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Visco: growth needed to ripen fruits of policy labours

In this interview with GlobalCapital, Ignazio Visco, governor of the Bank of Italy, shares his views on the outlook for Italy's economy and the country's banking sector, highlighting the need to improve the labour market and credit conditions which, if not dealt with, could slow economic recovery.

By Dariush Hessami 03 Mar 2014

GlobalCapital: Is the worst of the crisis over, both in Italy and across the wider eurozone?

Conditions in financial markets have been improving since the summer of 2012. Credit must be given to the progress on fiscal consolidation and structural reforms made by the countries hit by the tensions in sovereign debt markets; but an equally important contribution has come from the strengthening of European economic governance, the ECB's introduction of Outright Monetary Transactions, and the ongoing establishment of the Banking Union.

A modest expansion of economic activity, still fragile and uneven across countries, has begun in the euro area. The outlook for the Italian economy has improved, and in the last quarter of 2013 real GDP growth was positive for the first time since mid-2011. Despite encouraging signals, I still see a number of risks. For example, labour market and credit conditions are expected to improve only slowly, and could continue to weigh on the recovery.

GlobalCapital:Economists generally agree that fiscal performance in Italy in the past five to 10 years has been good. Do you agree?

Italy's reaction to the crisis was extremely prudent from the very beginning. In 2009 automatic stabilisers were given free rein but, unlike most European countries, Italy did not take discretionary deficit-increasing measures. Following the markets' massive reassessment of sovereign risk, fiscal consolidation was intensified: the deficit was brought back within the 3% limit in 2012 and this achievement was essentially maintained in 2013. The rapid restoration of a more sustainable path for the public finances inevitably produced contractionary effects in the short term, but helped to regain the trust of investors and prevent even worse outcomes, given the size of Italy's public debt.

GlobalCapital:How much more can Italy achieve in terms of fiscal consolidation? What are the prospects for privatisation and the spending review? Is a primary surplus of 5% of GDP by 2017 a realistic objective?

The spending review process has been strengthened with the appointment of a new commissioner. This builds upon tight spending constraints: primary spending has declined steadily in nominal terms since 2010. Keeping expenditure growth below inflation in the coming years would create the room needed to start reducing the overall fiscal burden, most notably the tax wedge on labour, thus fostering Italy's return to sustained growth. The government plans also include sales of assets amounting to 0.5% of GDP.

Running high primary surpluses is not unprecedented for Italy: in the second half of the 1990s a primary surplus of about 5% of GDP was achieved, on average. Currently, a 5% target for the structural primary surplus is broadly equivalent to what is necessary to comply with the requirement of a balanced structural budget.

GlobalCapital:Given the primary surplus target, what is the outlook for Italy's public debt trajectory in the coming five years?

Simple accounting exercises show that a structural primary surplus of 5% of GDP will allow the debt ratio to decline steadily even under unfavourable growth and interest rate conditions. In our macroeconomic projections, we expect the debt-to-GDP ratio to start declining in 2015. With the reformed Stability and Growth Pact, Italy is committed to reducing its debt ratio in the coming years. The resumption of economic growth and the maintenance of structural budget balance are both essential to achieve this objective.

GlobalCapital:What is being done to address the very serious challenge of youth unemployment?

The doubling of the unemployment rate to close to 13% is the most painful legacy of the crisis. Young people are paying an especially heavy price: even excluding students from the reference population, only 43% of young people between 15 and 24 are currently employed, down from 61% in 2007; for the 25-34 age group the employment rate has fallen from 74% to 66%. Youth unemployment is particularly worrisome because we know it has significant and long-lasting negative effects: entering the labour market during a recession leads to lower subsequent earnings and a higher future incidence of non-employment.

The policy response has included measures to provide incentives for hiring young workers on a permanent basis and to extend their access to unemployment insurance. Looking ahead, we definitely need to encourage more participation and employment of people at the margins of the labour market. But in order to achieve sustained progress Italy must make up the lags accumulated, including in human capital, in order to respond to a more competitive, innovative and rapidly changing economic environment.

