

Yves Mersch: Interview with Börsen-Zeitung

Mr Mersch, the euro area economy is booming and inflation is picking up. Will 2018 be the year of monetary policy change for the ECB, with a shift away from the ultra-loose monetary policy of the crisis years?

The change actually already got under way a year ago. We first reduced our monthly asset purchases from €80 billion to €60 billion, and as of January we will in fact be down to €30 billion. We are also letting our targeted longer-term refinancing operations expire. So it really cannot be said that we have not taken the improved data into account. Our monetary policy is data-dependent, and we always react to the latest developments. This will also be the case in 2018.

But the ECB has always downplayed the significance of all these decisions. Do you think that market participants have understood that the change is already under way, as you say it is?

Sometimes markets react more quickly than expected and sometimes they take a bit longer. And sometimes they overreact, so we have to be very careful. We don't want to cause any upset. But it is indeed surprising that long-term interest rates are now lower than they were in the summer, although growth has surprised very positively and growth and inflation forecasts have been adjusted upwards. It doesn't really follow.

The main thing for 2018 will be a decision on quantitative easing (QE), i.e. the large-scale purchase of assets, which is currently locked in until 2018. If growth and inflation develop as currently expected, will that be the end of QE?

We will make that decision when the time comes. Keeping the end-date open now was the right thing for the Governing Council to do. The first step is to implement the decision to halve our purchases to €30 billion. But as ECB President Mario Draghi recently said, we are now more confident that inflation is on a sustainable path towards our medium-term objective of below, but close to, 2%. But the more confident we are of meeting our objective, the more the likelihood of a further increase in our purchase programme trends towards zero.

So far there has been a one-sided promise to increase QE "in terms of size and/or duration", i.e. maintain the "easing bias", if the outlook for inflation worsens or financing conditions become unduly tight.

It's certainly a valid question to ask whether a promise that has a near-zero probability should continue to be made. Indeed, in the short term the risks to growth and inflation are more on the upside, meaning that both could turn out to be higher than currently forecast. So it makes increasingly less sense to give a one-sided signal that addresses the eventuality of the situation

unexpectedly deteriorating. So there is certainly scope for adjusting our communication on the easing bias soon. To a certain extent, this has already been done with the statement about our greater confidence in the path of inflation. In addition, it is clear that the net purchases are becoming less important compared with the holdings on the central bank's balance sheet, the reinvestments and forward guidance. This will no doubt be reflected in our communication as well.

If QE comes to an end in 2018, would it be sufficient to start communicating on this in the summer, or would preparations have to start earlier?

It shouldn't be left until the very last minute – the markets should be prepared in a proactive and ongoing way. This is important so that we avoid false expectations and short-term market turbulence. It would certainly be appropriate to take a position on this point before summer 2018.

Would there need to be a gradual winding-down from €30 billion, a “tapering”, or could the ECB drop to zero in one step?

We haven't yet gone through the various options in the Governing Council. The expert committees will also need to be involved in the preparations. Our aim is not to cause an unnecessary stir in the markets, and we will stick to this position.

The markets were recently hoping for more information about how the reduction to €30 billion would be distributed between the individual purchase programmes. Doesn't the Governing Council need to provide more guidance on this?

We will continue to purchase mainly public sector bonds, and the rest will be invested in private sector instruments. Corporate sector purchases will probably account for a slightly larger share, as we won't necessarily reduce these purchases proportionally. But the exact composition of the €30 billion will depend on the situation in the market. We need a certain amount of flexibility, because market conditions can change quickly.

Is the ECB still in control of affairs, especially now that self-imposed purchase limits are becoming increasingly relevant?

We are able to conduct our asset purchase programme. The important thing here is that we want to remain market-neutral. And we shouldn't overdo the discussion on the composition of the €30 billion. Including reinvestments, we will still be buying securities for more than €50 billion in some months. The question of whether we invest, say, €1 billion more or less in corporate bonds is not decisive.

To what extent have the Governing Council's discussions been affected by the Steinhoff issue – that is, losses resulting from the purchase of bonds issued by the beleaguered furniture retailer – especially given that Council members hold very different views on corporate sector asset purchases?

