Interview with Agefi

"Monetary policy is doing its duty, but it can't do everything"

What is your assessment of the economic climate in the euro area? A temporary dip or could it lead to a recession as in Germany?

The summer has confirmed that the euro area is experiencing a slowdown, one that is more lasting than we expected a few months ago but not more marked, with GDP growth of 0.2% in the second quarter. The situation in Germany, which is facing the threat of a technical recession, with two consecutive quarters of negative growth, is acting as a particular drag. On the other hand, the French economy is proving resilient with 180,000 net job creations since the start of the year. At the global level, the current undeniable slowdown is being caused by public policy? uncertainty and geopolitical tensions, which are triggering a crisis of confidence among private sector agents. The main culprit is US trade policy which is causing a confidence deficit among businesses – including in the United States – and leading to lower investment.

Another thing that stands out is the lack of inflation, to the despair of the central banks… and market expectations

Inflation remains too low in the euro area, at an annual rate of 1%, despite the welcome acceleration in wages (+2.5% on average). The rise in wages is not yet being passed through to prices: this lag may be temporary or could prove more lasting – that is a key question. As regards market expectations, we need to pay close attention to them but we should not be market dependant. There are a number of different measures of inflation expectations: the five-year/five-year forward swap rate, which financial markets prefer, stands between 1.2% and 1.3%; professional forecasters' consensus expectations, the ECB Survey of Professional Forecasters, are at 1.7%; and those of other economic actors, including households, are higher. It's true that we're seeing a downward trend in these expectations; but it's important that we analyse these different gauges more closely.

So nothing that calls into question the ECB's target?

The objective was set in 2003: for the medium term, inflation must be "close to, but below, 2%", which in the minds of its instigators meant inflation of the order of 1.7% to1.9%. I see no reason to change that. As Mario Draghi said in Sintra in June, it is more a question of the **symmetry** around this target: the ECB is prepared to go above 2% temporarily. We are now saying this clearly, since our July Governing Council meeting, at which we underlined our "commitment to symmetry in the inflation aim".

Is it still the role of monetary policy to react to this slowdown, and this low level of inflation?

Clearly, monetary policy needs to maintain its full support, and be ready to strengthen it: we will do this, and Christine Lagarde has said so. But given the cause of the slowdown, it would be a mistake to expect monetary policy to do everything. The first thing needed to reverse the private sector confidence deficit would be to get rid of the political uncertainty, both in the United States and the United Kingdom. And the too-low level of investment needs to be boosted by fiscal stimulus in those countries with sufficient leeway, and by structural reforms in those countries where they are necessary. The ECB’s monetary policy is doing its duty, but it can’t do everything, and it certainly can’t perform miracles.

Given the deterioration in the economic environment, is the ECB going to use all the tools at its disposal?

Allow me to use a musical metaphor: the ECB has a quartet of powerful instruments. The first is the current level of short-term rates; the second is forward guidance, in other words indications as to the future path of short rates; the third is the provision of liquidity to banks at favourable conditions, in order to boost the volume of credit supplied to the economy; the last is QE (Quantitative easing), the asset purchase programmes, which influence long-term interest rates. In this quartet, the instruments complement and reinforce each other. But each has its own partition to play: they do not all have to play at the same time or the same tempo, depending on the economic and financial context.

Do you sympathise with complaints from banks regarding the -0.4% deposit rate, which is now expected to be cut even further?

In the current context, the aim of any new cut in the deposit rate would be to avoid a tightening of financial conditions for economic actors. The Governing Council estimated in July that this tightening risk mainly concerned the short-term part of the yield curve rather than its long term part. Obviously, very favourable financing conditions benefit the entire economy. That said, keeping interest rates lower for longer also means implementing mitigating measures, as we need to be careful about the impact of negative interest rates on bank profitability: solid banks are essential for the effective transmission of monetary policy. That is why the Governing Council is looking into the possibility of

exempting a portion of excess reserves from the negative interest rate, via a tiered system. These mechanisms exist in all countries where policy rates are negative: Sweden, Japan, Switzerland…

At what level should excess reserves placed at the ECB be exonerated from the deposit rate? And how do you respond to worries among savers that their deposits will be taxed?

No French bank currently applies negative rates on household or SME deposits; to our knowledge, none intend to do so. Mitigating measures will help support this protection. Regarding a tiered system, the only limit – which technical discussions will shed light on -- is that it shouldn't affect the proper transmission of the central bank's decisions to the short end of the market.

And where are you at with the possibility of resuming net asset purchases?

Net asset purchases will remain an essential instrument of monetary policy. They are working powerfully: the ECB holds in its balance sheet a stock of almost 2.6 trillion euros and will maintain that elevated level for at least several years. It also has the option of re-starting net asset purchases at any time. Is it necessary to do so just now? This is a question to be discussed. QE targets long rates: a return to net asset purchases would target reduction of long-term premiums that were thought to be excessive. Since the end of net asset purchases in December 2018, long rates have significantly dropped in the euro zone, including in Italy. The elevated stock of assets held by the ECB has contributed to this: econometric studies show that the impact of stock on long rates is more important than the impact of flows of new purchases. Furthermore, the priority today is to better anchor inflation expectations to our target: that should be tackled by reinforced forward guidance.

What do you mean by reinforced forward guidance?

Since June 2018, our forward guidance has had two components: a temporal one, in which we communicate our intention not to lift rates before mid-2020 at the earliest. But there is also a second condition, an economic one, linked to the "continued sustained convergence of inflation to our aim over the medium-term". This "state-dependent" component is a bit overlooked today; we would do well to make it more precise and reinforce it.

Can insurance companies live with such low rates?

Insurance companies, as they have done for several years, must continue to adapt to a context of low rates. Their sensitivity to the evolution of long rates is included in the prudential surveillance that we have implemented with them. Low rates can also, however, be an incentive to insurers and asset managers to diversify their long-term investments.