

Interview Luxembourg Times with Governor Gaston Reinesch

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Q&A with Luxembourg central bank

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Gaston Reinesch, governor at the Luxembourg Central Bank, speaks to the Luxembourg Times about the country's economic outlook, the housing market and the European Central Bank.

Q: What is the outlook for the Luxembourg economy?

A: Real GDP growth in 2013 was 3.7% and 5.8% in 2014. As far as 2015 and 2016 are concerned, Statec, the Luxembourg statistical institute, recently, in October, significantly revised downwards its estimate for these years. For 2015, real GDP growth has been revised downwards from 4% to now 2.9% and for 2016 from 4.2% to now 3.1%.

As for the macroeconomic projections for 2017-18, as included in the draft budget bill, they have been reduced for 2017 from a former point estimate of 4.8% to a range from 2% to 3.4% and for 2018 from a point estimate of 4.8% to a range of 3% to 4.4%.

Although these growth rates are somewhat lower than initially foreseen, they are still highly appreciable and particularly so when compared with growth rates observed in other euro area economies.

Thus, by and large, one might say the Luxembourg economy is performing well from a cyclical perspective. This, in itself, is not a surprise.

As a small open economy, which is highly integrated into the internal market, thus substantially export-led, if not export-determined, Luxembourg is benefiting strongly from the euro area recovery.

Q: What effect has European Central Bank (ECB) policy had?

A: The accommodative monetary policy of the ECB has, directly and indirectly, also been beneficial for Luxembourg. Not only in stimulating the euro area economy but also in improving borrowing conditions and in contributing to a necessary stabilisation of the banking and financial system before and in the wake of the financial crisis.

Thus, it is also noteworthy that monetary policy globally had a net positive effect on the Luxembourg financial sector as a whole.

I will not comment further on the national economy, because the BCL team of economists is currently preparing the BCL opinion on the draft budget bill opinion which is going to be released on 1 December 2017 after having been presented in parliament. In this opinion a detailed examination of the macroeconomic situation, covering inter alia real GDP growth, employment and unemployment, inflation, the balance of payments, and unit labour costs, will be included.

I insist on the fact that this opinion on the draft budget bill is not at all a political document, but an analysis performed by a team of economists who apply the highest analytical standards. For an independent central bank, what drives the analysis, is not whether people like it or not. The aim is to come to a view as objective as possible on the state and perspectives of public finances.

Is the government successfully diversifying the economy?

Former governments and the current government have always been forcefully and successfully engaged in efforts to diversify the economy.

In this context, one always has to keep in mind that a necessary condition for successful diversification is an attractive business and investment environment. This is also true for the development and diversification of the more local network of very small-, small- and medium-sized enterprises, which also constitute an important pillar of the Luxembourg economy.

It is imperative to continue investing into hard and soft infrastructures, while ensuring concomitantly sound, sustainable and transparent public finances.

There is also an urgent need to solve the problems of traffic and congestion and to tackle with determination the problem of increasing house prices and rents.

How big a problem are house prices?

As far as the latter is concerned, the persistent, substantial and more or less regular rise in house prices is mainly due to the supply of housing persistently falling short of demand.

It is a complex problem with a lot of economic, social, fiscal and also macroprudential consequences (see also the warning on residential real estate addressed by the European Systemic Risk Board on 22 September 2016), whose explanations would require a separate interview.

The answer cannot lie in continued policies by the government aimed at increasingly supporting demand, which, in the end, from a macroeconomic perspective, would only contribute to an increase in house prices.

It is necessary to tackle rigidities on the supply side, notably by increasing the supply of land available for construction. Such supply-side reforms should be embedded in a comprehensive and revisited approach in terms of land and country planning (aménagement du territoire), viewing Luxembourg as a single agglomeration, rather than a fragmented territory.

The ECB's Danièle Nouy has said there are too many eurozone banks and the sector must have mergers and/or failures. What is your view?

Let me first clarify the concept of overbanking. The issue is not whether the sheer number of banks is too large or too small. By the way, it is quite difficult to determine what number would be optimal.

As a matter of fact, the financing of the euro area economy is generally indirect, as it takes place mainly through the banking intermediation, i.e. through the provision of credit by banks.

In relative terms, the direct financing of enterprises via the issuance of bonds or shares, is by far much less used than in the United States, where the situation is quite the opposite. There, the main source of financing consists in the direct issuance of bonds or shares, while the banking industry is by far relatively less used for that matter. Just to illustrate the situation, one can say it is generally admitted that, in the euro area, the banking sector provides between 75% and 85 % of all the financing of the domestic economy, while in the United States banks account for only 15% to 20 % of it.

Many observers and policy makers consider the situation unbalanced. Therefore, they promote the development of a 'Capital Markets Union.'

Of course, the need for financing is not infinitely expandable, and the emergence of wide bond and stock markets would reduce the need for indirect financing through banks.

A corollary of such a rebalancing between indirect and direct financing could be that the credit activity of the banking sector would shrink, with a possible effect on the number of banks.

