

Peter Praet: Interview in Handelsblatt

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in Handelsblatt, conducted by Mr Jan Mallien and Mr Frank Wiebe on 19 November 2018 and published on 23 November 2018.

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Mr Praet, economic sentiment indicators have recently fallen steeply and markets are increasingly nervous. How concerned are you about the euro area economy?

Growth in the euro area is normalising. We shouldn't forget that it was exceptionally high over the past two years. That was mainly due to the strength of the export sector. Following the turbulence in financial markets in China in mid-2015, central banks and fiscal authorities around the world conducted expansionary policies, and this supported trade. The momentum from exports has now abated. There are also a number of risks, such as protectionism, vulnerabilities in some emerging markets and financial market volatility.

What impact are the trade disputes having?

Our main scenario is that trade conflicts would be mainly confined to the United States and China. Moreover, one of the United States' main concerns is to improve the protection of intellectual property. We are not yet seeing much of an impact on sentiment in the euro area, but that could change, of course.

How great are the risks of Brexit, of the United Kingdom's departure from the EU?

The risks related to a hard Brexit should not be underestimated. The consequences would be greater for the United Kingdom than they would be for the euro area, but we would feel it here too – the United Kingdom isn't a small country.

The German economy contracted in the third quarter. What is your assessment of that?

The new emissions tests for the car industry had a significant impact in the third quarter, mainly in Germany. This matter may also affect the reputation of the companies involved. But we agree with the Bundesbank, which expects output to recover in the fourth quarter.

We've talked about a number of serious risks now, but the ECB still believes that positive and negative risks are balanced. Why is that?

The downside risks have increased, but at this stage we still think that the picture remains broadly balanced. In the case of some risks, things may turn out better than feared. A Brexit agreement with the United Kingdom, for example, could improve sentiment. And the trade disputes may eventually subside. But uncertainty has clearly increased, and this is unfortunately likely to have a dampening effect on investment.

Doesn't that mean that the balance of risks is on the negative side?

I believe it is too soon for a negative assessment, because many issues are of a binary nature, resulting in either a "good" or a "bad" outcome. This makes any risk assessment challenging. Also, any statement by a central bank that downside risks prevail must result from a thorough assessment, not least because of high market sensitivity to any change in our communication.

Markets have been pretty volatile recently. What does that mean for the ECB?

Our monetary policy has significantly helped to stabilise financing conditions for firms and

households and shield them from developments in China, the United States and emerging market economies, for example. It was mainly stock prices that were affected; interest rates have been fairly stable overall – except in Italy.

Euro area inflation has risen recently, so many people – especially in Germany – are asking why the ECB is sticking to its accommodative monetary policy.

Our mandate is to safeguard sustainable price stability in the euro area. This means that the rate of inflation must reach our aim of below, but close to, 2% in a sustained manner. At the moment, the increase is mainly related to the higher oil price. Core inflation, which excludes energy and food prices, has for some time been around 1%, sometimes even lower, and that's not enough to reach our aim in a sustained manner. We are confident that underlying inflation pressures are rising, but it will take time and it requires monetary policy to remain accommodative.

Are there any indications that this is happening?

We see that wages are increasing, and we expect that this will feed through into higher prices in six to twelve months.

Will Germans have to come to terms with price increases of more than 2%?

Price developments in Germany will probably be at the upper end of the range in the euro area, but I doubt they will be much above the 2% mark.

So far, the higher oil price has been the main contributing factor to inflation, but recently it has recorded a significant fall. Is that not dampening inflation too?

A higher oil price pushes up inflation but dampens growth. Lower oil prices have precisely the opposite effect. When many economists were predicting that oil prices would go above 100 dollars a few weeks ago, that had me worried. But the current level is good for growth in the euro area.

How big are the problems in Italy, in your view?

Financing conditions there have tightened. Short-term rates have remained low, but longer-term rates have risen considerably, and stocks are under pressure – especially those of banks, which have fallen by more than 30%. Banks will eventually have to pass on the tighter conditions they are facing to customers. Our estimates show that this will offset – possibly more than offset – any positive impact resulting from higher government spending.

Is there a risk of recession?

Italy's current financing conditions are much too tight for a country with weak growth and low inflation. Italy needs supply-side reforms to improve productivity. The European Commission has always been relatively open to the idea of allowing higher government spending in the event of such measures being taken. But we have not seen much happening on that front – it's mainly about higher spending. And this has led to much higher risk premia that if protracted, would, in my view, have detrimental effects on the economy.

