Vítor Constâncio: Interview in the Financial Times

Interview with Mr Vítor Constâncio, Vice-President of the European Central Bank, in the Financial Times, conducted by Ms Claire Jones on 11 May and published on 16 May 2018.

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People have become concerned about a slowdown in growth, and we've recently seen a poor print for core inflation, which is now just 0.7%. What can the ECB do if growth and inflation continue to disappoint? And is there a risk that you don't have enough ammunition left for the next downturn if the journey to the exit of the non-standard measures is slower than you currently anticipate?

First, let me say that I don't consider that the slowdown is such an unexpected or serious matter. We knew there would be a deceleration of growth from 2018 onwards. Perhaps some indicators in the first month have been more disappointing than expected, but very slightly so.

I still believe that we will have the kind of growth that is forecast in our staff projections, so I am not worried too much about that as long as there is no extraordinary international event that derails world growth. So it's not an immediate question what the ECB could do next. But it is, of course, to be expected that some time down the road there will be another recession.

There is this concern that perhaps, then, monetary policy, with its standard measures, would not have enough policy space to respond to that. It depends on the timing of such an episode. By then, I hope that fiscal policy can become more active in reacting to such a development. It will be very important to have more fiscal space, and to use it. And that's related to some of the reforms that are needed for monetary union to work better.

Presumably, interest rates by then would not be sufficiently high for a reduction in rates to be a sufficient response. Other monetary policy tools, then, would have to be used. I think one possibility would be to go into yield curve control, meaning targeting specifically some interest rates for longer term maturities. That would require lower amounts of purchases to be achieved than we have at the moment under our asset purchase programme. It would work because it could lower medium to long-term interest rates, which are the relevant ones for expenditure decisions.

Yield curve control is being used already in Japan – and it works. It has not distorted markets. [Former Chair of the US Federal Reserve Ben] Bernanke has a good answer to this issue of distorting the markets, which is to say that purchases by the central bank of government securities with different maturities have exactly the same impact as a change in maturities done by the Treasury itself.

The public sector always impacts the yield curve, one way or the other. The idea is that if the central bank uses an active policy to do so, then it's to correct distortions that exist in financial markets and ensure that lending rates to businesses and households in the economy as a whole are at the right level to get to the level of activity that would be desirable. If there are rigidities and distortions in the private sector that do not engineer the smooth functioning of the economy, then public intervention is fully justified. It does not add up to manipulation because the reality is not perfect to start with.

I'm just now thinking in very abstract terms; this was never discussed at the ECB's Governing Council. This is my personal take on possibilities; it is not more than that. We didn't start any discussion about the medium-term future of monetary policy, it's too soon in Europe to start thinking about that.

But I'll just say it's a possibility and it can work. We could buy more bonds to enforce it – the 33%

limit [that the ECB has on buying all of the outstanding stock of a country's government bonds] is a self-binding decision by the Governing Council. That decision could be slightly changed, theoretically, of course.

What about the use of the other non-standard measures? There is a view that some of the tools, such as the Outright Monetary Transactions (OMT) programme, are closely linked with the current ECB leadership and not as much with the ECB itself.

It's important to underline that the unconventional measures that we used – all of them are now part of the ECB toolkit.

So in the future, if ever we face again stressful situations in the euro area, the ECB would have no excuse not to use such instruments to stabilise the situation.

That I wanted to repeat: it would be virtually impossible, if such a stressful situation occurred again, for the ECB to ignore that these instruments are effective, legal and part of the toolkit.

People are important of course, but this transcends people.

What are you going to be watching in the coming months, from outside the ECB, in terms of trying to judge the health of the eurozone economy?

The real activity indicators [such as purchasing managers' indices] are very important, but in view of our ultimate objective the way inflation will continue to react will be also very important. Our staff projections indicate that inflation could be subdued in the first part of the year and could increase a bit in the second half of the year. So we hope that this will materialise, in order to ensure that what we forecast in the projections for the years to come will really happen.

