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Interview with the Governor, José Luis Escrivá, and the President of the Bundesbank, Joachim Nagel

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Question: Is the new Trump world order the most challenging situation in your professional careers?

Escrivá: I was a minister in Spain when the COVID-19 pandemic broke out. There was also huge uncertainty surrounding that shock, in terms of its economic impact. But I would say that, on that occasion, the direction of the shock was very clear and also the policy responses were also more straightforward. This time around, the uncertainty stemming from the decisions taken by the Trump administration is creating a much more complex environment and the policy responses are more difficult to formulate.

Nagel: In my perception, the uncertainty we have seen during the last couple of weeks will not go away quickly. The US administration has been announcing and withdrawing far-reaching, sometimes unprecedented decisions at a very fast pace, with major repercussions for economies and financial markets. This makes monetary policy even more difficult.

Question: You don't know what Trump will decide, but the ECB must decide on interest rates, anyway. How do you deal with that?

Escrivá: If we were able to identify a clear scenario in terms of future inflation developments and if there was a high likelihood attached to this scenario, our decisions would be easier to take. In the current juncture, we are required to gather more information and even give ourselves more time to try to disentangle which elements prevail. That is not easy. We need to be humble in assessing the current situation.

Nagel: Regarding monetary policy decisions, it is important to be cautious and not to overreact by overemphasising specific announcements that could change shortly afterwards. On the analytical side, we are continuously improving our economic projections and scenario analyses. I think this is the best approach for monetary policy in such a situation. For the Governing Council of the ECB, this means that we will continue with our data-dependent and meeting-by-meeting approach when deciding on the appropriate monetary policy stance. Up to now we have been successful with this strategy; inflation in the euro area has fallen to just over 2 per cent.

Question: What do you think of Trump's attack on the independence of the Federal Reserve?

Nagel: Central bank independence is part of the DNA of good monetary policy. History teaches us that, without such independence, central banks are not fully equipped to achieve and maintain price stability for the benefit of all. What is less well known is that the foundations for the renowned independence of the Bundesbank were laid after the Second World War, when the central bank system in Germany was rebuilt largely after the model of the US Federal Reserve System. The current attacks on the Fed are pointing in the completely wrong direction.

Escrivá: I would say that the decision to delegate monetary policy to central banks is primarily based on the notion that price stability is a higher goal for society as a whole. That goal can only be achieved through a medium-term orientation of monetary policy, which requires decoupling the decision-making process from the political cycle, which could be perceived as interference as happens in some parts of the world.

Question: If the independence is a central issue for you, Mr Nagel, I think you belong to the SPD. and Mr Escrivá, you have belonged to the government of Pedro Sanchez. How does it condition your independence?

Nagel: I started my career 26 years ago at the Bundesbank. So I'm a central banker through and through and it never played any role in my professional career that I'm a member of a political party – and it will not play a role in the future, either.

Escriva: I joined the Banco de España 40 years ago and worked for many years there. I have also worked at the ECB and the BIS. In addition, I have run an independent institution in Spain, the AIReF. At a certain point in time, I was invited to join the government, to contribute my experience, serve the public and help improve Spain. Now I have returned to my profession. This should not be perceived as a problem as indeed it is not so perceived in other European countries.

Question: There is a wind of deregulation going through the banking system. How to avoid a wrong signal to society, has the financial crisis been forgotten or the recent Credit Suisse disaster?

Escriva: I would say that one development that may give rise to concern is precisely the possibility of deregulation of the financial system stemming from the United States. Indeed, I firmly believe that all the reforms, following the financial crisis, in particular to both the regulatory framework and the supervisory framework, on the micro and macro sides and on the resolution side, have created a much more solid and much more resilient banking sector worldwide, in particular, in Europe. At the same time, we need to continuously assess whether the existing framework has become overly complex. This does not mean deregulation, but merely that a simplification of the framework might be in order to allow banks to plan their capital decisions in a more certain environment.

Nagel: The discussion in Europe is about how to make regulation less complicated, not less binding. We do not want to compromise on capital requirements, for instance – they remain

essential. In general, our regulation since the financial crisis has been an asset for banks and the financial sector as a whole. The point now is to look into opportunities for simplification – without weakening supervision or financial stability. It is a good exercise after one decade to evaluate the methods and results. In some areas, such as reporting obligations, the requirements may have become overly complex. We are therefore now assessing the situation to identify areas in which red tape could be cut.

Question: The financial markets in Europe have been rather resilient yet, but a major crash of a stock in bond markets is possible anytime. So how does the ECB prepare for the worst case?

Nagel: We have all the instruments in our toolbox, and we showed in the past that we can use this toolbox very swiftly or adapt it, if necessary. However, currently financial markets in Europe are robust and the banks in the euro area are in good shape. But the financial market turmoil in early April showed us that we shouldn't become complacent.

Escriva: I think the volatility in the market has been significant. I would tend to believe that there were very high valuations in some markets and a very low price for risk.

Question Do you think the control of the new European fiscal rules is being serious enough? Should the European Commission be stricter with the tax plans presented by the Member States?

Escrivá: The new fiscal framework gives countries greater control over their fiscal plans, and this makes the commitment of governments to the medium-term orientation of their policies more important. However, when I see what has been done so far, by closely examining the progress reports presented by certain countries, it seems to me that they have not gone far enough in providing medium-term orientation, as regards specifying the particular measures that must be taken and the assumed macroeconomic impact of the growth-enhancing public investment plans made possible by the increased flexibility allowed. It seems to me that the Commission and governments, which are ultimately responsible, need to pay more attention to this aspect.

