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Joint interview with the Governors of the Bundesbank, Joaquim Nagel, and the Banco de España, Pablo Hernández de Cos

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Full transcription

Question. ECB (European Central Bank) has now raised interest rates by another 0.75 percentage points. Is there a consensus among both of you that ECB must continue with its interest rate hikes?

Nagel: The decision that the ECB Governing Council took last week was very important in a situation where inflation in the euro area is at 10.7%, which is far too high. I am convinced that this hike will not be the end of the journey. There is still a long way to go. Inflation is stubborn and if we want to overcome it, monetary policy has to be even more stubborn.

Hernández de Cos: We've made substantial progress to withdraw monetary policy accommodation. But we will need to move rates to levels that allow inflation to converge to our 2% medium-term objective. And for this, we haven't reached the final point.

Q. Aren't you afraid that the steep rises in interest rates decided by the ECB may have just a limited impact on an inflation significantly driven by exogenous factors like the war while having a big effect on a recession? How do you judge political leaders outlining publicly this concern, as Macron or Meloni did?

Nagel: The mandate of the Eurosystem, and therefore of the Governing Council, is crystal clear: ensuring price stability. We have to fight high inflation. That is why central banks have been granted independence from the political sphere. We do our job and we are not done yet.

Hernández de Cos: A significant part of the shocks that are driving inflation up in Europe are supply driven. But there is also a demand component and the magnitude and the persistence of the inflation spike is being extraordinary and has also broadened. This increases the probability of second round effects. All these factors are being taken into account in our decisions. As to the future, we will take into account these past decisions and their transmission lag on activity and inflation. And, of course, future decisions will be conditioned on the inflation outlook, including the economic outlook and therefore the higher probability of a recession that we observe now.

Q. Did the ECB make mistakes? Should ECB have reacted earlier?

Hernández de Cos: Again, shocks that were hitting the euro area were different to those affecting the US economy. Indeed, close to 75% of the increase in inflation in the euro area has been due to the direct and indirect effect of energy and food prices. This is why the ECB reacted differently. And despite the significant inflation spike, long-term inflation expectations have remained well anchored, which proves, in my view, the adequacy of our response.

Nagel: As Pablo said, price pressures have broadened in the euro area: it's not just energy and food that have become significantly more expensive, but goods and services in general. In October, core inflation reached 5.0%. Inflation could become entrenched and there is a risk of long-term inflation expectations straying away from our inflation target of 2%. Now we need to act decisively, like we did in the past three meetings.

Q. You have said that the drivers of the inflation are different in Europe and in the US. But isn't the ECB trying to catch up with the Federal Reserve or the Bank of England? In other words, isn't the ECB going too fast now? And what's the goal: is the ECB going towards a neutral rate or an interest rate that cools the economy to tame inflation?

Hernández de Cos: The ECB acts independently, based on its own assessment of the inflation and economic outlook in the euro area, which of course depends as well on the evolution of the global economy. Are we going too fast? When judging the speed of our reaction, you have to take into account the origin of the shocks but also the magnitude and persistence of the inflation spike, and that the level of accommodation from which we started was extraordinary.

Nagel: This is not a catch-up race with other central banks. We are doing what we have to do to restore price stability in the euro area. This is our task and the best contribution that monetary policy can make to the welfare of families, workers and businesses. If we don't act decisively now, inflation would persist for longer. It would be much harder to rein in inflation in the future. And the pain inflicted would also be greater.

Q. How far will the ECB go up with interest rates? It used to be said that the concept of a neutral interest rate, where monetary policy neither supports nor restrains, does not make sense for a heterogeneous area like the euro area. Then it suddenly appeared in ECBs communications. And now it seems to have been vanished again…

Hernández de Cos: No one knows how far we will have to increase rates, given the enormous uncertainty of the outlook, which depends, among other factors, on the eventual course of the war in Ukraine. We will move rates to a level that allow inflation to converge to 2% in the medium run. I made a speech recently in Bilbao on which I gave an indication, which I considered valuable, of where I see this target compatible rate. The main conclusion again is that there is still ground to cover. But this is conditional on the inflation outlook and therefore it´s data dependent. As to the neutral rate, I see this as a communication device. By comparing it with current rates, one can draw conclusions so as to whether we are on a more or less restrictive territory.

