Interview with: Ignazio Visco

"There are no taboos"

The Italian Central Bank Governor talks about the ECB's fight against the deflation risk, fears about a new global financial crisis and a vision for Europe's future

Mister Visco, after the recent turbulences in global financial markets and especially the sell-off in European bank stocks market participants finally see a further monetary easing by the European Central Bank (ECB) in March as a done deal and speculation, what the ECB could all do, is again mounting enormously. Do you feel comfortable with that?

What counts for me are not market expectations but is the macroeconomic situation. The risks for growth and inflation, which we had already identified in December, have quite clearly increased. This is true for example for the headwinds from the emerging markets. At the moment markets also fear a slowdown in growth elsewhere, for example in the US. Worries about lower future growth have also led to concerns about a lower profitability of banks – especially in times of increased capital requirements. This explains a good deal of the recent volatility in financial markets.

But you don't worry about the expectations on the ECB? There have been also great expectations back in December, which were partly disappointed – and that led to severe turbulences in global financial markets.

In the past there have been from time to time excessive expectations around what the ECB can do. We are currently reassessing the risks for inflation and inflation expectations and after that we will decide what to do. But we have always made it very clear: We will do, within our mandate, what we must to secure price stability – meaning an inflation rate of below, but close to 2% over the medium-term. This is true for March and beyond. But from my point of view people are more worried about growth prospects in Europe than the ECB's policy.

Do you think that the fears in the markets are reasonable or are they exaggerated?

To me some of the movements in stock markets seem to be far from reasonable given the fundamentals. But that does not mean that they are not understandable. For example there might have been excessive expectations on the possible return on equity of banks in the future. On top of that there are perceptions of particular problems in individual countries – such as in Germany with Deutsche Bank or in Italy with Monte dei Paschi di Siena. There are exaggerations and there are concerns. These concerns are being addressed – by banks and by supervisors.

Let us stay with the macroeconomic situation first. Do you see a risk of deflation in the Euro area at the moment?

In the Euro area we are not in deflation – thanks to the monetary policy we have pursued. With no accommodation, with no programmes, I think we may have ended up in a deflationary situation. Now we have two big risks: one is the risk of a de-anchoring of inflation expectations, meaning that people lose trust into the ECB's ability to achieve 2% over the medium-term. And the ECB's credibility is, of course, of essential importance. The other risk is that of second-round effects, also on wages, given that inflation has been far too low for far too long now.

Inflation expectations in financial markets in five years for the next five years – a very prominent indicator for the ECB – have fallen again to a record low, at about the same level as before the start of the Asset Purchase Programme (Quantitative Easing, QE).

This is an important indicator for us and we have to monitor it very closely. But we look at a number of indicators. I would not say that we are observing a dramatic fall in inflation expectations at the moment. The situation is under control. But we have to be very cautious: Once expectations have fallen too much it is very hard to turn them around again. Therefore we need to act before this happens. Acting pre-emptively and aggressively may mean having to act less than you would have done, had you acted too late.

Is this also true for the second-round effects? Do you see such a risk?

First of all, as has been recently observed, there are "conspiring" forces at play globally which dampen inflation. This is particularly true for oil prices. In principle, we do not have to take direct action against all of them. But I see that the risk of second-round effects is materializing, especially because core inflation – which excludes energy and food – is also far from what we judge to be in line with price stability. For example we already see wage contracts which include the possibility of a revision if inflation is lower than expected. Apart from this, we also have to dispel the feeling that we can do nothing against the too-low inflation. Is it rather the opposite: in the longer-term, inflation, and deflation, are always monetary phenomena. If needed we have plenty of instruments available and we are able to create new ones.

ECB President Mario Draghi argues similarly. But, for example, is it really sensible to go further into negative territory with the deposit rate at a time in which investors worry about the profitability of banks? A more negative deposit rate means a higher "tax" on banks' deposits at the ECB – and that reduces their profitability.

It depends. You could do that in different ways…

… for example with a multi-tier deposit rate?

There are many suggestions. We have to look at them all. In any case negative rates are something unusual and I do not think we can live with them forever. But at the moment they have a special purpose: to induce banks to use their liquidity to generate credit. Of course you also need credit demand for this: but accommodative monetary policy also helps in this respect, because it improves the overall environment for the real economy.

