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Interview with the Governor published in Politico

Full transcript of questions and answers

Pablo Hernández de Cos, Governor of Banco de España

-Spain has suffered more from the pandemic than most other European member states with a deeper contraction, slower recovery and also higher inflation, what do you ascribe this weak performance to?

If you compare where Spanish GDP stands in the third quarter of the year with the fourth quarter of 2019, Spain is 6.6% below the pre-pandemic level and the euro area is 0.3%. There are three main elements explaining the relatively worse performance.

The first one is tourism. We are more dependent on tourism than the other large euro area economies. At the same time, we have observed some less favourable developments in our country in terms of the pandemic. Our dependence on British tourism is also higher and therefore the more adverse developments in British tourism observed during this period have also negatively influenced tourism developments in Spain.

The second element is private consumption. It dropped much more during 2020 because our initial restrictions were tougher than the euro area average. The recovery in household consumption has been also slower. And even if employment has performed relatively well in the Spanish economy, we did comparatively worse in terms of household disposable income in 2020, and consumer confidence is also lagging behind the rest of the euro area.

Investment is the third element that explains the difference, and in particular the lack of investment in transport equipment which may be explained by several factors, such as supply restrictions hampering production and sales. Restrictions have arisen everywhere, but particularly so in the automotive industry. The automotive industry is highly important to the Spanish economy and carmakers are suffering especially from the disruptions caused by the bottlenecks. We also perceive especially low demand from car rental firms to replace their fleets, which is also very much related to tourism.

So weaker tourism, household consumption and investment are the main reasons behind the Spanish economy's underperformance compared with the euro area.

-To what extent has the higher inflation level in Spain played a role?

It has started to bite in the second and third quarter this year but an important part of the effect is yet to be felt.

One of the main reasons behind increasing inflation in the Spanish economy is the sharp rise in electricity prices. We have simulated the impact of the increase in electricity prices that we have already observed and tried to extrapolate what might happen next year taking into account future market prices. Under these simulations, the impact of the electricity price spike is significant. On the level of GDP, a cumulative GDP loss of 1.5 percentage points distributed across 2021 and 2022 is estimated.

In any case, there is significant uncertainty surrounding such forecasts, given in particular the possibility of excess savings accumulated during periods of lockdown offsetting part of the impact, at least for higher income groups, since a substantial part of the increase in savings has concentrated in this group.

More in general, the energy price shock is a negative supply shock that conveys a deterioration of the terms of trade for both Spain and the euro area, as net gas and oil importers. This means that our real incomes are falling, which has an adverse impact on aggregate demand.

-To what extent is Omicron already taken into account in your latest economic forecast and what impact do you expect it to have beyond that on the growth and inflation outlook and Spain?

It has been taken into account at least partially, although the Eurosystem staff did not know how the Omicron variant would evolve when completing the forecast (late November). We are now seeing that many governments worldwide are taking decisions, which basically limit mobility and you might think that this would have an impact on consumption and tourism flows, in particular. And at the same time, it is true that, after almost two years of successive pandemic waves, consumers and firms have gained a lot of capacity to adjust to these restrictions. This means that the same level of restrictions today, as compared with the level observed a year and a half ago, generates a lower impact on growth. So we are better prepared, although this does not mean that the impact on growth is not going to be significant.

Both at the euro area and at the Spanish economy level, the staff incorporated, at least to a certain extent, an adverse impact from the current wave and, hence, from this new variant. This justifies, in fact, that the Eurosystem staff revised downwards GDP growth, both for Q4 this year and Q1 next year.

-But do you think beyond that there's still downside risk even to your latest forecast given?

In the short term what we are observing would mean downside risks to growth. In the medium term, I think we have to stick with the idea that the level of uncertainty is very high. We really don't know how the pandemic will evolve in the future.

-And inflation, do you see it pushing up inflation or keeping it up for longer?

The impact on inflation is not so straightforward. Omicron will have a contractionary impact on demand and this could actually translate into lower prices. But there will be also an impact on supply and this goes in the opposite direction.

-You committed basically at the last governing council meeting to keep QE going for a long time. And you yourself said in the press, that you don't expect interest rate hikes next year. But given that the outlook is so uncertain you revised up core inflation by 0.5 percentage points from just three months ago, why do you commit for such a long time? Wouldn't it be better to keep more flexible?

