Visco: Should Counter Deflation Risk With Major Asset Purchases

By David Barwick

FRANKFURT (MNI) - European Central Bank Governing Council Member Ignazio Visco had told MNI that a major asset purchase programme should be undertaken by the Bank in order to counter the risk of a downward spiral of output and prices in the Eurozone.

The ECB is considering different asset classes, Visco said in a recent interview, but sovereign bonds would clearly be most appropriate for the purpose, he said. The risks associated with such a purchase programme should be shared, he argued.

Visco, who heads the Bank of Italy, warned in the context of a possible deflationary threat that evidence already shows some postponement of investment, a hallmark of deflation in the classical sense.

"There is a macroeconomic risk that we may get to a downward spiral of stagnation and low inflation, or outright deflation," he cautioned. "We are considering a wide range of possible asset purchases, but obviously the market for government bonds is the most liquid and the deepest one, so ultimately this class of assets has to be considered as essential for our purposes."

He dismissed the potential economic boost from the twin stimuli of a weaker euro and sharply lower oil prices, observing that the disinflationary effect of the latter outweighed the inflationary impact of the former, and noting that the euro area was unable to benefit fully from a cheaper currency, given feeble world demand.

Returning to the topic of asset purchases, Visco said that while some fellow Governing Council members agree on risk sharing, others take a different view and in particular are opposed to sharing risks linked to government bonds.

"I have two answers to this," he said. "The first one is that this is a monetary policy measure, and the Governing Council of the ECB carries out a single monetary policy for the whole euro area. Currently, there is a very serious macroeconomic risk for the area, which monetary policy needs to tackle, consistent with our mandate to maintain price stability."

He continued: "The second answer is that even if we should not ignore the risk that may be attached to individual government bonds, this is not independent of the macroeconomic risk. Dealing with the latter will also reduce the former; this relationship is extremely important and we, at the ECB, must take it into account."

Although the slide in the price of oil is positive for the real economy, all else equal, it is a mixed blessing, he said.

"If it turns into a reduction in overall price levels that ends up reducing inflation expectations as well, or simply keeps inflation far from the objective, then real interest rates, given we are at the zero lower bound, are bound to rise or remain too high," he said.

Indeed, he affirmed, "the fall in the oil price certainly has a stronger effect than the depreciation of the euro as far as inflation is concerned."

At the same time, he said, it is hard for exporters to reap the benefits of a weaker euro in such a subdued global demand environment.

Underscoring his contention that the Eurozone was flirting with deflation, Visco pointed to "evidence that investment is being postponed," though he conceded that untangling the causes was difficult.

"In Italy, for example, one important factor has been uncertainty about political stability and the reform process. When you have frequent changes in policy makers and policy proposals, a wait-and-see attitude may be an understandable attitude," he said.

"On the other hand, the reduction in inflation expectations is a fact, in the short term but also, though to a lesser extent, in the medium-to long-term," he added. "This means that, especially at the short end, refinancing becomes more expensive. The replacement cost of capital tends to rise and this causes postponement of investments."

Visco declined to say whether the ECB was already behind the curve in its policy response, diplomatically observing that high uncertainty made this "very difficult to say" and in this context expressing understanding for divergent opinions on the Governing Council.

"This is why I consider it legitimate to have different points of view, to believe for instance that the risk attached to the individual bonds cannot be ignored," he said.

"But at the same time, it is also legitimate to say that we have a clear price-stability mandate, and in the present circumstances that means creating money. We cannot cut official interest rates anymore, since they are already at the zero lower bound; we have to create money. How do you create money? We can do it the old-fashioned way, by simply buying assets. And this is not unconventional; creating money is very much a conventional policy tool of central banks. Indeed, they are defined as money-creating institutions."

Asked whether there was any argument against waiting until March to decide on QE, Visco was careful not to commit the ECB to a decision next week, but emphasized that expectations were "not great" down the road.

"It is not only that conditions are uneven across countries," he elaborated. "Rather, overall prospects for the world economy are very uncertain. Investment is therefore being reduced and demand is weak in the area as a whole. In this context, it is essential to counter negative expectations and uncertainty; that is the main action which is needed."