The Steinhoff case hasn't resulted in any discussion in the Governing Council about changing the asset purchase programme. We have certain rules regarding

the suitability of individual instruments. We don't blindly buy 100% of a given bond, we watch the market constantly. The important thing for me is that we don't take on excessive risk. We also keep a constant eye on our risk management framework and adjust it if we see a need to do so.

The Governing Council doesn't want to consider raising interest rates until "well" after the end of net QE purchases, which is known as "sequencing". This follows the example of the Federal Reserve in the United States. But the Federal Reserve never had negative rates. Doesn't at least the negative deposit facility rate need to be scrapped more quickly?

The slightly negative interest rates support our asset purchase programme. If we had not had them, we might have needed to buy greater volumes to achieve the same effects. But the net purchases are becoming increasingly less significant. And the sequencing is something that the markets have understood very well. So we need to move step by step towards a normalisation of our monetary policy, we shouldn't rush it.

But isn't the negative rate a special case?

There are very different views about negative interest rates. We haven't seen any excessive distortions so far, and the advantages predominate. But this does not lead me to conclude that we should hang on to negative rates for a long time to come. Can you imagine that a whole generation is growing up without knowing what it means to gain interest on money? There is a risk of the savings culture being undermined, and we need to keep a close eye on this. The bottom line is that we need to approach the normalisation of our monetary policy carefully and gradually. But we also need to be very careful that we do not act too tentatively and too late and end up falling "behind the curve".

How much do you worry that the ECB would have hardly any ammunition left with which to counter a future downturn?

We are always saying that fiscal policy should build up buffers in good times. But that is also true for monetary policy. If a central bank were to run out of ways to react to a recession, that would be worrying. This too demonstrates that the current level of interest rates is certainly not the normal state of affairs.

In the United States the first interest rate rise came 14 months after the end of QE. In the case of the ECB, that would mean that if QE were to end in September 2018, the first rate increase would be in November 2019. Some market participants are even reckoning with 2020. Do you feel comfortable with such expectations?

We do not follow the example of others. Our actions are determined solely by the requirements of the euro area. 2019 and 2020 are a long way off; nobody can make reliable predictions that far ahead. I can only advise against tying oneself down so far in advance. That could damage credibility.

But the forward guidance on interest rates goes in that direction.

Forward guidance at some point reaches its limits. That has to be acknowledged. It was a useful additional tool in a specific context. But once we start heading back towards normality, forward guidance should not be expanded, it should be scaled back. We shouldn't limit our room for manoeuvre indefinitely.

Are banks, businesses and governments sufficiently prepared for a future interest rate turnaround?

There have always been people who believe in Father Christmas and who think that everything will continue as it is. Those who don't prepare themselves for increases in interest rates will ultimately be at a disadvantage. Even changes in the purchase programmes will affect the yield curve. But it's not the ECB's task to guarantee that the curve will always remain so flat. We, the ECB, via monetary policy normalisation, should pay heed to moving our focus from long-term interest rates back to the short end. The more a central bank concentrates on the long term, the closer it gets to redistribution – this is worrying from the perspective of economic governance (“Ordnungspolitik”).

Who has the most catching-up to do – banks, business or governments?

Some countries need to do much more to solve the problem of non-performing loans, the NPLs. Other countries are still taking on too much new debt, and others meanwhile have not built up any fiscal buffers at all. It must be clear to everyone that we don't conduct monetary policy for individual economic actors, but for the whole of the euro area economy.

Bundesbank President Jens Weidmann is concerned that the ECB will face ever greater political pressure.

Of course, some countries are more resistant to reform than others. But we've also seen that countries which hadn't undertaken reforms for a very long time were, in the end, able to do the necessary. Consider the reforms in France under President Emmanuel Macron. Such reforms are certainly more convincing for markets than merely making proposals on creating a European “debt union”.

Concerning NPLs, the ECB's banking supervisors want to be stricter, but are encountering a lot of political opposition within the EU. Are the euro area countries unwilling after all to address the problems of their banks?

The NPL problem has to be solved, no doubt about that. But you have to distinguish between substance and form. We supervise the banks, but are not the regulator. The relevant institutions, within their competences, must address the problems in a timely and determined manner. Despite all the criticism of the form no-one should hide behind it and wait for the problem to resolve itself.

