Peter Praet: Interview in Börsen-Zeitung

Interview with Mr Peter Praet, Member of the Executive Board of the European Central Bank, in Börsen-Zeitung, conducted by Mr Detlef Fechtner and Mr Mark Schrörs on 11 February 2019 and published on 18 February 2019.

* * *

Mr Praet, how badly is the euro area economy doing?

We have lately seen a marked increase in the risks for the euro area economy. That is why we revised our assessment at the last meeting of the ECB's Governing Council in January. We see the constellation of risks surrounding the economic outlook, in other words the balance of risks, as tilted to the downside. That is a significant change in our communication and reflects concerns about the general economic situation. At the same time, however, we said that our baseline scenario has so far remained intact. In March we will have new macroeconomic projections from ECB staff and we will then re-examine our assessment.

The December projections for 2019 to 2021 forecast growth of 1.7%, 1.7% and 1.5% and a gradual rise in inflation to 1.8% in 2021 – so approaching the ECB's target rate of below, but close to, 2%. That surely can't be upheld now, can it?

I expect that the projections for the near term, in particular, will be revised downwards. The data since December have been much weaker than I had expected. But our discussion in the ECB's Governing Council does not focus so much on the short-term perspective. The medium-term perspective is decisive for us, most especially the question of whether we are dealing with a temporary soft patch or with a more prolonged weakness.

And your response, particularly in view of the continuing weak data since the last Governing Council meeting?

First of all, the data since the January meeting have not only held negative surprises, they have also contained a few positive signs such as the further decline in unemployment. But it's also true that growth in the third and fourth quarter of 2018 and most likely also in the first quarter of 2019 is well below the potential growth rate of the euro area economy. So growth will have been below potential for three consecutive quarters and that's not good news. The question now is whether there will be a rebound in the second quarter and beyond. A rebound is likely, but it is too early to say by how much.

So would you say that the ECB's Governing Council is becoming less confident that we are now merely seeing a temporary economic dip?

The economic slowdown is broader and more persistent than had been thought and growth in the short term is likely to fall short of previous expectations. But as I said, what counts for us is the medium-term outlook and we see positive and negative factors there.

What does that mean in practice?

On the positive side, the situation for households and so for consumption is still favourable. That is a key driver of growth. Employment is still increasing and wages are picking up, boosting disposable income. Lower oil prices are also strengthening purchasing power. The fiscal stance has become slightly more expansionary in the euro area as a whole. That is not a major development, but it helps a little. Euro area non financial firms are doing well too. Of course there are still some weak spots in the corporate sector and these pose some risk. But all in all, corporate balance sheets are in good shape. So they have the capacity to invest. But there is indeed a negative side too.

And what's on that side?

The biggest problem by far is that political uncertainties have been persisting for so long now – whether they are related to protectionism, to Brexit, etc... The more time passes, the greater their likely negative impact on the economy. In the context of persistent uncertainties, additional shocks can have large effects on the economy. The uncertainties are already tempering business confidence more severely than expected. The state of the UK economy shows the damage that can occur when uncertainty persists for too long. Investment in the United Kingdom has fallen sharply. It is high time to put an end to these uncertainties in a positive way.

Is your main concern for the euro area economy also to do with firms' readiness to invest?

The uncertainties are increasingly affecting business confidence in the euro area and are likely to affect investment in 2019. If confirmed, this would be bad news for the European economy that needs investment following years of underinvestment in the aftermath of the global financial crisis. Moroever, the question is how the financial sector would react.

What exactly do you mean by that?

The financial sector often tends to act procyclically. Banks are a case in point, because they tend to amplify cyclical developments. When the economy is performing well, they are willing to grant credit, but when it is faltering, they are not so keen.

Do you see such a risk at present?

As far as the capital markets are concerned, credit risk premia have increased significantly over the past months – for both high and low credit-rated firms. That tightens borrowing conditions for firms on capital markets and weighs on the economy. On the other hand we have so far not seen any such tightening in bank lending conditions in the euro area. Overall, in light of these developments, we consider that the probability of a recession remains low.

But are you worried that that will change, that the banks will tighten conditions too?

Banks in the euro area now hold much more capital than before and are better able to withstand shocks. They also have larger liquidity buffers. That's all good news. At the same time, bank equity prices have fallen sharply and profitability is often very low, as is also reflected in the banks' very low price-to-book ratio of around 50%. In such a context there is a risk that the banks could act even more procyclically than they usually do and would amplify the cycle. To be clear, the uncertainties and the economic slowdown have so far not caused banks to tighten their lending conditions or to grant less credit. But we need to keep a very close eye on how this evolves. How will the banks behave if the economic slowdown continues?

Would you say that financing conditions in the euro area as a whole have already tightened significantly?

Financing conditions have tightened somewhat in recent months, but not significantly, thanks in part to our forward guidance on interest rates. This partly compensates for such effects. But you're absolutely right, we as central bankers must always ask ourselves whether our monetary policy stance is appropriate for us to attain our objective.

And what is your answer at the moment?

We have revised our assessment of risks to growth downward. I would say that is a clear indication that the level of alert is higher than before.

Three quarters of below-potential growth, higher risks and at least slightly tighter financing conditions – what does that signify for the inflation outlook? Is the ECB's Governing Council losing its confidence in reaching the target of 2% over the medium term?