Greece would not stand in the way of a decision on QE, he said: "We are all concerned about what's going on in general in the euro area, and developments in Greece are certainly crucial. All the constraints Greece faces in its refinancing activities are known. But we have to remain quiet, and I'm very confident that things will work out."

That did not necessarily mean that Greek debt would not participate in a possible QE programme, he suggested.

"In the end, as far as monetary policy is concerned, we have to look at the euro area as a whole," he reasoned. "Then there are a number of different issues regarding Greece, obviously. We have to consider each one of them, including the kind of programme that Greece is following, its growth prospects and so on. But that holds for all countries. Ultimately, what is most important is the unity of the euro area."

Visco said his own institution's research indicated that the impact of a QE programme based on purchases of sovereign paper could exceed some estimates seen in media, though he did not quantify his expectations.

"This reflects the fact that there are a number of transmission channels," he explained. "If you only consider the lending channel, then given that credit demand is low and there is not yet a generalized improvement in supply conditions, the effects may be not so large. But there are other channels. One is certainly the reduction of long-term interest rates, both for the assets that will be purchased and for other assets, through portfolio effects. The second is inflation expectations. The third is wealth effects, which may strengthen consumption. Finally, there is the exchange rate, which may be affected in a more persistent way than observed so far."

"Through all these channels, the effect may be such that we at least validate the projections put forth one year ago, which envisaged a return to price stability in a couple of years. Which is not what is currently expected by market participants," he added.

With respect to Italy's economy, a return to sustainable growth "is a slow process that necessitates contributions from all the involved parties," he said. "It will take time, but we are making the right adjustments. Our prospects are for moderate growth, picking up from this year and the next one."

Visco rejected a media report this week of capital flight from Italy, calling the information "factually incorrect," with the actual rise in Italy's Target 2 deficit in the second half of last year only half as large as that reported.

This increase, he noted, "mostly took place between July and September; it reflected a number of well identified technical factors, such as maturity mismatches between the government securities held by non-residents and new Treasury issues."

The Bank of Italy's October Economic Bulletin explained these developments in detail, he pointed out.

"On 9 January 2015 the deficit was 194.9 billion euros, a level lower than at the end of September 2014; in the last three months, aside from usual daily volatility, the deficit has therefore shown no clear tendency to increase," he said.

Transcript - Part 1: Interview with ECB's Ignazio Visco

FRANKFURT (MNI) - The following is part one of the complete transcript of a recent interview with European Central Bank Governing Council member and Bank of Italy Governor Ignazio Visco.

Q: What is it that has you worried to the point that you think that there should be a major asset purchase programme?

A: The reason is a macroeconomic one: too low inflation for too long. The negative change in prices observed in December in the euro area is a single figure, but it comes at the end of a long period of exceptionally low inflation, and core inflation is also below 1 per cent. Thus there is a macroeconomic risk that we may get to a downward spiral of stagnation and low inflation, or outright deflation. We are considering a wide range of possible asset purchases, but obviously the market for government bonds is the most liquid and the deepest one, so ultimately this class of assets has to be considered as essential for our purposes.

Some [in the Governing Council] agree with this view. Others argue that there is no substantial risk and that purchases of this type of assets may create undesirable side effects. One thing that is often argued is that risk sharing is not appropriate for government bond purchases because in the end you'd be transferring onto the balance sheet of central banks - and therefore of national states - risks that are attached to the bonds issued in other states.

I have two answers to this. The first one is that this is a monetary policy measure, and the Governing Council of the ECB carries out a single monetary policy for the whole euro area. Currently, there is a very serious macroeconomic risk for the area, which monetary policy needs to tackle, consistent with our mandate to maintain price stability. The second answer is that even if we should not ignore the risk that may be attached to individual government bonds, this is not independent of the macroeconomic risk. Dealing with the latter will also reduce the former; this relationship is extremely important and we, at the ECB, must take it into account.

Q: What do you mean exactly by reducing the macroeconomic risk?