GlobalCapital:How is Italy addressing the challenge of low productivity?

Loss of competitiveness is a matter of policy concern in Italy, but some qualifications are needed to avoid misplaced conclusions. Research conducted at the Bank of Italy shows that the drag on Italy's price competitiveness stems not from higher cost pressures but from the sluggish restructuring of Italian firms' production processes.

It is vital to take measures that foster productivity, not only at the firm level but also for the economy as a whole; strengthening competition remains a priority to make markets work more efficiently in allocating resources to the most productive uses. That said, measures to curb production costs can also support competitiveness, provided these cost savings are transferred to final prices.

As for concerns about labour costs, what matters most is the comparatively high tax wedge. Energy costs should also be considered: compared with their European competitors, Italian manufacturing firms face higher energy costs, with the high electricity prices due primarily to Italy's heavy reliance on natural gas for thermal power generation and to high taxation. An easing of the fiscal burden on productive factors, along with selective spending cuts to reduce waste and measures to make government more efficient, can stimulate the changes that the system needs.

GlobalCapital:Will the Destination Italy initiative help to encourage an increase in flows of FDI into Italy?

Italy still lags behind many EU countries as a destination for foreign direct investment. Strengthening its ability to attract FDI is a key policy priority. Italy's unsatisfactory performance in this area reflects factors related to the business environment: foreign investors require regulatory and administrative certainty and are discouraged by our often complex regulations and procedures. Foreign acquisitions of Italian companies are also hindered by the small average size of firms and by their family-based ownership structure. Another longstanding deterrent to FDI is the inefficiency of the judicial system.

Destination Italy is an ambitious initiative that addresses these issues. Three conditions are important for its success. First, it must be closely integrated with the overall reform effort. Second, the use of ad hoc regulatory actions targeted to foreign investors should be avoided. Third, communication needs to be more effective, particularly when describing the reforms under way and the opportunities they offer to international investors.

GlobalCapital:The IMF and the Banca d'Italia have suggested that credit constraints have had a damaging impact on growth. With problem loans having more than doubled from 4% to 10.5% between 2007 and 2012, what are your expectations for the forthcoming Asset Quality Review (AQR)?

Credit constraints have certainly been a major drag on growth. The banks' ability to expand credit supply has been hampered by tensions in the sovereign debt market and by the deterioration of loan quality induced by the recession. The recent strong improvement on the sovereign debt front and the significant steps taken in the last few years by Italian banks on both capital and provisioning should put them in a better position to finance the economy.

It must be kept in mind that the increase in the stock of non-performing loans partly reflects the definition of NPLs used by Italian banks, which is generally broader and stricter than elsewhere. This is not to downplay the problems posed by the large and growing stock of NPLs. In 2012 the Bank of Italy started ad hoc controls on banks' provisioning policies, which have contributed to reversing the declining trend

of coverage ratios and are helping Italian banks to be prepared for the ECB/SSM comprehensive assessment. In the near future, accelerating the disposal of impaired assets, for instance through NPL sales, would help to clean up Italian banks' balance sheets.

Italy's private market for impaired assets is still underdeveloped. But the gains in fiscal consolidation and in strengthening the institutional framework of the euro area have rekindled investors' interest in Italian debt, and some recent transactions in the market for distressed assets suggest that the price gap between demand and supply for these assets is now smaller than in the recent past. The comprehensive assessment should also help reduce this gap by reducing uncertainty about banks' asset quality.

GlobalCapital:What can be done to encourage the flow of more credit to the Italian SME sector?

Against the background of an uncertain economic outlook credit demand remains weak, but there are persistent tensions on the supply side as well. The flow of credit to Italian firms is now mainly held back by the perceived high risk of present and prospective borrowers, whose creditworthiness is more difficult to evaluate at the current juncture. This situation disproportionately affects SMEs, on which information is typically less available than on larger firms.