Three quarters of below-potential growth are certainly not good news. But we have a medium term perpective. At our last monetary policy meeting, we upheld the assessment that inflation will converge to levels that are below, but close to, 2% over the medium term. Wages are picking up at a pace that is more or less in line with expectations from our models. One thing that has not worked out as expected is the transmission to consumer prices. This pass-through is not working in line with projections. We are analysing this very carefully. But we remain confident that it will eventually do so; we need to be patient and persistent.

But what if the economic outlook deteriorates further and more permanently?

In our baseline scenario, capacity utilisation will remain high and firms will be in a position to pass higher wages through to higher prices. That would be more difficult if growth remained below potential. Downside risks to growth could then lead to downside risks to inflation in the medium term. We are not at that stage yet, but this will be an important discussion point at the next meetings of the ECB's Governing Council.

But if the outlook becomes gloomier, what will happen then? Will the ECB's Governing Council be even more careful in continuing on its cautious path towards monetary policy normalisation or could there be another turn towards more easing?

I have never spoken about a normalisation of our monetary policy stance. I have always referred to a normalisation of our instruments. There is a big difference. After the end of our net asset purchases, the primary instrument to steer our monetary policy stance is again our key interest rates. And as far as their path is concerned, we continue to expect them 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. This rotation of instruments from net purchases to the rate path has been implemented in such a way as to preserve our accommodative monetary policy stance. We have thus not tightened our monetary policy. Moreover, we have made it clear that, in any event, we stand ready to adjust all of our instruments, as appropriate, to ensure that inflation continues to move towards our inflation aim in a sustained manner.

President Mario Draghi always stresses that the toolbox is full. But with interest rates at or even below zero and the asset purchase programme at its self-imposed limits, what else is really left?

If there is a problem, there needs to be a careful assessment to establish the cause. A financial shock, for instance, is something different from a slowdown in growth for fundamental reasons. In the case of an economic slowdown, interest rates are generally the instrument of choice. If the euro area economy were to slow more sharply, we could adapt our forward guidance on interest rates and this could be complemented by other measures. But one thing is clear: the ECB's Governing Council will always find ways and means of acting if it needs to. In case we would cease to be confident that inflation is converging to a level that is below, but close to, 2%, it would be our mandate to act.

As a result of the weaker economic data, market participants have shifted their expectations for a first interest rate hike from autumn 2019 to, in some cases, well into 2020 – despite the Governing Council's unchanged outlook that interest rates will remain at their current levels "at least through the summer of 2019". Do you feel comfortable with that?

First of all, it shows that our forward guidance is effective. Our forward guidance on key interest rates has both a calendar-based – "at least through the summer of 2019" – and a state-contingent leg – "and in any case for as long as necessary". The shift in market expectations reflects the state-contingent leg of our forward guidance. Of course there will be a point in time when the calendar-based leg of our forward guidance will be discussed and, if needed, adapted. We have been very careful so far not to validate market expectations.

And at your meeting on 7 March – will that still be too early?

I can't say at this stage.

Would new net asset purchases also be an option in an emergency?

Asset purchases are part of our current toolbox, President Draghi has been clear about that. But that doesn't mean that they are the preferred option in current conditions. And it should be said that if forward guidance on interest rates is credible and steers expectations in the desired direction, further purchases may not be needed at all to ensure that financing conditions are appropriate.

Observers increasingly expect the ECB to launch new longer-term refinancing operations for banks – TLTROs – and they make the case that this measure, especially in conjunction with an increase in the deposit facility rate, could improve the situation for banks and support lending. What would you say to that, especially in the light of your concerns about the procyclical behaviour of banks?

Our TLTROs have been a very useful tool to deal with impairments in the transmission of monetary policy and are part of our toolbox. As the procyclical behaviour of banks is an important reason why economic cycles sometimes end badly, we do need to monitor the transmission of monetary policy through the banking system carefully. In March we will make an assessment of the current and expected state of bank transmission.

You will be leaving the ECB at the end of May, having experienced and helped to shape a period of great change at the ECB. Do you think that zero and negative interest rates, forward guidance and extensive asset purchases are the "new normal" for central banks, including the ECB, or can there ever be a return to the old regime that existed before the global financial crisis?

A return to greater normality will certainly take a long time. We are very cautious at the ECB about estimates of the natural rate of interest…

… meaning the rate at which growth and inflation are in equilibrium…

… but there doesn't seem to be any doubt that this rate, for reasons including demographics and technological progress, is now lower than it used to be. And that also means that the likelihood of reaching the lower bound on interest rates is much greater than previously thought. Then other tools are needed.

As the Federal Reserve did after the global financial crisis, does the ECB need to have a fundamental debate about its mandate, its objectives and its strategy, especially since the last review, in 2003, was more than 15 years ago?

The mandate is of course out of questions, it is enshrined in the Treaty. However after the experience of the past few years, it may also make sense for the ECB to review its overall monetary policy framework in the future. But now may not be the right time. Our strategy has a medium-term orientation, which gives us more room for manoeuvre. And with our two-pillar strategy, with the monetary analysis, we also look closely at aspects of financial stability.

Financial cycles have become increasingly important. I think that our framework has strengths that we should preserve.

Central bank independence is increasingly coming under attack around the world – not just in the United States, but also in Italy, for example. How much does that worry you?

The independence of central banks is of key importance and should not be called into question. Whatever the criticism may be, every other regime in which the central bank is closer to the finance ministry is much worse than the current system.

But not everybody seems to agree.

There may be populists who dream of something different. But most politicians are very conscious of the need to keep monetary and fiscal policy separate. Any other approach can quickly turn dangerous.