The ECB Acts, but More Action Is Needed

Angel Ubide says the European Central Bank's packages of monetary measures are a step in the right direction, but more must be done to counter excessively low inflation in Europe.

Transcript of interview recorded June 6, 2014.

Steve Weisman: This first week of June, the European Central Bank announced actions that to counter the threat of deflation in Europe. Angel Ubide of the Peterson Institute for International Economics is here with me, Steve Weisman, for a second discussion about this. The earlier one was with Jacob Kirkegaard, also this week. Angel, first give me a succinct account of what the European Central Bank did and its purpose.

Angel Ubide: Basically yesterday it cut rates. They cut the refinancing rate to 15 basis points and they cut the deposit rate to minus 10 basis points, the first time that a major central bank goes into negative interest rate's territory. They also launched, or announced, a new long-term lending operation whereby they will basically lend four-year money to banks at 25 basis points. And they hinted that they will probably have a start-up program of ABS [asset-backed securities] purchases later in the year or even next year. It would be basically launched to companies and households and then repackaged into a security and that's what is called asset-backed securities.

Steve Weisman: Is it not the functional equivalent of quantitative easing in the United States?

Angel Ubide: It's a bit different. The lending facility has an expiration date. So it's four-year money. The money will have to be repaid at some point. In fact, starting on September of 2016, some banks start repaying their money. So it's self-absorbing. And the asset backed security purchases, yes, that would be equivalent to quantitative easing although the amount there would be quite small.

Steve Weisman: You have been critical of the ECB for being, my words not yours, asleep at the wheel in the face of excessively low inflation and even possibly deflation. Have they started to get this right?

Angel Ubide: It's a good step in the right direction. Inflation at the moment is 0.5 percent. It's been very low already for a year. Inflation expectations are starting to be a little bit on the low side for my taste. And so it is good that the ECB is responding here at least to a slowdown, if you want to call it deterioration, in the inflation outlook. It remains to be seen whether this is enough or not. The key difference is this, when you do this liquidity operation you are doing what I call reactive easing. You are trying to prevent the tightening of financial conditions. This is happening because as you know, the ECB in 2011 did that three-year long-term lending operation which will expire early next year.

As banks were starting to repay this money, financial conditions were already tightening. So what the ECB has done was to offset this tightening and extend the current situation for another two to four years, depending how we measure it. I would think they need to be proactive and do more and that's where quantitative easing would be more effective.

Steve Weisman: Have they signaled any preparedness to do more if the situation continues to look as grim as it is now?

Angel Ubide: Yes. I think basically the message is if this set of measures is not enough to increase inflation or at least the inflation forecast, the ECB has said that they remained ready to do more.

Steve Weisman: Is this going to help the countries that are especially troubled on the southern periphery of Europe?

Angel Ubide: I think this helps healing balance sheets, both at the corporate, at the household and then at the sovereign level. Because what this is doing is essentially allowing for refinancing at a very low interest rate. This is the first step of getting better. Once you have healed your balance sheet, then you need to keep financial conditions very easy also for an extended period of time in order to kick-start a recovery to reach a velocity like here in the US and then be able to generate sustainable growth. We are not there yet.

Steve Weisman: What caused the ECB to change its mind?

Angel Ubide: I think that we've seen in the last six months persistent under-performance of inflation. Basically, at every month or almost at every month, inflation has [been predicted] to the wrong side. The ECB and other institutions were forecasting inflation for this year at around 1 percent three months ago in March and now your forecast presented yesterday, that forecast has been revised now, we're at 2.7 if I'm correct. So, it is a constant disappointment if you want, with inflation forecast that has led the ECB to act again.

Steve Weisman: Do we know if the ECB's governing board was unanimous or where there any internal disagreements?

Angel Ubide: President [Mario] Draghi said yesterday that the decision was unanimous.

Steve Weisman: What more can they do?

Angel Ubide: I think they need to become a bit, as I said, a bit more proactive. I understand that part of the reason why perhaps a more decisive action is delayed has to do with the process of asset quality review and balance sheet assessment that the ECB is undergoing on the European banking sector. If by the end of the year once this process is completed, the inflation outlook has not improved, in fact if inflation continues to under-perform and growth doesn't look like it is picking up, I think it's time that they do a proactive, as opposed to reactive easing. They launch an open-ended program of quantitative easing buying both public and private assets and they described it as a monthly amount of purchases until they can credibly and sustainably forecast inflation at 2 percent.

Steve Weisman: To be clear, you think that they should do at least some of this now, do you not?

Angel Ubide: Yes.

Steve Weisman: OK.

Angel Ubide: Yes, because as I said, inflation has already underperformed enough. Their current inflation forecast shows inflation in 2016 at 1.4 percent going towards 1.5 percent, 1.6 percent in 2017. To me that's too low. I would prefer to have a higher inflation focus.

Steve Weisman: You mean it's the forecast is too low in its accuracy or you think that even if they achieve that forecast there's room for more inflation?

Angel Ubide: Well, the ECB's mandate, as you know, is not very precisely defined. It's close but below 2 percent inflation and that can be interpreted in different ways. I personally would prefer to have a mandate that is much more clear, 2 percent inflation at the two, three year horizon. And given this where it is starting to be a long period of under-performance, I would probably prefer to generate the period of over performance so you can stabilize inflation at 2 percent in expectation terms. So I would be more aggressive right now.

Steve Weisman: Thank you, Angel.

Angel Ubide: Thank you.