What are your expectations for the June European Council meeting?

I hope I am wrong, but unfortunately I am not expecting much from the next summit. The European economy is going through a good patch of growth. That, of course, always reduces government's motivations to take bold decisions. As Jean Monnet said, humans take important decisions only in a state of need. Which means in a state of crisis.

I expect, nevertheless, that the fiscal backstop for the Single Resolution Fund will be decided, and that there will be some kind of long-term promises about a European Deposit Insurance Scheme.

There is also an absence of a macroeconomic tool to automatically stabilise the economy. On fiscal policy, we need two things to address this gap.

First, we need coordination of national fiscal policies to become stricter and discussed more from the perspective of the euro area as a whole. This is a very important thing that should have already happened. The second thing is a type of macro stabilisation fund, along the lines of a rainy-day fund, like the IMF has proposed.

Let's see what happens. France has proposed something along these lines. There are also proposals on the table from others. That would be one of my priorities for reform.

What about the other side of the coin? Germany and others are calling for risk reduction?

First, I would say there has been a huge amount of risk reduction already. The periphery countries have undertaken huge adjustments; they've gone from big deficits, both in the budget and the external current account, to complying with EU rules.

All the countries that experienced an acute crisis – Greece, Ireland, Portugal and Spain – now have budgets with deficits below 3% of GDP and a positive primary balance in their current account, with the exception of Spain. Last year, Spain still had a primary deficit of 0.5%, but this year it is very likely that they will also make a surplus. In some cases, this adjustment in the primary balance was in the double-digits, which is huge.

Our analysis, and the IMF's, shows that the positive current accounts that all of these peripheral countries have built are the result of a structural adjustment. This is not about lower imports and weaker demand; it is about the improved performance of exports and structural adjustments. And that's very important.

Second, in terms of the banking sector, the capital level of banks everywhere has increased and the average common equity ratio of banks here is 14.3%. There is no bank below 11% in the euro area. That also represents a huge reduction of risk.

Then, third, there is the BRRD [Bank Recovery and Resolution Directive], which rules that if there will be any collapse of banks, then no bailouts by the public sector can be engineered – at least before there is a private bail-in of 8% of the total assets of the bank. So that's a big risk reduction for national government budgets and for taxpayers. Banks are also building up their bail-in-able securities. And the fact that the BRRD has to be applied before any loan by the European Stability Mechanism is made to a bank means that, very likely, there will not be any direct recapitalisation on a European level.

So there is a long list of things, not to mention the reduction in non-performing loans. NPLs have been subject to intense action by supervisors. The average amount of NPLs compared with the total amount of credit came down to 4.8% last year, from slightly above 8% in 2013. Of course, there are around 30 banks that still have higher – in some cases, much higher – NPL ratios, but the targets are there. And the banks beat their targets to reduce their bad loans last year. So it's working, it's going in the right direction.

In a nutshell, enough risk reduction has been achieved to justify introducing elements of risk-sharing in the banking union project.

And that would be a European Deposit Insurance Scheme?

That would be EDIS and the backstop for the Single Resolution Fund, which, in practice, is not so important.

How do you think this taking on of responsibility for banking supervision is working?

There are risks in everything, of course, but I have always been in favour of having banking supervision with the central bank. That has been the tradition in my country, and there are many good arguments for that.

Back in 2001 the Governing Council of the ECB, on the basis of a proposal coming from Tommaso Padoa-Schioppa, issued a short paper lining up the arguments for having supervision in a central bank. And if you read that paper, you will see that the set of arguments is heavily tilted towards favouring giving supervision to central banks. So it's a long-standing position.[1]

There are many advantages, including one that is not mentioned in the paper: supervision is not just about micro-supervision these days; it now has a macro-financial perspective, for which central banks are much better prepared than any other institution to handle. Central banks monitor developments in all segments of the financial system.