By the way, a reduction already took place. For the whole eurozone, the number of banks shrunk quite significantly. In December 1998, there were 8,320 banks in the 11 countries adopting the euro on the January 1, 1999, while in October 2017, there are 4,839 banks in the 19 countries of the euro zone. This correspond to a reduction of 42 %.

As for Luxembourg, we had 212 banks when the euro zone was created, and 142 now, hence a reduction by 33 %.

With the emergence of capital markets, the demand for credit will retract and if the supply remains unchanged and all things being equal, the profitability of banks could be affected.

Finally, let us not forget that banks in addition to their financial intermediation role also fulfil the exclusive monetary intermediation function: they create money. Indeed, when someone is granted a loan by a bank, his or her account is credited and money is created. Would it be only for this reason, an economy cannot afford the absence of an efficient banking industry.

How can all this be addressed?

Some consider that the responsibility of the adjustment should be left to market forces, the weakest ones being simply eliminated. Others support a more organised adjustment, through the creation of a level playing field.

Now, there is no magic method. In my view, the number of banks should be high enough that competition remains present between banks to avoid a concentration that might be detrimental to borrowers, but at the same time should be small enough to ensure their profitability.

In this respect, the question of size also matters. For instance the crisis illustrates that megabanks are perhaps more resilient when confronted with shocks, but their management may represent a non-negligible challenge.

What about smaller banks?

While sharing the view that a development of genuine trans-European banks should be supported, I remain convinced that some space should remain for smaller 'local' banks, namely banks covering only one country or regional economy, with their business models adapted accordingly. The business model of such local banks should be based on traditional banking activities, such as deposit taking and the financing of SMEs and real estate, with a reasonable objective of return compatible with such a business model.

You're building cooperation with the award-winning economist Jean Tirole. Why?

The Central Bank of Luxembourg is very pleased with its cooperation agreement with Jean Tirole and the Toulouse School of Economics (TSE). Its research department ranks among the top research departments in the world.

One of the missions of a central bank is research in monetary and economic affairs and the computation and analysis of a lot of statistical material. Therefore, it is important to have bridges with the academic world and with top-level academic research.

Can you detail this cooperation?

Our agreement covers the establishment of a thematic chair of Central Banking in the TSE. This chair is fostering research on topics of a common interest to both institutions, for example in the field of macroprudential policy.

The collaboration materialises through several outputs, such as common research papers and articles, seminars for our staff held by professors and researchers of the TSE or linked to the TSE and exchange of researchers. Jean Tirole himself is also deeply involved in these activities. Let me add that our cooperation with the TSE was concluded before he was awarded the Nobel Prize in economics.

Why not have a similar thing with the University of Luxembourg?

The BCL, for years, has tried to put in place a similar cooperation with the University of Luxembourg, with no tangible result to date. Let me stress that this is not due to a lack of enthusiasm from our side, on the contrary.

I would also like to seize the opportunity of this interview to underscore that, over the last years, we have hired many PhD and masters graduates from the University of Luxembourg, mostly in economics or law, and that we have extended our trainee offers significantly. Such traineeships are also open to students that are about to finish their secondary studies.

Will there be a capital increase at the central bank?

The issue pertaining to a too low level of capital allocation of the Central Bank of Luxembourg is not new. On the contrary, it goes back to the creation of the central bank in 1998 and successive governments have been and are perfectly aware of it.

Indeed, it was quite regularly brought up by the governing bodies of the BCL as well as its auditors. Even the ECB has expressed its concern forcefully. The same is true for the International Monetary Fund.

At the beginning of my mandate, I considered it as my duty, as governor of the central bank, to add my voice to this concern, which, by the way, exposed me to some criticism in certain circles, which is difficult to rationalise.

This being said, in light of my experience, I came to the conclusion that what is needed is a global review of the BCL's Organic Law.

Why so?

Such a review could, among other things, cover the governance of the bank, the legal and economic qualifications of its missions which deepened and have been extended over time, notably in the wake of the financial crisis -- e.g. the Single Supervisory Mechanism, macroprudential function, operational management of non-standard monetary policy -- the improved access to necessary statistics as well as some clarifications of a more operational nature as far as the statute of the BCL staff is concerned.

Last but not least, this would be the opportune way to address the question of the appropriate level of capital. In this respect, different variants or a combination of them can be imagined, for example, the introduction of a distinction between subscribed and paid-in capital and a staggered increase in the latter.

An adequate level of capital could also open the possibility, in a longer-term perspective, for the bank to distribute parts of its possible future net results to the state.

Is there a concrete project?

Such a review of the Organic Law definitely does not fall under the formal competence of the Bank. But what we can do and are doing, and I am confident that the government is not opposed to such an approach, is gathering different options and suggestions identifying articles which need a review and put on paper these reflections on a way forward.

It is our intention to transmit these reflections to the government in the course of 2018.

It will be up to the government to decide, if it so wishes, to prepare and adopt a draft law based -- or not -- on our suggestions and to submit it to parliament.

What is your view on the end of the €500 note?

Let's be clear about what has been decided.

Taking into account concerns that the €500 banknote could facilitate illicit activities, the Governing Council, in substance, decided in May 2016 to stop the issuing €500 banknotes around the end of 2018.

