

Peter Praet: Interview with Espresso

Interview with Peter Praet, Member of the Executive Board of the ECB, conducted by João Silvestre on 18 June 2018 and published on 23 June 2018

Is the asset purchase programme (APP) really going to conclude at the end of this year?

What we did last week was to express an anticipation that net asset purchases would end at the end of the year. We didn't say we were now deciding to stop the programme in December. We still have six months to go. We translated the increased confidence we expressed about developments in the economy and inflation into an anticipation about the APP. And, at the same time, we also enhanced the *forward guidance* on interest rates. But, in any event, to anticipate the end of the programme is to give a strong signal.

What exactly do you mean by giving a strong signal?

We undertook a careful review of the progress made towards a sustained adjustment in the path of inflation to levels below, but close to, 2%. It was a strong signal because, in spite of a recent moderation in euro area economic growth, we concluded that progress towards our aim has been substantial so far, and actually sufficiently substantial for us to be in a position to express this anticipation of an end to net asset purchases at the end of the year. We think that the underlying strength of the economy gives grounds that inflation convergence will continue in the period ahead, even after a gradual winding down of net asset purchases.

What is that confidence based on?

There is a path of gradual improvement towards our inflation aim, as the euro area economy will continue to grow above potential. Increasing pressure on the utilisation of resources, notably in the labour market, will continue to support inflation over the medium term.

Is the ECB comfortable with the recent projection pointing to annual inflation of 1.7% over the period to 2020, clearly below the 2% aim for these three years?

The Eurosystem staff projections are only one element of our assessment. What is crucial is that we see a sustained path of adjustment of inflation towards levels that are below, but close to, 2%. Over the projection period, the contribution of energy to inflation declines, and inflation excluding energy and food gradually rises, as capacity constraints become increasingly binding.

What the ECB anticipated last week was the halving of asset purchases between October and December. But there was a proviso: the measure was subject to

data confirming the medium-term inflation outlook. What does this mean in practice?

Our baseline scenario is that the euro area expansion will continue in the period ahead. But new uncertainties have arisen in 2018. Last year was exceptional, with euro area GDP growing by about 3% in real terms between the first quarter of 2017 and the first quarter of 2018, with the combination of strong growth in domestic demand and a rebound in international trade. This year, international trade dynamics seem weaker. It may be attributable to a delayed impact of the appreciation of the euro since the beginning of 2017. Temporary factors and supply-side tensions related to very high levels of capacity utilisation in some euro area countries also contributed to a moderation in economic growth in early 2018. In a nutshell, both demand and supply-side factors are at work, and our baseline scenario is surrounded by more uncertainty. So we must be prudent and carefully monitor economic developments.

Why?

The level of uncertainty has increased. Protectionism, for example, is having an effect on business sentiment, which might already be holding back investment. It is still too early to tell. In addition, Brexit will have financial implications for firms not only in the United Kingdom, but at this stage no one knows what the final Brexit conditions will be.

Are these uncertainties the reason for your prudence in the way the asset purchase programme is being concluded?

Our baseline scenario still holds, but we must monitor the risks. This is why we decided to express an anticipation about the evolution of our net asset purchases. By doing so we are keeping what we call optionality.

Ultimately, if risks materialise, could one of the options be a further extension of the programme into 2019?

As our President, Mario Draghi, said last week, the asset purchase programme is now an integral part of our "toolbox". It is definitely an option, but, last week, we announced our anticipation of the end of net asset purchases, which reflects our confidence that inflation is on course to reach levels below, but close to, 2% over the medium term.

Well, are you being vigilant?

We are alert to the *tail risks* that may, for example, stem from protectionism and, potentially, from an associated sharp fall in confidence.

Might another option be to increase the monthly pace of purchases for the last three months of the year, to purchase more than €15 billion, if the situation deteriorates?

The asset purchase programme remains an integral part of our "toolbox". This being said, our monetary policy decisions altogether maintain the current ample degree of monetary accommodation that is still needed for inflation to

converge towards our aim. This includes, first, our enhanced forward guidance on interest rates, which we expect will remain at their present levels at least through the summer of 2019 and in any case for as long as necessary, and, second, our very large stock of assets for which we intend to reinvest the principal payments from maturing securities. The reinvestment policy plays a very important role, as the amounts are sizeable.

How long will the reinvestments last?

We intend to maintain our policy of reinvesting the principal payments from maturing securities for an extended period of time after the end of our net asset purchases, and in any case for as long as necessary to maintain favourable liquidity conditions and an ample degree of monetary accommodation. Our policy of reinvesting is another instrument at our disposal.

Regarding a change in interest rates, the ECB guaranteed that it will not take place until “through the summer of 2019”. Does it mean until the end of next summer?