Nagel: The neutral interest rate can help us in our assessment of whether monetary policy is already helping to tame inflation or not. But there is a difference between theory and monetary policy practice in an environment of huge uncertainty. And in the end, we aren't targeting interest rates, we are targeting inflation. We will raise interest rates by as much as it takes to put inflation safely on a path back to our two percent target.

Q. President Lagarde said yesterday that you're going to discuss in your December meeting the principles to start the APP portfolio tightening, the QT. Could you please outline how do you see this process, what should be the principles, the rhythm? How do you approach this important factor of monetary policy?

Hernández de Cos: At some point we'll have to start reducing our APP portfolio. We will decide on its key principles in December. In my view we have to do it in a cautious and very gradual manner. Mainly because we do not have much evidence on its effects. We need first to draw lessons from the reduction of the balance sheet stemming from the decision to modify the conditions for TLTRO. And the reduction of the stock of APP assets will have to be considered together with our rate path, so as to achieve the financial conditions compatible with achieving our inflation target.

Nagel: I think it is very important to have this discussion regarding our balance sheet. When acting against inflation, you have to think about the bond portfolio, too, which has increased massively over the past years. Now we are talking about nearly 5 trillion euro of bond holdings. We want to normalise monetary policy. And to achieve this, we should use all the instruments we have at our disposal. We should start reducing the size of our bond portfolio at the beginning of next year, for example by letting existing bonds mature with little market impact.

Q. Bundesbank-President Nagel, would the Bundesbank have liked to raise interest rates earlier, as it did in the 1970s, and thus prevent double-digit inflation, as it did then?

Nagel: What matters to me is to play a part in shaping monetary policy for the entire euro area. We have had good discussions in the Council and have largely reached consensual solutions. If you think of inflation in the 1970s after the oil price shocks, you cannot compare it one to one with the situation today. But there is an important point: our monetary policy is in the good tradition of the Bundesbank. It is our shared price stability objective that drives our decisions in the Council.

Q. While the ECB advances in withdrawing monetary policy accommodation to tame inflation, national governments are working on big fiscal packages that, in fact, act as a counterforce to your policy. The bank advocates for them to be "temporary, targeted and tailored". What you're seeing around, and specially the 200 billion German package, fits well with that concept? How afraid you are that those measures can contribute to unleash a "self-reinforcing" inflation spiral?

Nagel: For Germany, we do not expect the deficit ratio to change much in the current and in the coming year, even with that 200 billion package. Tax revenues are strong and coronavirus measures are unwinding. The 200 billion euro are spread over several years, they are an upper limit, and they are intended to be partly subject to taxation. The proposals of the expert commission do not undermine incentives to save energy. In the press conference of the IMF meetings, the German finance minister and myself both had the same understanding about the role of monetary policy and fiscal policy in the fight against inflation. The Eurosystem is responsible for restoring price stability. Governments can contribute, too, by implementing targeted support measures which do not fuel inflation.

Hernández de Cos: We are advocating for targeted fiscal measures. But the European Fiscal Council claims that a significant part is not being targeted. A generalised fiscal impulse would exacerbate inflationary pressures, which would imply an additional reaction of monetary policy. And the NGEU investment projects already represent an appreciable fiscal stimulus. In other words, consistency between fiscal and monetary policy is of the utmost essence. Fiscal measures should also be temporary in order not to increase fiscal imbalances, in a context on which the most indebted countries should reinforce the sustainability of their public accounts. I also advocate for a European response, that shows solidarity among member states and guarantees the functioning of our single market. But let´s be clear: the best economic policy to confront the current supply shocks is to implement structural reforms, including in the energy sector.

Q. Are there differences in how inflation is experienced by the people in Spain and Germany?

Hernández de Cos: I don't think so. Inflation in Spain causes people a lot of concern and is also hitting particularly the most vulnerable groups. With one special feature: consumer energy prices react particularly quickly to international energy prices. Accordingly, inflation has risen very fast in the last year. And the recent drop in international energy prices also explains the recent deceleration of inflation from above 10% in August to around 7.3% in October.

Nagel: In Germany, too, inflation is one of people's biggest worries at the moment. No matter who you talk to. Everyone is worried about their next gas and electricity bills and rising food prices. But just as in Spain – and other countries as well – it is the most vulnerable people that are hit hardest. Families with low incomes often have no savings to draw on. And they face even higher inflation rates than others since heating and food – the items that have seen the strongest price increases – make up a larger share of their spending. Inflation always has this social dimension. That makes it all the more important to restore price stability.