The other prominent instrument is the QE programme. In early December the ECB's Governing Council decided to extend the purchases beyond September 2016 to March 2017. But markets have not been very impressed. Does that mean that this time the monthly run-rate needs to be stepped up in order to have an effect?

I will take note of your suggestion.

But what do you think?

Of course, I cannot tell you what we will do. But you know that I am not conservative as to the use of this instrument. As I already said, I think that sometimes being aggressive is necessary. We have said from the start that this is an open-ended programme – depending on the achievement of price stability. Now we will have to see what the situation is like in March and then we will decide what and how much we buy and for how long.

Draghi is always emphasizing that there are "no limits" for the ECB within its mandate. But don't you think that the different opinions within the Governing Council are de facto such a limit? For example some central bankers in the Governing Council seem to oppose the idea of loading too much risk on the ECB's balance sheet.

There is much more agreement within the Governing Council than you might think. And certainly there is more agreement today than there was a couple of years ago. There is consensus in the Governing Council that we can do more if needed. Regarding our balance sheet, at the moment there is one main risk that needs to be minimized and it is not the ECB's balance sheet, but it does influence it – it is the macroeconomic risk. This does not mean that we are not careful of the financial risks we take in the balance sheet. But the macroeconomic risk is the top risk.

With QE the Eurosystem buys according to the ECB's capital key – that means mostly German papers. A lot of observers argue that it would be more effective to remove that key. Or is that a taboo?

I think there are no taboos. These discussions took place before the start of QE, including between Bundesbank President Jens Weidmann and myself. In the end we came to a compromise: a larger programme but with more liability on the side of the national central banks. That is fine for us. We make more profit and we take risks that can be managed. But in general I think that going back to the national central banks is a step backwards for the single monetary policy.

The QE programme started in March 2015 and it celebrates its "1st anniversary" now. At the same time inflation is due to fall below zero again and growth is fragile. That does not sound like a great success story, right?

The programme has been very effective. The problems we are now facing are due to the headwinds from the global economy that have been much stronger than expected initially. As I have said, just imagine where we would be today if there had been no purchases. But one thing also has to be clear: Monetary policy cannot solve all problems. Monetary policy has to take care of price stability. And we do this. But we can also have price stability in the Euro area and at the same time, for instance, severe problems with unemployment. And this is first and foremost a task for national governments.

But don't you think that there are already excessive expectations on what the ECB can achieve?

Yes, definitely. We do not have a magic wand – nor do we have a crystal ball. But when it comes to price stability we have the responsibility to use all the instruments at our disposal, we have the ability to do that – and we have the determination to do that.

But do you really think that the 2% goal is achievable in the medium-term – given the dramatic fall in oil prices and after the global financial crises? Especially in Germany a lot of people argue that the ECB should re-examine the 2%.

2% is a reasonable figure and there is absolutely no reason to deviate from it. On the contrary, we have to be committed and we have to act decisively to achieve this target.

In parts of the markets there is also the fear that the world could be on the brink of a global financial crisis such as in 2008 – this time with the epicentre in China and the emerging markets. Do you see such a risk?

I do not think this is the right question. Suppose you had asked me in 2006 whether there was a risk of a global financial crisis, and I had said no, what would it have looked like in hindsight? But to be more serious, I am convinced that the world economy today is much more resilient than it was then.

Is this really the case? In many areas, debt levels are even higher today and fiscal and monetary policy have hardly any room for manoeuvre.

Of course we still have legacies of the crisis, for example in the balance sheets of some banks. But these are problems which can be managed. We have also made significant progress in improving financial stability. There are certainly some hot spots. But the situation is better than it was back then.

And you don't worry about China as much as market participants do?

When it comes to China we know a lot and at the same time we do not know enough. But for the time being I would stick to the assessment of the International Monetary Fund: the Chinese authorities are taking the appropriate steps to manage the transformation of the economy – also with respect to the opening of financial markets and increasing flexibility of the currency. This process is bumpy. But from my point of view some of the fears about China are also exaggerated.

