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BANK OF ITALY GOVERNOR

Negative Rates Are Not Forever

BY SVEN AFHÜPPE AND REGINA KRIEGER

Ignazio Visco, the head of the Italian central bank says an aggressive monetary policy is still needed in the euro zone to guard against a "concrete deflation risk." In an interview, he also says Italy is on a good path and warns that bank regulation since the crisis may have gotten it wrong.

WHY IT MATTERS

The Italian central banker is a voting member of the European Central Bank's rate-setting governing council. He warns that the ECB is needed to avert deflation and buy time for the euro zone to grow.

FACTS

Born in Naples in 1949, Mr. Visco has been part of the Bank of Italy since 1972.

Mr. Visco replaced ECB President Mario Draghi as head of the Italian central bank in November 2011.

Consumer prices in the 19-nation euro zone fell back into negative territory in April, dropping 0.2 percent year-on-year.

With the latest dire inflation figures for the euro zone confirmed on Wednesday, Ignazio Visco's latest comments seem especially prescient.

The governor of Italy's central bank, the Banka d'Italia, warned in an interview with Handelsblatt that there remains a "concrete deflation risk" in the euro zone. That risk was part of the reason the European Central Bank had to remain aggressive with its monetary policy, which has sought to push down interest rates in the 19-nation euro zone to record lows.

Consumer prices in the currency bloc tumbled back into negative territory in April, according to the statistical agency Eurostat. Prices fell 0.2 percent year-on-year, compared to a flat rate in March. Even excluding more volatile prices like energy, prices rose only 0.7 percent on the month. That is far below the European Central Bank's declared target of keeping prices "close to but below" 2 percent over the medium term.

Mr. Visco, who succeeded ECB President Mario Draghi at the Italian central bank, defended the ECB's aggressive policies in the face of tough criticism from German policymakers, though he stopped short of calling for new measures to stimulate the European economy. The policies implemented by the ECB this year needed to be monitored for their effects in the coming months and given time to work.

But Mr. Visco also acknowledged that some of the ECB's policies may be affecting banks' health and profitability. "You can't have negative rates forever," he said, referring to the ECB's decision to push the rate it offers banks that deposit reserves with the ECB into negative territory. He also warned that a new "bail-in" plan introduced at the beginning of the year - designed to force investors to pay for a bank's failure in future rather than taxpayers - may be scaring off investors.

Handelsblatt: Mr. Visco, is the quantitative-easing program of the European Central Bank really working? Looking at the inflation rate in the euro zone, it is far away from the 2-percent target.

Ignazio Visco: What we did is what had to be done. And we have a mandate of delivering price stability. Without the asset purchase program, the inflation rate would be substantially lower than it is. Currently, we would face a stronger reduction in prices. And it is meant to avoid that this very low inflation is transferred into a permanent fall in inflation expectations. So again: the program has worked.

But does the ECB have to do more?

We have increased the size and extended the length of our program, and decided to include corporate bonds among the purchasable assets; this will be implemented this summer. We have to monitor what goes on. Obviously you can't have negative rates forever.

If you look at the oil price, the core inflation rate that is still low and the meager growth rate in the euro zone, do you think it is realistic to reach the 2-percent inflation target in the next years?

Well, oil prices fall once, so they don't exert a negative effect every year. The market doesn't think that the 2-percent target will be reached in the next few years, but the important thing is an increasing trend in price dynamics, towards price stability, which we need to reach in the medium term.

I don't think that we should change the definition of price stability. And then you have to consider the measurement bias coming from the many new high-tech and innovative products and services, which are not yet in the price index or might not be measured appropriately. This is one of the reasons not to consider a lower inflation objective.

Interest rates are close to zero now. In Germany there is a strong debate about the effects. Jens Weidmann, president of the German Bundesbank, and Finance Minister Wolfgang Schäuble are complaining about the impact on German savers. Can you understand this discussion?

What matters are real interest rates, not nominal. Moreover, the impact on interest income is counterbalanced by the impact on economic activity: with less slack in the economy and more jobs, income prospects are better for everybody. This has to be explained, but this is the role of finance ministers.

You don't expect a social conflict between people who borrow money and people who save money?

I am more worried about deflation. This is the worst thing that can happen. With this come bankruptcies and very negative effects on the real

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economy. I believe we still face a concrete deflation risk.

Will it be difficult to return to a normal monetary policy? The U.S. Federal Reserve has started to raise interest rates...