From reading your most recent speech, I had the impression that you thought austerity went much too far and the effects have been too drastic. Is that right?

Yes. And the main example of that is of course the case of Greece. No institution, not the Commission, not the ECB, not the IMF, ever thought possible – let alone planned for – a 25% drop in GDP in Greece. The first and second programmes for Greece were designed with a much more optimistic view on the cost of the adjustment.

So the adjustment programme was indeed too harsh. And also perhaps too mechanical, because what the programme didn't foresee was the total collapse of hope and expectations.

Then, at the same time, all countries in the euro area were reducing deficits, consolidating. That is, as I quote in my speech, the cause of the double-dip that we had in 2012, 2013, which should not have happened. And was the result of fiscal policy, not monetary policy.

So why are you so optimistic that next time it will be better, that fiscal policy can step into the breach during the next downturn?

In the first place, I don't anticipate that we will have the sort of imbalances that we had at that time. Everyone has learned lessons and it's very unlikely that Member States' economies will become as imbalanced again.

The adjustment that the more stressed countries went through shows that those Members States are now able to work effectively in the framework of the Monetary Union. Both in terms of the fiscal rules and in terms of the sort of level of structural change that we have seen in the past few years.

Do you think it was a mistake for the ECB to become involved in the Troika?

It was in a way unavoidable in view of the acuteness of the crisis we had, and good that it happened. Everyone wanted us to be there and we could not of course refuse what was then the expectation of everyone that we would help out with our expertise.

To what degree do you think austerity and the crisis have influenced the current political mood?

I think it plays a big role. I was just reading a paper written by three German economists on extreme politics, in a very good economic journal, about the political consequences of big recessions in 20 countries from 1870 to the present day.[2]

And indeed they show a correlation between extreme severe downturns and the political polarisation. Only in the case of financial crises during the ensuing five years, far-right parties increased on average their voting share by 30%. Far-left parties never benefited much from financial crises.

And so I'm not saying that the increase in populism, liberal democracy is some authoritarian drive, it's only the result of the economic crisis; there are other factors, but it's certainly a big one.

Let's talk more about the crisis. Can you remember the first moment when you became concerned?

I became concerned at the beginning of 2010, when, back in February, the budget deficits of several countries for 2009 were known and were higher than anyone expected. Particularly, of course in Greece, which recorded a deficit of 15% instead of an expected 5.6%, but also other countries. We started to feel the pressure in the bond market after that, so those were the first signs of something really becoming serious.

Then it intensified. We had a meeting of the Governing Council in Lisbon on 5 May, just a few weeks before I came here to the ECB. That was the day of the flash crash in Wall Street, with huge repercussions in bond markets everywhere.

Shortly afterwards, we decided to create the Securities Markets Programme (SMP) to start purchasing government bonds of several countries. That was an important moment. And, of course, at the same time, there was then the big loan to Greece, the creation of the European Financial Stability Fund, so those months of May, June 2010 were crucial. We were very active and it was the first big manifestation of the crisis.

The peak of concern was more in the second half of 2011, first half of 2012, because that was when the markets, without any change in economic fundamentals, started to attack heavily the government debt of Spain and Italy. There was contagion and, at the end of 2011, I spoke about the ECB's analysis of this, which showed it was already influencing, for instance, the price of French debt. So indeed, it was a development that was quite dangerous.

We decided on a second round of the SMP, ended up with the OMT decision and injecting a big supply of liquidity, €1 trillion. It wasn't particularly the French contagion that forced it, more the continuation of the pressure in the bond markets throughout the first months of 2012. We had to do something more significant than just a second round of the SMP. It clearly seemed that was not enough.

These decisions, plus the decisions of the European summit of June 2012, ended the acute phase of the euro area's existential crisis.

How have you seen the relationship with markets and with banks change during your 34 years in central banking?

