

22 September 2023

“It is quite normal if we do not always agree on everything”

Interview with Pablo Hernández de Cos published in Börsen Zeitung

Pablo Hernández de Cos, Governor of the Banco de España

Interview conducted by Mark Schrörs and Thilo Schäfer

Unlike the US Federal Reserve and the Bank of England this week, the European Central Bank (ECB) raised its key interest rates last week. But what's next? In the interview, Pablo Hernández de Cos, Governor of the Bank of Spain, talks about this and other topics.

Mr Hernandez de Cos, the European Central Bank (ECB) is in a dilemma with excess inflation and increasing economic risks. What worries you more at the moment - sticky inflation or a rapid economic deterioration?

Let me explain how we see the outlook. The euro area economy broadly stagnated in the first half of this year and has remained weak in the third quarter. In the coming quarters, we are likely to see low growth. This more negative short-term outlook is the main reason behind the ECB experts lowering their projections, and they now expect cumulative growth for the period 2023-2025 to be 1% lower. This is a significant downward revision. And the risks to this projection are tilted to the downside. But the baseline scenario is not a dramatic one, and they do not foresee a recession. As regards inflation, the staff projections for 2023 and 2024 have been revised slightly upwards, but that is mainly because of higher energy prices. For 2025, the projection is now slightly lower, at 2.1%, close to our target. And the risks to inflation are now balanced. In my view, developments since June have strengthened our confidence that the inflation path will move towards 2.0% by 2025.

Not everyone shares this confidence. What makes you so confident?

There are several factors: our monetary policy is being transmitted forcefully and increasingly dampening demand, which is an important factor in bringing inflation back to target. And, indeed, as I mentioned, the growth outlook has been revised downwards and the risks are on the downside. In addition, underlying inflation is now easing, so we seem to have finally turned the corner. Moreover, underlying inflation and wages are performing as expected. There are indeed some catch-up effects in wages, after the strong real wage losses in 2022, and we expect this catch-up to continue in 2024 and 2025 but, if wages behave as expected in the projections, and labour productivity recovers in line with its past procyclical pattern, this should lead to moderate growth in unit labour costs and, therefore, be compatible with inflation gradually falling towards our target. At the same time, having increased significantly in 2022, corporate profit margins are receding. This is compatible

with the assumption in the projections that margins will act as a buffer, in a context of higher wages and lower demand. Of course, there are upside risks to inflation, related in particular to potential higher energy prices. But, in the opposite direction, weaker demand is expected to ease price pressures.

Recently, however, some indicators of longer-term inflation expectations have risen again somewhat. Does that not worry you?

We always have to be very vigilant about inflation expectations. But for me a key point is that after two years of very high inflation, the medium-term inflation expectations of consumers, professional forecasters and market participants alike are still well anchored around our 2 percent target. On longer-term inflation expectations, there is an apparent disconnect between survey-based and market-based metrics, with the former converging to target and the latter remaining somewhat higher. The disconnect, however, essentially disappears if one removes the inflation risk premium embedded in market-based measures. The genuine inflation expectation component incorporated in the observed 5-year, 5-year forward inflation compensation derived from inflation swaps is essentially 2%. One should expect the inflation risk premium to increase in times like this: when inflation is still elevated and growth is subdued.

So you don't fear a second wave of inflation either? Some observers envisage such a risk, as occurred in the 1970s when the US Fed in particular gave in too early and thus fuelled inflation again. We are currently seeing a rise in oil prices.

Our economies are structured very differently to how they were back then, and the monetary policy response is also very different. We at the ECB have raised our key interest rates by 450 basis points, the strongest and fastest monetary policy tightening in our history. We are fully determined to ensure that inflation returns to our target in a timely manner, and we stand ready to adjust all our instruments. We are doing this specifically to prevent a scenario like that of the 1970s. It is important, however, that other policies also make their contribution. As energy prices fall, governments must roll back on their energy support measures, and should a renewed energy crisis necessitate new fiscal support measures, these should be much more targeted. Authorities should also undertake structural reform to strengthen the supply side. Fiscal policy for 2024 should be rather restrictive across the euro area, in line with the July Eurogroup statement and the September ECB staff projections. This is essential to avoid additional price pressures, which would otherwise call for an even stronger monetary policy response.

Continued, albeit low, growth at the same time as inflation falling towards the target value - would you call that a "soft landing"?

As I said, uncertainty remains very high and the risks are significant. But yes, I would call it a soft landing if the baseline scenario in the projections materialises.

And then there will be no need for further interest rate hikes and, with the latest, tenth interest rate hike in a row, rates will have reached their peak?

We have made an important statement in this respect. Based on the information available today and using a range of analytical tools, we can say that the interest rate level we have now reached, if maintained for a sufficiently long time, is broadly consistent with achieving our inflation target in the medium term. But that is a conditional statement. We have come to this conclusion on the basis of today's information. Uncertainty remains high. There could be further shocks, and our response to them will depend on their origin and scale and on their impact on the inflation outlook.