Nagel: What is important to me is that the Member States live up to the rules of the Stability and Growth Pact. It is the role of the European Commission to manage this process. We can all benefit from this, especially in a situation of new uncertainties. The fiscal rules allow for coping with extraordinary circumstances and the need for temporary additional expenditure. But in the end, Member States with high debt ratios have to reduce them. And the European Commission has to make sure the process is transparent and clear to everyone.

Question: Mr Nagel, Germany is headed for the third recession in a row. What does the new government have to do to change the German economy for the better?

Nagel: The Bundesbank has called on the German government to overcome constraints that are hampering economic growth. Germany has to improve its infrastructure, expand its labour supply, digitalise and speed up public services, cut red tape and strengthen its defence capabilities. The coalition treaty includes some important elements in this direction.

The German parliament has approved large scope for new investment. Now it is up to the new government to deliver and to implement these elements rapidly and efficiently. Germany must also take its role in Europe more seriously.

Escrivá: In Europe, we need to move forward and to address the challenges and introduce reforms to make our economy more competitive and more robust. And, in my opinion, it's very difficult to have strong leadership in Europe without Germany. The stakes are very high, but the expectations are also very high.

Question: What about Europe's future role in the world?

Nagel: The new German government has to contribute actively to the further development of the EU and Europe. And I agree with Jose Luis ESCRIVÁ that Germany has to play its part in leading the EU. The Common Market, Savings and Investment Union, defence and energy markets: they all matter. But Europe is much more than that. I think there should be a holistic understanding of why we need more Europe and not less. We now have a window of opportunity to strengthen the EU and bring Europe globally in a much better position. Ultimately, the European Union is the second largest economic area in the world. We are not weak. However, we can make much better use of our vast potential. Let's unleash it.

Escrivá: If instability and unpredictability continue to emanate from other parts of the world, there is room for Europe to play a more prominent role. For instance, the euro can play a bigger role as a reserve currency. Europe therefore needs to strengthen certain aspects to allow it to play a more important international role. We need to make headway and face up to challenges and introduce reforms to make our economy more competitive and resilient.

Question: In order to seize this opportunity, the German parliament decided on a huge debt program. About a billion euro will be taken up within the next 12 years. Is there a risk of inflation or even fiscal complacency?

Nagel: I'm supportive of using extra financial resources to effectively tackle the serious issues we face. These are very challenging times. With its requirements in defence and infrastructure, Germany is in an extraordinary situation right now, and the extra debt should be perceived as a unique opportunity for the country. But it is crystal clear that we cannot solve all problems with additional spending and that, after an adjustment period, the debt ratio will have to come back down. Germany's obligation to fulfil the European fiscal rules remains unchanged.

Escrivá: I come from a country with very limited fiscal space, and when you examine the issue, one key factor is the quality of spending. Even military spending can be growth enhancing, and the spillovers to the rest of the European economy can be significant. But crucial here are the details and the design of the programme, in terms of the quality of the investment and the assessment of the associated impacts on potential growth

Question: Can Spain assume an increase in military spending to reach the level of at least 2% of GDP every year, without any adjustment measures to compensate?

Escrivá: At European level, it has been agreed that Member States may use the so-called escape clause for four years and exceed the growth rate agreed for total spending in order to increase that on defence. Many countries have announced that they will take advantage of this flexibility, some have announced they will not and others, including Spain, that they need more time to take this decision. This prudence is consistent with what I said earlier about the fiscal space potentially available.

Question: You have just said that Spain has barely any fiscal space at all. Are you concerned that the Government is not adopting budgets?

Escrivá: Spain is currently benefiting from the Next Generation EU (NGEU) programme that has provided a fiscal stimulus in the form of grants and loans for investments and reforms, enabling improvements to be made in a number of areas of the economy. So this aspect is very important when assessing fiscal developments in Spain.

Question: What does your research service think about the sustainability of the pension system? The fiscal authority has just said that it's still seeing worrying signals

Escrivá: In terms of its sustainability, we argue that the most important thing is that Spain currently has a medium-term pension expenditure rule that is binding. Over the next 25 years, pension expenditure may not exceed an average level of 13.3% of GDP, which is approximately the current level of spending and more or less the average level across Europe. And we have a correction mechanism to address any deviations that may be detected by the AIReF, an independent institution, which has just examined this metric for the first time, concluding that, in the current circumstances, this 13.3% limit is not being exceeded and therefore there is no need to correct any deviation.

Question: The Spanish government is being interventionist in relation to the takeover bid for Banco Sabadell and has announced a public consultation to maybe stop this takeover. Is the Banco de España concerned?

Escrivá: The ECB, with the assistance of the Banco de España, issued a report on this matter nearly a year ago, it being our job to assess the solvency of the merged bank and of the two individual banks. The CNMC (the Spanish competition authority) has just issued an opinion, and Spanish law allows the government to lay down further conditions. We are now in that phase of the process. I should not express an opinion because other institutions have a different role to that of supervisor and analyse different angles. And we need to respect the time periods for other parties.

Question: Do you consider it appropriate to reduce working hours in Spain?

Escrivá. The progressive reduction in working hours in most European countries has essentially been achieved through collective bargaining taking into account the situation at industry and firm level as regards hours and productivity. Based on various metrics, Spain may have room to move in this direction, but taking into account what I have just mentioned.

Question: The PSOE (the Spanish socialist party) and the ERC (the Catalan republican left party) have agreed to back the efforts of Institut Català de Finances to become a

bank. Might the Banco de España, which has refused an application in the past, change its mind?

Escrivá. I am not aware of the details. All I can say is that the Banco de España examines banking licence applications in accordance with the legislation in force at the time, as it did in 2022.