

Interview with Thomson Reuters

Interview with Vítor Constâncio, Vice-President of the ECB, conducted by Paul Ingrassia, Balazs Koranyi and John O'Donnell on 14 September

Is quantitative easing working?

It is working and effective in many ways. The ultimate metric to assess success is the inflation rate normalization around our medium term target. That is achieved through the improvement of financial conditions in general, by the effect of our policies on expectations, the cost of capital, and rebalancing of portfolios. All of those channels have been working. Since last year, the lending rates of banks have gone down by more than 70 basis points and in several more vulnerable or periphery countries, like in Italy and Spain, more than 100 basis points, whereas our main policy rate has gone down only by 20 basis points. For the first time since 2009, in our survey with SMEs, the number of firms reporting that access to credit has improved was higher than firms saying the opposite. After years of negative growth rates, credit to the private sector is now growing at an annualized rate of 2 percent. So, all of these are good indications that our policy is improving financial conditions.

Still, you're contemplating a change in the asset purchase programme. What would be the triggers for such a change?

We said in January that we were aiming at achieving a sustained path of inflation towards our objective and we are far from that objective right now. We want to achieve that sustained path. We thought it was relevant to remind everyone that we said from the beginning that we would keep the policy until we achieve our goals.

Many people say there's not a whole lot you can still do. How would you respond to them?

We said at the last press conference that the size, composition and duration of our present large scale asset purchase programme can be changed. The total amount that we have purchased represents 5.3 percent of the GDP of the euro area, whereas what the Fed has done represents almost 25 percent of the U.S. GDP, what the Bank of Japan has done represents 64 percent of the Japanese GDP and what the U.K. has done 21 percent of the UK's GDP. So we are very far from what the major central banks have done using these instruments. But this is not a benchmark, I mentioned that as an illustration. There is scope, if the necessity is there.

If the price of oil does not continue to go down (it cannot go down indefinitely), we will see a jump in inflation in the last quarter of this year. But we may have before that some months of negative inflation.

Until now we have not seen a reason to doubt that the programme will work. The staff projections are recent, predicated on the completion of the whole programme and foresee inflation at 1.7% by 2017. But we are prepared for any contingency.

What can monetary policy do for growth and potential growth?

Monetary policy affects growth via financial conditions, which affect expenditure decisions, investment and the aggregate demand. What is more difficult for monetary policy is to affect potential growth. That depends very much on the growth of labour supply, technological progress, increasing productivity, organization of production. That's the supply side. The effects of monetary policy on that are very indirect. Europe has a big problem of low potential growth. It starts with demography: the working population is decreasing, so productivity has to be increased even more to compensate for it. Potential growth is very low and in present conditions, we fear that this will be a protracted period of low growth. This prospect of protracted low growth is shared by all advanced economies. So Europe has to do more in terms of supply side reforms, investment, productivity growth to get out of this situation.

Is embracing immigration important for Europe?

In general yes. But there are two dimensions to this: one is the medium to long term issue of immigration and demographic developments, and the other is the short term crisis of refugees that raises a lot of logistical issues, among others.

To me, it's clear that immigration is one of the things that can improve the demographic potential of Europe, which is necessary, if Europeans think and care about the welfare of future generations. The size of the working age population of the euro area is declining 0.6 percent a year until the 2030s. That's huge. To change the demographic trends, promoting birth is not enough, is also has to be done through immigration, if this is to be corrected. If not, we're creating a great difficulty to growth and to the welfare of future generations. This is a very acute problem because for years Europe has been doing the sort of collective demographic suicide and no one is thinking about this.

In the short term, the backlash against immigration has been dramatic. It's because the unemployment rate in Europe is a very high 11 percent, which is destabilizing the continent. In human and social terms, the costs are enormous and the reactions we see to immigration stem from that. It is very important to reduce unemployment and slack in the economy. Fortunately, in the present situation, the price stability objective and the engineering of growth go hand in hand.

Does slow wage growth present a challenge for the euro zone?

Countries have been adjusting. Now several of those countries are growing. There are other countries in the core of the euro zone where one could see that wages could grow more. Wages have been subdued in spite of the recovery. This will end if the recovery continues and that will help later inflation rates to normalize.

What is the outlook for the global economy and China?