Back when I began, the European financial system was much more bank-based than it is now. That was true everywhere, but it was particularly true in Europe. Monetary policy was totally directed towards bank's behaviour.

In 1973 in the United Kingdom, you had limits to deposits, which was a new attempt to put some limit on banks' ability to expand their balance sheets. Many other European had credit ceilings. Italy, France, Portugal, Spain all had ceilings, some up to the end of the 1980s.

It was only after that that more market-based monetary policy instruments started to become more significant. The growing importance of markets and the liberalisation of the controls exerted by central banks on the activity of banks started to change monetary policy in Europe completely, especially since the 1990s.

We've ended up with the present inflation targeting regimes, using interest rates as the main tool to control the spectrum of market interest rates.

The importance of banks in financing the economy has continued to decline and this requires a change in approach in the future. All these new fields beyond banking require some degree of regulation that is still not there, and this in my view will become more and more clear as market-based finance continues to grow to a huge size. The approach will need to become much more intrusive, and will be a return to the past in that respect.

What will that entail?

Controlling the excesses of finance cannot be achieved only with monetary policy interest rates. We need to expand the concept of leverage to other segments of the financial system, particularly synthetic leverage. I mean leverage which is not easily seen in the balance sheet, because it's built up with derivatives. It's not seen but it's very relevant for banks and for the economy, as we saw during the crisis.

The obstacles to regulating markets, and not just banks, are not so much technical; the obstacles are more political or ideological. It requires more regulation and supervision by not only central banks, but also in some cases governments. It is politicians that often need to enforce macroprudential measures, and in some countries some governments do not want to use them.

Another aspect that is different now is that we have in our economies too much finance. There is a strand of literature showing that after certain limits there are diminishing returns in the expansion of finance. And to tame these imbalances we will also need macroprudential measures.

You have talked about the need to reform economics too. What do you have in mind?

Big changes are happening, we are going in the right direction, but in my view we are not there yet.

The joke in the American camp at the beginning of the 1980s was that macro is just bad micro, meaning that the models had become dominated by the idea that agents make optimal economic decisions over infinite horizons into the future and that markets therefore tend to be self-equilibrating towards a single steady state.

Central banks' standard models – DGSE [Dynamic General Stochastic Equilibrium] models – have been transformed in many ways, but the 1980s view has still not fully disappeared.

This has to change. Economic agents clearly have finite horizons, which impact on their consumption decisions. People do not optimise and plan their lives up to their death. Nor does the financial sector play as important a part in models as it should. The possibility of multiple equilibria has also to be introduced; there are fallacies of composition, there are coordination failures.

All these elements have to become part and parcel of macroeconomics; macroeconomics is not just the aggregation of individual decisions by optimising agents, we should not just assume everything moves towards a general equilibrium of competitive markets.

The absolute minimum that has to happen is to rid macroeconomics of the imperialism of a certain type of microeconomic foundations; a new core model for macroeconomics has to emerge.

If agents act in different ways, we also have to address the question of income distribution. And fortunately there are already models, so-called HANK models, Heterogeneous Agents New Keynesian models, that consider this. There is a very nice paper in the latest NBER issue which is called "When Inequality Matters to Macro and Macro Matters for Inequality". So indeed, that places within macro the question of inequality – inequality which has been increasing too much in the past few decades.

Changes are being discussed and are taking place I just hope that progress could be quicker.

How does that impact central banking? We thought we could just target inflation, now you are saying the next generation has to consider all of these different preferences of agents, multiple equilibria, inequality...

Well first of all, central banks will always focus mostly on control of inflation, or more broadly macroeconomic stabilisation. The regime of flexible inflation targeting will not change in the visible horizon, and that is because it allows central banks to take a medium-term perspective towards hitting the inflation target. The advantage of adopting this gradualist approach to reaching the target, is – as [leading monetary economist and former Riksbank official] Lars Svensson has demonstrated very convincingly – that you can allow for some consideration of stabilisation of the economy in trying to move gradually towards the inflation target.

