Luis de Guindos: Interview with Público

Interview with Luis de Guindos, Vice-President of the European Central Bank (ECB), conducted by Sérgio Aníbal

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The euro area economy once again stumbled at the start of 2021. Are you confident that the recovery will be consistent from now on?

The key will be the way in which the vaccination process is rolled out. If the vaccination programme can start to be accelerated in Europe, as I think is possible, then perhaps in summer we could have the majority of the European population vaccinated. And if you look at the economic indicators in the euro area, there are signs that manufacturing is doing well, while services are lagging behind. So, if vaccination starts to create immunity, the containment measures will start to gradually be lifted, and that will be very good news for the services sector and will help the recovery. While we are still finalising our March projections, growth in the first quarter of this year, and perhaps the second, will be relatively weaker than expected, but by the second half of the year, if the vaccination programme goes as we hope, we could see a noticeable rebound in activity.

Will inflation continue to increase, as we saw in January?

We saw a relatively large increase in January, but it was not unexpected because we knew about the base effects in the same period last year that would be reversed, such as the change in the VAT rate in Germany, the drop in fuel prices a year ago, or temporary statistical effects. We would expect to see inflation above 1% on average during the whole of 2021.

There is currently a debate as to whether the current expansionary monetary and fiscal policies will lead to a return of very high inflation rates. Are you concerned about this possibility?

We projected an increase in inflation in 2021. In 2020, inflation was 0.3% and, with the recovery of the economy, we projected in December that inflation would be 1% on average. In terms of this debate surrounding inflation, we need to take into account that there are forces at odds with each other. On the one hand, we have the pandemic's impact on the output gap, which shows that there is currently a lack of demand. On the other hand, there is a great deal of monetary and fiscal stimuli, plus an increase in commodity prices and the recovery in world demand. All in all, I would say that we do not need to be very concerned about inflation in the short term, and in the medium term we will continue to look at it very carefully, as we always do. There are structural factors that could push inflation up all over the world, for instance supply chains are going to be more regional than before and globalisation is not going to be as rapid as it was in the last ten years. But in the short term, in the next 12 months, inflation will remain below our aim on average.

So, will the plans that the ECB had for the next few months remain unchanged? Does the recent rise in yields change anything?

At the moment, our priority is to maintain favourable financing conditions. We have recently seen an increase in yields, which is partly due to the expectation of higher inflation in the United States because of President Biden's programme, as well as the increase in commodity prices and the recovery in global demand. We will have to see whether this increase in nominal yields will have a negative impact on financing conditions. If we reach the conclusion that it will, then we are totally open to recalibrating our programme including the envelope of our pandemic emergency purchase programme (PEPP) if necessary. We have room for manoeuvre, and we have ammunition. But there is some good news. Despite the fact that yields have increased, we have not seen an increase in spreads which is a sign that, in terms of avoiding fragmentation, our programme is working. Yields are going up, but this is the case in both core and peripheral countries. This will be the key factor over the coming weeks and months for our monetary policy, i.e. understanding whether this increase in yields is due to trends in inflation or whether there are other factors that could hinder economic recovery. And that is something that we will have to examine, but one thing is clear: we have the flexibility that is needed in order to react.

In the context of the current crisis, the countries hit hardest are those that depend more on tourism but have less fiscal space to start with. And those are the countries that experienced problems during the last crisis. Do you see a risk of a divergence between economies, which might trigger some degree of fragmentation in terms of access to financing?

There are certainly significant disparities in terms of the rate at which economies are developing. If we look at larger countries, for example, on the one hand you have Spain which has seen its GDP fall by 11%, whilst on the other hand Germany has seen a drop of just over 5%. This is something which is very obvious and is connected with the structure of the economy, the weight of the services sector, of tourism, or the average size of companies. Another additional element is the fact that the fiscal space available was not the same in every country at the start of the crisis. The main instrument for dealing with that is going to be the NextGenerationEU plan which will focus more on those countries that have suffered most because of the pandemic.

Isn’t it taking too long to implement? We see the United States has plans that it intends to implement very quickly…

What I want to stress is that we would like the plan to be implemented as soon as possible. But there is something that is quite obvious: it is very important that the money is spent on projects that increase medium-term growth, that increase potential growth in economies. This is not only something to subsidise current expenditure. These resources, which are huge, should not only be spent on short-term targets, they should also be used as an instrument to improve the functioning of the economy in the medium term. But yes, the time being taken to implement the plan is a vital question and I hope that by the middle of the year we will start to see the funds flowing to the various countries.

What will the ECB’s asset purchase programmes after the PEPP look like? For instance, will the ECB be able to purchase debt without having to observe a self-imposed limit on the percentage of a country’s debt that it can hold?