That means that the interest rate peak has probably been reached, but that it is not certain?

We will remain vigilant and data dependent. Let me give two examples: if the risks to growth materialise and there is a sharper downturn than expected, we will of course respond to that. But equally, we will also respond if inflation turns out to be higher than expected, for example because of stronger profits or wage growth.

In recent years, the ECB models have not always been very accurate. Can you in good conscience make such a statement on that basis?

Preparing projections is a complex task, which combines results from a suite of different models with expert judgement. Economic models are very useful tools since they are based on solid theoretical and empirical foundations; and experts go to great lengths in developing and adapting them to incorporate structural changes in our economies or to better understand agents' behaviour in changing environments. But models are by definition simplified descriptions of reality and thus might not encompass the large dataset underlying a projection exercise. More importantly, empirical models are based on historical regularities, which may limit their accuracy in the face of extraordinary shocks, such as the pandemic, the supply and energy crisis and the war in Ukraine. Therefore, it is the task of experts to learn from forecast performance, to combine the new data and assumptions with the model results to improve forecasts.

However, I would like to indicate that despite the current high level of uncertainty, GDP and inflation forecast errors have decreased very significantly. For example, during recent months, the underlying inflation rate, which excludes energy and food prices, has changed in line with our predictions.

Are you happy with what the markets have made of the decision? They are already speculating more on interest rate cuts. That means looser financing conditions, which counteract the restrictive monetary policy.

On market reactions, I would stress that what you see in current rate pricing are two things: persistence, as a lot of inertia is priced into the curve of forward rates; and inversion, as policy rates (despite the inertia) are seen to decline steadily to much lower levels. Inertia is a reflection of our statement that "key ECB interest rates will be set at sufficiently restrictive levels for as long as necessary". The inversion reflects markets' conviction that inflation will continue to fall and that, in the face of inflation returning to the target, rates will also be adjusted. They see that the current level of our policy rates is restrictive: in other words, measurably higher than neutral. As inflation falls, it is realistic to expect the policy rates to

be eased back to neutral. Both persistence and inversion, I would say, are comforting features of rate expectations today, in that they demonstrate that markets believe what we say: if nothing changes, interest rates will be held at sufficiently restrictive levels for as long as necessary to get the job done. Incidentally, this is precisely an automatic adjustment mechanism of market conditions that was absent in the 1970s. Then it took years for market interest rates to rise to levels restrictive enough to help reduce inflation.

And how long is "long enough"?

That is a very difficult question and cannot be answered in advance. It depends on whether or not inflation and growth develop in line with their projected paths. But it is certainly too early to talk about interest rate cuts at the moment.

Too early to talk about cuts, but are market expectations unrealistic?

Looking at today's information, we certainly can't rule out cuts. But I do not want to and cannot confirm them either. As I said, uncertainty is still very high.

ECB President Christine Lagarde has admitted that the rate hike was only supported by a "solid majority" - which indicates some dissenting votes. Is it a problem if the Governing Council appears not to be united at such a critical time?

Does unity only exist when there is unanimity? It is quite normal if we do not always agree on everything. This is all the more true when uncertainty is so high. I think it is important and good that we have different views and open discussions. In any case, as President Lagarde also said during the press conference, "don't believe that we had an antagonistic adversarial discussion". In the end, we make a decision and we defend it together.

And don't national circumstances and sensitivities also play a role? In Spain, for example, interest rate hikes are viewed very critically because of the consequences for mortgages.

As members of the ECB Governing Council, Governors do not act as national representatives or representatives of their respective central banks, but in their personal and independent capacity, with the duty to act in the interests of the euro area as a whole. We cannot take into account the sometimes very specific circumstances in all countries. If necessary, that is up to national policies.

We have now talked a lot about interest rates. At the same time, the ECB is reducing its balance sheet, which has been inflated by the bond purchases. Does it need to be quicker, as some of your colleagues on the Governing Council are calling for? They advocate reducing reinvestment in the pandemic emergency purchase programme (PEPP) sooner than at the end of 2024.

First of all, the most important thing is that we have not discussed this issue so far. What is clear is that when we talk about tightening, we are talking about interest rates - the level and duration - and the balance sheet. There is a certain trade-off between these two instruments and both determine the degree of monetary tightening. In this trade-off we decided to use

interest rates as the primary tool for our policy. That is important to keep in mind. And, as I said, we have now done a lot very quickly in terms of hiking rates and we are confident that with the steps we have taken so far we will achieve our goal in the medium term. I should also mention that the speed of reduction of the balance sheet so far has been extraordinary compared with other central banks. Since TLTRO borrowing peaked at the end of 2021, the outstanding volume of TLTROs has fallen by €1.65 trillion. This is in addition to the decline in the asset purchase programme portfolio of almost €110 billion since the end of reinvestments in June. When it comes to the PEPP, it is also important to emphasise that PEPP reinvestment is the first line of defence if there are problems in monetary policy transmission.