At our last Governing Council meeting we said that we expect our key ECB interest rates to remain at their present levels at least through the summer of 2019. In any case, they will stay at their present levels for as long as necessary to ensure that the evolution of inflation remains aligned with our current expectations of a sustained adjustment path.

Our enhanced forward guidance signals that we will remain patient in determining the timing of the first rate rise. The path of very short-term interest rates that is implicit in the term structure of money market interest rates is compatible with our intention of being patient.

Negative interest rates are one of the most controversial points within the ECB’s current monetary policy framework. Particularly for the banks. What do you have to say to them?

You have to look at the whole package of measures that we have implemented. Consider, for example, the lines of funding aimed at bank lending to the real economy, known by the acronym TLTROs. They supported bank lending to the real economy. Banks that borrowed from the ECB and lent to the economy more than a pre-specified lending benchmark also benefited from a negative interest rate on their funding.

What role did the negative interest rates play?

They were important for enhancing the asset purchase programme and for forward guidance. They are an essential instrument in our toolbox that supports very favourable financial conditions, and therefore the economy. This led to improvements in the credit portfolio of banks. It also stimulated the demand for loans of households and firms.

Was the impact on savers one of the reasons for the negative reaction?

For those savers that do not want to take risks and therefore keep their

assets in savings accounts, it is an issue. But it is important to look at the overall situation, and to take into account the impact of our measures on growth and jobs. Young people who need to borrow have benefited and, in general, the important thing for them is to find jobs. Our measures have supported economic activity and job creation.

Has the policy of monetary tightening of the Federal Reserve System (Fed) put pressure on the decisions of the ECB?

There is no pressure. We are in a different situation. The Fed and the ECB are at two different stages of their monetary policy cycles.

PORTUGAL

Could the ending of this zero interest rate environment be a problem for more indebted countries, like Portugal?

Obviously, countries with higher debt levels have benefited more from lower refinancing costs, but this is not the objective of our monetary policy, which to ensure price stability.

More fundamentally, we should always keep in mind that investor confidence in the sustainability of public finances is the key determinant of interest rates on sovereign debt. If there are doubts about the sustainability of public finances, spreads can increase to very high levels, despite the ECB's asset purchase programme.

I have noted that, following heightened market volatility due to developments in Italy, spillovers to interest rates on Portuguese public debt were contained, thanks to significant progress in public finances. This again stresses the importance of sound public finances.

What is your assessment of Portugal's progress?

Commission and ECB staff concluded their eighth post-programme surveillance mission last week. They stress that the current favourable macroeconomic and financial conditions provide an opportunity to accelerate structural reforms, further reduce macroeconomic imbalances and increase Portugal's resilience to shocks. Fiscal consolidation remains necessary to ensure a steady decline in the debt ratio.

They also note that, while Portuguese banks have made considerable progress in strengthening their balance sheets, remaining vulnerabilities in the banking sector need to be addressed, in particular the high level of non-performing loans (13.7% in 2017 compared with an EU average of about 5%). Finally, addressing impediments to investment, increasing productivity and further improving the business environment remain key for strengthening potential growth.

To conclude, my assessment is that significant progress has been made, but that ensuring prosperity on a lasting basis requires continuing the implementation of an ambitious reform agenda going forward.

BANKING

It is essential to complete the banking union. In this respect, the European summit on 28 and 29 June is very important. The European banking landscape is still characterised by one important feature: a strong exposure of banks to their national economy, including a high exposure to domestic public debt. The completion of the banking union will, over time, lead to a lower exposure to national economies.

Regarding the situation of the banking sector, there is still a sizeable legacy of non-performing loans in some banks. An impressive effort has been made to reduce the level, but the situation has not yet been fully rectified.

The banks are now much more capitalised. Their liquidity is much stronger. But, on the other hand, we have to be clear: for the large banks, the new regime under the Bank Recovery and Resolution Directive – BRRD, to use its English acronym – has still not been tested in the event of a crisis – luckily.

The banks still have a strong national orientation: they have exposures to the public debt of their country and a strong focus on the domestic economy. If the national economy goes into recession, if budget deficits soar and public debt rises, this has immediate repercussions for the banks. European banking is not yet sufficiently diversified geographically. More consolidation, more cross-border holdings between banks from different countries, is needed. There is a need for more geographical diversification within the European Union. Smaller, local banks are also necessary to provide financial services to households and firms in a diversified banking landscape.

ITALY

We have seen very large market movements, following political declarations that unsettled market confidence. After political campaigns, it is normal that more precise government programmes are set out, and we now have to wait for more information about the fiscal plans of the new government.