A public guarantee scheme on new loans, such as the Guarantee Fund for SMEs created in Italy, can serve as a policy instrument for alleviating these problems. A preliminary evaluation conducted by the Bank of Italy shows that the guarantees provided by the Fund have supported the growth in bank lending to the beneficiary firms.

Over a medium term horizon, SMEs would clearly benefit from a rebalancing of their financial structure, as their heavy reliance on bank financing makes them less resilient to economic downturns and to adverse shocks to banks. Several policy measures have already been taken to boost equity and long term financing.

GlobalCapital: Are Italian banks equipped to deal with the expiry of the LTRO? Is LTRO funding being repaid quickly enough, and is there a danger that Italian banks may face a funding shortfall in 2015?

Since the summer of 2012, following the easing of the tensions in the sovereign debt market, we have seen a steady improvement in banks' funding situation.

Italian banks' repayments of LTRO funds have accelerated in recent months. Italian banks have continued to expand their retail funding bases while reducing the funding gap. An increasing number of intermediaries have regained access to the wholesale bond markets, including a number of medium sized institutions.

The normalisation of market conditions is allowing Italian banks to plan a gradual exit from the extraordinary support put in place by the Eurosystem. The ample availability of collateral reduces their liquidity risks. The decision by the ECB Governing Council to maintain the fixed-rate full-allotment procedure for as long as necessary and at least until July 2015, well past the deadlines for repayment, will help smooth any residual funding stress for small banks with limited market access.

GlobalCapital:Are Italian banks Basel III-ready? Do they need more capital? What is Italy's stance on bail-in?

As I have already pointed out, Italian banks have made important progress in strengthening their capital positions. Difficulties are present in a limited number of small and medium sized intermediaries, which are currently subject to intense supervisory action.

Basel III has been in effect in Europe since January 2014. Under the phasing-in arrangements adopted to smooth the transition towards the new regime, a very few intermediaries have a limited solvency gap and they are being closely monitored by the Bank of Italy. The adjustment towards the Basel III final targets, to be reached in January 2019, is being regularly and strictly monitored.

As regards bail-in, we appreciate its introduction in the resolution toolkit now enshrined in the EU Bank Recovery and Resolution Directive proposal. On one hand, by making creditors — rather than taxpayers — bear losses, the bail-in tool would help ensure that any failing bank can be restructured and resolved in a way that preserves financial stability and protects the public finances, and would contribute to fighting moral hazard as well. On the other hand, bail-in should be implemented in a co-ordinated and gradual way, to avoid legal risks and unintended consequences.

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To this end, bail-in should apply only when resolution conditions are met (and not when the bank is still viable). Adequate disclosure should also be ensured so as to increase the awareness of investors and legal certainty.

Furthermore, it should be noted that in the forthcoming EU Single Resolution Mechanism, bail-in will interact with other tools, notably the Single Resolution Fund (SRF). In this context, I believe bringing forward the entry into force of bail-in and delaying the introduction of other instruments, such as the SRF, may hamper the smooth transition to the new regime and may also have undesired effects on financial stability in the EU. All resolution tools provided for by the forthcoming regulation must closely interact and come into force in a consistent fashion.

GlobalCapital:What would the impact of European Banking Union be on the Italian banking industry?

Italian banks, and European banks more generally, need to recover their ability to support economic activity adequately. To this end, it is particularly important to break the adverse feedback loop between the conditions of sovereigns and those of "their" banking systems. This is one of the objectives of the Banking Union, of which the comprehensive assessment is a fundamental first step.

The comprehensive assessment will stimulate the process of cleaning up and restructuring banks' balance sheets, thus helping to reduce the fragmentation of financial markets along national boundaries.

Establishing an effective Banking Union is a keystone of institutional reform. But to dispel once and for all investors' unfounded fears about the reversibility of the euro, it is necessary to move forward with a shared determination towards a full European Union, paving the way for a fiscal union and, ultimately, making progress towards political union.

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