That means you would be cautious?

Indeed, I think we should be very cautious.

Does that then also apply to the active sale of bonds?

That is not something we are currently considering or will consider in the future.

And what about raising the reserve requirement ratio from 1%, which is being discussed? That would reduce the high liquidity in the system.

We already decided in July to end the remuneration of minimum reserves. This decision was justified to preserve the effectiveness of our monetary policy and improve its efficiency. Any potential further decision will always have to have a monetary policy justification and be proportional, taking into account, particularly, the sweeping post-crisis reforms of liquidity regulation. In this vein, further action on this front does not seem obvious to me. In any event, the ongoing review of our operational framework will have to look into this more deeply.

With a higher minimum reserve ratio, the risk-free profits of the banks, which they generate through the interplay of high excess liquidity and a rapid turnaround in interest rates, would also fall - and the balance sheet losses of central banks would be reduced.

We should always be guided solely by monetary policy considerations. Nothing else.

Could high losses damage central banks' credibility or increase political pressure?

Potential losses do not change the will and ability of central banks to provide price stability. That is important to state, as a signal to people. As regards the Banco de España, I can say that we will probably not distribute profits for a few years. But we will not need to recapitalise since we have accumulated significant provisions in recent years precisely to cover this type of risk.

France's Finance Minister Bruno Le Maire has called for an end to interest rate hikes - "enough is enough", he has said. Other politicians are sometimes sharply critical of the ECB. Are you worried about its independence?

We central bankers also often talk about fiscal policy. That doesn't always suit everyone and can sometimes lead to friction. But that's part of the conversation and a good thing, as long as it stays within a certain framework. The independence of the ECB is based on the EU Treaty. If someone criticises us, that has no impact on our independence.

Recently, the discussion has increased again about whether the central banks should raise their widespread inflation target of 2.0% because structurally higher inflation is to be expected in the future. What do you think of this?

In our last strategy review, which was completed in July 2021, we formulated our target somewhat more clearly. But now is not the moment to discuss the inflation target. At a time when we are fighting high inflation, that could be very damaging for the ECB's credibility.

You are also Chairman of the Basel Committee on Banking Supervision. Have you already drawn the first lessons from the turmoil in the banking industry in the USA and Switzerland in the spring, as the Committee advised at the time?

Indeed, we have. There are several lessons. First and foremost, the importance of banks' risk management practices and governance arrangements to ensure financial and operational resilience. Second, it is critical that supervisors act early and effectively to identify and promptly correct weaknesses in bank practices. Supervisors need to look much more closely at a bank's business model and its sustainability, for example. And they need to have the tools to act when they identify an outlier bank. Finally, a prudent and robust regulatory framework is key in safeguarding financial stability. But we need more in-depth analyses first. In this respect, recent events have underscored the need to implement Basel III, fully and consistently. Whatever we do for the future cannot be an excuse for not implementing what has already been agreed. Besides this, we need to analyse some features of the Basel framework, such as liquidity requirements and interest rate risk, in greater depth.

But is it still too early for regulatory changes? There is, for example, the discussion about the liquidity ratio.

As far as interest rate risks in the banking book are concerned, we have already had intensive discussions in the past. Even though banks that have failed were not subject to the existing IRRBB standard, these events have once again focused attention on the current Pillar2/3 approach, ways to strengthen it, and whether a Pillar 1 framework would promote greater comparability and consistency. With regard to liquidity, let me give an example of how new developments would need to be further evaluated. It has become clear how quickly liquidity can be withdrawn from banks and what role social media and influencers play in this. We have to analyse this carefully from a regulatory and supervisory perspective.

The turmoil in Switzerland has shown that the too-big-to-fail problem is still not solved; Credit Suisse could not be wound up. Isn't that frustrating?

I take a slightly more positive view than you. Without the new framework, the situation would have turned out much worse. There would have been more turmoil and more taxpayers' money would have been needed. In this respect, the FSB has recently emphasised that we remain convinced that the international resolution framework developed in the aftermath of the Great Financial Crisis is fit for purpose. At the same time, a number of implementation challenges have been identified and need to be addressed, something that the FSB will explain in detail in a future report on preliminary lessons learned.

How great do you think the risk is that the rapid turnaround in interest rates will also lead to a new banking and financial crisis?

It's important to stress that the system has become much more resilient. And this is mainly due to the regulatory reforms implemented globally during the last decade. As to the current context, at first, banks profit from interest rate hikes due to the increase in interest rate margins. This changes over time when, for example, credit risks increase in the course of the economic slowdown. And it is important to be prepared for this. This is why we're currently insisting to our banks that they should use the current high profits to increase their capital buffers in order to increase their resilience.

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