Yves Mersch: Interview with Bloomberg

INTERVIEW

Interview with Yves Mersch, Member of the Executive Board of the ECB and Vice-Chair of the Supervisory Board of the ECB, conducted by Paul Gordon and Carolynn Look

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The latest ECB forecasts weren’t much changed, some of the data is good, some of it not so good. What’s your view of the outlook at the moment?

I must say that since the last time we took action, the least one could say is that things in the economy have not gone for the worse. And even with sometimes conflicting incoming information, most of it has led us to say that the risk balance may still be somewhat to the downside but less so than it has been, and that led us to no change because we said we are broadly in line with our baseline.

Looking also at new incoming information I think nothing is pointing to a further deterioration at least not on the front of prices and production. I do not speak on the health system, and that is why I have to bring in a caveat. This is based on an assumption that things continue as they are right now, that there is no major deterioration on the health front. Now a deterioration on the health front might not be only an increase of people being contaminated, it would be an increase in pressure on the health systems. New generalised lockdown measures which so far we have seen have by and large been resisted or applied in a more ‘surgical’ fashion.

Since we do not exactly know in what direction the health situation will develop it is very difficult to draw very concrete conclusions on the development of our scenarios. At the beginning of the crisis or even until summer we had the feeling that between our baseline and the two extreme scenarios many thought we might came out somewhere in between. Now it looks as if we would be closer to the baseline scenario, maybe with chances to come out a bit closer to the upward scenario if the health situation is not deteriorating.

The second element of uncertainty is the feedback from the banking sector, let’s call it the financial amplification. Measures have been taken and this is not only measures from the monetary policy side: collateral, ample liquidity, the TLTROs, tiering PEPP. It is also the supervisory actions, the regulatory adjustment. And it is also the general ambience that Europe this time was able to not only have national reactions – which would have increased even more the already worrisome fragmentation that we see emerging in Europe again – but we also had a response at the European level. This was very supportive in trying to buffer the economic outfall. And you have seen that the trough, which is behind us, has been a little bit less steep than forecast, and the rebound is now being revised slightly upwards.

So uncertainty remains. It is no reason to be only intelligent if you are more pessimistic than the one who spoke before you. There is no reason to be complacent. We have our programs, they have been extremely efficient, and we believe that they need to continue.

A lot of the actions you’ve taken this year are linked to this crisis phase. What are you using to assess where we are in the crisis, and at different stages of both the health and the economic crisis do different tools become more relevant?

It is obvious that the response that we will see on the health front – and that means not only finding a vaccine, but producing it and distributing it, and access to it – those are different questions to be answered and that will affect the sequence of the solution. So those are areas which are outside our span of control obviously but they will affect the strength of the rebound.

And then there are areas of uncertainty which are closer to our area, and that is to what extent has such a shock induced structural shifts. And in order to give a good answer you have to distinguish first to what extent has this shock been working through the supply-side and the demand side. This is a very difficult question and we have seen different studies in this respect. By and large if I can cut the long story short, for the moment it looks as if the downfall in prices might be attributed roughly 50% to the demand side and 50% to the supply side. But – and this makes it a little bit more tricky – we see that the dynamics evolve as the situation develops. What has been downside for demand could suddenly become upside for demand, and for supply it is the same.

What are the global value chains that will be most disrupted and to what extent will that create an upward price pressure, as restraint on supply meets piled-up demand. You might also have behavioural changes on the demand side. It’s very difficult to speculate on how people will react permanently, because some short-term reaction might not be persistent and then if you did factor in a structural change, you might be on the wrong side.

For example, will there in the future be permanently less people in some sectors – leisure, tourism, those sectors that are most impacted – or will people revert to the normal consumption patterns once things clear up and a vaccine is distributed? It’s difficult to say. The distancing measures, will they be reinforced, will we stay with the present ones? The lockdown, will it be as strict as in the past?

That’s why we have beyond our baseline the positive scenario and less positive scenario and we have to continue to monitor closely incoming information. We better err on the side of prudence. That means we have to provide ample liquidity to support the recovery amidst longer uncertainty.

Now, on the instruments, of course, in some situations one instrument is more efficient and the Governing Council has signalled that asset purchases and TLTROs have presently more traction than our traditional instruments.

The economists that we’ve spoken to and markets in general are expecting more bond purchases at the December meeting. What are you thinking about what markets are saying and whether that matches up with what’s likely?