The situation is uncertain. There are three sources of uncertainty. One is the strength of the recovery in the U.S. We need a strong recovery in the U.S. Another one is China. We need that China will be able to stabilize the situation and keep growing. Then we have the uncertainty of what will be the reaction of emerging markets to the normalization of interest rates in the U.S.

If the recovery in the U.S. is stronger than it looks right now, that will be the more important thing for the world economy. China can still stabilize its situation and to keep growth above 6 percent is achievable in the short term. The more uncertain situation is in emerging markets. We don't know what will be the impact of interest rate normalization on the corporate bond market in those countries.

Are we witnessing a structural shift in the global economy?

China and other countries could not continue to grow forever at 9 or 10 percent a year. Growth in those countries was bound to decelerate. It is not a structural shift. The potential for growth in emerging markets is still there. What is more difficult to envisage is an acceleration of growth in advanced economies to the level we were used to before the crisis. We are facing this sort of configuration for quite some time. This does not mean that unemployment would continue to increase because we may have enough growth to push down unemployment to more healthy levels. There is growth (1.5% in euro area, 2.5% in US) and this can accelerate, depending on the international environment. But we will not see the same sort of potential growth as before for a while.

Could Europe experience what Japan has experienced?

I don't think so. The development in wages will be always different from Japan. There is more rigidity in wages in a recession (in Europe) and that is an important factor and that is why I never really feared we would have actual deflation in Europe. Wages will not be as flexible down as they were in Japan. Most of euro area GDP comes from services and inflation in services is basically about wage developments. It is very difficult to go to a situation of deflation in Europe. That's a difference with Japan.

Will divergence continue in the euro zone?

No. We saw an initial phase of catching up and convergence. Then came the crisis. If you look to the development of the economy in the U.S. and Europe, the recoveries are very similar until 2011. Then Europe had a double dip because of the recessionary adjustment. After painful adjustment and many reforms, Ireland, Spain, Portugal, Slovenia and Cyprus grew faster than the euro area average in the first half of this year. The only exception is Italy which is growing slightly less than the average.

We have growth again. We need to strengthen the confidence in peripheral countries. That has to be achieved by deepening integration. The Greek turmoil raised doubts. These doubts have to be now closed by additional institutional reforms.

What doubts were raised about the euro?

It raised doubts for the markets that countries like Greece could cope with the challenges of monetary union. There was never any doubt among the majority of member countries. We maintain that the euro is irreversible. Legally, no country can be expelled. The actual prospect of that happening was never for real.

Do you fear that some people in Europe may lose faith in its institutions?

At the ECB, we are doing the utmost within our mandate. We are aware that there are excessive expectations about what central banks can do. Unemployment is destabilizing the continent. European values are being eroded in several countries as a result of the fear that unemployment creates. It is for other policy makers to do their job.

Does a change in the stance of the Federal Reserve have implications and has market volatility become a permanent feature?

We don't know what the reaction of markets will be. Monetary policy is not about fine tuning volatility in financial markets. We have medium term objectives and that helps to stabilize expectations. Central banks should be independent from financial markets and not follow all their fluctuations. Excessive volatility is not good because it is a sign of uncertainty. There is a new situation now. Market liquidity, the facility to buy and sell without affecting prices too much, is reduced after the crisis. Market makers have reduced their inventories. Business seems to be less profitable. Regulatory reforms made liquidity a bit less cheap. Markets are adjusting to this situation and that can lead to volatility.

Are capital controls compatible with monetary union?

They are temporary. The situation in Greece after the agreement on the programme, has stabilized. We would expect the new government will show strong ownership of the programme. The situation of liquidity of the banking sector has improved in Greece after the agreement was reached. The stage is set for a gradual dismantling of the capital controls. They will be eliminated as they were in Cyprus.

Are you confident the IMF will join a bailout for Greece?

The IMF has endorsed the policies that were included in the memorandum. To join a new programme, the IMF has two conditions: one about debt sustainability and the other on ownership of the programme by the Greek authorities. Regarding the debt sustainability analysis, the discussions will take place at the time of the first review. You have seen various analyses showing that you cannot just consider the debt sustainability analysis in terms of debt ratios. A big part of the Greek debt is under concessional terms for quite a period of time. Everyone expects convergence of analysis will be possible. A haircut has been refused by the member states and I certainly hope it will not be necessary in view of the numbers. The more one digs into the numbers, the more that sort of conclusion seems to emerge. That's a matter for the negotiations.