The PEPP is a temporary programme tied to the evolution of the pandemic. We will recalibrate the programme depending on the evolution of the pandemic and the impact the pandemic is having on the economy. It is something that will be around until the pandemic and its consequences have come to an end. As regards the future, this is a question that will form part of our strategy review, where we will be examining a range of issues, including the definition of price stability, the way we calibrate side effects in our decision-making process, the consideration of secondary objectives and the instruments that we use. In my opinion – and I would stress that this is my own personal view – the most important part of this strategy review is going to be looking at how we are going to use our instruments. And my own approach is that we should have all the instruments available. We are using instruments classified as non-standard but which are becoming more conventional and will form part of any central bank’s toolkit. But we need to be careful with respect to the side effects they could have, mainly in terms of financial stability.

Several countries, Portugal included, will come out of this crisis with a great deal of debt, much more than before, and much of that debt is owned by the ECB. Is this a cause for concern?

It is true that one of the legacies of the crisis is the fact that the public debt ratio is higher than before the pandemic. But that is a consequence of the current fiscal policy. Governments need to spend money in order to fight the consequences of the pandemic and once the pandemic is over and the economic recovery starts to gain momentum, countries will need to once again work at reducing fiscal imbalances. If we can return to the GDP levels we had before, countries will have to implement sensible fiscal consolidation programmes. But that's not something to be dealt with right now. It can only take place once the pandemic is over. Now what we need to do is incur fiscal deficits, to spend correctly and once the pandemic is over, we will be able to look at the need for a fiscally responsible response to the current situation.

So, governments in the euro area should not be in a hurry to return to the European fiscal rules that are currently suspended…

I don't want to interfere in decisions that need to be made by the European Commission and the Council. What I can tell you is that our recommendation is that it is important to withdraw fiscal stimulus very gradually, in keeping with how the pandemic develops, and the evolution of the economy. If we start withdrawing fiscal stimulus too early, we could see a significant deceleration in the recovery. So our recommendation to governments is to be very careful with phasing out, to do so with prudence, and to not react prematurely. If mistakes have to be made, then better to make them by being excessively prudent when withdrawing fiscal stimulus.

Given the huge accumulation of government debt we are currently seeing, a group of economists recently called on the ECB to take steps to cancel some of the debt held by euro area countries. Could the ECB help in this way?

Not only is debt cancellation prohibited by the Treaty but it would be detrimental to everyone. From the outset, it would lead to a very significant drop in the flow of remittances or dividends that central banks transfer to the fiscal authorities in their respective countries at the end of each year. If you cancel part of the debt, profits would have to be used to cover that loss instead of being used to pay dividends. What you gain from the improvement in countries' debt ratios would be offset over time with a lower flow of dividends paid by the ECB and the national central banks to the different governments. So from a merely arithmetical standpoint, that could be detrimental to everyone. What's more, taking a decision of that kind could pose a risk to the central bank's credibility, since it could be interpreted as fiscal dominance, which could undermine the effectiveness of our policies.

In your view, how has the Portuguese economy responded to the crisis?

The Portuguese economy has been hit hard by the pandemic because of the significant weight of the services sector. I think that social distancing for economies like the Portuguese economy, or the Greek or Spanish economies, is particularly difficult to observe, and that's why the decline in Portugal's GDP last year was bigger than the European average. One positive for Portugal is that from a fiscal standpoint, in terms of its fiscal deficit, it was in a good position when the pandemic hit. It had even recorded a surplus, which gave it more leeway. But on the other hand, it still has a very high debt ratio, which is a problem. So what we hope to see for Portugal is that, as containment measures start to be lifted as the vaccination programme progresses, we will start to see a significant improvement in economic activity levels in the second half of the year. And we hope that by mid-2022, GDP will be back to its pre-crisis level.

Are you concerned that, as debt levels rise, non-performing loans in Portugal might increase once more and that we might see another banking sector crisis?

I don’t want to talk about the specifics of any national banking sector. What I can say, not only for Portugal but in general, is that so far we have not seen a wave of insolvencies or non-performing loans. I think that has to do first of all with the support measures put in place in terms of labour retention schemes, public loan guarantee schemes and moratoria. These measures have been extremely important in helping to avoid an increase in insolvencies that could give rise to non-performing loans. At the same time, the ECB’s actions have ensured the maintenance of very favourable financing conditions. As a result, both in terms of liquidity and financial costs, we have avoided a negative vicious circle between businesses and banks.

But that doesn’t mean that it still couldn’t happen…

This takes me back to the point I made earlier. It is very important that the withdrawal of fiscal stimulus is very gradual. Because if it isn’t, then the benign cycle that we have now could be transformed into a sort of vicious circle, which would be extremely negative.