Could there be a situation where the ECB would have to intervene?

We conduct monetary policy not for individual countries, but for the euro area as a whole. Italy is a large economy, but so far there have been no real contagion effects for other countries. Financing conditions in the euro area as a whole remain very good. And so our monetary policy assessment is unchanged for the time being.

So does that mean in other words that the ECB would step in if contagion effects occurred?

We would have to analyse the situation. The appropriate instrument would be what's known as Outright Monetary Transactions. Under this programme, the ECB would make targeted purchases of the relevant country's sovereign debt subject to certain conditions. But we would not even contemplate this move unless that country applies for assistance from the European Stability Mechanism, the ESM rescue fund, and accepts its conditions.

At present, however, people are also speculating about new targeted longer-term refinancing operations, or TLTROs, for banks. Might this not lead to misunderstandings, as it seems reasonable to assume that these operations are motivated by a desire to support Italy?

The TLTROs are a monetary instrument and we conduct monetary policy for the whole euro area. We carried out TLTROs for banks in 2014 and 2016 in order to shore up weak lending. In the meantime, lending has improved and fragmentation within the euro area has practically disappeared.

But could new TLTROs be needed all the same?

If these loans have a residual maturity of at least one year, the banking supervisor categorises them as long-term financing. The first TLTRO tranche expires in June 2020. This will start to have effects on the net stable funding ratio as of mid-2019. The banks are aware of this and they have been preparing themselves for it. It is premature to decide on a new TLTRO now.

As of January, the ECB no longer wants to make net asset purchases but only to replace maturing securities. How exactly will that be done in practice?

The principle is that we take a market-neutral approach. In December we will discuss the guidelines for our reinvestments.

You have said that forward guidance on monetary policy will become the ECB's most important instrument in 2019. This will also increase dependency on the markets. How long will this go on for?

Forward guidance is particularly important as long as the economy still requires support and the central bank's policy rate is at its effective lower bound. Significant monetary policy stimulus is still needed at present. We expect the key ECB interest rates to remain at their present levels at least through the summer of 2019, and in any case for as long as necessary to ensure the continued sustained convergence of inflation to levels that are below, but close to, 2% over the medium term. In due course, when monetary policy begins to normalise and uncertainty abates, forward guidance will also lose importance as a monetary policy instrument.

Will the first step be to increase the interest rate on the ECB's deposit facility from – 0.40% or the interest rate on the main refinancing operations from 0.00% – or both at the same time?

The rate on our deposit facility is currently decisive for the market rate, and so for the transmission of our monetary policy signal, because the banks are operating in an environment of excess liquidity. As that situation will continue for some time to come, the deposit facility rate remains the most important monetary policy instrument. However, it is still too early to discuss any adjustment to our key interest rates and their constellation.

Let's look beyond monetary policy. What do you see as the most serious deficiencies of the euro area?

The Franco-German agreement on a fiscal capacity is welcome and also has important political significance for European integration. Building up the ESM rescue fund is more urgent. We also need to complete the banking union and the capital markets union without undue delay.

The banking union envisages a common deposit insurance scheme. Germany has serious misgivings that this would amount to risk-sharing.

A common deposit insurance is essential for the completion of the banking union and to underpin the confidence of all depositors in the financial system. This protection of deposits up to €100,000 will be funded by contributions from banks. But this scheme is just one of the components that are necessary to make the banking sector more resilient and safeguard financial stability. It is of the utmost importance to implement the rules for bank resolution which stipulate that at least 8% of banks' liabilities should be made up of instruments that could absorb losses in the event of bank failure. In my view, all of these instruments should be either equity or subordinated bonds so that all customer deposits would be effectively protected.

We have now talked a lot about problems. Let's now ask what you see as the greatest achievement of the euro?

Citizens have overwhelmingly embraced the euro. People appreciate how it brings Europeans closer together. Many aspects of everyday life have become easier, such as doing business or travelling. The level of acceptance is high in all euro area countries.

Let's look ahead: your term of office expires at the end of May. Do you have any regrets?

I am confident that the sustained convergence of inflation to a level below, but close to, 2% over the medium term will proceed. I will be here for another six months, and I expect to see further progress towards our aim by the end of my mandate, but I will clearly have to leave before the normalisation of our monetary policy. To be successful in our monetary policy we need to be patient, prudent and persistent.