ECB Executive Board Member Benoit Coeuré has called for global coordination at a G 20 level in response to the weakness of the emerging market currencies.

I agree. Coordination is very important.

But what does it mean exactly? Joint statements or concrete steps like interventions?

Coordination and cooperation can take different forms from time to time. In the financial crisis of 2008/2009 we undertook joint actions. For example we set up swap-lines in order to avoid liquidity constraints affecting the real economy. But there is one thing that is important: We should not confuse means with ends at an international level.

What do you mean exactly?

Our objective at the ECB is price stability, which is also a precondition for growth. The instruments we use are our means. They do affect a number of markets, including the currency market. But the exchange rate is not a target per se.

Besides China there are also concerns in the markets about European banks. You also see overreactions there, correct?

Yes, definitely, also when it comes to banks' stock prices in Europe there are some exaggerations at the moment. In the context of the Single Supervisory Mechanism, a very precise, very detailed Comprehensive assessment has been carried out. The problems have been identified and they are being tackled. You should also not forget that the banking system in Europe is in a much better shape than it was some years ago. Banks have increased their capital significantly. Of course, there are some issues to discuss: in Italy the problem of non-performing loans, in Germany the issue of level-3-assets.

Recently Rome has agreed with Brussels on a compromise on how to deal with these non-performing loans, the NPLs. Banks are allowed to securitize these loans, to buy state guarantees for special tranches and to sell these securitizations. Recently the government has also issued a decree. Is this a breakthrough?

First of all, the reason why there was a build-up of an above-average amount of NPLs was the long and profound recession which has led, in Italy, to a loss of almost 10% of GDP. But these loans are mostly backed by provisions and guarantees. It certainly would have been more helpful to reduce the NPLs through the creation of a bad bank. But according to the European Commission this was not possible, because according to their interpretation, it would have constituted state aid. I agree that it could have been considered state aid, but I disagree with the assessment that it would have not been justified. But thanks to the decree it will become much easier to create a market for NPLs. And it will also become much easier to liquidate the collaterals, which will also help.

Will the ECB accept these securitizations as collateral?

There is discussion around this. But I do not see any reason why this should not be the case.

You have already called for a review of the EU bail-in rules. Is this a reaction to the criticism against Banca d'Italia after thousands of retail investors lost money following the rescuing of four regional banks in November?

I think the bail-in law should have been implemented gradually to give savers time to adapt to the new regime and to rethink their investments. And we should have given more thought to the unintended consequences. There are legal risks and we should discuss them seriously. But now the bail-in has come into force and we are certainly complying with the ruling. However, we should start the review process, which in any case should be undertaken by 2018 at the latest, and use the lessons drawn from our experiences so far. There are good ones but there are also bad ones.

You are a convinced European. How worried are you about the current status quo in Europe – with the refugee crisis, the debate about a Brexit? Do you fear that Europe could break up?

The most important thing is that we do not dismiss such questions lightly and that we do not deny that such a risk exists. In the end the sovereign debt crisis has again showed that Europe can stay united if needed. There was a large risk of a break-up of the EMU. This has also restarted the process towards a full union. But from my point of view the step-by-step policy – from monetary union to banking union, to capital markets union, to fiscal union and so on – poses a problem. Every step will be much harder than the one before.

What do you suggest?

We should think about where we want to arrive, eventually. We need a vision, which also impacts the imagination of the people and of markets. It would be too much to ask bluntly for a deep political union at the moment. But we need some elements of a political union, as well as a common budget for a truly European policy. In that case we would also need joint debt at the EU level. The issue of risk-sharing is a serious one, but we need to think about what we want to achieve. And it is also a problem that there is very little trust among politicians in Europe at the moment and that they are far too focussed on the upcoming elections. Politicians should take a longer-term view and should not only look at today and tomorrow.

In the recent crises we have also seen different political and economic cultures in the Euro area countries. Has the Euro tried to bring countries together which do not fit together?

The European process started in 1957. Since then there have been so many contacts and exchanges, and also thanks to programmes like Erasmus, young people in Europe are increasingly sharing experiences. I am convinced that today there is much more that unifies us than divides us.

The interview was conducted by Mark Schrörs and Thesy Kness-Bastaroli.