And regarding the moratoria, is there anything the ECB can do to help banks?

Moratoria provide relief to corporates and households. But it’s important to remember that once the moratoria end, normal debt repayments will have to resume.

Do you think that the moratoria may have a bigger impact on bank ratios in some countries than in others?

A moratorium is a moratorium. It’s a helping hand in the short term, but in the medium term the culture of payment has to be maintained. It’s true that corporates and governments will have more debt at the end of the crisis, but the alternative would have been much worse.

This crisis has also made existing inequality levels worse. What can the ECB do to tackle this issue?

Inequality is a serious issue. Fiscal policy is the correct instrument to deal with that, through taxation and public expenditure, which can be much more targeted than monetary policy. As regards the measures taken by the ECB, they have been a very important driving force behind the economic recovery and the creation of jobs, particularly between 2013 and 2019. And that is very important in dealing with the issue of inequality. Job creation is the most important social policy you can apply.

Nevertheless, the ECB has been criticised for inflating asset prices – which ultimately benefits the rich more – through its asset purchase programme.

I don’t agree with that narrative. Our policies can of course have an impact on asset prices, but more importantly they have a greater impact on economic development and price stability.

But couldn’t you find other instruments to support the economy and employment that wouldn’t inflate asset prices?

All policies have side effects. In the case of monetary policy, what is very relevant is what we call the proportionality analysis. This means assessing whether or not our actions are limited to what is essential to achieve the objectives, and whether the main effect we are looking for – in this case the recovery of the economy, employment and inflation – clearly outweighs the potential side effects. We always conduct this proportionality analysis. Our policies over the last ten years have reduced interest rates quite a lot. This has undoubtedly benefited families that needed to buy a house and arrange a mortgage, and corporates, mainly SMEs, that needed funding. I therefore think that when you conduct a comprehensive analysis of our policies, in terms of equality, we have done more good than bad.

President Lagarde has said that, from a personal standpoint, she will try to ensure that ECB policies take climate change considerations into account. What’s your personal view on that?

I think that she’s right. It’s a bit like the inequality issue. The most powerful instruments to deal with climate change are environmental taxes, that’s quite obvious. But that doesn’t mean that other stakeholders have nothing to do. We can also contribute to the fight against climate change.

How?

We can start by analysing the impact climate change will have on inflation, because it’s going to have an impact for sure. At the same time, we have to look at the impact it could have on financial stability, because banks and insurance companies will be affected by the consequences of climate change. We have to make it very clear that a disorderly transition is much worse than an orderly one for the welfare of the European citizens.

Do you think this is something that could be reflected in your asset purchase programmes?

I think that we have to include climate change considerations when we analyse the solvency of companies whose assets we are going to buy. The solvency of debt issuers does not depend only on the quality of their balance sheet; we should also take into consideration the potential implications of climate change in the medium term. This is something that we have started to do with our non-monetary portfolio, which could be a first step.

The ECB is embarking on a project to create a digital euro. Is this something you are doing because you are afraid of the potential effect that crypto-currencies could have on your monetary policy?

It’s not a reaction to crypto-currencies. The main reason is that digitalisation has become increasingly relevant and the pandemic has accelerated the pace of digitalisation. For us, the digital euro is not an option, it's something we just have to do. It's not trivial in terms of the potential implications for financial stability and for monetary policy, so we will have to calibrate this project to minimise any potential negative consequences it could have.

But don't crypto-currencies pose a risk to monetary policy?

First of all, let's call them crypto-assets rather than crypto-currencies. Over and above the doubts about the use of these assets, one of the issues raised is that they are very volatile instruments. Their value is extremely volatile, so I think we should tell people to be careful, that these are very volatile assets, that the underlying fundamentals are not very clear. So far, however, this volatility has not had any implications in terms of financial stability.

The ECB has found it difficult to reach its inflation objective in the last ten years. Do you think it would be a good idea to change this objective?

Our primary objective is price stability, so our objective is for inflation to be "below, but close to" 2%. Up until 2003, it was below 2%. We have had difficulties reaching that objective, but you have to bear in mind that there were structural factors behind the low inflation rate, like globalisation, demographic change and online shopping. But more fundamentally, price stability should be maintained over the medium term and since the euro's introduction, the average inflation rate in the euro area has been slightly above 1.6%. Having said that, the definition of price stability is one of the points we will look at as part of our strategy review. I think the issue of which instruments we use is much more important than the definition of price stability. In any case, what I would tell you is that monetary policy is always about evolution, not revolution. I don't know what the Governing Council's final decision will be, but I suppose that it will be an evolution compared with the definition we have at the moment.