investment banks, private equity and other alternative investment funds (AIFs). Don't forget that Lehman Brothers was not a bank in Luxembourg, but they sold their products to most banks at that time. So these are areas where we have to see whether what's involved is not in fact a bank-like activity. And if it is, then it should also be subject to the same regulations as a bank, because otherwise we don't have a level playing field. The objective is to de-risk the financial world and prevent the kind of risk accumulation that led to the crisis. We should regulate risk rather than entities according to their legal definition.

**How much of a risk are the Italian election results to financial stability in Europe?**

Italy is the third largest economy in the euro area. Italy has shown a certain amount of institutional resilience in the past, and of course the elections have been a lesson to the established parties. I hope that resilience will come into play in the coming weeks and months.

**And then on the other side of the Atlantic, President Trump has just announced an**

**increase in tariffs on steel and aluminium, which could start a trade conflict with Europe. How much does the ECB worry about that?**

Obviously, conflicts are not conducive to economic growth, but let's take things step by step. As the President of the ECB said at our recent press conference, they can affect the confidence channel. This is because confidence is so important, even at this stage of the economy's expansion.

**Some forecasts have shown a slight slowdown in growth in the euro area. How could that become a problem for the inflation target?**

Less than six months ago, some said that inflation would be below 1% in February or March, and growth forecasts were less than half of what they are now. All the indicators point to economic growth in Europe continuing, because, for example, both capacity utilisation and labour utilisation point to a continued need for further investment and capacity extension. Supply-side expansion is increasing potential growth and allowing for more labour utilisation and higher incomes.

**To conclude on a more personal note, what are your plans for December 2020?**

I couldn't even tell you where I will be spending Christmas 2020, and I have not given it any thought. Indeed, I still enjoy my work. But the older you get, the more you are unable to make plans which are 50 years ahead.

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[1] The Commission de Surveillance du Secteur Financier is the supervisory authority of the Luxembourg financial sector.