A: I mean two things. First, moving inflation back towards our definition of price stability. Second, helping demand to face the headwinds that may be ahead. Everybody says that a supply shock like the fall of low oil prices is a positive one. Well, it is positive for the real economy, ceteris paribus. But if it turns into a reduction in overall price levels that ends up reducing inflation expectations as well, or simply keeps inflation far from the objective, then real interest rates, given we are at the zero lower bound, are bound to rise or remain too high.

Q: Is there any argument against waiting for example until March, or is there already enough evidence for such an important decision?

A: Obviously, I will never say when and what specifically we will decide. What is important is to agree on the objectives and on the most effective way to attain them. Of course, you see that there are differing views. But we don't disagree blindly. We discuss, and each one of us always thinks that the others may have a good point. One may not see, say, a widespread deflation risk. In Germany, for instance, inflation is now low, but it is associated with levels of demand and employment which are still high. However, looking ahead, expectations are not great. It is not only that conditions are uneven across countries. Rather, overall prospects for the world economy are very uncertain.

Investment is therefore being reduced and demand is weak in the area as a whole. In this context, it is essential to counter negative expectations and uncertainty; that is the main action which is needed.

Q: Do you think the ECB is already behind the curve?

A: You are asking whether we should have acted sooner. It's very difficult to say. Really, there is a lot of uncertainty. This is why I consider it legitimate to have different points of view, to believe for instance that the risk attached to the individual bonds cannot be ignored. But at the same time, it is also legitimate to say that we have a clear price-stability mandate, and in the present circumstances that means creating money. We cannot cut official interest rates anymore, since they are already at the zero lower bound; we have to create money. How do you create money? We can do it the old-fashioned way, by simply buying assets. And this is not unconventional; creating money is very much a conventional policy tool of central banks. Indeed, they are defined as money-creating institutions.

Q: Some colleagues of yours feel that Greece could pose an obstacle to an easy decision on QE. Do you share that view?

A: No. We are all concerned about what's going on in general in the euro area, and developments in Greece are certainly crucial. All the constraints Greece faces in its refinancing activities are known. But we have to remain quiet, and I'm very confident that things will work out.

Q: And does the political uncertainty surrounding Greece imply that if QE is done, it has to be done without Greece?

A: In the end, as far as monetary policy is concerned, we have to look at the euro area as a whole. Then there are a number of different issues regarding Greece, obviously. We have to consider each one of them, including the kind of programme that Greece is following, its growth prospects and so on. But that holds for all countries. Ultimately, what is most important is the unity of the euro area.

Transcript - Part 2: Interview with ECB's Ignazio Visco

FRANKFURT (MNI) - The following is part two of the complete transcript of a recent interview with European Central Bank Governing Council member and Bank of Italy Governor Ignazio Visco.

Q: How do you respond to those who, like Bundesbank President Jens Weidmann, point to the weakness of oil prices and the decline of the exchange rate and assert that this already amounts to a stimulus that may mitigate the need for further policy measures?

A: I don't deny that there is an impact. The positive effects of lower oil prices on costs and disposable income are there. On the other hand, my assessment is based on two considerations.

First, the fall in the oil price certainly has a stronger effect than the depreciation of the euro as far as inflation is concerned. Second, as for the stimulus effect, the depreciation has a favourable impact on exports, but there is no buoyant demand around the world; emerging economies, in particular, are not doing that great.

In fact, I think the decline in the price of oil is also due, to a considerable extent, to weak demand, or to the assessment of demand conditions.

After all, supply increases due to new energy sources have been steadily happening for three or four years, but the drop in prices has been very sharp only since the middle of last year. I think it's very hard to attribute this entirely to a supply shock.

Q: Have you seen any evidence in the Eurozone of people or businesses postponing investment or consumption decisions in the expectation that prices will decrease?

A: There is evidence that investment is being postponed. The identification of the causes of this is however difficult. In Italy, for example, one important factor has been uncertainty about political stability and the reform process.

When you have frequent changes in policy makers and policy proposals, a wait-and-see attitude may be an understandable attitude. On the other hand, the reduction in inflation expectations is a fact, in the short term but also, though to a lesser extent, in the medium to long term. This means that, especially at the short end, refinancing becomes more expensive. The replacement cost of capital tends to rise and this causes postponement of investments.

Q: You seemed elsewhere to implicitly accept the idea that the amount of QE would be one trillion euros. Did you intend to endorse that view?