Q. Looking at the economic scenario one cannot exclude that at some point there might be turbulences in the bond market. The ECB has put in place the TPI but the mechanism hasn't got clearly defined principles to be activated. Could you please explain how do you see it, the criteria to activate it and tell if you are afraid that it might be hard to find a consensus within the Governing Council if the issue comes up at some point?

Hernández de Cos: We agreed unanimously on having a TPI, and we stand ready to activate it if needed. This is based on our conviction that the singleness of our monetary policy is a precondition to deliver on our price stability mandate. We would activate it if we observe unwarranted and disorderly market dynamics that pose a serious threat to the transmission of monetary policy across the euro area. We have also emphasized that there are eligibility criteria, which have to do with debt sustainability, and with countries complying with the European governance framework, including the fiscal framework.

Nagel: Let me make three points, complementing what Pablo said. First, we stand ready to use the TPI, should we need to do so, on the basis of appropriate criteria. Second, if the TPI is activated, then only for one exclusive purpose: to achieve our price stability mandate, nothing else. And third, the purpose of the TPI is not to come up with favourable financial conditions for governments. It's all about our price stability objective. Governments are responsible for ensuring sound public finances.

Q. What role do interest rates play for savers or homebuyers in each of the two countries?

Hernández de Cos: One important difference is that around 75 percent of home mortgage loans in Spain have variable interest rates, whose reference rate has increased by more than 300 basis points since December. This implies a quicker transmission of our monetary policy in Spain.

Nagel: In Germany, most mortgages have interest rates that are fixed for a long time. So for existing loans, the turnaround in interest rates won't be felt until later. Nevertheless, people who want to build or buy a home now face higher interest rates. Savers, on the other hand, stand to benefit when rates go up. Anyway, higher interest rates are necessary to bring down inflation.

Q. The ECB chief economist has called on Eurozone governments to tax rich people and companies more to finance support for those hit hardest by the crisis. Do you agree with that? Furthermore, the interest hikes are fuelling the results of the European banks and the Spanish government is going to tax those so called windfall profits. What's your opinion?

Hernández de Cos: On the tax on banks, we are preparing an ECB opinion focusing on its implications for monetary policy and financial stability. On the first question, I will not enter into distributional issues that depend on the preferences of parliaments. As I said before, the fiscal support should be targeted towards the most vulnerable. How you want to finance this, is a matter to be decided by governments.

Nagel: I will not comment here on specific fiscal policy measures of other countries. But I do want to stress one point: sound fiscal policy is key, not just today, but also in the future. In the euro area, fiscal rules are an especially important element for a stable economic development.

Q. Do you see risks for the real estate market? Are there fears in the two countries of bursting real estate bubble?

Nagel: After a long period of very low interest rates, rising interest rates can put real estate markets under pressure. High residential real estate valuations were one of the reasons why German authorities took certain macroprudential measures several months ago. In addition to the countercyclical capital buffers, banks must also have higher capital buffers for residential real estate loans. This further enhances the resilience of the financial system.

Hernández de Cos: Since the real estate bubble burst in Spain during the great financial crisis, significant deleveraging has taken place in firms and households and a positive current account surplus is being maintained. The resilience of the financial sector has also improved significantly. Contrary to other countries, we have not seen an exuberant dynamic of the residential real estate sector. But, of course, the current macro-financial environment is expected to have an impact.

Q. Wages are losing purchasing power pretty much across all the Eurozone even though with different intensity. The upgrading is much lower than the pace of inflation. Do you see more room for increasing wages for the workers or are we close to a scenario of a spiral between wages and prices so you would recommend extreme prudence on this issue?

Nagel: In the current situation, the impulse is coming from higher prices. So, if anything, there is a risk of a price-wage spiral, not the other way round. And it always takes two to tango: not only employees earning higher wages, but also businesses setting higher prices for consumers. At the moment, we do not see such a spiral in Germany, though the risk has increased. What matters most: no one should expect inflation to stay high in the medium term. We will bring inflation back to two percent.

Hernández de Cos: Wages have increased very moderately. Mark-ups have also remained moderate. To preserve this, I´m advocating in Spain for an income agreement between trade unions and firm representatives, including the public sector as well, that distributes the national income loss that comes from the price increase of imported energy. It’s needed to avoid an inflation spiral that would cause further losses to our economy.