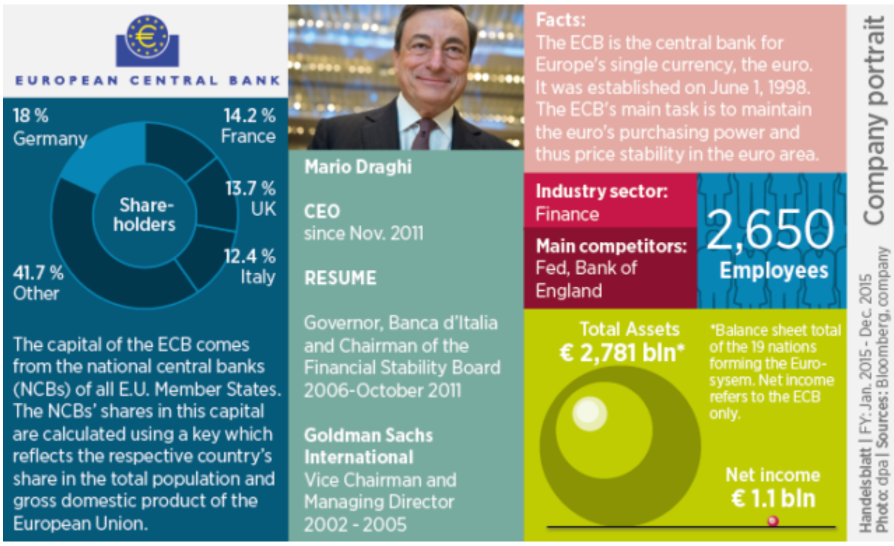
It will be easier the more the economy will go back to normal. Monetary policy provides a contribution, but it cannot be the only instrument to revive economic growth in the euro area. Productivity growth is not dependent on what the central bank does. It will take time.

Honestly, you can't be happy with the level of lending by European banks, can you?

It is improving. Fragmentation across financial markets in the euro area has been reduced. We are doing more. The new targeted longer-term refinancing operations provide substantial incentives to bank lending; banks can get a reward from the central bank if they lend to households and firms. The idea of having negative deposit rates for deposit facilities is to make it advantageous for banks to find opportunities to lend.

The problem of many banks in the euro zone is the lack of profitability. Was it a good idea to introduce negative deposit rates?

I don't think that the profitability of banks is only affected by the fall in interest rates. The problem is that you need higher growth. This would give more profit opportunities to banks because they can lend more.



And there is also a one-off effect: an increase in profits coming from capital gains.

We live in a world of digital transformation. Couldn't that mean we will see growth in the next years through innovation and with a lower inflation rate?

We should be against deflation for the same reason as we find that price stability is important, because if you have falling prices, and you are indebted and you have increasing real interest rates because of decreasing inflation, then you may go bankrupt. And if you have many corporations or households which are in this state, this creates problems.

Are you talking about Italy?

Italian households have a very low debt level so there is no risk there. Other countries where household debt is as high as 200 percent of their income may indeed have a problem. But obviously public debt is an issue for Italy.

And what can be done to get it down?

Low growth and low inflation make it more difficult. This is why Italy had an increase in the ratio of debt to gross domestic product, even if fiscal policy has been prudent. The long-term debt sustainability in Italy is high, better than in other European countries, but we have a problem with the sheer size of the debt now. That has increased in terms of GDP because the government deficits, small as they are, have been accompanied by a zero nominal rate of growth, if not negative, for many years. The solution is really not to push further down demand, but to increase real and also nominal growth rates. And this is why the price component is also important.

So rising interest rates would be dangerous and difficult for Italy?

It depends - if they are accompanied by rising inflation they are not a problem. If they are simply an increase in nominal rates and there is no inflation this a signal that there is

ECB President Mario Draghi at a meeting of the European Central Bank's governing council in Naples, Italy in 2014. Source: AP

a financial problem. This is what happened at the end of 2011. In that period a large part of the increase in yields of government bonds was not due to hedging against the risk of default, but hedging against the risk of a breakup of the euro.

Has Italian Prime Minister Matteo Renzi done enough to strength the Italian economy?

The reform effort has gone forward for several years in Italy. The pension system has been overhauled and put firmly on a sustainable path. The recent reforms in the labour market are an important achievement. The government is also working to encourage innovation. Italy is lagging behind others in the use of new technologies. This explains the difference between us and Germany.

And what is the reason?

One is the dimension of firms. They are too small and do not have enough space for innovation and research. There are 4.3 million firms in Italy with less than 50 employees, which give jobs to 6 million dependent workers and more or less 5 million self-employed. A lot was done in the use of flexible labour with short-term contracts, employing young people, but not enough in terms of new products and services. With the crisis, the unemployment rate increased in a very short time.

What else should be done?

Investment in education, because the skills that are needed now are different. Then we need to fight illegal behaviour and corruption. One important change was the creation of an effective anti-corruption authority. And we need to work on the banking sector.

Non-performing loans (NPLs) are still pretty high.

Italy got out of the first phase of global financial crisis almost undamaged because there were no toxic assets in Italian banks. But in the following years, the recession has made it difficult for many firms to pay back their loans, as they were struggling to stay afloat in the market. We have seen a drop in industrial production in the last seven years of about 25 percent and non-performing loans have been increasing. Bad loans represent the worst category of NPLs, related to firms actually in distress. They amount to 10 per cent of total loans, around €210 billion. We have pushed banks to provision against this.

In what way?