Of course the markets like if we buy up everything that they have. We will take our decisions on the basis of the whole euro area and on the basis of the shutdown in individual countries.

And we will take decisions on the basis of the information that we have accumulated since our last decision-making. We are open-minded, but the open mindedness goes both ways. We always insist on symmetry. If the situation should hugely improve, our reaction should be the opposite of a reaction to a deterioration and also different from a continuation along the baseline.

We have encouraged the banks to continue financing the economy. We have given them very favourable conditions through different instruments – the tiering, the TLTRO, the PELTRO – and the banks have done their job. We have also seen public guarantees that have been extremely helpful in maintaining asset quality, and we have seen the moratoria. But one day they will run off. Our concern is to avoid cliff effects. The cliff effects can be coming from both sides. Either the banks do not prepare sufficiently in advance – preparing in advance means recognizing impairments, increasing the provisioning, and we have given them capital space in order to do that. And: this capital space is not meant to be distributed to shareholders, it is meant for the economy. But as supervisors we certainly also need to insist that banks do proper risk management and acknowledge the recognition of impairment and do the appropriate provisioning.

The banks’ capital situation has improved in the second quarter as much as it had deteriorated in the first quarter. The impairment has also doubled. But we could imagine further impairments as support measures unfold, structural change sets in, the pace of recovery is uncertain.

If you compare with the situation under the great financial crisis I think we have reacted faster and more forcefully with all public-sector firepower in this crisis. But we have to continue to transform the cliffs into ramps. That needs the contribution not only of monetary policy, but also of other policy areas, especially fiscal policy.

What's the importance of interest rates in this environment, and what some economists have described as the dual rate? Could there be a situation that as the crisis progresses and we see that lockdown restrictions don't materialize in the very harsh way that we've seen before, where perhaps stimulus in the form of more PEPP isn't the most appropriate tool?

We have never said that the interest rate is no more at our disposal. We have communicated in the past that we believe that the other instruments might have equivalent or superior effects in present circumstances. The next time we take a decision we again will do a holistic assessment of all our toolbox instruments and we will choose the one that we consider most appropriate in view of the situation.

As to your underlying question, if we were to have a dual rate system we would have to look very carefully not to lose control and to keep traction with the instruments that would be most appropriate to transmit our monetary policy decisions.

It has been argued that a rate cut would be one of the best ways to tackle an appreciation of the euro. Is that an argument that makes sense to you?

I have to start by telling you…

… that you don't target the exchange rate.

So that's my first point. The second is that as Europeans we are very attached to multilateralism, and on exchange rates we have consensus language at the global level that has been valid for many years now, and that does not only speak about the exchange rates being in line with fundamentals but it also speaks about the volatility, excess volatility being disruptive.

This being said, it is obvious that the recent movement in the exchange rate has had statistical effects on some of our measures of inflation and production. And since we are very committed to price stability, we will certainly monitor the developments.

So, we will monitor very closely the effects of exchange rate developments on our efforts to attain our objective of price stability, but this is by no way a change in strategy.

You were previously, but more so now, targeting a price stability goal which is somewhat different to the Fed's goal.

We have had the numerical definition of price stability from our inception, we have been well served by our strategy and our definition of price stability, and I would add that we have been well served by having a definition that is medium term oriented.

This medium term orientation gives us the necessary flexibility which is especially important in times of high uncertainty, and which allows also a time varying response function which takes into account the different effects of a shock. I've never been convinced to change a winning team.

It's not entirely a winning team in terms of inflation though. It's not entirely the ECB's fault but inflation has been well below the goal for a very long time.

If you look over 22 years we do not need to hide. But if you have shocks for example as we see now – VAT reduction – or through commodities on which we have no influence – then we see through it. So it's not by changing the goalposts that we will score more goals convincingly.

There was a report out recently suggesting that a sweeping review is being undertaken, and one argument in that is that the relatively high flexibility of PEPP could be copied over to the asset-purchase program. Is that true, and does it make sense?

I saw the article, but as a member of the Executive Board I am not aware of such a development. I can tell you that we look of course permanently at all developments. The PEPP has been created first and foremost to be a backstop to ensure the smooth transmission of our monetary policy decisions, and to be a backstop to provide liquidity. And it has been extremely efficient. In view of its sheer size it also has a second function, and that is to reinforce our monetary policy stance. But it is an emergency instrument created because of the pandemic.