A: The one trillion figure includes the other components of the intended balance sheet expansion: the TLTROs as well as the ABS and covered bonds purchase programmes. To be precise on this is difficult. Obviously the expansion has to be substantial and to be perceived as such. You must obtain not only a liquidity effect, but also a clear perception that inflation will not be allowed to fall any further.

Q: But you wouldn't be in favour of something like declaring that the ECB will purchase government bonds until inflation goes back up to 2%, right?

A: We are discussing various issues; you will see which will be the outcome. We have said very clearly that we will keep interest rates low for a very long period of time, until we have a clear improvement in growth and inflation prospects. This is our forward guidance, without a precise figure.

Q: Will there then be a monthly amount the ECB declares its intention of purchasing?

A: We'll see.

Q: What is the effect that you anticipate on inflation?

A: Estimates differ widely. Evaluations carried out at the Bank of Italy suggest a figure higher than some of those which have been reported in the press. This reflects the fact that there are a number of transmission channels.

If you only consider the lending channel, then given that credit demand is low and there is not yet a generalized improvement in supply conditions, the effects may be not so large. But there are other channels. One is certainly the reduction of long-term interest rates, both for the assets that will be purchased and for other assets, through portfolio effects.

The second is inflation expectations. The third is wealth effects, which may strengthen consumption. Finally, there is the exchange rate, which may be affected in a more persistent way than observed so far.

Through all these channels, the effect may be such that we at least validate the projections put forth one year ago, which envisaged a return to price stability in a couple of years. Which is not what is currently expected by market participants.

Q: Is no one at the ECB actually hoping to depress the euro further by doing QE?

A: No. But clearly, as I have just argued, there are a number of channels through which relative price adjustments may take place and there are portfolio re-compositions. This is why it is pretty difficult to come up with a precise estimate.

Q: Is the ECB demanding higher capital from Italian banks?

A: No. What the Supervisory Board is requesting is not an increase in capital ratios. It is only asking banks to comply with the outcome of the Comprehensive Assessment. Communication has to be improved. But, of course, banks will have to continue their efforts to reach better capital positions.

Q: Might QE have a significant impact on Italy's economy?

A: Monetary policy is a powerful tool, but it cannot increase the rate of productivity or the ability of an economy to keep pace with the technological change. However, it can contribute to a level of demand which favors price stability and a sustainable economic recovery.

Q: So when could we see a return to sustainable growth in Italy?

A: It is a slow process that necessitates contributions from all the involved parties: the government, the political system, public administration, households, firms and banks.

The reforms that have been put into place in the recent years go in the right direction. Some people might have wanted something different, some might have preferred something stronger, while others may think that this was too much.

I believe that what has to be done is to fully implement the reforms and monitor their effects, recognizing that we are in a time of big changes, as a large manufacturing country that does not have the kind of presence in particular markets or sectors the way Germany does, but rather is mainly composed of small firms that are still going through the changes required by technological innovations.

It will take time, but we are making the right adjustments. Our prospects are for moderate growth, picking up from this year and the next one.

Q: According to Monday's Eurointelligence, "the target watchers at the Ifo Institute have noted a rise in Italy's Target 2 deficit from E79 billion in July to E209 billion in December." This is interpreted as evidence of an on-going capital flight. Is this concern justified?

A: No, it is not. First of all, the information provided by Eurointelligence is factually incorrect.

As reported on the Ifo Institute's website, the deficit increased by (as opposed to from) E79 billion between end-July 2014 (when the deficit was E130.3 billion, not 79 billion) and end-December 2014. This makes a huge difference: the order of magnitude of the increase in Italy's Target 2 deficit between July and December is roughly half as large as the one indicated by Eurointelligence.

The increase in Italy's Target 2 deficit mostly took place between July and September; it reflected a number of well identified technical factors, such as maturity mismatches between the government securities held by non-residents and new Treasury issues.

This is explained in detail in our October Economic Bulletin. On 9 January 2015 the deficit was E194.9 billion, a level lower than at the end of September 2014; in the last three months, aside from usual daily volatility, the deficit has therefore shown no clear tendency to increase.