By booking losses in the last years in their P&L. These amount now to about 60 percent of the gross bad loans. So from €210 billion gross bad loans you go down to around €90 billion net bad loans. And these net bad loans are backed by guarantees amounting to much more than €90 billion (more or less €80 billion of real estate guarantees at market prices plus around €40 billion of personal guarantees). But the time to recover these credits is long, it may even take 6 or 7 years. This is why the government has engineered a number of new measures to reduce it. The more you cut the time, the more the market value of NPLs goes up.

So you don't expect new turmoil in the Italian banks in the next months?

It does not only depend on balance-sheet conditions, it also depends on market conditions and on the economy.

Is Italy on its way to recovery?

It is a fragile recovery, but it is a recovery. We see investment rising, finally, we see employment picking up thanks to the reforms and incentives by the government. We have seen exports maintaining their strength. But the economy has to be helped by further structural change, investment in innovation and changes in the way banks organize their business. We need a comprehensive strategy towards growth.

But Brussels is still eyeing Italy's debt levels...

The debt issue is relevant. The government knows it well. The point is to tackle debt without endangering the recovery. It is simultaneous: you need growth to pick up and you have to have prudence on the fiscal side to avoid that the debt increases too much.

What about the bank bailout fund "Atlante"? You were among the architects of the resolution fund...

It is a private fund. The role that we and the government played is that of making clear the risks that the banks at large are facing because of possible spillover effects given the substantial deterioration of market conditions. We made clear the risks. If "Atlante" works well, it will help very much to kick-start a good market for NPL.

As part of the efforts to create a European banking union, a 'bail-in' system requiring investors to pay for bank resolutions has been in force since the beginning of the year. Was it introduced too quickly?

Being used retroactively, this created problems. I have recently emphasised, also in the light of the (bad) experience we have gained in Italy with the resolution of four small banks last November, the importance of reconsidering the adequacy of the new legislative framework for managing banking crises. Just as the crisis has impaired the quality of bank credit, the legislative response on crisis management has engendered uncertainty about investing in bank liabilities.

An instrument - the bail-in - devised to reduce the impact of a crisis must not create the premises to make one more likely: if this is the case, its design and/or its implementation must be rethought. We must strike the right balance: indeed, investors who have been hit by a bail-in will find no comfort in the fact that they have been protected as taxpayers. And we should not rule out the possibility of temporary public support in the event of systemic bank crises, when the use of a bail-in is not sufficient to achieve the resolution objectives but instead risks compromising financial stability.

> "An instrument - the bail-in - devised to reduce the impact of a crisis must not create the premises to make one more likely."

I have not been alone in advocating such reconsideration. The need to assess the degree of flexibility of the BRRD during the review of the directive, scheduled to take place by June 2018, was mentioned among others by the IMF in its Global Financial Stability Report published a few weeks ago. It highlighted the necessity of applying the new rules (including those on state aid) with flexibility and caution during the changeover to the new regime, when public intervention is no longer admissible but the banks have not yet put in place sufficient buffers to absorb losses without undesired effects on systemic stability.

In comparison to big U.S. banks like JP Morgan or Bank of America, European banks seem very weak. Is it a danger for the euro zone not to have a really strong global player? Even Deutsche Bank is weak.

They are global investment banks and ours are commercial banks. Europe is financing its domestic economy mostly through banks. There will be a shift. We need to have more equity and more market financing in general.

What would be the impact of a Brexit?

If it happens, it will affect trade. And it will deal a blow to the European Union project. Brexit is something that should put all of us in the face of our responsibility.

Where do you see the future of the European project?

I think it is important to have a fiscal union after the banking union and the capital market union. We have to find some unity at the political level. There are components we urgently need: a unified approach to migration, or to domestic security. We seem to be dominated by electoral cycles. This lack of political initiatives, which reflects the short-term ability of the political system, is worrying me.

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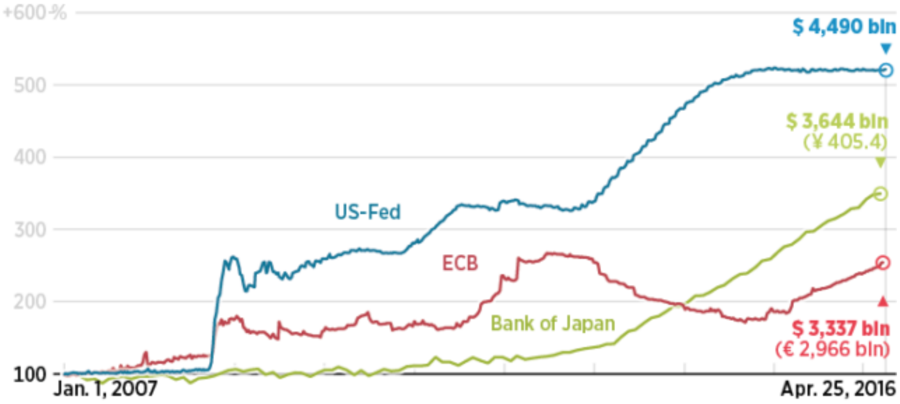
Pumping Money into the Markets

The central banks of the United States, Japan and the euro zone have been buying up bonds, providing markets with liquidity



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