Luis de Guindos: Interview with Börsen-Zeitung

Interview with Mr Luis de Guindos, Vice-President of the European Central Bank, and Börsen-Zeitung, conducted by Mr Mark Schrörs and Mr Detlef Fechtner on 5 November 2019 and published on 12 November 2019.

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Mr de Guindos, how did you find your first days with the new President of the ECB, Christine Lagarde, who succeeded Mario Draghi at the start of November?

They were great! We held some initial meetings and discussions which went really well for President Lagarde and for us. Our first Governing Council meeting chaired by her takes place this week.

You sound very enthusiastic.

President Lagarde has vast experience and knows exactly which topics are the most crucial. She will undoubtedly be an excellent ECB President.

The ECB President is new, but the same cannot be said for the economic environment, which inspires less enthusiasm. How worried are you about the euro area economy?

For two years now, we have seen a persistent weakening of the economy and a slowdown in growth. In the third and fourth quarters, however, we now observe a stabilisation. A recession in the euro area is highly unlikely. The real threat at present is an extended phase of extremely low growth, below potential.

Does that mean you are basically more optimistic than you were recently? Has this anything to do with the rapprochement between the United States and China in the trade dispute and the recent postponement of the Brexit deadline?

The news reports are more encouraging than they were two or three months ago. A no-deal Brexit is off the table for now. There is some hope of an initial partial agreement in the US-China trade dispute, which at least suggests that it will not escalate any further. Averting escalation would be good news in itself.

So have the risks and uncertainties surrounding the economic outlook abated?

Let me put it this way: the risks are now slightly less tilted to the downside than they were before.

And how do you view the outlook for inflation? Have the risks decreased in that regard too?

The latest development is precisely in line with our expectations. We expected that inflation would fall clearly below 1% in September and October. Inflation was 0.7% in October but is probably hovering around 1% at the moment. The same applies to core inflation, which excludes energy and food prices. The big question is why the current wage increases are not pushing up inflation.

And what is your answer?

There are many possible explanations: the low growth rate, the aftermath of the debt crisis or the fact that many firms are now evidently focusing less on maximising their returns and more on maintaining or expanding their market share. Central banks worldwide are dealing with these same phenomena.

Given the recent improvement in the euro area economy, do you think that the accommodative September package, including the restart of bond purchases (Quantitative Easing, QE) is still appropriate – or was it an overreaction, as some critical members of the ECB's Governing Council have said openly?

Adopting the September policy package was, and remains, the absolutely right decision. As mentioned, the risk of a recession is very low. But there is another danger, namely that growth remains extremely low, at levels far below the potential growth rate, for years to come. An environment of low growth and low inflation could de-anchor inflation expectations…

… and so move them lastingly away from the ECB's inflation aim of below, but close to, 2%.

Inflation expectations have recently shown a marked decline but they have not yet become de-anchored. That could change, however, as occurred in 2015 when there was a real risk of deflation. That is why we adopted the September package.

But with interest rates already at such low levels, more and more economists, and even some central bankers, harbour doubts that further loosening will have a significant positive impact on the real economy.

Our models show that the package will have a noticeable positive effect on growth and on inflation over the next two years. By the way, the most important component of the package is forward guidance. It is the core element and the message is clear: interest rates will remain lower for longer. And if the inflation outlook should not converge to our aim, we will take appropriate action in future, too, and – if necessary – adopt new measures.

Former central bankers such as ex-ECB chief economists Otmar Issing and Jürgen Stark recently issued a memorandum criticising the ECB for sticking too rigidly to a "point target"of close to 2% and not paying enough heed to the negative side effects of its ultra-loose monetary policy.

Monetary policy always has side effects. We are highly aware of them; we meticulously observe the side effects of our measures and factor them into our decisions. That is why we have now introduced a two-tier system for reserve remuneration so as to mitigate the adverse impact of the negative deposit rates on banks.

The two-tier system will make banks partially exempt from the negative deposit rates and should help first and foremost to boost their profitability. But there are many more negative side effects: the possible build-up of new financial surpluses, the misallocation of resources, a "zombification" of the economy. Many experts already think that the euro area is heading towards a "Japanification", with a prolonged period of low growth and low inflation and with no end in sight to the ultra-loose monetary policy.

As I said, we are well aware of the side effects of our monetary policy and we will hold the side effects up to even closer scrutiny in future and pay them even more attention. As for a possible "Japanification", I don't see any such danger. The situation in the euro area is completely different to that in Japan. We have no real estate bubble in the euro area and the banks have a much stronger capital position. Fiscal policy has far more leeway and, even if demographic developments in the euro area are not good either, they are still far better than those in Japan. While it may be tempting to draw parallels, the euro area is not Japan.