What will change are the models used to analyse the consequences of policy – and the set of instruments that will have to be used. Central banks in the future will have to respond in a different way if they want to achieve the overall objective of reasonable inflation and macroeconomic stabilisation.

The growing complexity of market-based finance and the change in the financial system will make it difficult for central banks to go back completely to the old, comfortable, traditional approach of having very lean balance sheets and just targeting the overnight money market rate.

The set of instruments will have to be broadened. Several have been used during the crisis, some of them just for very stressful periods of course, but they are now part of the toolkit.

Do you think what you're saying is shared by other people on the Governing Council?

I wouldn't speculate on that. This view is developing in academia everywhere and has been discussed extensively in [the Kansas City Federal Reserve's flagship conference in] Jackson Hole in 2016, for instance. So it's part of the ongoing discussion at the interface between academia and central banking.

Do you think the ECB has done enough to justify the impact of its policies on inequality? If we were to do quantitative easing (QE) again, would helicopter money be a better option?

Helicopter money has never been a policy option. We are attentive to the question of inequality. I spoke in August last year to the European Economic Association about inequality and monetary policy, and since then further work has been done in the ECB to expand on what I said.

First, if we take into account the effects of QE and non-conventional monetary policy combined, we have shown that those effects on income as a result of lower unemployment are more significant than the effects of high prices for financial assets.

Turning to wealth distribution, what extraordinary monetary policy clearly does is to increase the price of assets, particularly of course risky assets. But people are too fixated on the increase in the price of stocks; one has to look to the overall impact on other asset prices.

If we look at the increases in bond prices or in equities, which are indeed owned mainly by wealthy people, they are totally overwhelmed by the increase in housing prices. The rise in house prices make up the bulk of the wealth effect, and the wealth tied in houses is held by the middle income segments of the population.

In terms of the overall wealth distribution, the situation has improved rather than becoming more unequal as a result of our extraordinary policies.

Over the course of your career what are you most proud of?

I'm proud of many things I've done in my 34 years in central banking. I am proud that I eliminated credit ceilings in my country when I was Governor and introduced a market-based system of monetary policy with the creation of auctions for treasury bills. I also ended the fixation that Portugal had on its exchange rate, which involved daily auctions with market players. We modernised the bank and the financial system during the 1980s, so that is one thing.

Here at the ECB, I've overseen the creation of a macroprudential policy and financial stability department, which is state of the art. And I am proud of course of having participated actively in all of the policy decisions that happened since I came here in 2010, especially those that put a stop to the existential crisis over the future of the euro.

Is there any decision that the ECB took that in hindsight you regret?

The rate hike in 2008 was an overreaction. There seemed to be some justification at the time for the increase in rates in 2011, though in hindsight it was clearly premature. That's it, I already said it in the speech.

Will you stay in Germany or are you going to go back to Portugal?

I'm going back to Portugal. In June, I will be at the ECB conference in Sintra. Normally we invite former members of the Executive Board, so I hope they will continue to invite me. Particularly as I don't intend to go and work for any private financial institution. I will do some postgraduate teaching in Madrid.

I always hoped I would have the opportunity to be a free intellectual. In my career I never had that luxury.

I always thought and dreamed about it, and I hope to have a sufficient number of years to satisfy that ambition. I am going to have a blog. It's usual in the United States; in other places, not so usual. I will comment on general questions about the future, about Europe, about macroeconomics.

What will your first post be about?

I am still hesitating. It could be about the future of monetary policy and the points I left out in my recent speech, from neutral interest rates to yield curve control.

Are there any rules that bind you in terms of what you can write about?

Beyond the ECB rules what will bind me is European decorum.

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[1] The role of central banks in prudential supervision

[2] See Funke, M. Schularik, M. and Trebesch, C. (2016) "Going to extremes: politics after financial crises, 1870-2014" in *European Economic Review,* 88, 227-260.