Could you imagine banking supervision being separated from the ECB sometime, as is being demanded particularly in Germany?

I can imagine a lot of things. But I'm not convinced that the previous German model was better. Personally, I am very strongly convinced that monetary

policy needs access and proximity to the supervisory authority in order to fulfil its mandate. There is no ideal model for this proximity. I'm not convinced by the argument that supervision would function better outside the ECB.

The ECB was also criticised for pushing for a change to its statute in order to obtain more effective control over clearing houses. Was that a mistake?

No. A stronger role for the ECB in the oversight of central counterparties is quite clearly a monetary policy responsibility. I fail to understand those insinuating that we are expanding our mandate. Monetary policy has to deal with those entities where liquidity is collected and pooled. If we didn't take care of this, we would be recklessly negligent of our mandate.

How concerned are you about the rising value of Bitcoin? Is it a risk to financial stability?

First of all, Bitcoin turnover is between €250 and €350 billion. The volume is therefore comparatively low. That's why Bitcoin trading is not at present an issue for monetary policy. Regarding the increase in price, we are seeing speculative hype that might be a cause for concern. But of course individual investors are free to gamble. However, if something goes wrong, they should not come to us and say we should have outlawed it and protected them from themselves. Second, there are now banks which hold positions in Bitcoin. It is a matter for the supervisors to judge how big the risks are. Third, and what concerns me most, is when financial market infrastructures such as stock exchanges enter this business. That poses a major threat to financial stability.

So you don't think much of Bitcoin futures and other recent developments?

If these transactions are kept separate from others, it's a secondary matter who wins and who loses. However, if all the participants in these financial centres are jointly liable, that can create difficulties, for instance, for banks or the whole system. And if the banking system gets into trouble, there will again be demands for support from the ECB. I would say from the outset: we shouldn't do this.

Do you think that private cryptocurrencies could become a real alternative to central bank money?

Money needs trust. Public currencies, for example the euro, have the backing of public institutions such as the ECB. Many of these currencies have no backing, nothing. It's a somewhat different matter for the underlying technology, the blockchain. That's a challenge we all have to face, especially banks. Each institution has to know that in the future financial intermediation will no longer be heaven-sent, but has to be fought for.

Bundesbank Executive Board member Carl-Ludwig Thiele has raised hopes for a return of the €500 banknote. The Governing Council's decision to stop issuing the €500 only relates to the second series of banknotes and probably a new series of banknotes will appear in the next decade. Is that correct?

Strictly speaking, the decision to suspend the €500 banknote only concerns the second series, so that's correct. But it's unlikely that we would resume production. We shouldn't try to turn the clock back. In theory, the Governing Council is free to change its mind tomorrow. But I think the chances of that are as high as for additional net purchases under QE.

Let us come back in more detail to the matter of monetary policy: do you think that there will be a return to the normality that prevailed before the global financial crisis – or is there a “new normal”, with, for example, inflation at a permanently lower level and instruments such as bond purchases being a permanent feature?

I don't think we're already living in a “new normal”. The discussion on this should continue but caution is called for. There are certainly factors which have a lasting impact on prices – ageing populations, new technologies, globalisation. But many of the factors that keep inflation below target are also temporary. I am convinced, as is the Governing Council, that we are definitely able to reach our objective of below, but close to, 2%. We are already seeing a build-up of reflationary forces. In the future we can certainly have a debate about our objective – as we did in the early 2000s. But we shouldn't have this debate if we are just short of our objective. That would only destroy confidence.

Irrespective of 2% – is “inflation targeting” outdated?

Inflation targeting is fashionable, but it's fading. In a region as varied as the euro area, we were well advised not to impose on ourselves a strict inflation targeting regime, but to be more flexible. We have settled for a definition of price stability over the medium term of below, but close to, 2%. I think it has served us very well.

And are you worried that the era of central bank independence could be coming to an end?

I am very concerned about these discussions. But as central bankers we also have our own responsibility: the more space we occupy, the more we need to ask ourselves whether that is still compatible with our independence. We need a tightly defined mandate. The closer we move to the political domain the greater the risk of our getting burnt.