You mentioned the state of the banking sector. Is it really that good? Judging by equity prices, investors do not seem convinced.

Speaking of the negative side effects of persistently low interest rates on financial stability, I see two main risks at the moment, one of them being the area of asset management. Regulators and supervisors need to keep a closer eye on this sector and take action if necessary. And the other main risk is low bank profitability. That is a reality. The European banks' return on equity is far below the level demanded by investors, resulting in extremely low market valuations. This may have far-reaching consequences.

Specifically?

It is very difficult for banks to raise fresh capital and this can stand in the way of the urgently needed further consolidation in the sector. Moreover, prolonged low profitability can erode the banks' capital base. We are fully aware of that.

So has the time come to say goodbye to zero and negative interest rates?

No, because we need them for monetary policy reasons. Low bank profitability can mainly be attributed to structural factors such as excessive costs and overcapacity in the sector. Compared with these factors, low interest rates have only a marginal impact. Banks should not seek to deflect attention from their actual problems by criticising the low interest rates. They would do better to channel all their effort into adapting to the new situation, lowering their costs and eliminating overcapacity.

Do you see a risk of a credit crunch or a risk that the banks might amplify a downturn through procyclical lending?

We neither see a credit crunch nor expect one. Banks have much more capital available than they did before. Their liquidity position is strong. Banks are more resilient than they were a few years ago. But, as I said, that is no reason to relax.

The ECB and others are also calling on fiscal policymakers to make more of an effort. A more active fiscal policy should support the economy and thereby help monetary policy too. The spotlight is also on Germany as a country that should invest more.

Some countries such as Germany and the Netherlands have fiscal space and they should make more use of this leeway in the current environment. But something that is more important than exerting pressure on individual countries is this: we need to rethink the fiscal rules and the fiscal framework in the euro area. The current set-up with 19 national fiscal policies and the Stability and Growth Pact is suboptimal. We urgently need a centralised budgetary instrument in order to pursue a common anticyclical fiscal policy. That could also take some of the pressure off national budgets.

But there doesn't seem to be much political will for this at the moment, does there? The planned euro area budget is small and is intended to be used primarily to support economic convergence.

The question of political will is a different matter. What is clear, however, is that, in an environment of low interest rates and a lower equilibrium interest rate, monetary policy will reach the lower bound for rates more often in future. At the same time, the negative side effects of accommodative monetary policy are becoming increasingly evident. So fiscal policy will need to play a much stronger role in future.

Has the ECB exhausted all its options with monetary policy?

No!

Well, that's very definite.

Yes, it’s definite. If necessary, we could cut interest rates further. We could increase the volumes in our asset purchase programme. We could further improve the conditions for our targeted longer-term refinancing operations, the TLTROs. We have definitely not exhausted all our options. We have scope to take further action, and we will take further action should it become necessary. But it’s also clear, as I said, that the negative side effects are becoming ever more pronounced. What’s more, in the current environment, with interest rates very low for longer, fiscal policy would have a much bigger impact on the economy than would otherwise be the case.

In an emergency, would helicopter money be an option for the ECB, meaning that the central bank would give money to euro area citizens?

Helicopter money is not something we are considering. But there’s something else I’d like to make clear. We just decided on a package of measures in September. That’s not something you can do every month or two. We shouldn’t undermine the package now by speculating about possible next steps. The package is appropriate and we believe that it will be effective.

Criticism of the package was particularly loud in Germany – just as it has been of the ECB’s actions more generally over the past few years. Can Christine Lagarde as ECB President repair the relationship with Germany?

Germany is of course very important for the ECB. Germany is the biggest country in the euro area, and the biggest economy. We need to pay attention to what is happening in Germany and to the public mood. I’m sure that President Lagarde will manage to build up a good relationship.

She has already said that she wants to review the ECB’s strategy. What does that mean in concrete terms, and what would you consider to be the priorities?

It will certainly cover various aspects. One aspect is price stability – what price stability means and how we define it. It will also cover the symmetry of our aim. Our reaction function is another aspect – in other words, how we react when we don’t meet our objective. I’m sure the discussion will be a lengthy process. It’s not something that can be decided in one or two Governing Council meetings.

Will it be an extensive undertaking like it was last time, back in 2002–03?

We will certainly be gathering a great deal of information and input. Just look at what the Federal Reserve is doing. It started reviewing its strategy six months ago and won’t be finished until early 2020. In our case, I’m sure there will be different views about certain aspects, but I hope that we will be able to agree on a common position in the end.