First, it is true that according to the forecast, we see further convergence towards our symmetric inflation target of 2% over the medium term. The second point is that the forecast at the end of the projection horizon is 1.8%. And not only this but other indicators for the medium-term inflation outlook for the euro area point to the fact that we are still below our target. The third point relates to uncertainty which still stands at very high levels. For instance, we have been surprised by inflation over recent quarters.

So with all these factors combined, we made a policy decision that incorporates two basic principles, which are flexibility and optionality. President Lagarde emphasised these two words last Thursday.

And I want to emphasise this flexibility and optionality as well.

We decided to end the PEPP as anticipated by the end of March. At the same time, we are also making the point that if there is a pandemic-related need, we will consider restarting net asset purchases through the pandemic programme.

Another example of flexibility is that our forward guidance is state dependent. Meaning that at each point in time, we analyse the three conditions we have defined for the first interest rate hike to happen.

At the same time, we increased the volume of asset purchases under the APP for the second and the third quarter to guarantee a smooth decline in purchases and avoid cliff effects. In addition, the duration of the APP is open-ended and very much linked to the lift-off in rates. So the lift-off is state contingent and the APP is also state dependent.

We also increased the reinvestment period of PEPP by one year and we indicated that we will reinvest under PEPP in a flexible manner in order to avoid fragmentation. Indeed, we stressed that, within our mandate, under stressed conditions, flexibility will remain an element of monetary policy whenever threats to monetary policy transmission jeopardise the attainment of price stability.

So, all in all, there are plenty of elements of flexibility in our policy.

-In your communication you put heavy emphasis on flexibility towards giving more, rather than less support and that is although inflation has surprised on the upside and not on the downside.

The fact is that as a way to face the current high uncertainty and the need to maintain optionality in the conduct of our monetary policy (the need for keeping the optionality I just mentioned), we included in our statement that the Governing Council stands ready to adjust all its instruments “as appropriate” and in “either direction” to ensure that inflation stabilises at its 2% target over the medium term.

In any case, this issue is very much related to the question of the extent to which risks to inflation are on the upside.

In this regard, the risks that inflation will be higher than projected in the forecast depend crucially on wages. It's very difficult to imagine a scenario of inflation in the medium term being more dynamic than in our current baseline without seeing relatively strong wage growth.

And here, there are two elements in the forecast that go in opposite directions. On the one hand, the forecast has incorporated very mild second-round effects on wages, basically because negotiated wages are growing at a relatively moderate pace, much lower than prices. Also, automatic indexation mechanisms in the euro area nowadays play a very limited role. In addition, the evidence that we have from the last decade is that the second-round effects played a very small role in the past.

On the other hand, the wage path projected for 2022, 2023, 2024 is higher than 3% on average, which is significantly above what we saw in the last decade (around 1 pp higher). In order to justify such a high number, one has to incorporate some higher elasticities of wages to slack. This is something that has yet to materialise. In some sense, there is a kind of positive judgement on wages that we are not calling second-round effects but are embedded in the forecasts.

In any case, as it has been customary during the pandemic, we also incorporated alternative macro scenarios. So not only the baseline but also a mild and a severe scenario. In the mild scenario, so under more positive assumptions in terms of the pandemic, consumption etc., what you get for 2024 is inflation at 2%. When you look at the severe scenario, what you get is an inflation number of 1.3%, which is a good example of the high level of uncertainty that we are facing.

So overall I think we have made a very balanced decision.

-What will it take for the ECB to restart PEPP?

Such a decision would be conditional on the evolution of the pandemic and its impact on our economies and the inflation outlook. And of course, this includes the period of transition out of the pandemic. So we will have to analyse at each point in time whether the pandemic is affecting our economy and the inflation outlook to an extent that might justify this reopening of net purchases under the PEPP.

-Do you think there's an exceptionally high bar towards doing that?

I think that this is an option that is on the table and that will be executed if needed.

-So this means 2024 What's the big what's your big, big the biggest challenge for you next year, the big the big challenge the big hope for next year?

Well, I think the big challenge will remain pandemic-related. We are in the fourth or fifth wave and this has been created by a new variant that seems to be capable of spreading much quicker than the Delta variant and is forcing countries to impose restrictions again. So, for me, the main policy uncertainty that we will have to face is related to the pandemic and its economic effects.