The notes which are or will be in circulation at that moment will retain their value and their statute of legal tender.

They will keep exactly the same statute as all other denominated banknotes, i.e. they will continue to be used as a means of payment and as a store of value.

For those who so desire, every €500 note can be exchanged at central banks for other euro-denominated banknotes for a total value of €500, and this, for an unlimited period of time.

Can this decision be seen as a step towards the abolition of cash?

No.

Cash -- ie banknotes -- will remain and there is absolutely no discussion at the level of the ECB to abolish it.

Although it is thus a purely hypothetical question, personally, I would be opposed to such a move, notably because at present banknotes are the sole possibility for citizens to keep their money as central bank money as compared to commercial bank money.

To those who advocate an abolition of cash, I say they at least should be consistent and propose that the abolition of cash should go hand in hand with the introduction of the possibility for the citizens, who so wish, to open a current account, possibly with a fixed ceiling, with central banks.

When should the ECB wind down its bond-buying programme and how?

The risk of deflation is now behind us and the euro area is experiencing, by and large, quite a solid and broad-based economic recovery.

This recovery is supported by our very accommodative monetary policy over the last years, a policy which became necessary as a reaction to the great financial and economic crisis starting in 2007 and its numerous and long-lasting effects.

Possible downside risks surrounding the euro area growth outlook relate predominantly to global factors, such as geopolitical risks, and developments in foreign exchange markets.

Despite the fact that the news is good as far as notably the business cycle and, concomitantly, the closing of the output gap are concerned, measures of headline inflation have not yet shown sufficient signs of a sustained upward trend.

What is the inflation outlook?

The latest ECB staff projections, published in September 2017, indicate an inflation rate of 1.5% this year, 1.2% in 2018 and 1.5% in 2019.

While one can look through the V-shaped profile of inflation rates, the 2018 projected rate being mostly due to a technical base effect related to energy prices, it remains nevertheless that, given our single mandate, we have not yet reached our objective, i.e. an inflation rate of below but close to 2% over the medium term, and this on a sustainable basis.

On the basis of these considerations, the Governing Council of the ECB, in the pursuit of its price stability objective, has taken a package of decisions during the monetary policy meeting that took place on October 26.

Could you please recall what the measures were?

First, concerning key ECB policy interest rates, it was decided to keep them unchanged. In terms of forward guidance, the Governing Council expects them to remain at the present levels, (a) for an extended period of time, and (b) well past the horizon of its net asset purchases in the context of the asset purchasing programme, APP in short.

Second, concerning the APP, it was decided to continue to make net asset purchases at the current monthly pace of €60 billion until the end of December this year. From January 2018, net purchases are intended to continue at a monthly pace of €30 billion until the end of September 2018, or beyond if necessary, and in any case until the Governing Council sees a sustained adjustment in the path of inflation consistent with its inflation objective.

Should the economic outlook worsen or financial conditions become inconsistent with future progress towards such a sustained adjustment, the APP could, if necessary, be increased in terms of size and/or duration.

Finally, and this is also an important consideration, it was decided that the Eurosystem will re-invest the principal payments from maturing securities purchased under the APP for an extended period of time after the end of its net asset purchases, and, in any case, for as long as necessary.

And your take on the policy?

In my view the present APP, which contributes to the necessary degree of monetary accommodation, currently has three elements. First, the net purchases, a flow element, second, the large volume of assets held, a stock element, already high and still increasing, and, third, the re-investments of principal payments from maturing securities.

The level of the stock combined with the re-investments, on their own, constitute already a very significant and continued monetary policy stimulus independently even of the effect of net purchases. In other terms, even if net purchases were, always in line with the forward guidance of APP, reduced or stopped at some point in time, the APP would still continue to constitute a very accommodating non-standard monetary policy measure.

What problems do you see/anticipate because of the euro's strengthening?

First and foremost, it is important to stress that the exchange rate is not a policy target of the monetary policy of the ECB.

There was and is -- without much surprise, in an environment of largely flexible exchange rates -- an alternation of more or less prolonged periods of appreciation and depreciation, coupled with high volatility and high fluctuation around the trend.

During depreciations of the euro, everything else being equal, exporters of the euro area are pleased (as exports from the euro area become cheaper for non-euro area countries) and importers in the euro area are concerned (as imports become more expensive for euro area countries). During appreciations, it is the other way around.

What is the impact on inflation?

In terms of inflation, an appreciation of the euro, everything else being equal, should reduce headline inflation in the euro area, an effect which should nevertheless not be over-estimated given the size of the internal market of the euro area.

The duration and magnitude of the alternating trends are difficult to explain *ex post* and even more difficult, if not impossible, to forecast.

This is not, in abstract terms, a very comfortable situation for monetary policy because the exchange rate is an important variable entering macroeconomic and inflation projections of the euro area.

Thus, looking at the current situation, the recent volatility of the exchange rate represents a source of uncertainty, which requires monitoring with regard to its possible implications for the medium-term outlook of price stability.

All these elements are taken into account in the set of information on which monetary policy decisions of the ECB are based.