Will there be greater clarity in the future about what the medium-term inflation aim of “below, but close to, 2%” means? Some Governing Council members seem to think that levels of 1.5% or less would be acceptable, while others wouldn’t go much below 1.9%.

You’ll have to be patient, we haven’t even really started discussing it. But I’d like to make another point here. The big question at the moment has to be why it is proving difficult to raise inflation. But there’s no question that the unconventional monetary policy measures have been successful. When we started taking those measures, there was a risk of deflation. That dangerous situation has been averted; there’s no longer a risk of deflation.

Does the fact that inflation is low worldwide suggest that the aim should be lower?

I don’t see any convincing reason to lower our aim. It’s also important not to confuse what’s happening now with what the medium-term aim should be.

But are you of the view that the ECB's inflation aim is symmetric? Bundesbank President Jens Weidmann said recently that the current formulation of the objective is not symmetric.

There has always been symmetry in the implementation of our monetary policy – we have always acted decisively whenever inflation has shown signs of deviating from our medium-term aim. And it doesn't matter whether it is too high or too low – we act with the same decisiveness.

Does that also mean that after years of inflation being below the objective, rates will need to be above the level of below, but close to, 2% for a longer period?

That will be part of our discussion of the strategy.

There are also discussions about the relationship between monetary and fiscal policy. Some people, including renowned experts, have been saying that the strict separation and the independence of central banks was the right approach when inflation needed to be dampened, but that more cooperation or even coordination is needed when inflation is too low. What is your view?

Monetary and fiscal policy are of course related and interact with one another. But that mustn't affect the independence of the ECB in any way. We must be absolutely independent in our decision-making. But we do look at what is happening around us. How is the global economy doing? What is happening in Europe? What are the financial markets doing? And we also look at the fiscal policy stance. We need to look at all of these things.

Do you think that in this respect it might even be helpful that you, like Christine Lagarde, have experience as a minister? Some critics have bemoaned the lack of economic expertise and central bank experience.

We see ourselves as a college – we each bring different experiences and backgrounds to the Executive Board and the Governing Council of the ECB. I myself was Spanish Finance Minister during the worst phase of the sovereign debt crisis. I'm an economist and I know what problems the banking system can create for an economy. I know what the consequences are when a credit and housing market bubble bursts. I know that we need to complete banking union and that we need a capital markets union. I know that we need a central fiscal capacity in the euro area. Each one of us brings our perspective and our experience to the table, and that enriches the decision-making process.

On the subject of banking union, the German Finance Minister Olaf Scholz has now proposed a compromise solution for a common European deposit insurance scheme. What do you think of the proposal? Will it help to break the deadlock surrounding this topic?

This is a positive development, an important step forward on this debate. The ECB has always firmly emphasised the need to complete the banking union – where a European deposit insurance scheme is a key missing element. We need to make sure that a €1 deposit is just as safe, and just as valuable, wherever you are in the euro area. This would enhance confidence in our banking system. And that's key to support the bank-based transmission of our monetary policy, essential for a solid and effective economic and monetary union.

The ECB used to conduct its work in the background, but in recent years it has edged ever further into the political domain. It used to have a much more narrow focus on price stability, but it has been given a whole series of new responsibilities. Critics think that it's time to go back to a narrower definition of the mandate.

When President Draghi said the famous words “whatever it takes” in 2012…

…when he promised in the summer of 2012 to do whatever it takes, within the limits of the ECB’s mandate, to preserve the euro…

…the message was clear: the ECB stands ready to safeguard the integrity of the euro. Monetary policy is not an isolated tool and it does not operate in a political vacuum, separate from the rest of the world. It interacts with fiscal policy and also with structural policies. We don’t live in an ivory tower. But at the same time monetary policy is not almighty. Take the trade dispute or Brexit, which have economic consequences. The ECB can make liquidity available, which helps, but it doesn’t solve the problems.

In his eight years as ECB President Mario Draghi made monetary policy ever more accommodative and he never raised interest rates. You have a bit more than seven years to go. Do you think interest rates will be raised again at some point in that period?

When President Draghi arrived at the ECB, I’m sure that he also expected to be raising rates at some point. But the economic situation meant it wasn’t possible. He did at least stop asset purchases for a while, even if he didn’t manage to raise rates. I don’t know how things will stand two or three years from now. There are models that make predictions for the next 50 years, but life is much more complicated than that.

There’s also the question of whether there will ever be a normalisation of monetary policy, with an end to asset purchases and zero and negative interest rates.

That depends on how the economy evolves, how inflation evolves and how risks evolve. If we see economic activity improving again over the next few quarters, as we expect, and rising labour costs push prices up further, we will adjust our policy. Nothing is set in stone.