Take a democracy: It's always easier to govern if you have emergency powers and you prolong the emergency powers forever. The PEPP is an emergency instrument. We have stated that we have disenfranchised ourselves from a certain number of self-imposed constraints in view of the pandemic and in view of its exceptional nature and threat – and that means it must be temporary.

Now of course you can extend the temporary character, but the pandemic will not last forever. But unconstrained flexibility also increases the risk of arbitrariness. And in order to limit the arbitrariness of institutions, we have the scrutiny of jurisdictions. And we have publicly in the courts promised to jurisdictions what we were doing in order to protect the red lines that have been put into the Treaty, especially the monetary financing prohibition.

So if you now say we have emergency instruments which do not need to respect these constraints, and we use them now also in our normal procedures, I do not know what the same jurisdictions would say in their future assessment.

So does that imply that the APP is not temporary?

It is subject to constraints vetted by the ECJ, and it is temporary as we have already once suspended it. The PEPP is exceptional and therefore temporary. We have always said it is linked to the assessment of the

Governing Council on how long this pandemic is affecting us. So we cannot say the pandemic is over but we continue with the PEPP, or we transfer the PEPP features into the APP. To my humble understanding of what the law means this would be very curious.

President Lagarde said recently that a Eurosystem taskforce on the digital euro is due to present its findings in the coming weeks. How has this review affected your position on the matter?

We have a treaty obligation to promote safe and efficient payment systems, because they are supporting our monetary transmission mechanism. Therefore we must follow technological evolution very closely in order to be permanently able to serve our citizens. It's also extremely important that a central bank keeps a direct link to its citizens. That means with the emergence of non-European public and private initiatives as of late, there is also a discussion concerning European sovereignty and maintenance of the role of the currency. Cash is still in strong demand. Maybe in terms of payment it has receded a bit during the crisis, but the demand is still there. So we are ready to bring to our citizens what they ask. We want to give them a choice and we will give them a choice. That's the explanation why we also develop studies into a central bank digital currency. That doesn't mean we are rolling it out or implementing it, we are just conducting a thorough study as is being done in other jurisdictions.

Could we soon see experiments being run in the eurozone similar to what the PBOC is doing in China?

The PBOC has its own governance and its own strategy, we follow ours. There is a long list of questions that are not yet solved, and we will come closer to a solutions by doing small, real-time experiments.

There was a report by Buzzfeed talking about banks who are filing suspicious activity reports, and yet still moving money around. It suggests the banking system is still falling short in some areas. What's your view on that?

If they fall short they should stand up and be responsible for it. Some banks have been subject to close supervisory reviews and queries in the past, and as far as we know from all of the banks action has been taken. These are reports looking 10 or 12 years back.

The banks have adjusted their governance and procedures. We are not in charge directly. We are awaiting new legislation from the Commission on anti-money laundering – all this is strengthening the European framework.

Your career goes back to the birth of the euro. For roughly half of that time the ECB struggled to hit its inflation goal. Not all of that is the ECB's fault, but you'll leave before the strategy review is completed. What is your lasting advice to the ECB and to your successor?

If the world changes and you do not change, then you are falling behind the curve and not fulfilling your role. You regularly have to do a re-assessment of yourself, your instruments, and your strategy. In the future it might make sense not to wait 18 years but rather to do it more often, especially if we face a higher number of shocks that we have no experience with, which might have structural change as a consequence.

Secondly, you also do not change as a kind of fashion. It should reflect structural changes. Because otherwise you blur the perception in the public of what you stand for. We must be able to explain the strategy review to the public at large. Any change must be soundly warranted and explained.

The measurement of inflation is one of the first work streams that has been internally discussed. On owner-occupied housing, we have made a lot of progress on how to collect information, how to distinguish what is the housing element from the investment element. Another question is whether we collect only prices of goods and services, or should look into experiences with a cost of living index rather than a CPI. There are a lot of discussions on this topic.That’s my only regret – I love this discussion, that is my life and I have to leave it.

The brand new element to this discussion is climate change, which President Lagarde is pushing pretty hard for. Are you comfortable with that?

It’s a societal change that we will have to factor in. The difficult part is the circumscription, definition, there’s a lot of greenwashing going around as well. But what is important is that it reaches the real economy, where it will have transformational capacities that will affect a lot of people. It’s a question of transition and a transition needs to be financed. It’s not all in the hands of central banks, we are at the end of it. If we are pushing awareness that’s already a big contribution. If in the end central bankers are perceived as politicians, that would not be helpful in my opinion.